Insurance Newsletter

July 2017

Brexit - EIOPA opinion on supervisory convergence

EIOPA has published an opinion on supervisory convergence in the light of Brexit. The opinion is addressed to national competent authorities of Member States (NCAs) and addresses issues relating to authorisation of new EU undertakings as UK groups seek to establish a presence within the EU27.

Key points covered in the opinion are:

- The authorisation process: EIOPA stresses that there can be no automatic recognition of an authorisation granted by another supervisory authority. This includes approval of internal models, although previous approvals can be "taken into account" where relevant

- Governance: Undertakings should not be an "empty shell" – they must demonstrate an appropriate level of corporate substance, proportionate to the planned business. This means that there must be an "appropriate presence" in the Member State of members of the supervisory board and key function holders dedicating sufficient time to fulfil their duties

- Reinsurance: the extent of reinsurance should not undermine the responsibility of the entity to manage its risks – a minimum retention of 10% of the business written is suggested. Solvency II does not explicitly require a minimum risk retention for firms and this potentially creates an inconsistency unless the minimum risk retention is to be applied to all (re)insurers in future

- Outsourcing: Some sceptism is expressed about potential levels of outsourcing back to the UK (or another third country). EIOPA acknowledges that in general outsourcing of critical or important functions is permitted provided the supervisory body remains fully responsible for the activity. It comments, however, that outsourcing should not be allowed to deplete the corporate substance of the firm and that the undertaking should retain sufficient expertise and resources to monitor and manage its risks. Further, EIOPA suggests that undertakings with complex risk-profiles or a large scale of business should not be permitted to outsource a "significant part" of their key functions.

Firms looking to set up new authorised entities in the EU should have regard to the opinion in their business planning. In particular, the opinion suggest that EIOPA may encourage a tougher line on reinsurance and outsourcing back to the UK than a strict interpretation of the Solvency II requirements might otherwise suggest.

Opinion

Insurance Linked Securities

HM Treasury has published a response to its consultation on introducing a new Insurance Linked Securities regime, together with updated draft regulations to implement the regime.

A number of changes have been made to the regulations as a result of the consultation process. The most important of these are:

- the pre-approval requirements for new cells entering into new risk transfer arrangements have been removed. Instead, the Regulations will require an mISPV to notify the PRA within 5 working days of the assumption of a new risk.

To balance this the mISPV's permissions must set out clearly the transaction structures into which it can enter. There is no softening of the initial authorisation period for the mISPV

- provisions have been added to the Regulations allowing arrangements to be entered into between cells as if they were legally binding contracts. In particular, it is envisaged that a group of cells might issue different tranches of securities to fund a particular risk transfer arrangement. PCCs can only do this if arrangements between cells are within the scope of their Part 4A permission granted by the PRA

- the tax regulations have been amended to make the provisions for removal of special tax treatment somewhat more lenient: there is no longer a condition relating to connected investors, although HMT envisages that in some cases such arrangements may be caught by the prohibition on arrangements made with the purpose of securing a tax advantage; the condition relating to tax advantages will now apply on a cell by cell basis rather than breaches impacting on the entire mISPV; and the withdrawal of special tax treatment where certain tax penalties are imposed has been made more limited in scope.

HMT plans to lay the regulations before Parliament after the summer recess with a view to the regime coming into force in the autumn.

Consultation response and regulations

Asset management market study - implications for insurers

The FCA has proposed changes to governance arrangements in the asset management industry with a view to improving value for money for investors. Although the changes are the result of a market study looking at the asset management sector, the FCA suggests that similar provisions might also be applied to other retail investment products including unit-linked and with-profits insurance policies. The proposals are set out in a consultation paper accompanying the market study final report - CP17/18.

The rationale for potentially introducing equivalent provisions is two-fold:

- to benefit unit-linked and with-profits policyholders through the delivery of increased protection

- to avoid unintended consequences for competition between economically similar products.

There is a recognition that special governance arrangements apply to with-profits business and that these differences will need to be taken into account.

In the immediate term, the FCA is seeking feedback on whether it would be appropriate to consider extending the remedies set out in the CP for asset managers to unit-linked and with-profits products. The key relevant proposals being consulted on are outlined below.

CP17/18

Firms should:

- Assess whether value for money has been provided to investors and whether charges are reasonable in relation to costs incurred
- Consider whether savings resulting from economies of scale should be shared with investors
- Assess and report on the quality of services investors receive
- Appoint a minimum of two and at least 25% of the board as independent directors

When the SM&CR is extended to asset managers, a new Prescribed Responsibility will be introduced. The relevant individual will be responsible for ensuring that the firm complies with its obligation to act in the best interests of investors.

Retirement income review - interim report

The FCA has published its Retirement Outcomes Review Interim Report. This sets out preliminary findings of the review launched in July 2016 to look at the evolution of the market since the introduction of pension freedoms in April 2015. The review focuses on customer outcomes in respect of non-advised sales. Issues relating to advised sales are within the scope of the Treasury-led Financial Advice Market Review and the FCA is taking forward recommendations of that review in other contexts.

Findings of the report include:

- increasing numbers of customers are accessing pensions savings early. Many are reinvesting in alternative savings vehicles. The FCA is concerned that this is partly driven by mis-trust in the pensions industry and that customers may as a result be paying more tax than necessary and missing out on benefits (e.g. employer contributions)
- there is a move away from annuity products in favour of drawdown. Where this is on a non-advised basis, the FCA is concerned that customers may need additional protection since they will be managing their investment strategy and longevity risk themselves
- in general customers do not shop around for pensions products, which may mean they are not getting the best available deal
- there is a reduction in providers offering annuities on the open market, which may weaken effective competition
- there has been limited product innovation since the pensions freedoms were introduced.

The FCA does not suggest taking action on all fronts in the short term. Areas where it suggests action may be appropriate at this stage are outlined below.

The FCA is inviting comments on the interim report by 15 September 2017 with a final report due to be published in Q2 2018.

Interim report

Issues	Possible remedies
Protection of customers buying drawdown without advice	Providers to offer “default investment parthways” based on retirement outcomes chosen by the consumer
Customers accessing part of a pensions pot early are often forced into a new drawdown product for the remainder of their savings	Allowing customers to access some savings early while leaving the remainder in their existing product – this may require a joint initiative between the FCA, Government and industry
Customers buying drawdown products do not generally shop around	Use of a new “single cost summary metric” showing the total cost of drawdown. Introduction of drawdown comparison tools.
Customer engagement with and understanding of pensions decisions	Improvements to communication of existing information, including: reviewing customer communications, increasing awareness of enhanced annuities, introducing additional comparison tools and developing the “Pensions Dashboard”.

Solvency II round up

Solvency II statistics

EIOPA has published quarterly statistics from Q3 2016 based on quantitative reporting by insurers to their NCAs. The statistics give an interesting snapshot of the collective balance sheets of the European insurance industry.

The figures show that the UK has the third lowest average SCR ratio, at 145%. Only Greece (131%) and Portugal (138%) are lower.

The report analyses the asset spread in which insurers across the EU are invested (other than to back unit-linked business). Despite the challenges of a low interest rate environment the largest asset classes remain government bonds (31.64% of total assets) and corporate bonds (31.69% of total assets). Structured notes and property together accounted for less than 4% of assets.

EIOPA statistics webpage

The MA and illiquid unrated assets

The PRA has published a policy statement and final supervisory statement on illiquid unrated assets and ERMs in the context of the matching adjustment. This was consulted on in December last year and the consultation period closed in March.

The supervisory statement covers (i) the use of internal credit assessments for assigning fundamental spreads in respect of illiquid unrated assets and (ii) the treatment of risks arising from "no negative equity guarantees" (NNEGs) (or other guarantees) in ERMs.

The SS focuses on ensuring that the risk arising from an NNEG is properly reflected in the value of the restructured ERMs (i.e. the notes issued as part of the securitisation) or the fundamental spread. The PRA expects that the "Effective Value" of the restructured ERM (total value of the notes + MA benefit) should not be higher than the value of the unrestructured ERMs after deducting amounts in respect of expenses, NNEGs, other guarantees etc.

The PRA has made fairly limited changes to the draft SS following the consultation. Key areas where the PRA received feedback and in some cases made changes are outlined below.

Policy statement and supervisory statement

Feedback on CP 48/16

Paragraph 1.1 to the SS has been amended to make it clearer that its scope extends to all unrated assets in the MA portfolio, not just restricted ERMs.

There was some push back on the PRA's principle that there should be broad consistency between internal ratings and ones which would be assigned by an ECAI. The PRA has rejected these arguments.

Some firms complained to the PRA about the assumptions and data used by EIOPA in calculating the fundamental spread, with one firm apparently suggesting that a better credit quality step could be assigned to internally rated assets to counter this. The PRA has, unsurprisingly, rejected this suggestion and introduced wording into the supervisory statement explicitly to prohibit taking this approach. The SS therefore includes a statement that the credit quality step mapping should be independent of the firm's views about the resulting fundamental spread and the firm should use the relevant EIOPA prescribed fundamental spread.

EIOPA advice on amendments to the Delegated Regulation

EIOPA has published a consultation on its first set of advice to the Commission on possible amendments to the Delegated Regulation. It plans to finalise this advice by October 2017. A further consultation paper will be issued by the end of the year on a number of other items still being reviewed, with a view to publishing final advice by February 2018.

The first set of advice covers: simplified calculations in the standard formula; reducing reliance on external credit ratings; treatment of guarantees and certain exposures in the market risk module; risk-mitigation techniques; undertaking-specific parameters; look-through approach; and loss-absorbing capacity of deferred taxes.

Some points of interest arising out of the advice are:

- EIOPA proposes that the look-through approach should be extended to apply to "investment related undertakings", i.e. related undertakings which are effectively investment vehicles of the participating undertaking
- EIOPA suggests more closely aligning the treatment of exposures to "Regional Governments and Local Authorities" in the market risk module to the treatment in the banking sector
- In relation to longevity risk transfers, stakeholders have raised concerns over two areas in particular: (i) derivatives are not included in the assumed transfer to a reference undertaking in the risk margin calculation (unlike reinsurance); and (ii) it is not clear how to allow for techniques which introduce material basis risk. Unhelpfully, EIOPA's response on (i) is that these comments will be responded to in the next set of advice and on (ii) is simply to state that the wording of the Delegated Regulation does not allow for the possibility of recognising a risk mitigation technique with material basis risk
- EIOPA sets out extensive information in the paper about the application throughout the EEA of the rules on the loss-absorbing capacity of deferred taxes. It is, however, continuing its work in this area and will advise changes, if necessary, in the later consultation.

Consultation

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