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Solvency II newsflash

Treasury issues Call for Evidence as part of post-Brexit review of Solvency II

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On Monday 19 October the Treasury issued a Call for Evidence, seeking the views of UK insurers on various aspects of the Solvency II risk management framework. This is the first stage of the much-anticipated review of Solvency II following the UK's departure from the European Union and can be found in full here.

The review of Solvency II has been commissioned with the recognition that, while it has many desirable features, the current framework was designed to be appropriate for insurers across the EU and so may not be optimal for the unique characteristics of the UK insurance industry. The UK Government, the regulator and both industry and professional bodies are all in broad agreement that Brexit provides an opportunity to review and tailor the current framework to best allow for these characteristics.

That said, the Treasury notes that Government and the Prudential Regulation Authority remain supportive of the main principles underlying the current framework, and that there will be emphasis on ensuring that any changes do not have adversely impact the security of policyholders' benefits or the financial soundness of UK insurers. The Treasury also hopes that the review will promote innovation and encourage investment in line with the Government's environmental targets – for example in infrastructure assets.

The Call for Evidence focuses on a number of areas of interest within the current framework, setting out observations and limitations before posing questions for insurers to submit their views on. There are no direct views expressed in the paper as to what the changes should be. As announced by Rishi Sunak on 23 June, the key areas of consideration are the risk margin and the matching adjustment. Firms are asked to respond to the Treasury by **19 January 2021**.

Perhaps the most frequently-mentioned aspect of Solvency II when discussing potential reforms is the **risk margin**. The Treasury notes that the risk margin has generally been larger and more volatile than expected. This may be largely due to the limitations of the cost-of-capital calculation methodology, particularly in a low-interest rate environment. Insurers are asked to comment on the current calculation methodology and to provide suggestions for changes that could be made to improve the calculation approach.

Another popular discussion topic has been the **matching adjustment** (the "MA"), which rewards the close matching of long-term predictable liabilities, such as annuities, through an enhancement to the discount rate. The Government continues to support these principles and the need for clear eligibility criteria for backing assets but recognises the current requirements may be overly stringent and that more flexible eligibility criteria and approval processes could improve efficiency within firms while still providing appropriate policyholder protection. Insurers are asked their views on the current MA eligibility requirements, approval process and calculation approach. Suggestions for improvements are welcomed, particularly any changes which would increase the importance of environment, social and governance considerations when making investment decisions in relation to MA portfolios.

A key objective of the review is to promote growth and competition in the UK insurance market and insurers are asked for suggestions around how **competition could be increased**, with examples provided such as removing the requirement for overseas insurers to hold sufficient UK-based assets to cover their notional Solvency Capital Requirement ("SCR") or reducing the onerousness of regulation on new market entrants to encourage growth.

Consideration is also given to the appropriateness of the calculation of the **SCR**, particularly under the Standard Formula (the "SF"). It is noted that, particularly for smaller firms, the benefits of moving away from the SF may be insufficient to justify the significant costs of designing, gaining approval for, and subsequently implementing and maintaining an Internal Model ("IM"). Consequently, insurers are asked for suggestions on changes to the SCR methodology, including on the SF calculation methodology, the IM approval process, and how the SF methodology could be adapted for firms who feel that the SF does not adequately allow for their specific risk profile but cannot justify developing an IM.

Insurers are also asked to comment on the calculation of **consolidated SCRs**, the calculation of **Transitional Measures** (a hot topic and operational burden for many insurers, which they will be pleased to see included after it did not feature on Sunak's initial list), the expected impact of the transition from **LIBOR to overnight indexed swap rates**, the current **reporting requirements and templates** and the requirements for **UK branches of international insurers**.

Our view

We welcome the Call for Evidence and would encourage all insurers to take time to review it and respond to the Treasury with as much information as possible. We have been discussing potential Solvency II reforms with our clients for a number of years now and we are excited to see this first step being taken.

In particular, we are pleased to see the **risk margin** and **matching adjustment** highlighted, with over half of the questions set out in the paper focused on these areas. These are the most frequently mentioned areas of interest when discussing potential reforms of the current framework and we are sure that insurers will be encouraged by the focus on these areas. Amendments to the risk margin could reduce interest rate sensitivity of the Solvency II balance sheet and could see a change in appetite from insurers with respect to the reinsurance of longevity risk. These are important impacts to consider for any reform. While we do not expect to see wholescale changes in the magnitude of the matching adjustment, this is a great opportunity to simplify the operation of a matching adjustment portfolio, the approval process and potentially remove the additional complexities and risks that have been introduced through the restructure of assets.

Consideration of the Standard Formula calculation is not a surprise either given it does not necessarily capture some of the more UK specific risks, such as volatility risk for with-profits contracts. The notion of an adapted Standard Formula for companies to better reflect risk, but without going through a full internal model approval process, would seem to be a useful halfway house, assuming appropriate governance.

We also view the potential temporary calculation of multiple Group SCRs as important to assist the continuation of consolidation of the UK insurance market as it will remove the need to move from an internal model to the standard formula for a period post acquisition. The reduced costs should ultimately provide better policyholder protection as well as potentially encourage investment in the insurance market.

We appreciate the efforts being undertaken by the Government and regulator but feel that any review of regulation needs to heavily influenced by the opinions of those who will be required to comply with it. The more feedback that industry can provide, the more effective we can expect the review to be in terms of delivering an improved solvency framework which should benefit all UK insurers in terms of greater efficiency and providing improved protection for their policyholders.

We continue to speak to a wide range of insurers across the UK and abroad about Solvency II developments and how this could impact their business. If you would like to discuss these points further, please get in touch with one of the authors of this Newsflash.

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