

Possible changes to UK Solvency II implementation

November 2017

On 27 October the Treasury Committee published a report on the Solvency II Directive and its impact on the UK insurance industry. The report is critical of the extent of disagreement between the PRA and the industry. It makes a number of recommendations, the majority of which are aimed at the PRA. Some of these recommendations were pre-empted by the PRA's announcement on 25 October of a series of improvements it is intending to make to implementation of Solvency II and its publication of a consultation paper on the matching adjustment.

PRA reviews aspects of the Solvency II regime

On 25 October the PRA announced that it was publishing a short series of consultation papers on reform to the implementation of Solvency II, starting with the matching adjustment. These are intended to support the commitment which the PRA made to the Treasury Committee in February 2017 to explore reform of some areas of the implementation of the directive. As discussed further below, the areas which the PRA intends to address are unlikely to go far enough to satisfy all of the recommendations of the Treasury Committee arising out of its inquiry into the regime, published on 27 October.

The PRA has published a consultation on the matching adjustment and intends to publish further consultations on the model change process and reporting requirements. It is also continuing to work on possible simplifications to the recalculation process for the transitional measure on technical provisions and the merits of its policy on external audit of the SFCR.

CP21/17 - Solvency II: Matching adjustment

The PRA's consultation paper on the matching adjustment proposes a new supervisory statement (SS) which will (i) consolidate the numerous directors' letters on matching adjustment approval published by the PRA between June 2014 and January 2016; and (ii) introduce new guidance on the matching adjustment, in particular to address issues raised by the ABI and individual insurers during the Treasury Committee inquiry into insurance regulation in 2016/17. This is to be welcomed, but it remains to be seen whether in practice the PRA will show increased flexibility in its application of the matching adjustment regime.

There is no clear sign-posting between the directors' letters and the supervisory statement. The majority of substantial points have been carried across but the PRA has made a few changes to wording in some areas. The new SS should therefore be read carefully to ensure ongoing compliance.

The new guidance has been sign-posted and key aspects of this are discussed below.

Asset eligibility - cash flows with uncertain but bounded timing

In order for assets to be eligible for the matching adjustment portfolio, their cash flows must be fixed (subject to an exception for inflation linked assets).

New guidance has been proposed to address the position for bonds where the start of repayments is uncertain but has a fixed latest point - e.g. bonds with an initial construction phase. The PRA suggests that firms may be able to treat the cash flows under such bonds as fixed provided they are recognised at their latest date (and provided other eligibility conditions are met). This additional guidance may be helpful for insurers looking to invest in infrastructure projects where the project bonds have uncertain start dates for interest payments. Other potential sticking points such as early redemption provisions will still need to be considered.

Asset eligibility - “sufficient compensation”

An exception to the fixed cash flow requirement applies in cases where the insurer would, if the cash flows are changed (such as on an early redemption), receive sufficient compensation to allow it to obtain the same cash flows by re-investing the compensation in assets of an equivalent or better quality.

The PRA proposes new guidance which contemplates firms having criteria for assessing “sufficient compensation” which may allow a possible partial recognition of an asset’s cash flows up to the level of contractual compensation payable. The PRA considers that this may allow firms to consider a wider range of assets as meeting the sufficient compensation requirement.

Changes to the portfolio

Examples are included in the draft SS of assets and liabilities which may have “new features” and which may therefore lead to a new approval being required if they are added to the MA portfolio. These are:

- bulk purchase annuities with collateralisation where the existing bulk purchase annuities in the portfolio are not collateralised
- assets involving restructuring, pairing or grouping
- infrastructure investments funding a materially different underlying project
- assets with a different form of compensation clause to those already included in the portfolio (e.g. modified rather than full Spens clauses)
- new bespoke reinsurance arrangements.

Helpfully, the PRA also clarifies that where a firm makes changes without prior supervisory approval (presumably in circumstances where the firm considers approval is not required but the PRA subsequently decides that it was), this is likely to be a breach of the PRA Rules but not of the conditions for matching adjustment approval.

The guidance does not consider whether a new approval requirement would be triggered where a large volume of business but with no new features is transferred into the portfolio (i.e. would the scale of the transfer of itself lead to a new approval being required?).

Breaches of the MA requirements

Where a firm is no longer able to comply with the conditions for application of the matching adjustment it must immediately inform the PRA. If it is not able to restore compliance with the conditions within two months of the date of non-compliance it must cease to apply the matching adjustment to its insurance obligations.

A literal reading of this requirement might be that the two month remedy period will always run from the date of non-compliance regardless of when the insurer becomes aware of it. The PRA has, however, included new guidance in the draft SS that where a breach is reasonably only determined after the date it has occurred, the two month period to remedy the breach starts from the point at which the breach is detected. This is a helpful clarification although the PRA's view of what is "reasonable" will be important. The SS emphasizes that firms must ensure they have appropriate processes in place to identify and investigate potential breaches on a timely basis.

Asset restructurings

The draft SS discusses the PRA's expectations of firms engaging in restructuring of assets (including equity release mortgages), some of which have previously been articulated in directors' letters and some of which are new guidance. In particular, the PRA expects firms to:

- be able to demonstrate compliance with risk management requirements and with the prudent person principle, consider carefully the prudence of any arrangements entered into for MA purposes and consider any new risks generated by the arrangements, such as counterparty risk
- demonstrate that restructuring transactions are not used to "circumvent MA eligibility conditions" (although it is not entirely clear how this should be applied, given that the aim of restructurings is to create eligible assets where they did not previously exist)
- consider whether the un-restructured asset is likely to remain appropriate over time, consistent with the duration of the restructuring arrangements
- demonstrate a robust rating process for any SPV or notes issued by an SPV as part of the restructuring.

Trading in the MA portfolio

The draft SS contains guidance on the extent to which firms can rebalance assets and carry out some limited asset trading without breaching the MA requirements. The guidance focuses on governance and controls around investment management and sets out the PRA's views of good practice in respect of investment strategy and discretion given to investment managers.

PRA announcement

CP21/17

The Treasury Committee report

The report draws on evidence provided to the Treasury Committee during 2016 and early 2017 regarding EU insurance regulation. The Committee is critical of the extent of disagreement between the PRA and the insurance industry and observes that this does not foster good policy-making. It makes recommendations to (chiefly) the PRA on actions which it considers should be taken to improve the current system of prudential regulation in the UK (based on Solvency II). The report also looks ahead to changes that might be made to

UK implementation of the Solvency II regime following Brexit, in order to improve the competitiveness of the UK insurance industry.

Competition objective

The Committee recommends that HMT should review the PRA's approach to its competition objective (at least for insurers) and consider giving the secondary competition objective equal primacy with the PRA's other statutory objectives.

This is seen as important to ensure that the PRA takes into account the competitiveness of the insurance sector in its approach to regulation. It is not clear whether, however, whether promoting the competition objective would be consistent with Article 27 of the Solvency II Directive, which states that the main objective of supervision is the protection of policy holders and beneficiaries.

Progress report

A number of recommendations for work which the PRA should undertake are included in the report. The Committee states that it expects the PRA to present a progress report on the extent to which there has been change or substantive progress in relation to the issues raised by 31 March 2018. This should include an explanation of how the PRA's implementation of the directive ensures proportionality and meets its secondary competition objective.

Many of the recommendations are arguably outside of the PRA's power to address in the current environment as they would require divergence from the requirements of Solvency II. The Committee acknowledges this to an extent by suggesting that the PRA should comment on whether it can progress the recommendations unilaterally or needs to wait for EIOPA and should "consider the end goal, including areas which can be developed after Brexit, rather than confining its thinking to what can be accomplished within the parameters of Solvency II". It must be questionable whether this is necessarily the best use of PRA capacity in view of the other competing priorities for the regulator in the run up to Brexit.

Key recommendations

Recommendation	Comment
The PRA should progress work on how "regulatory forbearance" can be incorporated into a post-Brexit regulatory model.	The ability of the PRA to allow firms some flexibility in complying with their capital requirements during the last financial crisis was seen as a valuable tool which has been lost under the Solvency II regime.
The PRA should take action now to address problems with the risk margin. The Committee requests that the PRA provides an update on the best approach for improving the risk margin calibration.	In its evidence to the Treasury Committee in February, the PRA indicated that it had concerns with industry proposals for reform and preferred to prioritize work to reform the risk margin at European level. The 25 October announcement did not include any reference to making improvements to the risk margin. In view of the level of discontent with the risk margin this approach may disappoint industry.

<p>The PRA should conduct a fundamental review of the matching adjustment and its eligibility criteria, including introducing more flexibility to avoid the need for artificial restructuring of firms' cash-flows for purely regulatory purposes.</p>	<p>PRA CP21/17 addresses some proposed changes to the assessment of asset and liability eligibility and other aspects of the matching adjustment.</p>
<p>The PRA should review its practices with regard to approval of internal models and changes to internal models in order to apply a more proportionate approach to each of these.</p>	<p>The PRA has announced that it will publish a consultation on proposals on the minor model change process in December 2017 with the aim of reducing burden on firms. It remains to be seen whether this will go far enough to satisfy the committee.</p>
<p>The PRA should assess whether the standard formula could be enhanced, in particular to avoid the need for firms to use an internal model.</p>	<p>This is clearly beyond the power of the PRA pre-Brexit (and may be politically undesirable post-Brexit, depending on the appetite for equivalence).</p>
<p>Current regular reporting requirements should be reviewed with a view to streamlining them (in particular the quarterly reporting requirements).</p>	<p>The PRA has announced that it will publish a consultation on proposals to reduce the reporting burden on firms in January 2018.</p>
<p>The PRA should consider whether its rules regarding use of the volatility adjustment should be amended, first to remove the requirement for supervisory approval and secondly to allow the use of a "dynamic" volatility adjustment.</p>	<p>The latter recommendation is partly based on the actions of other European regulators such as the Dutch regulator. However, it is not clear that this is consistent with a strict interpretation of the directive.</p>
<p>Further consideration should be given to possible improvements to the way in which the Transitional Measure on Technical Provisions is calculated (and recalculated).</p>	<p>The PRA has announced that it is continuing to assess the feasibility of further simplification to the recalculation process.</p>
<p>The PRA should develop rules for contract boundaries which reflect their economic substance rather than their legal form - although no specific recommendations are made.</p>	<p>It is not clear how this could be achieved in compliance with Solvency II. It does not appear to be within the scope of the PRA's current work on improvements to the regime.</p>
<p>The PRA should provide a view on whether UK regulation post-Brexit can be aligned with IFRS17.</p>	<p>There may be some advantages in aligning the regulatory and accounting regime but this will need to be balanced against maintaining consistency with Solvency II and minimizing disruption.</p>
<p>The PRA should develop a solution for firms who will lose the legal validity of their contracts after Brexit.</p>	<p>This is only within the PRA's powers to the extent that it relates to contracts written <i>into</i> the UK from other EEA states. A solution to this issue, if found, will need to be the subject of political agreement.</p>

Treasury Committee report

NEXT STEPS:

- December 2017: PRA consultation paper expected on model change process
- January 2018: PRA consultation paper expected on proposals to reduce the reporting burden
- 31 January 2018: deadline for responses to CP21/17
- 31 March 2018: Progress report requested from the PRA by the Treasury Committee



Oliver Wareham
T +44 (0)20 7090 3041
E oliver.wareham@slaughterandmay.com



Beth Dobson
T +44 (0)20 7090 3070
E beth.dobson@slaughterandmay.com

© Slaughter and May 2017

This material is for general information only and is not intended to provide legal advice. For further information, please speak to your usual Slaughter and May contact.