Insurance Newsletter

3 July 2018

The Retirement Outcomes Review

On 28 June the FCA published the long awaited Final Report of its Retirement Outcomes Review (**"ROR"**), alongside a consultation paper on introducing remedies arising out of the Final Report (CP18/17).

The ROR was launched in June 2016 and an interim report was published in July 2017. The ROR was intended to look at emerging issues in the retirement market, in particular in the light of the pensions freedoms introduced by the Government in 2015. It focused primarily on non-advised consumers, on the basis that those taking advice already receive support in making retirement decisions.

The consultation paper sets out (i) proposed remedies; and (ii) additional potential remedies for discussion, on which feedback is sought. The FCA would like feedback on the potential remedies by 9 August and comments on the remainder of the consultation by 6 September. It intends to publish final rules in all areas by July 2019. Key points are summarised below.

Issue	Proposed/ potential remedy
Many non-advised customers have inadequate information regarding when and how to access their pension pots	• Customers should be sent "wake-up packs", including single page summaries, from the age of 50 and every 5 years thereafter • Retirement risk warnings should be sent alongside the wake up packs to help consumers engage with the risks associated with their options • A range of "investment pathways" should be provided to non-advised customers to help them make appropriate choices (feedback sought)
Large numbers of non-advised drawdown customers are being defaulted into holding cash, which is likely to be unsuitable for many	Rules could be introduced preventing customers from being defaulted into cash without making an active choice (feedback sought)
The vast majority of consumers accessing pension pots without taking advice accepted the drawdown option offered by their pension provider which may lead to consumers paying higher charges. In general there is a lack of competition	• Amendments to the information prompt for consumers potentially eligible to purchase enhanced annuities • Changes to the charges information required to be provided to consumers • Changes to rules regarding provision of annual information

FCA webpage

Solvency II round-up

CP13/18 - Solvency II: Equity release mortgages

The proposals

On 30 June the PRA published a consultation on amendments to SS3/17 (Matching adjustment - illiquid unrated assets and equity release mortgages). The amendments are intended to clarify the PRA's position on a number of aspects of the supervisory statement (originally published in July 2017) as they relate to investments in equity release mortgages (**"ERMs"**). As with the original SS, the PRA's main aim is to ensure that firms do not take inappropriately large matching adjustment benefit from restructured ERMs held within MA portfolios.

Key points are:

- The PRA expects firms to value any no-negative equity guarantees (NNEGs) embedded in ERMs using a forward price for the relevant property calculated based on the deferment price discounted using the Solvency II basic risk-free rate. This approach differs from that taken by some insurers who have calculated forward prices by including an assumption of property growth in excess of the risk free rate. The PRA does not consider the latter approach to be consistent with the principles it set out in SS3/17

- The PRA proposes a minimum calibration for the property deferment rate, which it considers should be not less than 1% (with a "best view" being 2%)

- Some amendments to other parts of the SS are proposed to clarify that where the Effective Value of the ERMs is higher than the "economic value" this may reflect issues with the note valuation, credit rating or contractual terms and not just the fundamental spread calculation

- The PRA considers that the approach described above should also be used by firms in valuing their ERMs in their Solvency I ICAS calculation for the purposes of the Transitional Measure on Technical Provisions (**"TMTP"**). The PRA's view is that this is necessary for the requirements of INSPRU 7 to be satisfied. This applies whether or not the ERMs are held within an MA portfolio

- The PRA recognises that the clarifications being consulted on could have a significant impact on firms and is therefore proposing a short phase-in period of up to three years.

Impact on matching adjustment benefit

Valuing the NNEG using the PRA's approach rather than based on modelling expected returns on the ERMs could have a significant impact on some firms' MA benefit. Although this is a consultation, the PRA's proposals appear to be an expression of the PRA's evolving thinking on ERMs and the matching adjustment. It may therefore be difficult for firms to persuade the PRA to take a different approach. The three year phase in period is relatively short in the context of the importance of the matching adjustment to many firms, in particular where significant restructuring costs have been incurred and matching adjustment approval was previously obtained from the PRA.

The TMTP

The PRA's proposals regarding the TMTP will exacerbate the impact of the proposals on firms. As well as potentially taking a lower MA benefit, firms will not be able to increase their transitional deduction to absorb some of this loss of benefit under the PRA's proposed approach. This will also affect firms holding ERMs outside of an MA portfolio. It is not entirely clear that the PRA's proposed approach is consistent with the policy rationale of the TMTP, to allow a transition from firms' Solvency I technical provisions as at 31 December 2015 to the full Solvency II calculations.

PRA webpage

The risk margin

In its responses to the Treasury Committee inquiry into insurance regulation earlier this year, the PRA had indicated that it was carrying out follow up work on possible changes to the risk margin. The risk margin is a component of the calculation of technical provisions under Solvency II and the way in which it is calculated has been widely criticised by industry, in particular although not only in the UK.

On 4 June the PRA wrote to Nicky Morgan MP, the Chair of the Treasury Committee, with an update on its work on possible reforms to the risk margin. In the letter the PRA again acknowledges that the current design of the risk margin is unsatisfactory and reports that it has been considering the use of future risk mitigation and transfer mechanisms in the calculation of the risk margin. However, the PRA goes on to say that

> *"in the context of the ongoing uncertainty about our future relationship with the EU in relation to financial services we do not yet see a durable way to implement a change with sufficient certainty for firms to be able to rely on it for pricing, capital planning and use of reinsurance".*

PRA letter

CP9/18 - Solvency II: Internal models - modelling of the volatility adjustment

In CP9/18 the PRA proposes allowing firms to apply a dynamic volatility adjustment ("DVA") in their internal model SCR calculations and sets out its expectations of what firms should consider in model and model change applications when seeking approval to apply a DVA. The CP includes a draft supervisory statement covering these issues. SS17/16 will also be amended to reflect the change in policy.

The volatility adjustment is intended to stabilise an insurer's balance sheet during short periods of high market volatility by adding an extra spread component to the discount rate used for the calculation of technical provisions. The prescribed methodology for calculating the volatility adjustment is based on a constant adjustment but some jurisdictions (not previously including the UK) have allowed the use of a DVA in internal model SCR calculations. A DVA allows the volatility adjustment to move in line with modelled credit spreads during a one-year forecast of basic own funds.

Key points raised in the draft supervisory statement include:

- use of a DVA in the internal model will require PRA approval as a change to the model

- the PRA expects firms to be able to demonstrate that, in applicable stressed scenarios, use of the DVA in the internal model will not result in a breach of a relevant requirement, including the prudent person principle and the system of governance requirements relating to the application of the volatility adjustment. This is an extension to the SCR calculation of the requirements applying to use of the volatility adjustment in the technical provisions calculation

- the PRA anticipates that firm's models will make adjustments to the EIOPA methodology for applying the volatility adjustment in the technical provisions calculation. This is likely to be necessary to ensure that the SCR captures all quantifiable risks to which the firm is exposed. The PRA comments that any adjustments should not result in a lower SCR than would have been the case had EIOPA's methodology been used with no adjustments.

The consultation period closes on 11 July.

CP9/18

The New EU Securitisation Regime

A delegated regulation setting out a new EU framework for securitisations (the "Securitisation Regulation") was published in the Official Journal in December 2017 and comes into effect in Member States on 1 January 2019. The new framework will harmonise securitisation requirements across sectors and also introduce a new regime for simple, transparent and standardised ("STS") securitisations.

On 1 June the Commission published a proposed Amending Regulation making changes to the Solvency II legislation to reflect the new framework. The PRA has also published draft guidance in CP12/18 – Securitisation: The new EU framework and Significant Risk Transfer (May 2018). Only part of the PRA consultation is relevant to insurers (with the remainder being of relevance to CRD IV firms).

For insurers, there are three key changes which will be introduced as a result of the Securitisation Regulation, described below.

In its draft guidance, the PRA clarifies its view that insurers and ISPVs can (depending on the transaction) be both originators and institutional investors within the Securitisation Regulation. In particular, firms entering into restructuring transactions which result in the issuance of tranched securities should consider whether the transaction is a securitisation for the purposes of the regulation. This may be the case, for example, on restructuring of equity release mortgages or other assets for matching adjustment purposes. Steps may therefore need to be taken to ensure that the risk retention and due diligence requirements are met when undertaking these types of restructuring transactions.

Risk retention: The risk retention requirements in Articles 254 and 245 of the Level 2 Delegated Regulation will be deleted and replaced by the relevant provisions in the Securitisation Regulation. The essential requirements, including the level of risk retention, will remain unchanged although there are some changes in the detail - for example the exemptions from the risk retention requirements.

Due diligence: Similarly, the due diligence requirements in Article 246 of the Level 2 Delegated Regulation will be deleted and replaced by the Securitisation Regulation due diligence requirements. These are similar to the current requirements but with a slightly more granular level of detail

STS securitisations: The Level 2 Delegated Regulation will be amended so that STS securitisation positions which fulfil the relevant provisions of the Securitisation Regulation will attract reduced risk charges (which will differ depending on whether the securitisation position is senior or non-senior)

The Securitisation Regulation

The Amending Regulation

CP12/18

Law Commission Insurable Interest Bill

The Law Commission has published an updated version of its insurable interest bill, the first version of which was published in May 2016. Given the complexity surrounding this area of insurance law it has unsurprisingly proved difficult to find a proposal which satisfies all stakeholders. The law of unintended consequences has loomed large in the background and it is clear from the accompanying notes to the draft bill that the Commission has listened to substantial stakeholder input in formulating this updated version.

The most significant change is the narrowing of the bill to cover life insurance (or rather "life-related insurance") only. The Law Commission has concluded that amendments to the law in respect of non-life insurance would be merely clarificatory as there is no issue in practice with the operation of the rules in this area. Although not mentioned in the notes, we are aware that some concerns had been raised by industry regarding the possible impact of the bill on legal analyses of the distinction between some types of derivatives and non-life insurance products, which may also have been an influencing factor.

Some other points to note in the draft bill are:

- the bill takes the approach of including a general definition of insurable interest, which focuses on the existence of a reasonable prospect of economic loss, as well as specific circumstances in which insurable interest will exist regardless of whether the economic loss test is met
- the specific circumstances set out in the bill do not constitute a closed group. In principle this allows the Court to extend the categories of insurable interest beyond those set out in the bill, although it is difficult to see on what basis the Court would feel itself empowered to do so given that the bill replaces any other rule of law relating to insurable interest (including at common law)
- the bill addresses the position of trustees and other administrators of group schemes, trusts in respect of life insurance investment policies and policies in respect of multiple lives where the identity of the insured lives may change during the term of the policy
- the Life Assurance Act 1774 is largely repealed, although to the extent that it currently applies to non-life policies it will continue to do so. One consequence of this is that policies lacking insurable interest will no longer be illegal and the basic position will therefore be that the insured will be entitled to have its premiums returned. This is subject to provisions in the draft bill addressing the making of untrue and misleading statements by the insured.

Comments can be made on the draft bill until 14 September.

Law Commission webpage

Financial planning by insurers

On 17 May 2018 the PRA published a final supervisory statement on "Financial management and planning by insurers", following on from a consultation published in November 2017. The supervisory statement addresses (i) the need for firms to document their risk appetite in a statement approved by the board; (ii) the interaction between firms' business plans and their risk appetite; and (iii) dividend suitability and sustainability.

Some key points set out in the supervisory statement include:

- the risk appetite statement should include the risk appetite for the levels of capital to be maintained and the appetite for the level and volatility of future dividend payments in the context of the firm's business plans, levels of capital and volatility of earnings
- the business plan should reflect achievable capital generation and a capacity for dividend payouts in accordance with the risk appetite. Regular management information should be provided to senior management and the board

to show how the insurer is performing against its plans

- the ORSA should ensure effective links between the business plan, risk appetite and capital management plans
- potential dividend payments should be appropriate in relation to actual and projected business performance, current and future capital position and the firm's documented risk appetite.

The PRA does not expect insurers to seek pre-approval of dividends as a matter of course provided the requirements set out in the supervisory statement have been satisfied. In particular, the firm's capital position must be within risk appetite after the payment and the SCR coverage must be above 100%.

PRA webpage

Jonathan Marks
T +44 (0)20 7090 3056
E jonathan.marks@slaughterandmay.com

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