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Solvency II newsflash

PRA told to pull a EU-turn

October and early November saw the Prudential Regulation Authority (PRA) hit with something of a double-whammy. First it received a significant amount of implied criticism from the Treasury Committee – and was presented with a pre-Christmas shopping list of aspects of the regulatory regime that MPs believe should be changed. This was swiftly followed up by European Insurance and Occupational Pensions Authority (EIOPA) consulting on a proposal which included a recommendation of no change to the calibration of the Risk Margin – one of the key areas identified by MPs. This article looks at where this leaves the PRA.

Uncomfortable reading for the PRA

A little over six months ago, we reported on the Treasury Committee's investigation into insurance regulation. The Committee delivered its report on 27 October 2017.

MPs have sided with the industry on virtually every issue discussed and there is implied criticism of the PRA throughout. There are 11 areas where the PRA has been told that it needs to work with industry to find a solution; with MPs expecting a progress report by 31 March 2018. These include the "usual suspects" of Risk Margin, Matching Adjustment, Internal Models and the Transitional Measure on Technical Provisions.

The Committee's view is that balance has swung too far towards policyholder protection, at the cost of more expensive insurance products and hampering firms' ability to invest in the UK economy. The Committee has therefore recommended that the Treasury considers elevating the status of the PRA's secondary objective of facilitating effective competition, so that it sits alongside the primary objectives of promoting firms' safety and soundness and protecting policyholders.

What the Treasury Committee's report did not specify was how the PRA should address the 11 issues discussed. For some of the areas discussed there are no obvious solutions that can be implemented within the legal constraints of Solvency II.

No help for the PRA from EIOPA

On 6 November, EIOPA published its Consultation Paper on its second set of advice to the European Commission on the Solvency II Delegated Acts. The main headline from the proposals is that EIOPA has recommended no change to the calibration of the Risk Margin. This is likely to come as a big disappointment to both the UK insurance industry and the PRA – whose stated strategy was to "fix" the Risk Margin at a European level, rather than the UK making changes unilaterally.

EIOPA's advice focuses narrowly on whether the assumed cost of capital rate (currently assumed to be 6% over and above the risk-free rate) is justified based on observed market data. To this end, EIOPA has attempted to determine the "equity risk premium" that investors expect to receive when investing in insurance company shares. This is disappointing given that the scope set out by the Commission was much broader, with EIOPA asked to "Assess if the methods and assumptions applied in the calculation of the risk margin continue to be appropriate."

The consultation paper is somewhat ambiguous on whether EIOPA believes that longevity risk is hedgeable. When responding to a proposal that the Risk Margin be calibrated based on reinsurance pricing, EIOPA stated that such prices are typically not directly observable. This is doubtless an area where EIOPA could have tried harder: for instance it could have asked national regulators to collect information about reinsurance transactions from firms.

Later on, EIOPA responds to separate proposal that longevity risk be deemed to be hedgeable. EIOPA does not really give much of an opinion, merely noting that if longevity risk were to be deemed hedgeable then the cost of hedging would need to be reflected in the Risk Margin. This is of course correct, but it does not provide a reason for assuming that longevity risk is not hedgeable – providing that the cost of hedging can be appropriately allowed for. It remains unclear whether the decision as to whether or not longevity risk should be included in the Risk Margin is a matter for EIOPA, the PRA or firms themselves.

Another proposal was that firms be allowed to use the Matching Adjustment or Volatility Adjustment when discounting the projected costs of capital. EIOPA has essentially kicked this proposal down the road to 2021 – when it reviews the so-called "Long-Term Guarantees package".

Having seemingly rejected these proposals out of hand, EIOPA has focused its analysis on the cost of capital rate, ignoring fundamental questions about whether the Risk Margin results in an appropriate degree of protection for policyholders and whether it leads to firms investing in a pro-cyclical manner.

Stephen Makin, Head of Risk and Capital

Until the UK leaves the EU in March 2019 the PRA is pretty limited in what it can do on risk margin. It has no control over either the 6% cost of capital charge or the swaps discount rate used in its calculation, and treating longevity risk as hedgeable is something of a stretch which would bring with it some unwelcome consequences. Fundamentally, the risk margin design is in need of major and urgent overhaul.

"Industry will therefore be desperately disappointed at the lack of imagination shown by EIOPA in simply recycling a dusty old approach from CEIOPS.

What comes next?

The PRA is now clearly under pressure to be seen to be taking action with respect to certain aspects of the Solvency II regime. Industry should brace itself a series of PRA publications over the coming months – with the recent consultation paper on the Matching Adjustment being the first of these. Firms should be alive to any potential changes in the rules and be ready to review their policies in light of these.

Hymans Robertson has a wealth of relevant Solvency II experience, from risk and capital optimisation under Solvency II, through to broader areas such as model calibration and validation in the areas of longevity risk, credit risk, and dependency & aggregation.

Our consultants would be delighted to support you. If you would like more information or advice, please get in touch