Insurance Newsletter

29 March 2018

Brexit latest

Transition

The Brexit soap opera continues with some apparently more positive news. Agreement on a transitional period appears to have been reached between the UK and the EU in the context of the proposed Withdrawal Agreement. On 19 March it was announced that agreement had been reach for the transitional (or "implementation") period to run until the end of 2020. This potentially provides some breathing space for many insurers and other financial institutions; if the transition period materialises, this will delay the drop dead-date for Brexit related restructurings.

On the other hand, applying the mantra that 'nothing is agreed until everything is agreed', in some senses the position for the sector is no more certain legally than it was in December following the first phase of negotiations. Many outstanding points remain in the draft Withdrawal Agreement, including a definitive way forward on the Irish border. In addition, the transitional period, if not extended, is relatively short. Firms will want to continue to work on existing restructuring plans, but perhaps with the reassurance that putting everything in place is reasonably likely to be less time critical than it might have been. For EEA insurers operating in the UK under freedom of services or freedom of establishment passports, the PRA has given some additional comfort on the timetable for authorisation, as discussed below.

"Mutual recognition"

The Government's favoured position on the future relationship with the EU in the area of financial services has been made clearer in recent weeks.

On 7 March the Chancellor gave a speech on Brexit and financial services in which he argued for a free trade deal with the EU to include financial services, based on principles of mutual recognition and reciprocal regulatory equivalence. He proposed that on exit the UK would have an (inevitably) equivalent regime to the EU, which would be followed by separately evolving rules to deliver "equivalent regulatory outcomes". An objective process would be needed to assess the equivalence of regulatory outcomes and the consequences of any divergence.

It remains to be seen how the EU will respond to this approach and, if it is adopted, to what extent there will be tension between the need to maintain equivalence and the desire of the UK industry to move away from aspects of Solvency II which have been perceived as cumbersome and uncommercial. For the time being, the EU negotiating guidelines published on 23 March make no direct mention of financial services.

Chancellor speech

Update to branch authorisation and supervision of international insurers

On 28 March the PRA published a policy statement (PS4/18) and final supervisory statement (SS2/18) on branch authorisation and supervision of international insurers, together with a Dear CEO letter giving an update following the March 2018 European Council meeting.

In the Dear CEO letter the PRA states that in view of the agreed implementation period, together with the Government's commitment to creating a temporary permissions regime if necessary, firms may plan on the assumption that PRA authorisation will only be needed by the end of the implementation period – in the interim, they can assume that they will continue to be able to continue undertaking their activities in the UK in much the same way as now. Guidance on the timing of applications will be provided by the PRA on a case-by-case basis: this suggests that the PRA will be prepared to continue processing applications already in hand. There is also a recognition that converting a branch to a subsidiary is a complex process and the PRA has indicated that it is prepared to give firms a "reasonable period" to restructure, taking into account the operational steps involved and the risks to the PRA's objective.

The PRA has made one material change to the draft supervisory statement, to increase the threshold for FSCS-protected liabilities (indicating whether branch, rather than subsidiary, authorisation is appropriate) from £200 to £500 million.

It is important to note that the PRA's proposed approach deals only with international insurers operating in the UK; the policy statement and related materials do not provide any solace for UK insurers with policyholders or activities in other parts of the EEA.

Dear CEO letter

PS4/18

SS2/18

Communications with policyholders

On 14 March the FCA published a letter addressed to the ABI responding to queries regarding communications with policyholder in the light of Brexit. The FCA's view is that firms should consider the impact which Brexit will have on the operation of customers' contracts and will need keep under review "what, if anything, needs to be brought to customers' attention when buying or renewing a policy". The FCA acknowledges that this may be influenced by the final legal agreement reached between the UK and the EU and comments that any future review of communications with customers will take into account any uncertainty over the final agreement at the time the communications are made.

Although the FCA letter does not provide chapter and verse on what communications firms should make, it does indicate that the FCA is taking a relatively flexible and pragmatic approach. It is interesting to contrast this with the suggestion in the European Commission's 8 February notice to stakeholders on the withdrawal of the UK from the EU that the Solvency II Directive requires firms to inform policyholders about the impact on their rights and on the provision of services which may emerge from Brexit. The suggestion in the Commission communication does not appear to be supported by the directive articles to which it refers.

FCA letter to ABI

Commission notice

PRA ongoing work on Solvency II refinements

In its initial announcement responding to the Treasury Committee report on the impact of Solvency II on the insurance industry, in October 2017, the PRA committed to reviewing a number of specific aspects of implementation of Solvency II. It was also asked to report back to the committee by March 2018 on wider topics. The past couple of months have seen a number of developments in this area.

Proposed changes to reporting requirements

On 11 January 2018, the PRA published a consultation paper (CP2/18) setting out changes to its insurance reporting requirements. The proposals in CP2/18 are intended to reduce the reporting burden on Solvency II firms and arise partly out of the recommended areas for reform identified by the Treasury Committee in its 2017 review of insurance regulation.

The proposals include relaxing the current process for quarterly reporting waivers for category 4 and 5 firms and acknowledging the wider availability of quarterly reporting waivers for category 3 firms than was indicated in earlier guidance.

CP2/18

Formal response to the Committee

On 28 February the PRA published its final response to the Treasury Committee report. This follows on from an initial response published on 3 January and fulfils the Treasury Committee request that the PRA should publish a full response by March this year. The PRA has subsequently provided a further update in the form of a letter to the Committee dated 27 March.

In the February response, the PRA suggests as areas for improvement within an EU context or post-Brexit (i.e. not on a stand-alone basis): inclusion of macro-prudential tools; amendments to the standard formula treatment of infrastructure assets (in progress); capital charges for simple, transparent and standardised securitisations (review in progress); common basis for deriving discount curves; treatment of sovereign debt; and the definition of “financial institutions” for group solvency calculation purposes.

The response and subsequent letter also include comments on the following points where the PRA has or has been perceived to have the ability to make unilateral changes to its regime:

COMPETITION	The Committee had suggested that the PRA should have a primary competition objective. Although in any case not within the PRA’s power to change, the PRA does discuss how it currently exercises its secondary competition objective and more generally its regard to competitiveness, such as in facilitating the new ILS regime. It also suggests that giving the PRA a primary competition objective would dilute the focus of the PRA on prudential regulation and would excessively overlap with existing competition regulators.
RISK MARGIN	The PRA has been carrying out work on the use of future risk mitigation and transfer mechanisms in the calculation of the risk margin and plans to consult on the outcome with a view to implementation of any new policy by the end of 2018.
MATCHING ADJUSTMENT	The PRA points to its October consultation on the MA and comments on the extent to which it is constrained by the European legislation. It states that it would prefer a regime that avoids the incentive for firms to re-structure assets to secure MA benefit (with the implication that it does not have the power to introduce this).

VOLATILITY ADJUSTMENT	The PRA argues that supervisory approval is important to ensure that the risks which arise from use of the VA are not detrimental to policyholders and that it has been flexible in its approach to approval of the VA. It is, however, reviewing its approach the use of a "dynamic" VA (previously not allowed in the UK) in the light of the EIOPA (November 2017) opinion on the use of dynamic VAs in internal models and is planning to consult on any necessary updates to its policy during April.
TRANSITIONAL MEASURE ON TECHNICAL PROVISIONS (TMTP)	The PRA is currently assessing the feasibility of simplifying the recalculation of transitionals and discussing these proposals with industry. It expects to consult on any proposed changes in 2018.
PRO-CYCLICALITY AND REGULATORY FORBEARANCE	The PRA refers to the existing aspects of the Solvency II regime which are designed to counter pro-cyclicality but comments that it has pushed at European level for more macro-prudential tools to be available to regulators. It is also working with EIOPA and the ERSB to improve guidance on when an "exceptional adverse situation" should be declared (allowing an extension of the SCR recovery time) and to explore the possibility of tools to decrease capital requirements in times of stress (which could potentially form part of the Commission's 2021 review of Solvency II).
CONTRACT BOUNDARIES AND IFRS 17	The PRA comments that it has no scope to change the definition of the contract boundary to align with IFRS 17.
STANDARD FORMULA	The PRA comments that there are aspects of the standard formula which are inadequate but are not within the current Commission review e.g. inflation risk, gilt spread risk and operational risk. It comments that "We are engaging in the review and will consider our position further once it has concluded".
EXTERNAL AUDIT OF THE SFCR	The PRA plans to consult on removing the requirement for smaller firms to carry out an external audit of their SFCRs, with effect from the end of 2018.
LONGEVITY TRANSFER HEDGE ARRANGEMENTS	The PRA points out that is has clarified that there is no approval process for these transactions but confirms that it expects to be notified of new transactions. The PRA is open to considering whether some of the information required could be omitted to reduce any undue burden.

PRA response

Solvency II – EIOPA advice on amendments to the Level 2

On 28 February 2018 EIOPA delivered its second set of advice to the Commission on possible amendments to the Level 2 Delegated Regulation. Most of the advice relates to the standard formula but some other specific aspects of the Level 2 are also considered. Some key points raised in the advice are:

- <u>Interest rate risk</u>: EIOPA advises that there is strong evidence that the current approach in the standard formula for calculating capital requirements for interest rate risk leads to a severe under-estimation of the risks. It therefore proposes a new method for the calculation, which could have a material impact – in particular for life insurers whose liability cash-flows depend on the level of interest rates. EIOPA estimates that the average impact on the solvency ratio for relevant life insurance undertakings would be around 14 percentage points and suggests a phasing in period of 3 years in view of the material impact

- Unlisted debt and equity: EIOPA proposes some modifications to the rules applying to unlisted debt and equity, to allow instruments meeting certain criteria to attract a more favourable risk charge

- Risk margin: EIOPA has considered whether the current cost-of-capital rate of 6% which is used in the risk margin calculation should be amended. The general view of the industry is that this rate is too high and unrealistic compared to the actual cost of capital in the market. EIOPA, however, advises that the rate is appropriate and should remain unchanged. Further, EIOPA has decided not to consider other aspects of the operation of the risk margin at this stage – instead, it will consider these as part of the review of Solvency II which the Commission is required to undertake by 2021. Both of these aspects of the advice are likely to be disappointing to many insurers, in particular UK insurers, who have lobbied strongly for changes to the way in which the risk margin works.

- Own funds: EIOPA has compared the own funds requirements in the insurance and banking sectors, with a view to improving harmonisation between the two sectors where possible. As a result of the review, EIOPA proposes a number of changes to the own funds requirements for insurers, principally:

  - (subject to supervisory approval) to allow redemption of Tier 1 and Tier 2 instruments in the first five years of issuance where there is a change in regulatory classification of the own fund item or a material change in the tax treatment of the item, without requiring this to be out of the proceeds of a new issuance, provided that a sufficient capital buffer is retained. This will bring the position back in line with the general approach taken into the UK pre Solvency II
  - to allow a partial write down or partial conversion where the mandatory principal loss absorbency mechanism trigger of a three month SCR breach has been reached but the 75% SCR breach and MCR triggers have not been (with a potential further write down every three months if the SCR coverage ratio deteriorates)
  - to allow exceptional waivers from the write down or conversion requirement in certain circumstances where the tax effects of the write down or conversion could significantly weaken the solvency position of the firm.

EIOPA advice

FCA publications on pension transfers

On 26 March the FCA published PS18/6 setting out final rules and guidance on how advice should be provided to customers on pension transfers which would involve giving up safeguarded benefits, primarily transfers from defined benefit (DB) to defined contribution (DC) schemes. This has been an area of particular regulatory scrutiny since the introduction by the Government of pension freedoms in April 2015, which customers with pension savings in DB schemes can only take advantage of if they transfer their savings to a DC scheme.

The FCA's view is that advisers should start from the assumption that a transfer will be unsuitable, but advisers can recommend a transfer where this can be demonstrated to be suitable for the customer. It had consulted on moving to a more neutral starting position but has decided against this, partly due to the level of unsuitable advice identified in its supervisory work.

Key areas of change include:

- requiring all advice on pension transfers to be a personal recommendation

- clarifying the role of pension transfer specialists when checking (rather than giving) advice
- new analysis requirements involving undertaking an “appropriate pension transfer analysis” (APTA) and a prescribed “transfer value comparator” (TVC).

The majority of the new rules will come into force on 1 April 2018, with the APTA and TVC requirements coming into force on 1 October 2018 and changes to assumptions to use when revaluing benefits in April 2019.

The FCA has also published CP18/7, consulting on further changes to rules and guidance to improve the quality of pension transfer advice. These arise out of discussion questions raised in the earlier consultation as well as the FCA’s ongoing supervisory work and include:

- raising qualification levels for pension transfer specialists
- guidance on the types of risk which advisers should be addressing when looking at clients’ attitude to risk
- guidance on how firms can conduct initial discussions with potential customers without stepping across the advice boundary
- a requirement for firms to provide a suitability report regardless of the outcome of advice
- whether the FCA should intervene in relation to charging structures, including possibly introducing a ban on contingent charging (i.e. where a fee for advice is only paid when a transfer goes ahead).

The consultation period closes on 25 May 2018.

PS18/6

CP18/7

The Insurance Distribution Directive

On 19 March 2018 an amending directive was published in the Official Journal, changing the transposition deadline of the IDD to 1 July 2018 and the application date for the new regime to 1 October 2018. This finalised a process begun in in 2017 when the European Commission published the draft amending directive, in response to a call from the European Parliament for a delay.

Amending directive

SOLVENCY II PUBLICATION – UDPATE

In February 2017 we published our landmark guide to Solvency II in book form. In view of the number of changes in practice and policy since that date we are now preparing a supplement updating our book to reflect the latest position. We are also taking the opportunity to comment on selected other topical issues: Brexit, the Insurance Distribution Directive and IFRS 17.

If you would like to receive a copy of the supplement, with or without a copy of the original book, please let us know at **insurance@slaughterandmay.com**

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