CAPCO

PRUDENTIAL REGULATION OF THE INSURANCE SECTOR:

SOLVENCY II REFORM

A CALL FOR EVIDENCE –
SOLVENCY II CONSIDERATIONS FOR INSURANCE FIRMS

BACKGROUND

HM Treasury released a consultation on 19th October 2020 signifying the UK's departure from the European Union (EU) rules, given the current regime is centered on an EU insurance sector the Call for Evidence (CfE) seeks to garner industry views in support of a UK Solvency II model.

The purpose of the review is to assess potential areas for reform of Solvency II, aiding in greater efficiency and effectiveness of the application of the UK prudential regulatory system.

The treasury review of the Solvency II regime forms part of a package of measures for the financial services after Brexit, as unveiled by the UK Chancellor Rishi Sunak earlier in 2020. He stated the review aims to ensure the Solvency II regime is "properly tailored to take account of the structural features of the UK insurance sector".

SUMMARY

HM Treasury outline the current model as being prescriptive and rules-based in nature, advocating that an approach which encompasses judgment and rules could be the right balance to support a more effective operation of the framework once the UK departs from the EU (Brexit).

The CfE consultation is the first step in tailoring the framework for the UK insurance sector. It is worth noting that HM Treasury deem the current model not fit for the UK insurance market. Given the imminency of the UK's departure from the EU, it remains unclear how reforms will be taken forward.

KEY MESSAGE

The consultation emphasises the importance of the UK model aligning with the UK insurance sector, and has three key objectives:

1. To promote a more innovative and competitive insurance sector globally

2. Ensure the safety and soundness of firms whilst affording protection to policyholders

3. Support the provision of long-term capital in pursuit of sustainable growth for insurance firms. Extending to investment in infrastructure, venture capital (VC) and growth equity, long-term productive assets, and consistency with investment in the UK Government's climate change objectives.

AREAS UNDER REVIEW

1. Risk margin (RM)

- The structural design of the risk margin calculation methodology (Cost of capital) is based on an EU insurance sector, the review asks for feedback on how the risk margin could be reformed and adapted to the UK insurance sector as well as the cost and benefits of the existing methodology used to calculate the risk margin

2. Matching adjustment (MA)

- Views are requested from the insurance sector to better understand whether the matching adjustment is operating optimally and if there are barriers in the current process and if the criteria to determine the eligibility of assets and liabilities is appropriate. It is important to note, the call for evidence also seeks views from the industry on the application and approval processes that need to be followed

3. **Calculation of the solvency capital requirement (SCR)**
- The current approach to the SCR calculation is prescriptive and may require reform to align closer to the risk profile of UK insurance firms. The CfE is looking for insurance firms to consider the role that the determination of the SCR can play in support of delivering long-term capital to support growth. This includes investment in infrastructure, venture capital (VC) and growth equity, long-term productive assets, and the role this could play in supporting delivery of the UK Governments climate change objectives including the Green Finance Strategy

4. **Calculation of the consolidated group solvency capital requirement (SCR) using multiple internal models**
- Most insurance groups are required to calculate the SCR at the insurance group level, as well as at the individual insurance firm level

- The group SCR calculation follows a particular set of Solvency II rules where only one group can use the internal model to calculate the group SCR. Under the current rules, this restriction could lead to temporary substantial increases in the group SCR following a merger or acquisition

- The CfE seeks views from the industry in relation to the calculation of the group SCR, with focus on situations where the use of multiple internal models may be more appropriate for the reporting firm

5. **Calculation of the Transitional Measure on Technical Provisions (TMTP)**
- The calculation allows firms to apply a transitional deduction to the value of insurance liabilities in specific circumstances. The review seeks views on whether the technical provisions for the calculation of the TMTP can be improved with consideration to any costs and benefits of changes and whether the TMTP should be integrated into broader transitional arrangements following any reform to the Solvency II model

- TMTP deductions require firms to maintain legacy models, this requirement may become onerous and outdated with model assumptions unreliable leading to greater risk, the review seeks views on what changes could be made to the calculation.

6. **Reporting requirements**
- The review seeks views from the industry in relation to detailed reporting requirements for firms and branches of overseas insurers, and whether these requirements are proportionate to the costs of preparation.

7. **Branch capital requirements for foreign insurance firms**
- The consultation seeks views from the industry on ways the branch regime could be reformed to support overseas entities establishing foreign branches in the UK and improving the application requirements for branches and aid in mitigating the regulatory burden on firms

8. **Thresholds for regulation by the PRA under Solvency II**
- Where most UK insurance firms are in scope for Solvency II regulation, some do not meet the thresholds for regulation and are exempt. The consultation asks for views in relation to small insurance firms who are subject to a simpler prudential framework, and on the scope of the application of Solvency II

9. **Mobilization of new insurance firms**
- The government is keen to understand the industry view on the mobilization of new insurance firms, and whether the existing regime creates any barriers and what key features need to be considered in developing out the regime with new insurance firms in mind

- Additionally, the consultation seeks views relating to when insurance firms are expected to exceed thresholds for size in Solvency II within the first five years of authorisation, and therefore would be subject to Solvency II from the point that they commence operations

10. Risk-Free Rates: transition from the London Inter-bank Offered Rate (LIBOR) to Overnight Indexed Swap (OIS) rates

- With consideration that firms cannot rely on LIBOR from the end of 2021, it has been recommended that the Sterling Overnight Index Average (SONIA) is used as a preferred replacement for LIBOR Sterling market, this may require a legislative and methodological change to the credit Risk Adjustment (CRA) currently applied to LIBOR

- HM Treasury seek views from the industry to understand what factors should be considered as part of the proposed transition of discount curves from LIBOR to OIS rates, and when this transition should be introduced.

CONSIDERATIONS

The call for evidence is a directed effort by HM Treasury to review the UK Solvency II regime, and consideration should be given to the interaction between the Solvency II review and the Future Regulatory Framework Review (FRF).The UK Government should consider how reforms to the UK Solvency II regime will need to be taken forward given the necessity to adapt following the UK departure from the EU. Whilst legislation is pushed for and advantageous for life insurers, who tend to focus on UK customers; commercial insurers who provide insurance for spaceships to Gene Simmons' tongue are keen for the UK rules to have equivalence with those in Europe. Composite insurers will want to ensure there is a balance, but ultimately will be vying for simplification.

With a significant proportion of the CfE focusing on the risk margin and solvency matching adjustment, firms should consider the impact reform to the risk margin could have, with potential to reduce interest rate sensitivity of the Solvency II balance sheet.

Additional consideration should be given to the potential benefits of a reform to the SCR standard formula (SF) calculation, one without as binary an approach to approval as the full internal model. For firms opting to use a mix of the standard formula and internal model for their calculation, management of model risk and governance will be critical to any future reform to the Solvency II framework. Given the current rules allow firms to either calculate SCR on a standard formula or apply to the Prudential Regulation Authority (PRA) for approval to customise the calculation using an internal model, there may be scope to reform the calculation methodologies to alleviate some of the current restrictive elements of firms using an internal model methodology. The merit of any reform to reporting could lead to a harmonised reporting and disclosure framework for the industry, thus reducing the operational burden to prepare multiple layers of reporting.

RECOMMENDATIONS

Firms are continuing to navigate the uncertainty brought by the global COVID-19 pandemic, with the UK financial services effort focused on Brexit readiness, the insurance sector should review operational readiness post Brexit whilst planning for an overhaul to the Solvency II regulatory reporting and disclosures.

Insurance firms should consider the key review points, as outlined by HM Treasury to understand which areas are most relevant for their business. It is important to note, that responses will help shape the future Solvency II UK model, firms' responses should be underpinned by evidence whilst outlining the costs and relative benefits to their business.

The CfE aims to support the UK Insurance Sector, aiding the industry to maintain competitive internationally whilst ensuring policyholder protection, without compromising the safety and soundness of insurance firms.

It is worth noting that whilst firms finalize their preparations for post Brexit operations, they should consider the impact changes to branch capital requirements may have for international firms with UK operations or those looking to operate in the UK in future.

Additionally, life insurers may seek to assess the impact on investment, reinsurance and capital management practices that changes to the risk margin, capital requirements and matching adjustment may pose. With reform to Solvency II in the wake of Brexit, it is imperative for insurance firms to assess their investment in transformation, notably on digital enablement and ways of working which can support efficient change execution and value creation across the organization, particularly with managing reform at scale.

Solvency II came into force on **1 January 2016**

Brexit date **31st January 2020**

A Call for Evidence Consultation **19th October 2020**

Consultation Closes **19th February 2021**

Where the reform remains unclear, it is evident that the insurance sector will need to prepare for an overhaul to the existing regime post Brexit.

Future changes by the Prudential Regulation Authority (PRA), which transpose the Solvency II Directive requirements tailored for a UK insurance industry following Brexit will likely result in commitment by the industry to implement changes in a robust and compliant way.

Following HM Treasury's review of the consultation responses in early 2021, firms should brace for another wave of prudential change and consider their delivery plans and resourcing capability.

INSURANCE PRACTICE

The Insurance industry is facing a number of challenges that include digital transformation, becoming more transparent to stakeholders and utilising ways of working, extracting greater insights and value from data; as well as mitigating the impact of regulatory change and rising cost pressures. Through Capco's focus on enhancing the capabilities and talent, whilst leveraging our long-standing strengths around digital, modern technology architectures, change and data, we have a strong offering to help our clients navigate the challenges and opportunities faced.

To support in your understanding and implementation of the latest Solvency II requirements, Capco's Insurance practice has a team of experts in regulatory and accounting change execution. Our Insurance team has a wealth of experience in supporting clients to meet regulatory reporting and disclosure requirements in an efficient and compliant way.

Our insurance domain offering is underpinned by capabilities within consulting, digital & technology and data, providing an end to end service to unlock value at an enterprise level.

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Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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