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GOVERNMENT ISSUES SOLVENCY II CALL FOR EVIDENCE

A significant overhaul of solvency legislation is expected

By Amera Dooley (Senior Associate Knowledge Lawyer)

On October 19, HM Treasury issued a "call for evidence", which seeks industry views on how to tailor Solvency II to better support the unique features of the UK insurance sector.

Solvency II, as implemented in 2016, followed a maximum harmonisation approach designed to cover the entire EU insurance market. As such, it would be problematic to adjust Solvency II at an EU level to reflect certain specific features of the UK market. Once the transition period ends, the UK will no longer be constrained by the EU legislative framework and, in issuing the call for evidence, the government is confident it will have the legal remit to alter some aspects of Solvency II to encourage growth in the UK and new market entrants.

The call for evidence signals the UK's departure from EU rules without waiting for an EU confirmation of Solvency II equivalence. Presumably, by the time the Treasury gets feedback from the EU on the UK's equivalence position, this will influence the eventual approach to the UK's revisions of Solvency II.

Although the Treasury deems the prescriptive model inherited under Solvency II not fit for the UK, it is not clear as yet how any reforms will be taken forward, although a significant rewrite of onshored legislative material is expected.

The Treasury is looking at improving the standard formula, which could mean greater use of adjustments and insurers avoiding the more complex internal model route. For an internal model, easier requirements and approval processes with more flexibility in the internal model design are being considered. The Treasury is also looking to give the Prudential Regulation Authority (PRA) more flexibility in how it applies both methods.

Reporting

Other notable areas of reform include reviewing reporting requirements, where the Treasury is seeking views on the benefits versus the costs of the existing reporting requirements, including whether existing reporting waivers could be extended.

Perhaps to allow the UK to remain a "hub" for insurance after Brexit, the Treasury is seeking views on whether to reduce the regulatory burden for branches of foreign firms operating in the UK, including the possibility of removing capital requirements. The Treasury and the PRA, given its new insurer start-up unit (NISU), are keen to improve the mobilisation of new insurers and seek views on a proportionate regime which reduces barriers for new entrants.

Given the PRA's representations to the Treasury Select Committee on Solvency II back in 2018, it is no surprise the first item mentioned is the risk margin, the additional capital buffer insurers hold for non-hedgeable risks. As the call for evidence notes, UK life insurers that underwrite significant quantities of long-term life business with guarantees, such as annuities, are disproportionately affected by the Solvency II methodology used to calculate the risk margin.

The risk margin has also been criticised for being too volatile, especially when interest rates are so low. The call for evidence does not set out a solution for the risk margin, but asks for views on "the preferred means of modifying the current 'cost of capital' approach". Affected insurers should, therefore, forward proposals especially if another methodology is preferred.

Another area under review is the matching adjustment. Under existing rules, the matching adjustment is restrictive in the types of liabilities and assets that qualify, with the Treasury now exploring the possibility of loosening eligibility requirements. The costs and complexities of restructuring assets so they qualify for the matching adjustment also acts as a barrier to its use by smaller firms.

Once the Treasury has reviewed the feedback, it is expected to consult in the first half of 2021 on changes which require amendments to onshored legislation, primarily the Solvency 2 and Insurance (Amendment, etc.) (EU Exit) Regulations 2019. Changes are also to be expected to be made to PRA rules, as these transpose the Solvency II Directive requirements. A significant overhaul of onshored Solvency legislation is expected and will be made in light of the reforms of UK legislation initiated by the Future Regulatory Framework Review and which is currently considering how the UK's regulatory framework for financial services could be adapted for the UK's post-Brexit future.

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