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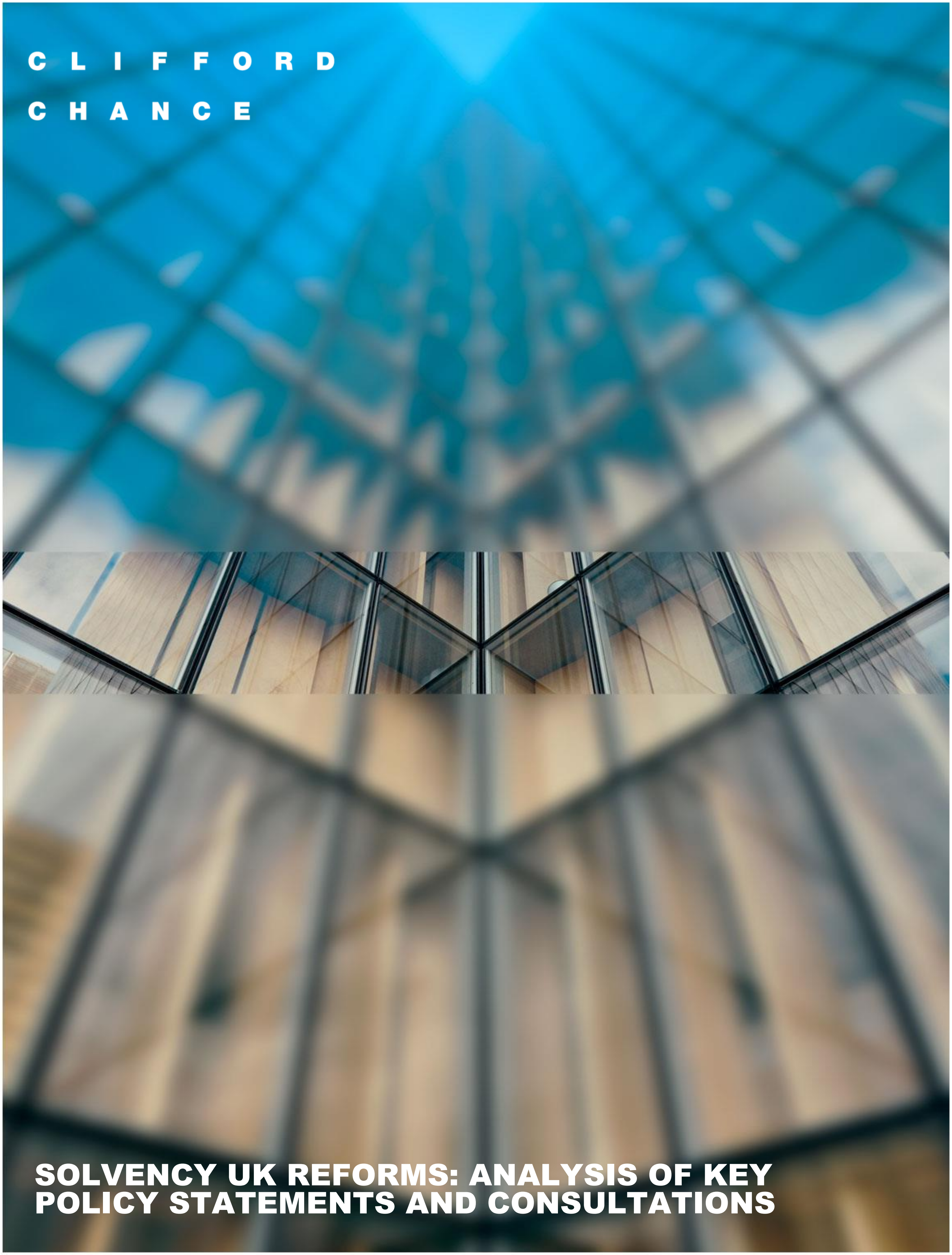

SOLVENCY UK REFORMS: ANALYSIS OF KEY POLICY STATEMENTS AND CONSULTATIONS

Contents

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1. Introduction

Overview of Developments

As part of the ongoing reform of Solvency II, on 28 February 2024, the PRA published Policy Statement PS2/24, which sets out near-final rules and updated policy materials relating to Consultation Paper CP12/23, and summarises the feedback on the proposals outlined in its June 2023 Consultation Paper CP12/23 and Policy Statement PS3/24.

On 29 February 2024, the PRA then released a separate Policy Statement PS3/24 on the reporting and disclosure phase. This incorporates feedback from two consultations: Consultation Paper CP14/22 ("Review of Solvency II: Reporting phase 2") (which received 18 responses), and Chapter 7 ("Reporting and disclosure") of CP12/23 ("Review of Solvency II: Adapting to the UK insurance market") (28 responses). The PRA has, since publishing the consultation amended the final policy to reduce "the reporting and disclosure burden" where respondents demonstrated that insurers' costs would outweigh the supervisory benefit to the PRA.

On 15 April 2024, the PRA issued a statement to clarify certain points from the Consultation Paper CP19/23 on Solvency II Matching Adjustment (MA) reforms. This consultation paper, published on 28 September 2023, closed on 5 January 2024, with the PRA currently planning to issue a policy statement with final rules in early June. The points raised in that statement are also outlined in this briefing.

On 22 April 2024, the PRA followed up with Consultation Paper CP5/24. This is the final PRA consultation needed to implement the conclusions of the Solvency II review and to finalise the PRA rules and other policy materials that will replace Solvency II-assimilated law. While this consultation focused on the restatement of assimilated law without changing the policy, the PRA has identified a small number of areas where they believe policy changes are warranted; these are set out in this briefing. Responses to the consultation are requested by 22 July 2024.

Both policy statements and the live consultation are part of the wider Solvency II reforms being developed on a phased-implementation basis by the PRA and HM Treasury (HMT). These reforms aim to ensure that the UK regime remains fit for purpose for a more competitive and dynamic UK insurance sector while maintaining high standards of policyholder protection. The new UK prudential regime for insurers will eventually be known as "Solvency UK".

- ### Key Developments

The key developments are as follows:

- **December 2023:**
  - Revised **Risk Margin requirements** came into effect through:
    - HMT legislation, namely the Insurance and Reinsurance Undertakings (Prudential Requirements) (Risk Margin) Regulations 2023, on 31 December 2023; and
    - PRA Rulebook updates, through consequential amendments published in PS12/23 on 19 December 2023 to ensure alignment with the regulations.

- **First half of 2024:**
  - The transfer of:
    - the remaining firm-facing Solvency II requirements from assimilated law into the PRA Rulebook and other policy materials, with the third and final consultation paper CP5/24 and final rules to be implemented by 31 December 2024; and
    - EIOPA guidelines (where appropriate) into PRA policy materials in the future, where such guidelines were not considered in CP12/23.
- **June 2024:**
  - The final policy on **MA reforms** will be published. This builds upon CP19/23, the second Solvency UK consultation paper launched in September 2023.
  - HMT legislation on the MA, namely the Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023, will come into effect on 30 June 2024.
- **December 2024:**
  - Full implementation of Solvency UK is anticipated, encompassing:
    - **transfer of remaining Solvency II requirements** to the PRA Rulebook; and
    - **application of final policies** outlined in PS2/24 (excluding those previously implemented).
- **Material Policy Changes**

While the full details are covered in section 3, the main policy changes in PS2/24 include:

- **Removal of disclosure requirements:** The requirement for firms to disclose residual model limitation capital add-ons (RML CAOs) and the removal of disclosure of information in relation to safeguards (including RML CAOs) from the PRA's regular aggregated report on CAOs.
- **Dynamic CAOs:** Allowing for capital add-ons (CAO) that dynamically adjust based on specific outputs calculated by firms (e.g., SCR calculations), reflecting how underlying risk deviation may change over time. This can benefit firms by potentially reducing the need for frequent CAO reviews.
- **Internal Model integration flexibility:** Allowing insurance groups up to six months after an acquisition to create a clear and realistic plan for integrating any internal models, rather than the initial proposed requirement of having the plan finalised at the acquisition point. Additionally, a two-year period is provided to then implement the plan.
- **Increased Solvency II threshold:** Raising the gross written premium threshold for entering Solvency II to £25 million, (i.e., £10 million more than the threshold proposed in CP12/23).
- **Earlier removal of FRR test:** The PRA confirmed in December 2023 that it will no longer expect firms to carry out the Financial Resource Requirement (FRR) test when recalculating the transitional measure on technical provisions (TMTP), subject to case-by-case assessments for some firms. This is one year earlier than the removal date proposed in CP12/23.

2. Unchanged CP12/23 Policy Proposals

Third-country Branches (TCBs)

The PRA had proposed to remove the requirements for TCBs to calculate and report branch capital requirements, including the branch Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR), and to establish and report a branch risk margin for ongoing supervision. The PRA intends to implement this policy to facilitate effective competition and enhance the UK's competitiveness.

Although branch capital requirements will be removed, the PRA will still require TCBs to calculate and hold sufficient assets to cover their insurance and reinsurance obligations in the UK. These obligations should be calculated using the "branch best estimate of liabilities", as set out in the PRA's near-final rules.

Respondents to CP12/23 expressed concern that the removal of these requirements would reduce policyholder protection and result in overseas firms benefiting from a "light touch" regime. However, the PRA reiterated that the TCB regime already contains appropriate safeguards to ensure policyholder protection: a TCB will not be authorised unless the home jurisdiction has a supervisory regime broadly equivalent to that of the UK. Additionally, the PRA highlighted that existing branch capital requirements offer limited protection to policyholders in the event of a winding up scenario, as assets held in the UK to cover SCR are not ring-fenced.

TCBs must continue to hold a security deposit with a UK bank. However, the PRA is amending the relevant rules so that the calculation of the deposit is no longer linked to MCR but is instead a final amount specified in the relevant rules, depending on the type of business.

These changes, alongside other reforms, will be implemented on 31 December 2024, and will be applicable to all TCB undertakings (except Swiss general insurers) as defined in the PRA Rulebook, including any insurers that already have a branch established in the UK. This includes UK branches of insurers headquartered in the EEA. Swiss general insurers are subject to different rules pursuant to the UK-Swiss Direct Insurance Agreement.

Mobilisation Regime

The PRA will introduce its mobilisation regime, as described in CP12/23, as an optional stage for newly authorised insurers to operate with business restrictions while completing the final aspects of their development. This regime is expected to reduce barriers for new entrants, particularly start-ups, who may struggle to meet authorisation requirements immediately.

Insurers are expected to spend no longer than 12 months in mobilisation, consistent with the existing mobilisation period for banks. In circumstances beyond an insurer's control that affect its ability to exit mobilisation, the insurer is encouraged to engage with the PRA and FCA as early as possible.

The type of business that a firm can write while in mobilisation will be restricted and decided on a case-by-case basis by the PRA. Generally, firms will only be allowed to write policies covering short-term and short-tail risks, with a cumulative net exposure below a maximum threshold set by the PRA on an individual firm basis. This reflects the fact that firms will not have achieved full operational capacity and is intended to protect policyholders, in line with the PRA's policyholder protection objective.

The MCR floor for firms in mobilisation is lowered to £1 million during the early stages of development. The PRA considers that the lowered MCR floor is still high enough to ensure that firms in mobilisation have a realistic chance of meeting regulatory capital requirements for their proposed business models at the end of the 12-month period. In addition to a lowered MCR floor, the PRA will implement its "minimum expectations" for firms in mobilisation, as set out in CP12/23. These expectations are intended to be applied proportionally, and the PRA's expectations may differ depending on a firm's proposed business model.

The PRA expects to publish information and guidance on the new regime, reflecting the approach set out in PS2/24, by 31 December 2024.

Currency Redenomination

The PRA has confirmed its intention to proceed with the redenomination of monetary values specified in the PRA Rulebook for Solvency II firms from EUR to GBP, as set out in CP12/23: redenominated values will become effective on 31 December 2024. This redenomination will align the monetary values with the UK's domestic currency and the main reporting currency of most PRA-regulated firms.

3. Amended CP12/23 Policy Proposals and Implications

Internal Models

In CP12/23, the PRA proposed changes to the Solvency II internal model (IM) framework, including streamlining Solvency II tests and standards for new IMs and IM changes; introducing an internal model ongoing review (IMOR) framework; and increasing flexibility in IM permissions by moving away from a rigid "approved" or "not approved" system towards a more flexible approach with various IM permission safeguards. These changes were generally supported by respondents to CP12/23.

In light of the responses received, the PRA has made some changes to the new IM statement of policy, "Solvency II internal models: Permissions and ongoing monitoring." These changes include adding that the PRA intends to determine complete applications within six months – clarifying the PRA's expectation that each Model Limitation Adjustment (MLA) will result in a positive increase in the SCR – as well as text confirming that MLAs form part of a firm's IM and are not expert judgements.

The PRA has also added wording to the new supervisory statement (SS1/24), "Expectations for meeting the PRA's internal model requirements for insurers under Solvency II" to explain that firms may be able to justify certain model changes as minor, provided they do not exceed the firm's major model change threshold.

Additionally, the PRA has made three notable revisions to the revised drafting of the "Solvency Capital Requirement – Internal Models" part of the PRA Rulebook. These are: the addition of a new rule to enable firms to make administrative changes to their IM change policy; the removal of express references to a firm having to demonstrate certain matters to "the PRA's satisfaction"; and the revision of the rules on the integration of partial internal models to require firms to "explain and justify" their choice of alternate integration technique.

The revisions to the Solvency II internal model framework represent a positive development for firms. They should offer greater flexibility in obtaining IM permissions by introducing mechanisms to address potential non-compliance issues and moving away from a rigid binary approval system. While the PRA's commitment to determining application outcomes within six months is commendable, it remains to be seen if this time frame will be consistently achievable in practice. Furthermore, while the PRA intends to introduce safeguards, it has acknowledged the importance of firms maintaining ownership of their models, as emphasised by respondents. This approach ensures that safeguards do not impede the ownership and responsibility of firms over their IMs.

Capital Add-ons

The PRA had proposed a new residual model limitation (RML) CAO, intended to act as a safeguard to ensure that IMs meet the relevant calibration requirements or mitigate non-compliance. These proposals were broadly welcomed and will be implemented by the PRA. CP12/23 proposed that firms would be required to disclose RML CAOs in their Solvency and Financial Condition Reports (SFCRs). However, in response to feedback from respondents, PS2/24 has removed this requirement, so reducing the risks of revealing proprietary and sensitive information.

The PRA also proposed the publication of regular reports summarising the use of CAOs at an industry level. However, PS2/24 states that the PRA will not include the reporting of these safeguards in its regular summary report on CAOs but will instead publish in 2027 a report on the use of safeguards.

Some respondents expressed concerns about potential capital increases resulting from increased use of CAOs. The PRA has confirmed that it does not intend to use CAOs in this way, and that they remain an exceptional tool for use when the assumptions underlying the SI or IM deviate significantly from the risk profile of the firm's business.

The PRA has now also introduced the concept of dynamic CAOs, i.e., where a CAO is calculated by reference to a formula, such as a percentage of SCR, which will change from time to time. This represents a shift from the PRA's historical use of fixed CAOs and acknowledges that a dynamic CAO may more appropriately reflect how risks change over time.

Firms should be pleased that the PRA has recognised the need for dynamically specified CAOs and has reduced the need for safeguard reporting and disclosure. The PRA is currently finalising implementation details and will announce its approach before the reforms take effect in late 2024.

Flexibility in Calculating the Group SCR

The PRA had proposed additional flexibility in the group capital requirement calculation by allowing the temporary combination of multiple SCR calculation approaches for consolidated Group SCR for up to two years during periods of change, such as acquisitions, disposals or reorganisations.

Respondents to CP12/23 generally welcomed these proposals. The PRA has further refined the material published with CP12/23; the PRA may grant a temporary six-month permission for groups to use more than one calculation approach when calculating their Group SCR while developing the "clear and realistic" plan to establish a group internal model which is required in order for the two-year permission to be granted.

There are some other changes in relation to group supervision:

- "significant" intra-group transactions will be defined as transactions with a material influence on the solvency or liquidity position of the group or of one of the firms involved in the transaction; and
- a "significant" branch is one with a gross written premium that exceeds 5% of the group's gross written premium.

Firms will welcome the increased flexibility in using different calculation methods and the temporary six-month period to develop an integration plan as this will allow more time to gather data, knowledge and expertise to optimise the integration approach.

Thresholds

The PRA has proposed to increase the thresholds above which insurers enter the Solvency II regime. The minimum Gross Written Premium (GWP) required to fall under Solvency II has been raised from €5 million to £25 million, an increase from the £10 million GWP threshold proposed in CP12/23. Firms with technical provisions exceeding £50 million will fall under Solvency II, in line with the proposal in CP 12/23. This is double the previous €25 million threshold. Firms with reinsurance exceeding £2.5 million in GWP or £5 million in gross technical provisions will now trigger Solvency II requirements, replacing the previously lower thresholds proposed in CP12/23. The reinsurance activities of Non-Directive Firms (NDFs) must still be capped at 10% of their overall business in terms of size.

The impact of the Solvency II thresholds reforms will be felt by smaller firms, who will benefit from the ability to write more business under relatively simpler prudential rules. These reforms are aimed at nurturing small firms, insurtechs and new entrants in line with the PRA's secondary objective to improve competitiveness and UK growth in the medium to long term. The PRA's decision to increase the GWP threshold from £15 million to £25 million was based on consultation feedback and underscores the broad appetite for the application of Solvency II to be more proportionate to the size of firms. Conversely, the decision not to increase the technical provisions threshold beyond the £50 million proposal in CP12/23 reflects the PRA's view that the thresholds for technical provisions are a better indicator of the potential risks to the PRA's primary objective of safety and soundness.

The importance of these changes should not be overshadowed – the PRA has calculated that its final policy will enable a total of around 15 firms to move out of the Solvency II regime.

Transitional Measures on Technical Provisions (TMTP) and the Risk-Free Interest Rate

The PRA's proposals for the TMTP outlined in CP12/23 were well-received by respondents, who urged the PRA to expedite the removal of the TMTP's Financial Resources Requirement (FRR) test at year-end 2023. Additionally, some sought greater flexibility in defining the business scope for TMTP calculations. Responding to these concerns, the PRA issued a statement in December 2023, outlining its intention to consider removing the FRR test for firms whose TMTP it restricts (following individual assessments), and to remove the FRR test requirement entirely for all other firms.

PS2/24 confirms this approach, with the FRR test being completely removed from the TMTP framework by year-end 2024. This earlier implementation will impact the 31 December 2023 balance sheets of firms previously restricted by the FRR test and should therefore reduce associated calculation costs.

4. Finalised PS3/24 Policy on Reporting and Disclosure

The PRA has amended its final policy in response to feedback indicating that the costs and burden for firms may outweigh the supervisory benefit of the proposed reporting or disclosure changes. The PRA is deleting existing templates, not proceeding with the introduction of certain proposed new templates, simplifying proposed new templates and reverting to quarterly reporting of life and non-life technical provisions. The PRA will also maintain the existing 11-week remittance deadline for QMC.01 and remove the proposed split of the group balance sheet and group SCR result (by internal model and standard formula parts) from two templates at the group and ring-fenced fund (RFF) level.

The PRA has also made presentational changes to the near-final rules to enhance their readability, including merging the remaining National Specific Template (NST) requirements into the new Chapter 2A of the Reporting Part of the PRA Rulebook and changing some of the rule headings and template descriptions. There are also consistency-driven changes to the near-final rules set out in paragraph 4.96 of PS3/24, and the PRA has deleted one further template on risk concentration to further reduce the existing reporting burden for insurance groups.

While firms may be unenthusiastic about the reporting changes, the PRA maintains that the revisions to its draft policy strike a balance between enhancing the value of its reporting requirements and ensuring the continued collection of information crucial for supervising UK insurers.

5. MA Clarification Statement

The PRA released a statement on 15 April 2024, to clarify points from the consultation paper CP19/23 on Solvency II MA reforms. The PRA is currently reviewing CP19/23 feedback and plans to release a policy statement with final rules in early June. To recap, the PRA's proposals in CP19/23 would widen the range of investments that insurers can include in their MA portfolios to embrace assets with 'highly predictable' – and not just 'fixed' – cash flows. Other changes proposed by the PRA would include a streamlined process for certain MA applications and a new requirement for a senior manager to attest to the sufficiency of the fundamental spread and quality of the MA on an annual basis.

Below is a summary of the PRA clarifications:

- **Existing Approvals**: Current MA approvals (which are made under Part 4 of the Solvency II Regulations 2015) will remain valid. Firms will not need to reapply for those MA permissions they were granted before 30 June 2024.
- **Treatment of Existing Assets**: CP19/23 included proposals relating to the inclusion of assets with highly predictable cash flows in MA portfolios. The PRA clarifies that the reforms aim to expand MA eligibility criteria, not to redefine what constitutes 'fixed' cash flows. The PRA confirms that it will adjust policy materials to avoid any unintended changes to the classification of assets with 'fixed' cash flows.
- **Implementation of New Requirements**: The PRA acknowledges the practical challenges firms may face with the 30 June 2024 implementation date and will communicate, as part of the policy statement, the date(s) on which new requirements will take effect, and whether early adoption will be possible voluntarily. In advance of the policy statement publication, the PRA notes the following comments relating to specific proposed new requirements:
  - *MA Attestation*: Understanding the time needed for full documentation, the PRA states that firms may align the timing of annual attestations with a firm's SFCR, potentially taking effect at year-end 2024. Firms can also consider voluntary fundamental spread additions at any time, not just for attestations.
  - *Voluntary Fundamental Spread Additions*: Firms have until 30 June 2024 to apply these additions, with the expectations of processes being fully embedded by their first year-end post implementation.

   - *Notching of the Fundamental Spread*: Firms will not need new MA applications for the new regime unless there are other MA portfolio changes. The PRA will provide further guidance on documenting compliance with new notching requirements.

   - *Sub-investment Grade MA Cap*: Similar to notching, new MA applications are not expected solely for the new regime's compliance documentation unless coupled with other changes to the MA portfolio that would require an MA application.

   - *Triggers for Variations of MA Permissions*: The PRA is aware that some firms interpreted the proposed changes to Supervisory Statement SS7/18 (relating to the expected triggers for variations of MA permissions) as requiring new applications in a wider range of circumstances than is currently the case. The PRA has made clear that the proposed changes aim to enhance clarity without altering the current triggers for variations of MA permissions.

- **PRA Application Review Process:** The PRA will provide further guidance and materials on the MA application process under the reformed regime before 30 June 2024.

6. Assimilated Law Consultation

The PRA's Consultation Paper CP5/24 outlines the process of incorporating certain Solvency II requirements from assimilated law into the PRA's regulatory framework. The term "assimilated law" relates to what was previously referred to as "retained EU law" and the current consultation considers the UK's onshored version of Commission Delegated Regulation (EU) 2015/35, the Solvency 2 Regulations 2015 and related Technical Standards. Notably, the PRA has deferred proposals to restate references to the credit quality step mapping tables in BTS 2016/1800, with plans to address these in future proposals.

The restatement process will require some adjustments. For instance, references to the EU's prudential framework will be removed, and the PRA will rectify inconsistencies and errors in assimilated law, such as incorrect cross-references or omissions in definitions, alongside making consequential amendments.

Despite these changes, the PRA's overarching goal is to maintain the regulatory expectations and its supervisory approach as they currently stand, barring significant policy changes. This approach is rooted in the rationale that priority reform areas have already been identified and are undergoing consultation; introducing additional substantive reforms at this stage could potentially hinder and complicate their enactment. However, the PRA acknowledges the possibility of considering further reforms to the policy material being restated under CP5/24 at a later date.

There are two notable exceptions to this preservation of the status quo:

- The PRA says that it is aware of a small number of UK insurers that have outstanding preference shares with dividend stopper features (i.e., typically restricting distributions that can be made on ordinary shares). Those features have the potential to undermine the Tier 1 classification of ordinary shares when certain transitional measures expire on 1 January 2026. The PRA is therefore proposing a new time-limited transitional rule which would allow firms to continue to treat transitioned preference share instruments with dividend stoppers issued prior to 18 January 2015 as not relevant when assessing the compliance of their ordinary shares with certain unrestricted Tier 1 own fund requirements. The rule would take effect from 2 January 2026 and would last for 25 years.

- The PRA proposes to restate EUR-denominated amounts into the UK framework in GBP using the same conversion rate as that adopted in PS2/24 for a similar purpose.

- The consultation paper provides a detailed account of the restatement process, categorised by various topics such as Technical Provisions, Own Funds and Solvency Capital Requirement. It includes an appendix of mapping tables to aid understanding of where existing provisions will be relocated:

   - Requirements on firms found in assimilated law will be restated in the corresponding sections of the PRA Rulebook.

   - Regulations outlining the PRA's supervisory approach will be incorporated into appropriate policy statements.

   - Regulations providing additional expectations or clarifications will be captured in relevant supervisory statements.

- Regarding EIOPA guidelines (which firms are still expected to consider) the PRA is not undertaking a comprehensive restatement within CP5/24. However, certain guidelines will be exceptionally incorporated into PRA policy materials for clarity, with a full review of remaining EIOPA guidelines planned for a future date.

Stakeholders are invited to submit their feedback on the consultation by 22 July 2024, with the anticipated implementation date for the changes set for 31 December 2024. Overall, firms should not expect major disruptions, but a close review of the consultation paper is recommended to understand the specific changes relevant to their operations. It is also important for firms to review and bookmark for future reference the mapping tables in Appendix 2. These tables show where existing Solvency II requirements will be relocated within the PRA Rulebook and other materials. This will help firms locate the relevant rules after the changes take effect.

7. Next Steps

Solvency UK

As noted above, the consultation on the transfer of the remaining firm-facing Solvency II requirements is expected to conclude by the first half of this year. In the first half of 2024, the transfer of the remaining firm-facing Solvency II requirements from assimilated law into the PRA Rulebook and other policy materials will take place. EIOPA guidelines will also be transferred into PRA policy materials in the future, where appropriate. Full implementation of Solvency UK is anticipated in December 2024, encompassing the transfer of remaining Solvency II requirements to the PRA Rulebook and the application of final policies outlined in PS2/24.

Reporting and Disclosure

On reporting and disclosure, the Bank of England Insurance Taxonomy 2.0.0, reflecting the near-final policy set out in PS3/24, was published on 24 April 2024 and covers all XBRL-based insurance reporting from 31 December 2024.

Following publication of both final policies, the PRA will engage further with firms and provide additional information to support the preparation and implementation of the Solvency II reforms leading up to the 31 December 2024 implementation date, and beyond. The PRA may also consider further measures to increase the proportionality of the regime for smaller insurers. This information will be made available on the PRA Solvency II webpage throughout 2024.

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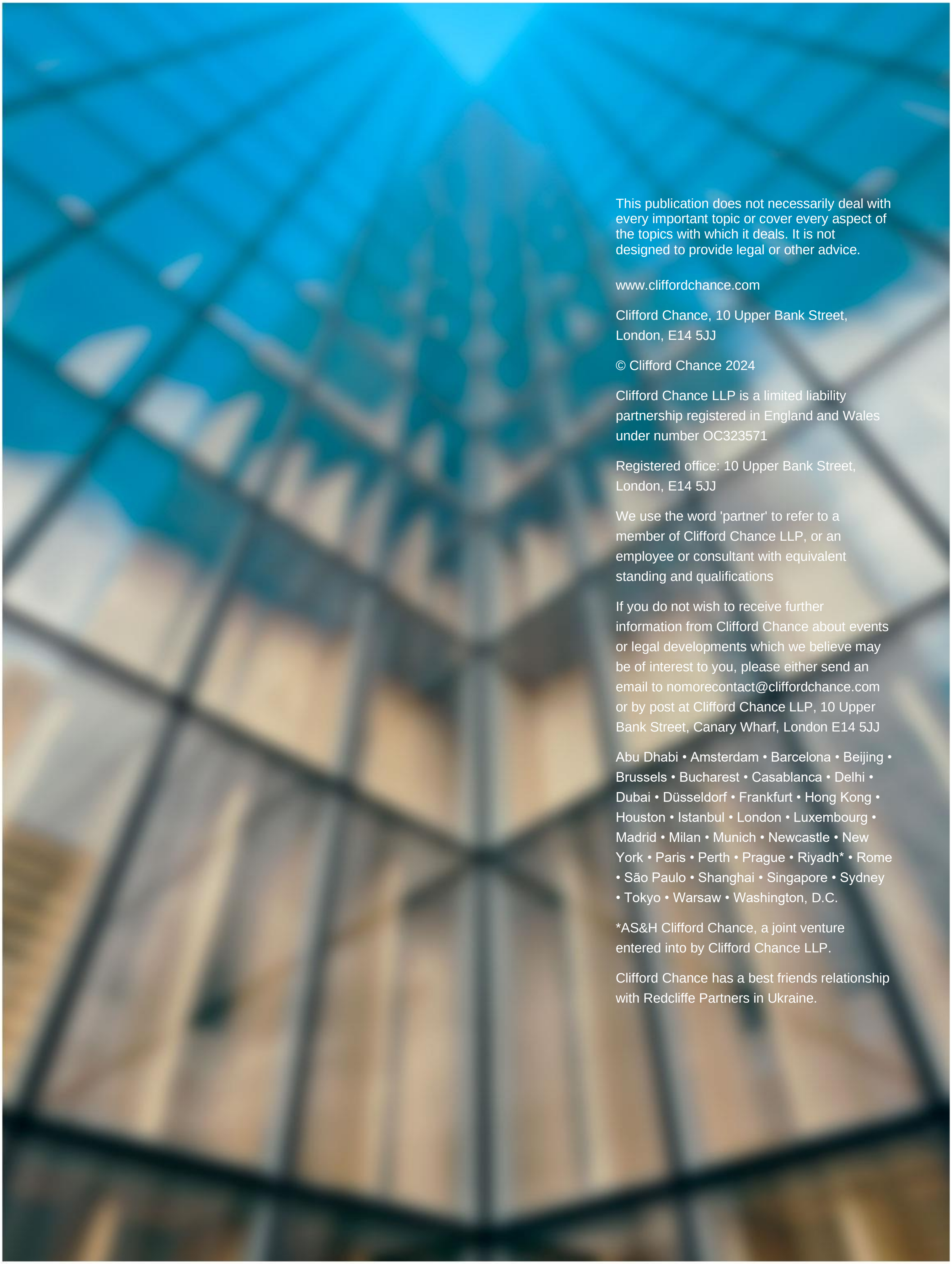

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