CLIFFORD CHANCE

REVIEW OF SOLVENCY II: CALL FOR EVIDENCE – RESPONSE

On Thursday 1 July, HM Treasury ("**HMT**") published a response to its Call for Evidence (the "**Response**") issued on 19 October 2020. Overall, the Response shows the government agreeing that many aspects of Solvency II are overly rigid. Both the government and the UK insurance industry desire a revised regime that allows insurers to provide long-term capital to the economy, including investment in long-term assets and investment consistent with the government's climate change objectives. Despite no proposed changes yet, the Response shows the governments wish to move toward simpler, less-prescriptive regulation with greater scope for supervisory judgment.

'Judgement-based' supervision is already a key aspect of the Prudential Regulation Authority's ("**PRA**") supervisory approach, but this judgement is constrained by the heavily rules-based Solvency II regime. A large-scale deletion of Solvency II rules is unlikely. Instead, the Review raises the possibility of greater flexibility on the PRA judgement with greater latitude expected to be introduced through new 'activity-specific' regulatory principles in the Financial Services and Markets Act 2000 ("**FSMA**"). These proposals are being consulted in Phase II of the Future Regulatory Framework ("**FRF**") Review, which runs parallel to the Solvency II reforms.

BACKGROUND

The Call for Evidence is the first stage of the review of Solvency II legislation, which the UK government announced back in June 2020. The Call for Evidence follows the government's post-Brexit aim to improve the efficiency and effectiveness of the UK's prudential regulatory regime and so allow it to better recognise the unique features of the UK insurance sector.

The UK insurance sector, including life and non-life insurers, reinsurers, trade bodies and law firms (including Clifford Chance), engaged well with the Call for Evidence as shown by the 64 responses received by HMT. Respondents were strongly supportive of the Solvency II regime generally, not least because of the cost and disruption to replace it in full. They welcomed the enhanced standards of risk management and reporting and the overall standard of prudential supervision. However, there is a desire for an evolution of Solvency II to reflect more closely the specific structures and processes of UK firms and the shape of the UK market. There is also a request for increased flexibility to allow for innovation, improved market access, better proportionality and to enhance competition. Respondents supported the Review's objectives, including support for a vibrant, innovative and internationally competitive insurance sector in UK, protection of policyholders and financial soundness of firms and enabling insurers to provide long term capital to support economic growth in the UK.

The government agrees with the evidence supplied in the responses that many aspects of Solvency II are overly rigid and rules based and the Response confirms the objective of government to create a prudential regulatory regime which is more flexible and proportionate, including a mix of rules and judgement so that it can be applied more efficiently by firms and the regulator to achieve the desired outcomes. HMT acknowledge that there are links and dependencies between the various areas where reforms may be made, and it will be necessary to assess the overall impact of the various individual proposals. Annexes A-K of the Response summarises responses to the Call for Evidence and we discuss some of the key items below.

RISK MARGIN

The Response reports a consensus in the responses that the risk margin is currently too high and too volatile, both unforeseen consequences from its design, particularly at current low-interest rates. It has a particularly severe impact on annuity writers and has resulted in extensive reinsurance of longevity risk offshore. In principle, the government agrees that there is a strong case for reform. Several methods for reforming the risk margin were proposed by respondents and are summarised in the Response, including reducing the current 'cost of capital' parameter in the existing methodology, incorporating a time-sensitive component (a 'lambda' factor) in the risk margin methodology, treating longevity risk as a 'non-hedgeable' risk in Solvency II and adopting the percentile methodology known as the Margin Over Current Estimate ("**MOCE**") in the Insurance Capital Standard that is currently under development by the International Association of Insurance Supervisors ("**IAIS**"). We expect the PRA to test the effect of the various proposals in the quantitative impact study (QIS) which it will undertake during this summer.

Although most respondents did not express a clear preference on the method to be used for risk margin reform, we would expect the chosen method(s) of reform to result in amendments to Commission Delegated Regulation (EU) 2015/35 as it forms part of the domestic law of the UK under the European Union (Withdrawal) Act 2018 ("**EUWA**"). Reforms to the risk margin would also impact any reforms planned for the Transitional Measure on Technical Provisions ("**TMTP**").

MATCHING ADJUSTMENT

Many respondents support the principles of the matching adjustment and its continued use in the prudential regime. However, the current restrictions on eligible assets are a barrier to broader investment by insurers in the UK economy. Given the government push for greater infrastructure investment and combatting climate change, HMT will probably seek to loosen the criteria for the eligibility of different asset classes for the matching adjustment portfolio and allow a little more flexibility regarding the definition of assets "matching" liabilities. As there are different options proposed for altering the criteria, which are elaborated in the Response, we expect the PRA also to test these in the QIS.

The government and respondents agree that the application process for the matching adjustment and for subsequent changes to the portfolio needs to be less onerous and proportionate to the benefits and risks for insurers of applying the matching adjustment. Revisions to the process and forms to be submitted should be achievable quickly and without any significant amendment to regulations or rules.

SOLVENCY CAPITAL REQUIREMENT

The government agrees in the Response that the framework for the calculation of the solvency capital requirement for insurance firms – whether they use the standard formula or an internal model – needs to operate efficiently and effectively. Potential reforms need to ensure that the requirements in Solvency II do not place disproportionate burdens on insurers, either with the calculation of the solvency capital requirement or model application processes. Although HMT does not specify in the Response which capital reforms are likely to be adopted, HMT acknowledges that a better tailored standard formula approach could reduce the current pressure to adopt an internal model and has indicated that the PRA will examine the use of capital add-ons as a tool to ensure that capital levels are appropriate.

HMT and the PRA will probably reform the application process for internal models, possibly including implementing a faster assessment by shortening the six-month statutory review period. A reduction in documentation requirements is another 'quick win' and should help the PRA to set out a more tailored and proportionate approval and supervision process for internal model firms.

OTHER AREAS

The Response identifies several other potential areas of reform to Solvency II. On reporting, the government acknowledges the benefit in streamlining reporting requirements and notes the associated cost, complexity and 'burden' involved in preparing reports under the current regime. The PRA will likely look to avoid potential duplication between the various regulatory reports required under Solvency II, and between Solvency II reports and other accounting disclosures (including International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Principles (GAAP)). In addition, firms should expect technical changes to the risk-free rates (used by insurance firms to discount their liabilities) when the

London Inter-bank Offered Rate (LIBOR) is discontinued. The PRA announced further details on these issues on 3 June 2021.[1]

The Response confirms branch capital requirements for foreign insurance firms will be reconsidered given the costs they can entail and given other ways available to ensure effective supervision of such branches. There appears to be a recognition that as branches are not separate undertakings, it is rather artificial to ask insurers and their branches to calculate branch-specific capital requirements and then retain own funds to meet them. Removing somewhat protectionist branch capital requirements and focusing more on the quality of home country supervision of the entity as a whole will likely make it easier and more attractive for third-country insurers to set up operations in the UK.

Other notable areas of reform include the mobilisation of insurance firms and thresholds for the application of Solvency II. The Response shows a consensus between the government and industry that Solvency II contains significant barriers to new market entrants, with many respondents citing the complexity and associated cost of compliance. While HMT appears to agree that firms should be appropriately supervised whatever their size, the UK supervisory system appears historically to have adopted a somewhat heavy-handed and conservative approach to the Solvency II regulation. This is despite the overarching 'proportionality principle' contained in Solvency II and recognised by HMT and PRA which specifies that supervisory requirements should be proportionate to the nature, scale and complexity of the risks faced by insurers. We expect HMT and the PRA to reconsider how the UK applies the 'proportionality principle' when assessing changes to Solvency II's scope of application and the practical application of Solvency II based principles in the future.

NEXT STEPS

The government confirms in the Response that the evidence base for reform in the above areas is compelling and that the responses confirmed the government's view of the priority areas. The reforms to Solvency II will be further informed by a second FRF review consultation due later in 2021. A key aspect of the FRF review is determining changes to regulators' objectives, principles and accountability arrangements. In line with this, we expect HMT to set out further FSMA requirements that the PRA must adhere to when amending elements of Solvency II in its Rulebook. The government may also set out what the PRA must have regard to when establishing and maintaining the revised Solvency II regime.

The PRA QIS this summer will model the impact of different options for risk margin, matching adjustment and capital requirements to better understand which reforms would best meet the government's objectives and what the aggregate impact of the various reforms would be. The study will then inform a comprehensive package of reforms expected for consultation in early 2022. Unless specific changes are made earlier, the PRA's transactional direction which delays to onshoring changes in its Rulebook until 31 March 2022, will continue to apply.

[1] https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor

CONTACTS

Ashley Prebble
Partner

T +44 20 7006 058
E ashley.prebble@cliffordchance.com

Narind Singh
Partner

T +44 20 7006 4481
E narind.singh@cliffordchance.com

Cheng Li Yow
Partner

T +44 20 7006 8940
E chengli.yow@cliffordchance.com

Katherine Coates
Special Counsel

T +44 20 7006 1203
E katherine.coates@cliffordchance.com

Amera Dooley
Senior Associate
Knowledge Lawyer

T +44 20 7006 6402
E amera.dooley@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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