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SOLVENCY UK: THE LIABILITY VALUATION PACKAGE AND MOBILISATION REGIME FOR INSURERS

In June 2020, the UK Government announced an overhaul of insurance regulation dubbed 'Solvency UK' in a bid to increase flexibility and unlock capital for investment by insurers. Despite a Call for Evidence in October 2020 and a Feedback Statement in July 2021, no further details emerged. This was until a speech to the Association of British Insurers ("**ABI**") in February 2022 in which the Economic Secretary to the Treasury & City Minister, John Glen, announced the UK's direction of travel towards greater regulatory divergence from the EU in the following areas: the risk margin; the matching adjustment; and more generally, a reduction in reporting and administrative requirements.

PROPOSED REFORMS

At the end of April 2022, HM Treasury ("**HMT**") published a consultation paper that outlines Solvency UK proposals, including a more developed 'liability valuation' package for reform of the risk margin and the matching adjustment with a new 'mobilisation regime' also proposed. On the same day, the Prudential Regulation Authority ("**PRA**") published Discussion Paper DP2/22 which assesses HMT's proposals, particularly on the 'liability valuation' package.

The current proposals are in line with the Government's aim for Solvency UK to be "appropriately tailored" to the UK insurance market and appear generally well-received by the industry. As HMT and the PRA seem confident that the net effect of the proposals will release capital for the industry and with the ABI estimating that around that c£95bn of UK insurers' assets could be repurposed to support long-term productive finance initiatives, there is an expectation that Solvency UK will support the Government's other ambitious aim, that of increased investment by insurers in UK assets, in particular, infrastructure assets and green investments to help the UK's climate change objectives. Another complementary objective is to promote the international competitiveness of UK insurance firms, with the Government's Future Regulatory Framework ("**FRF**") Review (this is running concurrently with the Solvency II review) proposing the introduction of new secondary objectives for the PRA and the FCA. It remains to be seen whether Solvency UK will provide for a more competitive regime, given the PRA focus on financial stability and

Key points

- A proposal to reduce the Risk Margin by 60% to 70%, achieved by modifying the existing “cost of capital” approach. The PRA target a 60% reduction for Life and 30% for Non-Life Insurers.
- The benefit of the reduced Risk Margin being partially offset by an increase in the Fundamental Spreads, potentially reducing the current benefit of Matching Adjustments.
- The Fundamental spreads will become more sensitive to changes in credit spreads, with the PRA proposing an addition of at least 35% of the spread which will need to be reflected in internal models.
- Proposals to make the UK more attractive to foreign insurers, including removing local capital requirements and need to hold local assets for branches of foreign insurers.
- A 'mobilisation regime' to allow new insurers to take advantage of modified entry requirements such as a lower capital floor and modified governance and reporting requirements.

policyholder protection rather than economic aims, with an obvious tension between the PRA's primary 'safety and soundness' objective and a new secondary competitiveness objective.

A summary of the key reforms includes:

- A reduction in the risk margin of around 60 to 70% for long-term life insurers.

No detail on the source of the percentage reductions is given but, presumably, these are based on firm responses to the PRA's Quantitative Impact Study ("**QIS**") and Qualitative Questionnaire launched in July 2021. There is a recognition by HMT that the current risk margin methodology can overstate the market value of a firm's liabilities, particularly in low-interest-rate environments. The reduction is greater for the life sector since the adverse effects of the risk margin are more pronounced for life insurers than general insurers, with a more modest reduction of 30% expected for general insurers since they do not typically hold long-term liabilities that result in a high and volatile risk margin.

The reduction in risk margin is intended to free up capital for UK life insurers to write more new business and is also likely to reduce the benefit of using offshore reinsurance as a capital management tool which harms the UK economy. Reduction in size of margin also addresses to some extent the concerns about its volatility, particularly if coupled with changes to the basis of calculation. HMT suggests that the size and volatility of the risk margin could be reduced using either a modified cost of capital methodology or the Margin over Current Estimate model used in the Insurance Capital Standard ("**ICS**") set by the International Association of Insurance Supervisors ("**IAIS**").

In perhaps an indication of the outcome, both HMT and PRA agree that the modified cost of capital approach is the preferred approach. Several reasons for this preference are given, including the modified cost of capital approach being: sensitive to the significant differences in risk profile and liability duration across the population of UK insurance firms; less disruptive for firms as current systems would only need slight adaptation; comparable with the revised risk margin methodology being proposed for use in the EU (which benefits insurers with a presence in both the UK and EU) and; a clear theoretical link between the risk margin formula and the concept of the risk margin as the amount needed to facilitate a recapitalisation or transfer to a third party.

- A reassessment of the fundamental spread of the matching adjustment.

The matching adjustment provides relief for insurers who hold long-term assets which match the cash flows of similarly long-term insurance liabilities. When insurers invest in long-term assets they are exposed to credit, illiquidity, and other residual risks. The fundamental spread part of the matching adjustment calculation is intended to capture these retained risks, and the higher the fundamental spread, the lower the matching adjustment benefit.

As HMT notes, there is no consensus on how the fundamental spread should be reformed. However, HMT proposes changing the calibration of retained risks in the fundamental spread with the PRA agreeing that such reform is needed. The PRA point out that issues with the fundamental spread mean there is a risk that the matching adjustment benefit currently being taken by firms is too high. The PRA argues that this is since insurers' investments have changed over time and the proportion of investment assets rated and valued by insurers themselves has increased.

HMT outlines a revised fundamental spread methodology that incorporates market measures of credit risk including a credit risk premium ("**CRP**") i.e., the premium a willing arm's length third party would demand for taking on expected loss due to a default. The PRA agree with the inclusion of a CRP and specifies in DP2/22 the various ways this could be achieved in practice, with a suggestion of a CRP calibrated at a minimum of 35% of credit spreads. Whilst this change is likely to be more tailored to the portfolio held by an individual insurer it is currently difficult to judge what impact the revised methodology will have on existing portfolios and what changes will be required to internal models to reflect it. Feedback is sought in both papers on the likely impact of the proposals on individual insurers.

- Flexibility to allow more investment in long-term assets.

HMT explains that reform of the fundamental spread so that it better measures credit risk in respect of the different types of matching assets actually held in the portfolio should increase confidence in the suitability of a wider variety of assets for inclusion in matching adjustment portfolios. Therefore, flexibility in the treatment of such investments is proposed, including (but not limited to): broadening the range of assets eligible for the matching adjustment portfolio, extending the range of liabilities eligible for the matching adjustment, introducing a more proportionate approach to matching adjustment breaches and greater flexibility for how innovative assets are treated.

As the PRA note in DP DP2/22, the package of matching adjustment reforms would make it easier for insurers that wish to place these new assets or redeploy their existing assets into investments which support growth, infrastructure, and the transition to net-zero, despite limited capital incentives to assist this. As the PRA also note, insurers are free to choose how to use any capital released from the risk margin and matching adjustment reforms. If they choose to use it to support the writing of new business, the PRA's preliminary assessment is that a package of a c.60% risk margin reduction and fundamental spread with a 35% CRP could support between £45bn and £90bn of new business, and therefore investment from the insurance sector. There is inherent uncertainty around these estimates, not least because insurers could choose to return some of the released capital to shareholders. HMT asks in its consultation how the regulator might prevent this from happening.

- A reduction in the reporting and administrative burden, and a new 'mobilisation regime'.

For reporting, HMT proposes simplifying particularly complex templates, reducing the reporting frequency of some templates, deleting others, and making other templates more appropriate for the needs of the UK market. HMT has noted criticism of the UK's lengthy and burdensome authorisation process and it hopes that with lower regulatory requirements (but with proportionate restrictions on the firm's activities), new entrants will find the UK a more welcoming regulatory environment.

This vision is supported by reforms to remove requirements for branches of foreign insurers to calculate local capital requirements and hold local assets (foreign insurers are not defined but we assume this proposal applies to insurers from all countries, not just to the EU or other equivalently regulated countries), increasing the thresholds before UK Solvency II requirements apply, and simplifying the calculation of Solvency II transitional measures. If HMT does not make similar provisions for local insurers, there is a possibility that the third country branch changes will create advantages for branches over UK insurers and/or local UK subsidiaries of international groups. UK insurers presumably will not get similar benefits if they operate EU branches, so firms may query why the UK is taking this approach? HMT answer this by explaining that the reforms are intended to not only increase the UK's attractiveness to branches of foreign insurers but also to help to boost competitiveness and competition in the UK market.

A new 'mobilisation regime' for new firms is proposed. This would allow a new insurer to take advantage of modified entry requirements such as a lower capital floor and modified governance and reporting requirements. This would be accompanied by some restrictions on the firm's activities during this (time-limited) mobilisation phase. HMT suggests that this could enhance competition by making it easier for start-up firms to obtain authorisation and thus attract capital and innovation to the UK.

NEXT STEPS

The deadline for the HMT consultation and the PRA's Discussion Paper is 21 July 2022. A response by HMT/PRA to the current consultations in terms of introducing the relevant provisions will to an extent be driven by the progress of the Government's FRF Review for which consultation closed on 9 February 2022, with a response now awaited. The FRF Review will indicate the aspects of Solvency UK to be set out in legislation, but with most requirements expected to be in PRA rules. In the meantime, the PRA is currently working on Phase 2 of its review of reporting requirements for insurers, with the publication of a consultation paper expected in late summer 2022.

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