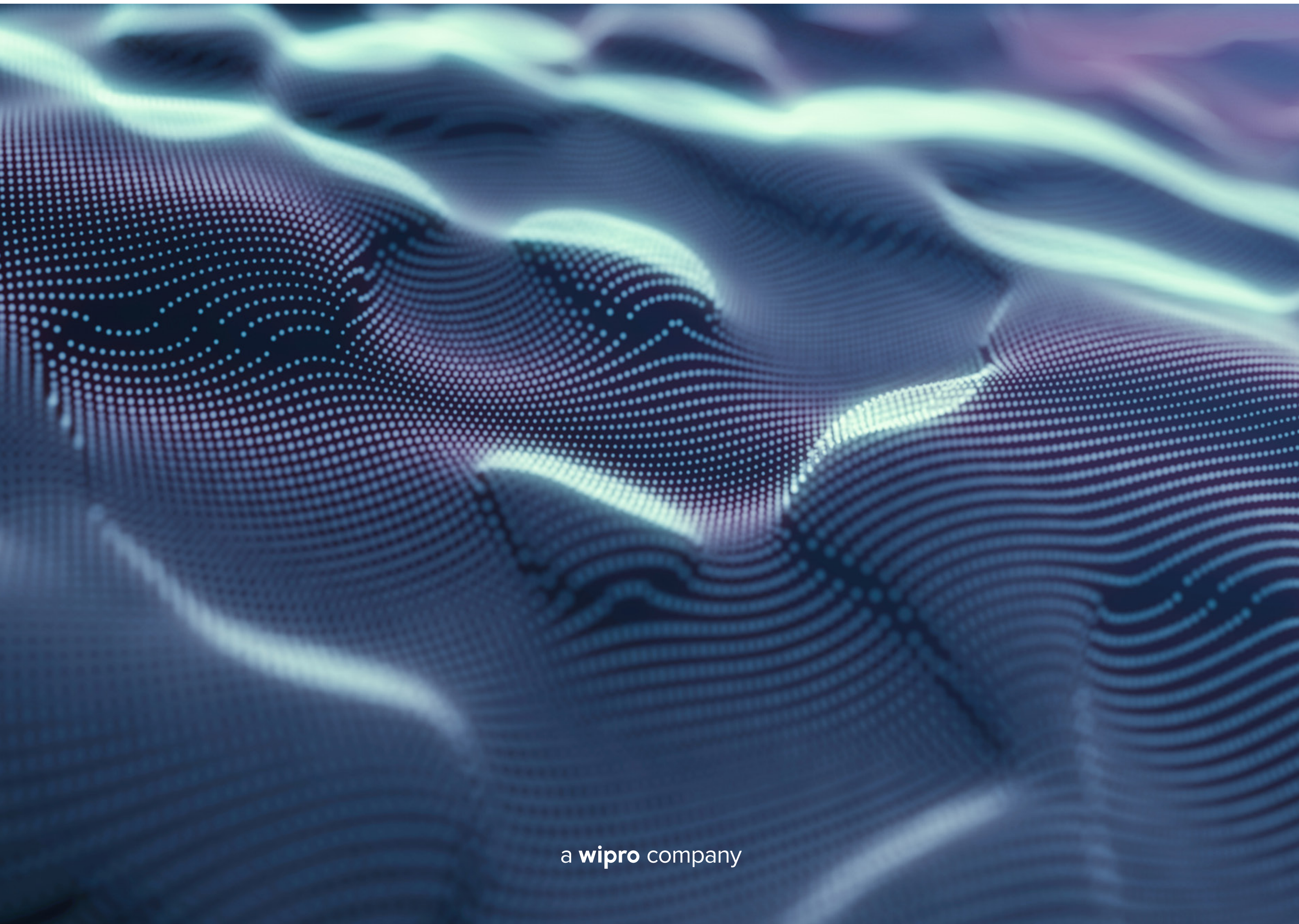
CAPCO

SOLVENCY II: UK REFORM

A CALL FOR EVIDENCE - RESPONSE



a wipro company

BACKGROUND

HM Treasury's (HMT) consultation on 19th October 2020 invited the Insurance industry to review areas of reform to the Solvency II framework towards a UK Solvency II model, as discussed in Capco's paper[1] Prudential Regulation of the Insurance Sector: Solvency II Reform.

HMT have now issued their response[2] in July 2021, and it is worth noting that in alignment with feedback across the insurance sector, the UK Government also agrees with the sentiment that the current Solvency II regime is rigid in areas and welcomes the prospect of reform.

While the insurance industry awaits any official changes to Solvency II, the response from HMT outlines that a simplified, less prescriptive and more proportionate approach to prudential reporting will likely be taken.

SUMMARY

The Call for Evidence (CfE) reviews ten core areas including:

- Risk margin (RM)
- Matching adjustment (MA)
- Calculation of the solvency capital requirement (SCR)
- Calculation of the consolidated group solvency capital requirement using multiple internal models
- Calculation of the Transitional Measure on Technical Provisions (TMTP)
- Reporting requirements
- Branch capital requirements for foreign insurance firms.
- Thresholds for regulation by the Prudential Regulation Authority (PRA) under Solvency II
- Mobilisation of new insurance firms
- Risk-free rates: transition from the London Inter-bank Offered Rate (LIBOR) to Overnight Indexed Swap (OIS) rates.

In summary, the responses across the industry were largely supportive of the Solvency II regime, citing improvements to the risk management and reporting under Solvency II, though noting that certain aspects were overly rigid, and rules based.

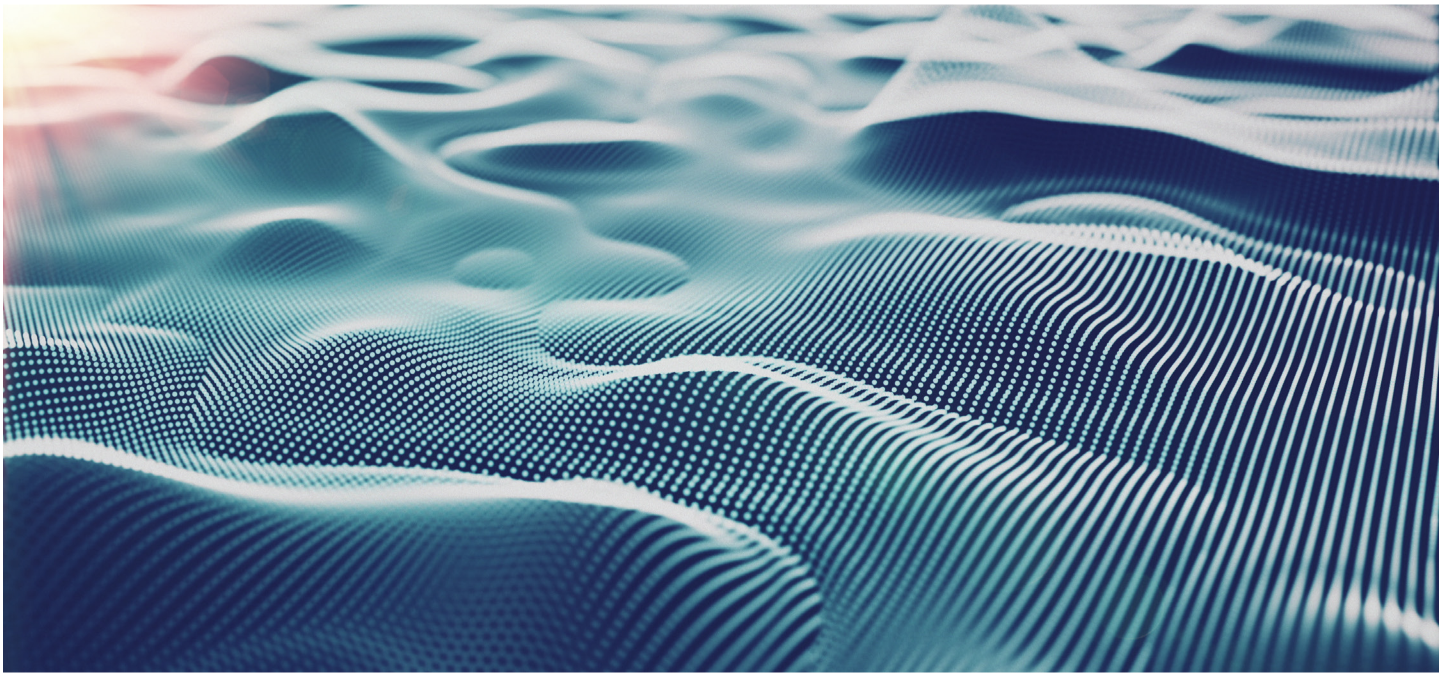
RESPONSE

The majority of respondents indicated they had no desire for a replacement of Solvency II with a different regime, advocating for improvements in the following areas to:

- Reflect the structures and processes of UK insurance firms
- Improve efficiency and effectiveness, removal of requirements that deliver little benefit
- Be more flexible and agile, and less rules-based and prescriptive
- Enable provision of a wider choice of more affordable products
- Enhance competition and better support smaller insurance firms, and entities that may want to become insurance firms
- Reduce supervisory complexity
- Reporting should be streamlined to avoid becoming too onerous and avoid duplication
- Provide guidance on the transition to Overnight Indexed Swap.

While a number of respondents recommended any reforms to the prudential regulatory regime should be considered in parallel with reforms made as part of the Governments Future Regulatory Framework[3] Review for financial services, a small number were against reforms being made to Solvency II which could diverge between the prudential regulatory regimes of the United Kingdom (UK) and European Union (EU).

The Call for Evidence response outlined several areas which could impact insurer's ability to play their part in supporting the economy. The review offers the industry a much-needed opportunity to reform areas that are arbitrary and overly cumbersome.

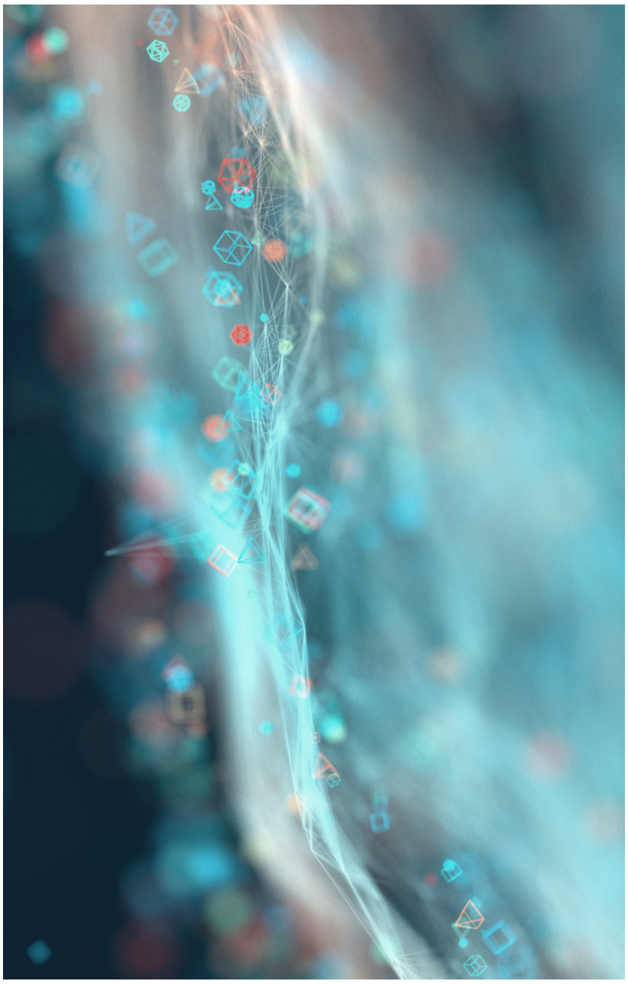


RISK MARGIN (RM)

There was overwhelming consensus from respondents that the risk margin is currently too high and volatile, therefore presenting a strong case for reform in this area. The Government suggest that changes to the risk margin could help to reduce volatility in insurance firms' balance sheets with reforms contributing to a more dynamic and prosperous internationally competitive insurance sector.

With the risk margin playing a key role in policyholder protection, by ensuring liabilities are held on the balance sheet at the value they could be transferred to another business, there is consensus between the Government, PRA and the insurance industry responses to the CfE that the risk margin is volatile and in the current low interest-rate environment is set too high. This results in an unintended distortion and procyclical effect and reform will likely focus on making the risk margin less sensitive to interest rate movement. Firms should bear in mind that any changes to the risk margin would affect reforms to the Transitional Measure on Technical Provisions (TMTP).

In addition to the risk margin, the Government acknowledged responses for reform to the matching adjustment, seeking to make it more proportionate to the benefits and risks for insurance firms.



MATCHING ADJUSTMENT (MA)

The matching adjustment is integral to Solvency II by facilitating an effective market for annuity products, this aids stability on the balance sheet, incentivizing the industry to invest in certain long-term assets. A critical factor with any reform to the MA will be to consider the appropriateness of any calibration of the MA and the range of MA eligible assets.

Changes suggested to address binary and inflexible eligibility requirements included fixed cashflow requirement to more principals based as well as a sandbox concept to invest in less traditional assets in matching adjustment portfolios. In addition to responses suggesting changes to eligibility requirements, the industry cited ways to improve the calculation and approval process of the matching adjustment. Furthermore, responses from industry also recommended changes to better reflect emerging climate change risks or indeed the matching adjustment should better support sustainable investments.

SOLVENCY CAPITAL REQUIREMENT (SCR)

With respondents supporting the risk-based nature of the framework, there were diverging views on the 1 in 200 Value at Risk (VaR) over a one-year horizon calibration standard with respondents commenting that the a “to ultimate” time horizon for the SCR would be more useful for non-life firms and more consistent with standard actuarial techniques.

Some respondents suggested making use of stress testing across the entire SCR distribution, extending its use to insurance firms that use the standard formula, whilst some opposed this approach. One of the key messages was that requirements for Solvency II do not create onerous activities for Insurers in calculating the SCR or the model application process. It is also worth noting that some feedback from the industry suggested placing more reliance on ensuring accountability through the Senior Manager Certification Regime.

Most responses advocated for principles-based rules and to improve proportionality in implementation approaches, additionally many respondents supported recalibration of the standard formula (SF) to reflect UK insurance firms risk profiles with some citing SF calibration issues as barriers to investing in long-term productive assets.

OTHER AREAS

With many firms advocating for the removal of branch capital requirements for foreign firms, many suggested that the prudential supervision of branches of foreign insurance firms should have a high degree of recognition of home state supervision of the whole insurance firm.

Responses differed in relation to thresholds for regulation by the PRA under Solvency II, with some suggesting thresholds should be increased and others considering they should not.

A standout response regarding reporting requirements was for reforms to the volume of data submitted to reduce the burden on reporting institutions and to look at streamlining reporting requirements to avoid duplication between Solvency II templates and Accounting Disclosures.

Another key area of review was on the transition from LIBOR to OIS, in support of a smoother transition responses suggesting transition could be for firms to choose a blend of LIBOR and OIS risk free rate curves over a period throughout 2021, with responses varying on the timing of the transition.

In addition to the above, other areas outlined in responses from the industry included issues with contract boundaries, risk mitigation techniques and the treatment of with-profits funds.

NEXT STEPS

The Government has in this response confirmed both that the evidence for reform is compelling, and the specific areas being considered for reform.

The Government has provided this evidence to the PRA and asked them to model various options to understand which best meets their objectives. To develop these options the PRA has launched a Quantitative Impact Study (QIS)[4] which is in progress. This will inform a comprehensive package of reforms to be published in early 2022. Invites have already been issued for this study, however firms who believe they have an interest may apply to join and should do so where relevant.

Changes to regulatory supervision for a reformed Solvency II will also be considered as part of the Government's Future Regulatory Framework (FRF). Due later in 2021, this will define regulatory objectives, principles, and accountability defining a framework the PRA must have regard to establishing and maintaining a Solvency II regime.

CONSIDERATIONS

Given the volume and consistency of responses it is clear that significant changes are being considered within the areas of risk margin, solvency capital requirements, reporting, and regulatory application.

The government has clearly acknowledged the benefit in streamlining reporting requirements. The PRA should consider where there are opportunities to rationalise the various reports required between Solvency II and other accounting disclosures including IFRS 9/17 and GAAP. As well, they should consider technical changes to the risk-free rate as LIBOR is discontinued at the end of 2021.

Though the specific changes to the risk margin being considered are as yet unclear, these changes will likely impact reforms being considered to the TMTP calculation, as well as requiring amendments to the delegated authority codified by the EU Commission Delegated Regulation 2015/35.

Firms should be aware therefore that these changes are likely to have significant impacts on how they treat capital, investment spend, and their existing reporting and disclosure structures. More broadly this response demonstrates government appetite for a shift from a heavily rules-based approach to a judgement-based regime. With a greater emphasis on judgement, both firms and the regulator will need to consider how requirements are understood, and how any changes in approach are clearly communicated. This should be included in the scope of the FRF, and firms should ensure that this does not become an obstacle to ongoing regulatory compliance.

Beyond pursuing implementation 'as soon as possible,' an indicative timeline for these changes has not been published and is unlikely before early 2022. In setting a timeline, the government should consider the onus placed on firms to implement these changes against the backdrop of existing requirements from IFRS 9/17. Firms should also consider the wider business impacts from these changes and begin

to make allowances within resource and budget planning to avoid additional pressure on BAU processes and reporting infrastructure.

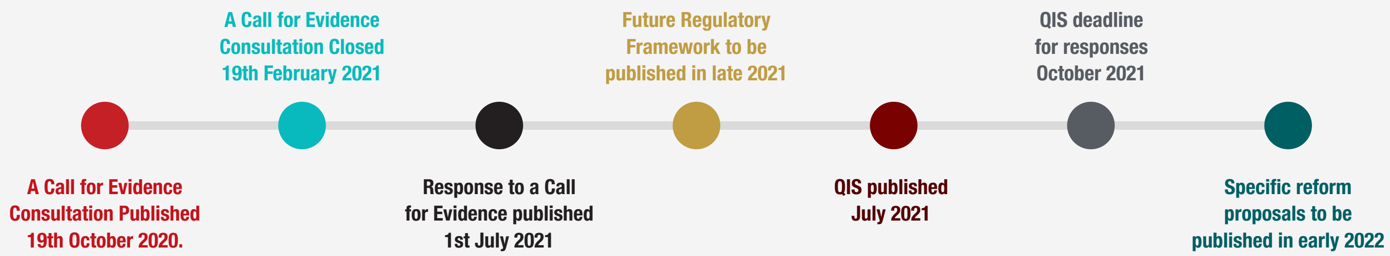
A stated aim of the review has been to support insurance firms providing long-term capital to underpin growth. Firms should therefore consider how these changes could impact their investment spend in the future. In particular, the proposed amendments can be seen in light of the government's goal of encouraging climate change investment through incentivising long-term investments, and allowing the more efficient use of capital.

RECOMMENDATIONS

As firms continue to navigate the uncertainty brought by the global Covid-19 pandemic, and the implications of Brexit, the Insurance sector should plan for an overhaul of the Solvency II regulatory reporting and disclosures. Insurance firms should consider the key reform points as outlined here, and understand which areas are most relevant for their business.

Firms that have been invited to respond to the QIS should take the opportunity to do so, and prioritise resource to ensure the reforms fully incorporate the feedback received and are practicable. If you have not received an invitation however believe it to be in your firm's interest to be involved, the government has asked for applications by contacting insurancedata@ bankofengland.co.uk. Further details on the QIS can be found online[5].

TIMELINE



CAPCO'S INSURANCE PRACTICE

The Insurance Industry is faced by a number of challenges including digital transformation, increased expectations of transparency, ways of working, the increasing role of data, as well as mitigating the impact of regulatory change and rising cost pressures. Through Capco's focus on enhancing capabilities and talent, alongside existing strengths in digital and modern technology architectures, Capco has developed a strong offering to help clients navigate these challenges and opportunities.

To support 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 efficiently meeting regulatory-mandated reporting and disclosure requirements.

Our Insurance domain offering is underpinned by our capabilities within consulting, digital, technology, and data, providing end-to-end services to unlock value at an enterprise level.

SOURCES

1. Christine De Marco, Bhavesh Mulji. “Prudential Regulation Of The Insurance Sector Solvency II Re Form” CAPCO. December 7, 2020. https://www.capco.com/Intelligence/Capco-Intelligence/prudential-regulation-of-the-insurance-sector-solvency-ii-re-form

2. “Review of Solvency II: Call for Evidence - Response” HM Treasury. July 2021. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/998396/Solvency_II_Call_for_Evidence_Response.pdf

3. “Future Regulatory Framework (FRF) Review: Consultation” HM Treasury. October 19, 2020. https://www.gov.uk/government/consultations/future-regulatory-framework-frf-review-consultation

4. Charlotte Gerken. “Letter from Charlotte Gerken ‘Gathering data for the Solvency II Review’” Prudential Regulation Authority. July 20, 2021. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2021/july/letter-from-charlotte-gerken-gathering-data-solvency-ii-review.pdf?la=en&hash=C8F5FE4004B70BC04FDF46C8E1C776C7F8B57270

5. “Review of Solvency II: Quantitative Impact Study (QIS)” Bank of England. https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/solvency-ii/solvency-ii-reform-quantitative-impact-survey

AUTHORS

Christine De Marco
Bhavesh Mulji

Contributor:
Steven Eldridge

CONTACTS

Somnath Ghosh, Partner, London
T: +44(0) 7557 631 469 **E:** somnath.ghosh@capco.com

Matt Hutchins, Partner, London
T: +44(0) 7885 828 120 **E:** matthew.hutchins@capco.com

ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

To learn more, visit www.capco.com or follow us on Twitter, Facebook, YouTube, LinkedIn Instagram, and Xing.

WORLDWIDE OFFICES

APAC
Bangalore
Bangkok
Gurgaon
Hong Kong
Kuala Lumpur
Mumbai
Pune
Singapore

EUROPE
Berlin
Bratislava
Brussels
Dusseldorf
Edinburgh
Frankfurt
Geneva
London
Munich
Paris
Vienna
Warsaw
Zurich

NORTH AMERICA
Charlotte
Chicago
Dallas
Hartford
Houston
New York
Orlando
Toronto
Tysons Corner
Washington, DC

SOUTH AMERICA
São Paulo

WWW.CAPCO.COM

CAPCO
a wipro company

JN_3657