HM Treasury

Review of Solvency II:

Consultation

April 2022

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Contents

Foreword

The UK has one of the most vibrant and innovative insurance sectors in the world. The sector is a world leader in the provision of complex and bespoke forms of insurance and reinsurance. This consultation sets out further details on the Government's package of proposed reforms to the prudential regulatory regime for insurance firms known as Solvency II.

I first set out these proposals in my speech at the Association of British Insurers Annual Dinner on 21 February 2022. I made clear that policyholder protection is a top priority and will be safeguarded through these proposals. The reforms are:

- a substantial reduction in the risk margin of around 60-70% for long-term life insurers;
- a reassessment of the fundamental spread used in the calculation of the matching adjustment;
- the introduction of a significant increase in flexibility to allow more investment in long-term assets; and
- a major reduction in the EU-derived regulations which make up the current reporting and administrative burden.

I am confident that these reforms will help maintain and grow the insurance sector whilst ensuring both a very high standard of policyholder protection and the safety and soundness of UK insurers. The reforms could result in a material release of possibly as much as 10% or even 15% of the capital currently held by life insurers and unlock tens of billions of pounds for long term productive investments, including infrastructure.

It is also important to note that this review is not taking place in isolation. The Government is making huge strides to capitalise on newfound freedoms and restore the UK's status as a sovereign and independent country, including through the recently announced Brexit Freedoms Bill. The Treasury has also proposed important changes to the UK's financial services regulatory framework more generally, so that we have a coherent, agile, and internationally respected approach to financial services regulation that is right for the UK.

This consultation is the next step in the review of Solvency II. I invite all interested stakeholders to use this an opportunity to share their views on this important package of reforms.

John P. Glen

John Glen MP, Economic Secretary to the Treasury

Chapter 1

Introduction

Background

1.1 The UK insurance sector is the fourth largest in the world. It provides a wide array of vital products and services for households and businesses that facilitate the management and reduction of risk. It is a world leader in the provision of complex and bespoke forms of insurance and reinsurance. UK insurance firms held around £2.2 trillion in invested assets as at Q2 2021[1]. The Government will pursue even higher quality regulation as we embrace our new-found freedoms outside of the EU because it will lead to better markets and outcomes for consumers.

1.2 Both the Government and the Prudential Regulation Authority (PRA) continue to support the fundamental principles and frameworks of Solvency II. The over-arching aim of the Solvency II review is to ensure that the UK's prudential regulatory regime is better tailored to reflect the particular structures, products and business models of the UK insurance sector and the wider UK regulatory approach. Taking advantage of our new freedom in this way will contribute to the UK being the best regulated economy in the world.

1.3 The Government received evidence in response to the Call for Evidence published as the first stage in the review in October 2020, analysis of which has informed the Government's view of how best to:

- spur a vibrant, innovative, and internationally competitive insurance sector;
- protect policyholders and ensure the safety and soundness of firms; and
- support insurance firms to provide long-term capital to underpin growth.

This consultation

1.4 In some areas of reform the way forward seems clear, and this consultation seeks evidence on their likely impact to help determine the precise form that those reforms should take. There are other areas on which further evidence is needed before the Government is able to come to a view on the way forward.

1.5 The proposals set out here need to be considered as a package. Both matching adjustment and risk margin changes affect liability valuation. There

[1] Source: PRA

is also a link between how the fundamental spread is calibrated and how wide the matching adjustment asset eligibility criteria can be before there is a material impact on policyholder protection. The evidence received in response to this consultation will be important in understanding the combined impact of the reforms. The Government will use this to reach a final conclusion.

Implementation

1.6 The Government is conducting the Future Regulatory Framework Review to determine how the overall framework for financial services regulation will adapt to the UK's position outside the EU. The Government intends to delete large amounts of retained EU law and move to a comprehensive model of financial services regulation based on the Financial Services and Markets Act 2000, under which the financial services regulators are responsible for determining the detailed regulatory requirements that apply to firms, acting within a framework established by Government and Parliament. The Government is also proposing to make the appropriate enhancements to ensure that the framework remains fit for the future and can support the UK's high standards of regulation.

1.7 Changes to the prudential regulatory framework will require further analysis by the PRA and changes to the PRA's rules. The Government will consider the feedback from this consultation before deciding which aspects of the reforms best sit in legislation and which in the PRA's rules. The PRA will bring forward its own consultation in due course consistent with its own consultation requirements.

Who should respond to this consultation?

1.8 This consultation will be of interest to authorised UK insurance firms within the scope of Solvency II, the Society of Lloyd's and its managing agents, non-Solvency II insurance firms, as well as any insurance firm intending to operate in, or provide services into, the UK.

1.9 The Government welcomes views from insurance firms, and the wider financial services and business sector, as well as consumer organisations and members of the public.

1.10 Details on how to respond to the consultation can be found in Chapter 7.

Chapter 2

Risk margin

2.1 The difference between an insurer's best estimate of its liabilities and the market value of its liabilities is known as the risk margin. It ensures that an insurance firm holds assets equal to the amount needed to transfer its liabilities to a third party. In this way, the risk margin protects policyholders by giving them a high degree of confidence that they will continue to have a claim on a viable business. It also strengthens the safety and soundness of insurance firms. As at year-end 2021, the risk margin for life business was in excess of £32bn, while for non-life business the risk margin was in excess of £7bn[2].

2.2 The Government is proposing a substantial reduction in the risk margin, including a cut of around 60-70%, for long-term life insurers. Such a large reduction is possible as the current methodology can overstate the market value of a firm's liabilities, particularly in low interest rate environments. Observations of the prices at which insurers can transfer longevity risk suggest that the current methodology results in a risk margin that is too high for some life insurers such as annuity writers.

2.3 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 set by the International Association of Insurance Supervisors. The Government sees merit in the modified cost of capital approach because:

- it is sensitive to the significant differences in risk profile and liability duration across the population of UK insurance firms;
- there is less disruption for firms as current systems would only need slight adaptation, rather than the more significant changes that would be needed to accommodate a Margin over Current Estimate approach;
- there is comparability 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
- it retains 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.

2.4 The adverse effects of the risk margin are more pronounced for life insurers than general insurers. This reflects the relatively long duration of life insurers'

[2] Source: PRA

liabilities, the risks associated with those liabilities, and the assets used to fund them. General insurers do not typically hold the long-term liabilities that result in a high and volatile risk margin. The risk margin calibration may need to be different for different types of insurance firm to account for this.

2.5 The PRA considers that a reduction in risk margin of 60% or just over for long-term life business could be consistent with observed transfer values, but only if accompanied by a significant strengthening of the fundamental spread in the matching adjustment. The PRA considers that an appropriate reduction in the risk margin held by general insurers is likely to be in the region of 30%. The PRA will set out more detail on the rationale behind its view on the appropriate calibration.

Additional resource available on insurers' balance sheets

2.6 A high risk margin increases the costs to insurers of writing new business and leads to a suboptimal allocation of capital resources. Cutting the risk margin would lead to additional resource becoming available as the Transitional Measures on Technical Provisions (TMTPs) that apply to business written before 2016 are phased out over the next ten years.

A reduction in the volatility of insurers' balance sheets

2.7 The methodology currently used to calculate the risk margin has undesirable consequences. It is sensitive to movements in interest rates, particularly when interest rates are low. It also moves in a procyclical manner. The volatility of the risk margin makes this more difficult for firms to manage. A reduction in the risk margin will reduce the volatility and associated pro-cyclical behaviour of insurers' balance sheets. It may also enable insurers to manage their balance sheets more effectively as they would need to hold less resource to cover the impact of volatility arising from movements in the risk margin. It will also increase incentives for insurers to write new business and increase the affordability and range of their products.

A reduction in incentives for life insurers to reinsure longevity risk outside the UK

2.8 Life insurance firms have increasingly reinsured longevity risk to reduce the expense that writing that risk exerts on their balance sheets, including in the form of a higher risk margin. They have reinsured around 80% of longevity risk[3] associated with new business written since 2016. Reinsurance is particularly cost-effective in reducing the risk margin if the provider of the reinsurance is outside the UK in a jurisdiction that does not require a risk margin to be held. A smaller risk margin would reduce the financial incentive to reinsure longevity risk, though this will only be one of a range of factors that insurers take into account. A greater proportion of life business remaining in the UK would retain the associated premiums in the UK and hence boost the UK economy. It would also reduce the supervisory and regulatory risks associated with the offshore reinsurance of longevity risk.

2.9 The Government welcomes views on the benefits and risks of reductions in the risk margin, drawing out the benefits of retaining additional premiums

[3] Source: PRA, based on responses to the Qualitative Questionnaire that accompanied the QIS

to invest in the UK while still maintaining a high standard of policyholder protection.

Consultation questions

Question 2.1

How would a reduction in the risk margin for long-term life insurers toward the bottom or top of the 60%-70% range impact on:

- policyholders and their level of protection; and
- insurers and their reinsurance, investment and product pricing decisions.

Question 2.2

How would a reduction in the risk margin for general insurers of 30% impact on:

- policyholders and their level of protection; and
- insurers and their reinsurance, investment and product pricing decisions.

Question 2.3

Do you agree that a modified cost of capital methodology should be used to calculate the risk margin?

Question 2.4

Is there any further information about actual transfer values of insurance risk that should be taken into account when finalising the calibration of the risk margin reforms?

Question 2.5

How could the Government be assured that resource that becomes available following a reduction in the risk margin would not be distributed to shareholders or used to increase remuneration to parties within the insurance firm?

Chapter 3

Matching adjustment

Rationale and current calculation

3.1 The matching adjustment benefits insurers who hold long-term assets which match the cash flows of similarly long-term insurance liabilities. This makes prudential sense as the close matching that underlies the matching adjustment reduces the risk that insurers may need to sell assets to meet claims by policyholders as they fall due. In such a situation it may not be possible to sell assets at the price at which an insurer has valued them or at all, particularly if assets are illiquid and a ready market does not exist.

3.2 The matching adjustment allows insurers to recognise upfront as capital part of as yet unearned future cashflows. The matching adjustment does not affect the total investment returns earned on the matching assets, only the timing at which they may be extracted as profit. Use of the matching adjustment provides a substantial benefit to life insurers. It is used extensively and has a significant impact on commercial decisions, supporting the provision of annuities and benefiting wider UK economy. At year-end 2020 insurer balance sheets benefited by £81 billion from the matching adjustment[4].

3.3 When insurers invest in long-term assets they are exposed to credit, illiquidity and other residual risks. When insurers closely match asset and liability cashflows they can hold those assets to maturity and should be less exposed to illiquidity risk. However, they retain credit and other residual risks. These retained risks are reflected by excluding from the matching adjustment an allowance for them: the fundamental spread. That there is not yet consensus on how the fundamental spread should be reformed demonstrates how important it is and how difficult it is to get right. The higher the fundamental spread, the lower the matching adjustment benefit.

3.4 The matching adjustment calculation relies on a set of assumptions and models about how much of the future return on investments can be considered risk-free. Such returns are recognised in advance of them being realised, even though credit and other risks are faced over the life of the matched liability and assets could go on not to achieve returns that match the benefit received. Many of the investments made by life insurers are very long-term in nature so the assumptions need to reflect how these assets might perform many years into the future, including in economic downturns and extreme events.

4 Source: PRA

3.5 The fundamental spread currently includes explicit allowance for the expected probability of default and the cost of selling a downgraded asset and replacing it with an asset with the original rating and cashflows. It is subject to a floor[5] that explicitly recognises that there is a minimum level of retained risks for financial and non-financial sectors, which varies with the credit rating of the asset.

Calibration of retained risk

3.6 There are several indicators to suggest that the fundamental spread does not properly capture retained risks. If the fundamental spread is miscalibrated, policyholders may be inappropriately exposed to credit risk and other retained risks. The risks of an insurer being unable to meet its contractual obligations may rise and policyholders may not receive their expected payments. These risks may be heightened given the steady increase in the proportion of assets in matching adjustment portfolios that are illiquid. The proportion of assets invested in less liquid asset classes has increased from around 31% in 2018 to around 41% in 2021[6].

3.7 Currently, the fundamental spread is heavily driven by its floor. While this can have helpful countercyclical effects, it also indicates that the core methodology may under-estimate the risks retained by insurers. The fundamental spread has been relatively static since 2016, even though the credit spread on assets has varied over this period. Changes in credit spreads can be slow to be reflected in the fundamental spread when the floor to the fundamental spread applies as the floor is calculated using a 30-year average spread. In addition, the fundamental spread is the same for all assets with the same credit rating, sector and term. This low level of granularity may mask signals of credit deterioration. It also means insurers have an incentive to invest in assets with a credit spread at the higher end of that which is available within a given credit rating, sector and term.

Solvency capital requirement

3.8 Reform of the fundamental spread will likely lead to a re-evaluation of the internal models used to determine the solvency capital requirement, which includes an allowance for market stress events. Larger annuity writers use internal models to determine this. Other writers apply a standard formula. A fundamental spread methodology more closely aligned to a firm's own view of credit risk under stress may be helpful in designing internal models.

Credit risk

3.9 The Government is considering the merits of a fundamental spread methodology that incorporates market measures of credit risk. This should be phased in to allow firms to reflect the impact on capital, pricing and investment decisions in an orderly manner. The fundamental spread would be the sum of allowances for:

5 Based on a 30-year average of credit spreads

6 Source: PRA

- the expected loss, determined by the historic profile of defaults and recovery rates associated with assets of a certain credit rating; and
- a credit risk premium (CRP) based on market measures of the asset spread.

> Where CRP = X. (average spread for comparator index over n-years) + Z. (difference between the spread of an asset and that of the comparator index)

3.10 The parameters X, Z, n, and any floors applicable to the CRP should be calibrated to result in a fundamental spread that:

- appropriately reflects the credit risk of an asset;
- better reflects changes in investment decisions;
- avoids introducing material volatility to life insurers' balance sheets; and
- continues to provide incentives for life insurers to provide long-term products such as annuities and invest in long-term assets such as infrastructure.

3.11 The n parameter could be calibrated to include a medium-term average of index spreads, making the CRP relatively stable. Incorporating current spreads could have imparted excessive volatility into the fundamental spread and therefore insurers' balance sheets. The X parameter could be calibrated to deliver the preferred degree of sensitivity to changes in the medium-term average spread for assets of a given credit rating. The CRP could be calculated separately by asset class or sector.

3.12 Movement in the spread of an individual asset relative to the spread for the index of comparable assets may be driven by asset-specific retained risks, particularly if it is sustained for a period of time. It may reflect a period in which the credit rating of the asset does not reflect the retained risks of the asset. The parameter Z can be calibrated to deliver the preferred degree of sensitivity to changes in the difference between the spread of an asset and that of the comparator index. This would reduce (but not remove) incentives to invest in assets where the credit spread is very high given the assigned credit rating. It would not prevent investment in such assets, not least because an insurer may also choose to diversify its portfolio by investing in assets with a spread below the average asset spread for assets of similar sector, rating and term.

3.13 The PRA considers a credit risk premium calibrated to be equivalent to at least 35% of credit spreads on average and over time to be consistent with its statutory objectives. The PRA supports achieving this through design options which are structured without a direct dependency on spot spreads as was tested in its quantitative impact study[7]. The PRA will set out more

[7] https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/solvency-ii/solvency-ii-reform-quantitative-impact-survey

detail on this potential methodology and the rationale behind its view on the appropriate calibration.

3.14 The Government has not reached a final decision on calibration at this stage. A lower calibration may be appropriate if this delivered significant benefits for the wider economy while preserving high standards of policyholder protection and ensuring the continued safety and soundness of firms in the sector.

3.15 Reform of the fundamental spread and the risk margin both affect the liability transfer value and the level of risk capital held by insurers. The inter-dependencies are complex. As a result, reforms to the risk margin and fundamental spread need to be considered together.

3.16 A further degree of sensitivity could be introduced to the calculation of the fundamental spread by widening the current credit quality step system to include notched ratings such as AA on negative outlook. Notched data could be used where available or derived by interpolation.

Consultation questions

Question 3.1

Taking into account the fundamental spread methodology needing to be sufficiently responsive to changes in investment decisions and reflect long-term exposure to credit risks, do you agree with the above assessment that the current methodology does not:

- sufficiently address the risks associated with assets with the same credit rating but different market measures of retained risks; or
- take account of all the risks associated with holding internally rated or illiquid assets?

Question 3.2

What is the impact of the fundamental spread including a credit risk premium of 25, 35 or 45% of spreads on life insurers':

- key balance sheet metrics including best estimate liabilities, own funds and the solvency capital requirements;
- incentives to provide annuities;
- annuity prices;
- investment in economic infrastructure, such as clean energy, transport, digital, water and waste;
- investment to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and
- relative incentives to invest in different types of assets, including assets of different credit ratings and different risks, assets with different liquidity, assets that are internally or externally rated, and assets in different sectors?

When answering this question please set out the assumptions you are making, including the size of X and Z.

Question 3.3

What is the threshold for any increase in the fundamental spread above which adverse effects become significant, such as excessive balance sheet volatility or increased reinsurance of risks off-shore?

Question 3.4

What is the impact on policyholder protection of a credit risk premium of 25, 35 and 45% of spreads, when accompanied by a risk margin reduction for long-term life insurers of 60-70%?

Question 3.5

What is the impact of selecting an averaging period (n) of 0.5, 1, 2, 5, 10 and 30 years?

Question 3.6

Are there other ways to achieve the same outcomes that changes to the fundamental spread would have?

Chapter 4

Increasing investment flexibility

4.1 Reforming the fundamental spread so that it better measures credit risk would increase confidence in a wider variety of assets being suitable for inclusion in matching adjustment portfolios. It would also justify increased flexibility in how such investments are treated when there is a matching adjustment application or breach.

Broaden the range of assets eligible for the matching adjustment portfolio

4.2 The cash flows generated by assets eligible for matching adjustment portfolios are currently required to be fixed in terms of timing and amount. This requirement contributes to high standards of policyholder protection as policyholders can be assured that fixed payments due under the terms of their policies can be met by a matching asset that generates similar fixed cash flows. This requirement poses a particular challenge for insurers in relation to investment in some types of long-term productive finance. This problem is particularly acute where the issuer of the asset does not offer prepayment protection. Some assets without fixed cashflows individually have been permitted to be included in cases where fixed cashflows result from pairing these with cashflows from other assets.

4.3 The Government proposes to ease in a targeted way the restrictions on which assets insurers can include in matching adjustment portfolios. Insurers will be able to include assets with prepayment risk for which the issuer has the option to repay the asset at an earlier date, such as callable bonds, commercial real estate lending, housing association bonds and loans, infrastructure assets and local authority loan portfolios. Policyholder protection will be maintained by combining this easing of restrictions with proportionate actions to ensure risk mitigation. Risk mitigation techniques may include firm-specific exposure limits, tests to allow the PRA to assess and mitigate concentration risk, changes to liquidity plan requirements, or reporting requirements.

4.4 The treatment of assets with construction phases will also be amended under these proposals so that firms can recognise penalties and other consequential amounts that may be payable to the insurer if completion is delayed. For cases in which construction projects are to be funded in instalments, these may be invested in the interim in matching adjustment-eligible assets of appropriate duration rather than in risk-free assets.

Extension of the range of liabilities eligible for the matching adjustment

4.5 The Government also proposes to extend the range of liabilities eligible for the matching adjustment to include products that insure against morbidity risk, such as income protection products. These have similar characteristics to products currently eligible for the matching adjustment, such as in payment annuities.

4.6 Insurance firms currently hold reserves of some £2 billion for in-payment income protection products[8]. Extending eligibility to include morbidity-dependent liabilities should improve customer pricing and support innovation in products designed to protect policyholders from the financial risks of ill-health, such as the provision of social care insurance. This benefit may grow over time if it encourages greater demand for new and existing products.

4.7 With-profits annuities and deferred annuities in with profit funds will also become eligible for matching adjustment portfolios, on the basis that part of these annuities are benefits that are contractually guaranteed and may be matched with bond assets. The extent to which such liabilities could be included in a matching adjustment portfolio would need to be consistent with the investment policies and wider financial management and governance arrangements for the with profits funds. Life insurers currently hold reserves of over £20 billion[9] against with-profits annuities and deferred annuities in with profit funds.

Removal of the disproportionately severe treatment of assets in matching adjustment portfolios whose ratings are below BBB

4.8 Introducing a more credit risk sensitive fundamental spread removes the need for a cap on the matching adjustment benefit for sub-investment grade assets. Assets rated below BBB are currently subject to this cap to reflect the relatively high credit risk associated with them and the increasing uncertainty in market valuation as liquidity reduces.

4.9 Removing the disproportionately severe treatment of assets for which the rating is below BBB will encourage insurers to diversify into a wider range of assets. Insurers currently invest very little in assets rated below BBB. Around £3.3 billion (or 1%) of matching adjustment assets are rated BB or below. A further £83 billion (or 25%) of matching adjustment assets are rated BBB[10]. Removing the cap reduces the likelihood that insurers would pro-cyclically sell BBB assets in a market downturn.

Acceleration of matching adjustment eligibility decisions by disconnecting them from the review of valuation, rating and capital issues for less complex assets

4.10 The PRA will consider the case for introducing a more streamlined approach to accelerate reviewing matching adjustment eligibility applications where appropriate. This approach could be available for less complex assets, typically those that have not been either internally restructured or possess novel features. The eligibility decision could be separated from the review of asset valuation, credit rating and capital modelling, increasing the ability of insurers to rapidly deploy capital into new asset classes.

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8 Source: PRA

9 Source: PRA

10 Source: PRA

Introduction of a more proportionate approach to matching adjustment breaches

4.11 A more proportionate approach to matching adjustment breaches will allow insurers to plan on the basis of a more stable matching adjustment benefit, both in relation to their technical provisions and in the solvency capital requirement. It will also reduce or avoid costs associated with any restructuring of the asset portfolio needed as a consequence of the loss of the matching adjustment benefit.

4.12 The current approach is disproportionate. A breach of the rules for matching adjustment portfolios that lasts for more than two months leads automatically to the insurer immediately losing the full matching adjustment benefit. The insurer must then re-apply for matching adjustment approval, though this is not allowed for two years. This severe sanction may lead to insurers to adopt an overly cautious approach to managing the matching adjustment portfolio and results in a cliff edge effect.

Provision of greater flexibility for how innovative assets are treated

4.13 The PRA will consider how it might more rapidly assess matching adjustment applications for assets whose risks may be harder to assess. For example, if an insurer has already received approval to invest in a particular innovative asset class in their matching adjustment portfolio, the PRA may consider this when considering applications by other insurers to invest in such assets. Reforms to the internal modelling framework may provide additional flexibility in the way the requirements can be met for assets for which there is limited historical data.

4.14 Reducing the costs and uncertainty associated with investment in innovative assets would reduce the disincentive to invest in such assets. This is beneficial as innovative assets may have features which can make them suitable to back annuity liabilities and to include in matching adjustment portfolios.

Consultation questions

Question 4.1

What would be the impact of these reforms on insurers' use of the matching adjustment and investment:

- in economic infrastructure, such as clean energy, transport, digital, water and waste;
- to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and
- in any other asset classes.

Question 4.2

What are the additional risks that these reforms may pose to policyholder protection?

Question 4.3

What safeguards are appropriate to protect policyholders from the risks posed by allowing a wider range of assets into matching adjustment portfolios?

Question 4.4

What impact will these reforms have on insurers providing a greater range and more affordable pricing of products?

Question 4.5

What changes to the matching adjustment approval process are necessary to ensure that applications to use the matching adjustment are approved more quickly?

Chapter 5

Reducing reporting and administrative burdens

Reforms to the internal model framework

5.1 Reducing the number and prescriptiveness of internal model standards requirements will simplify the internal model framework while maintaining high modelling standards. It will reduce burdens on firms and provide additional flexibility in the way that the remaining requirements can be met. Requirements that could be reduced include those relating to documentation, statistical quality standards, the 'Use Test' and profit & loss attribution.

5.2 The intent is to enable the PRA and firms to avoid protracted discussions on detailed technical modelling issues where simpler approaches may be sufficient when supported by a model approval safeguard. Any residual limitations with models should be mitigated by the use of safeguards, such as approval conditions, capital add-ons and exposure limits. This would lead to more proportionate outcomes than the current requirement to meet all tests or have the model rejected in full.

Removing requirements for branches of foreign insurers to calculate local capital requirements and hold local assets to cover them

5.3 The Government proposes removing the requirements for UK branches of foreign insurers to calculate branch capital requirements and to hold local assets to cover them. This reform should benefit around 160 branches[11] of foreign insurers immediately, as well as any other branches that establish in the UK in the future. The reforms should enhance the UK's attractiveness to branches of foreign insurers, helping to boost competitiveness and competition in the UK market.

Increasing the thresholds before Solvency II applies

5.4 Doubling the thresholds for the size and complexity of insurers before the Solvency II regime applies should enable more of the smallest firms to enter the market under the less burdensome non-directive regulatory regime. It should enable existing small firms to reach a greater scale before needing to meet Solvency II requirements. As a result, competition should increase. Firms will continue to have the option to opt into Solvency II even if they are below the threshold for its application.

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[11] Source: PRA

Reforming reporting requirements

5.5 The Government proposes reforming the overall reporting framework with a focus on enhancing proportionality by:

- simplifying particularly complex templates;
- reducing the reporting frequency of some templates and deleting others; and
- making other templates more appropriate for the needs of the UK market.

5.6 The PRA has already consulted on proposals to reform reporting requirements. Delivered in December 2021, these reforms will lead to a reduction in the number of templates that firms need to complete of around 15%, and over 40% in some cases[12]. The PRA plans to consult again on further reductions to reporting requirements in late summer 2022.

Introduction of a mobilisation regime for new insurers

5.7 The Government proposes to amend legislation to enable the PRA to introduce a new mobilisation regime for insurers, consistent with that used for the credit institutions sector. The new regime will create an optional phase in a new insurer's route to market, which will include modified entry requirements. This could take the form of a lower capital floor, lower expectations for key personnel and governance structures, and exemptions from some reporting requirements. Reduced regulatory standards would be accompanied by proportionate restrictions on the firm's activity to protect policyholders during mobilisation. The mobilisation phase would also be time limited.

5.8 This should enhance competition in the insurance sector. It should remove the circular dependency problem that potential start-up firms can face when they lack sufficient capital for authorisation but struggle to attract further investment because they have no certainty of being authorised. It will complement other steps that the PRA is taking to accelerate the time it takes to assess authorisation applications from new firms.

Allow more than one approach to calculating consolidated group capital requirements

5.9 Allowing more than one approach to the calculation of group capital requirements in certain circumstances should benefit insurance groups pursuing growth. It will allow groups to temporarily use multiple group internal models following an acquisition or merger. Acquired firms will no longer be required to temporarily hold additional capital post-acquisition, while legacy models are combined with those of the acquiring insurer.

Simplification of the calculation of Solvency II transitional measures to reduce the administrative burden of maintaining legacy systems

[12] Source: PRA. While the reforms affected all firms, medium sized insurers realised the greatest benefit through the extension of the small firm reporting waivers

5.10 Simplifying the calculation of transitional measures on technical provisions should reduce the burdens and costs for firms, potentially including those arising from the need to retain legacy models for business written before the introduction of Solvency II in 2016. Current costs vary by firm but are typically between £100,000 and £400,000 each year[13].

Consultation Questions

Question 5.1

What is the impact of these reforms on regulatory costs incurred by insurers?

Question 5.2

What would be the impact of removing capital requirements for branches of foreign insurers operating in the UK, both on existing branches and on the decision to establish new branches?

Question 5.3

What would be the impact of a new mobilisation regime for insurers and changes to thresholds at which Solvency II applies on:

- businesses currently considering whether to become an authorised insurer; and
- small insurers' ability to expand before Solvency II applies?

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13 Source: PRA

Chapter 6

Summary of questions

Note for respondents: This is a list of the questions for respondents which we have asked in different chapters of this consultation. Although we have summarised the questions here for ease of reference, there may be additional context in the chapter text to which we would encourage you to refer before responding.

Question 2.1

How would a reduction in the risk margin for long-term life insurers toward the bottom or top of the 60%-70% range impact on:

- policyholders and their level of protection; and
- insurers and their reinsurance, investment and product pricing decisions.

Question 2.2

How would a reduction in the risk margin for general insurers of 30% impact on:

- policyholders and their level of protection; and
- insurers and their reinsurance, investment and product pricing decisions.

Question 2.3

Do you agree that a modified cost of capital methodology should be used to calculate the risk margin?

Question 2.4

Is there any further information about actual transfer values of insurance risk that should be taken into account when finalising the calibration of the risk margin reforms?

Question 2.5

How could the Government be assured that resource that becomes available following a reduction in the risk margin would not be distributed to shareholders or used to increase remuneration to parties within the insurance firm?

Question 3.1

Taking into account the fundamental spread methodology needing to be sufficiently responsive to changes in investment decisions and reflect long-term exposure to credit risks, do you agree with the above assessment that the current methodology does not:

- sufficiently address the risks associated with assets with the same credit rating but different market measures of retained risks; or

- take account of all the risks associated with holding internally rated or illiquid assets?

Question 3.2

What is the impact of the fundamental spread including a credit risk premium of 25, 35 or 45% of spreads on life insurers':

- key balance sheet metrics including best estimate liabilities, own funds and the solvency capital requirements;
- incentives to provide annuities;
- annuity prices;
- investment in economic infrastructure, such as clean energy, transport, digital, water and waste;
- investment to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and
- relative incentives to invest in different types of assets, including assets of different credit ratings and different risks, assets with different liquidity, assets that are internally or externally rated, and assets in different sectors?

When answering this question please set out the assumptions you are making, including the size of X and Z.

Question 3.3

What is the threshold for any increase in the fundamental spread above which adverse effects become significant, such as excessive balance sheet volatility or increased reinsurance of risks off-shore?

Question 3.4

What is the impact on policyholder protection of a credit risk premium of 25, 35 and 45% of spreads, when accompanied by a risk margin reduction for long-term life insurers of 60-70%?

Question 3.5

What is the impact of selecting an averaging period (n) of 0.5, 1, 2, 5, 10 and 30 years?

Question 3.6

Are there other ways to achieve the same impact that changes to the fundamental spread would have?

Question 4.1

What would be the impact of these reforms on insurers' use of the matching adjustment and investment:

- in economic infrastructure, such as clean energy, transport, digital, water and waste;

- to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and
- in any other asset classes.

Question 4.2

What are the additional risks that these reforms may pose to policyholder protection?

Question 4.3

What safeguards are appropriate to protect policyholders from the risks posed by allowing a wider range of assets into matching adjustment portfolios?

Question 4.4

What impact will these reforms have on insurers providing a greater range and more affordable pricing of products?

Question 4.5

What changes to the matching adjustment approval process are necessary to ensure that applications to use the matching adjustment are approved more quickly?

Question 5.1

What is the impact of these reforms on regulatory costs incurred by insurers?

Question 5.2

What would be the impact of removing capital requirements for branches of foreign insurers operating in the UK, both on existing branches and on the decision to establish new branches?

Question 5.3

What would be the impact of a new mobilisation regime for insurers and changes to thresholds at which Solvency II applies on:

- businesses currently considering whether to become an authorised insurer; and
- small insurers' ability to expand before Solvency II applies?

Chapter 7

Next steps

7.1 The Government welcomes responses to the Solvency II reform proposals set out in this paper. To support robust evidence-based policy making, respondents are asked to include qualitative and quantitative evidence. Evidence on the costs and benefits of specific reforms is particularly welcome. The Government is committed to ensuring a very high standard of policyholder protection and respondents are encouraged to address this issue fully in their responses.

7.2 The Government will carefully consider the responses to this consultation before announcing its response. This consultation will run for 12 weeks, closing on 21 July 2022.

7.3 More information on how HM Treasury will use your personal data for the purposes of this consultation is available on the Solvency II Consultation webpage.

Contact

7.4 Responses should be submitted to SolvencyIIReview@hmtreasury.gov.uk by 21 July 2022. Responses submitted in any other way may not be considered.

Processing of Personal Data

This notice sets out how HM Treasury will use your personal data for the purposes of the Solvency II Review consultation and explains your rights under the UK General Data Protection Regulation (UK GDPR) and the Data Protection Act 2018 (DPA).

Your data (Data Subject Categories)

The personal information relates to you as either a member of the public, parliamentarians, and representatives of organisations or companies.

The data we collect (Data Categories)

Information may include your name, address, email address, job title, and employer of the correspondent, as well as your opinions. It is possible that you will volunteer additional identifying information about themselves or third parties.

Legal basis of processing

The processing is necessary for the performance of a task carried out in the public interest or in the exercise of official authority vested in HM Treasury. For the purpose of this consultation the task is consulting on departmental policies or proposals or obtaining opinion data in order to develop good effective government policies.

Special categories data

Any of the categories of special category data may be processed if such data is volunteered by the respondent

Legal basis for processing special category data

Where special category data is volunteered by you (the data subject), the legal basis relied upon for processing it is: the processing is necessary for reasons of substantial public interest for the exercise of a function of the Crown, a Minister of the Crown, or a government department.

This function is consulting on departmental policies or proposals, or obtaining opinion data, to develop good effective policies.

Purpose

The personal information is processed for the purpose of obtaining the opinions of members of the public and representatives of organisations and companies, about departmental policies, proposals, or generally to obtain public opinion data on an issue of public interest.

Who we share your responses with

Information provided in response to a consultation may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 2018 (DPA) and the Environmental Information Regulations 2004 (EIR).

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence.

In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

Where someone submits special category personal data or personal data about third parties, we will endeavour to delete that data before publication takes place.

Where information about respondents is not published, it may be shared with officials within other public bodies involved in this consultation process to assist us in developing the policies to which it relates. Examples of these public bodies appear at: https://www.gov.uk/government/organisations

As the personal information is stored on our IT infrastructure, it will be accessible to our IT contractor, NTT. NTT will only process this data for our purposes and in fulfilment with the contractual obligations they have with us.

At a future date, HM Treasury may decide to publish summarised and/or anonymised versions of responses to this consultation document as part of a future publication.

How long we will hold your data (Retention)

Personal information in responses to consultations will generally be published and therefore retained indefinitely as a historic record under the Public Records Act 1958.

Personal information in responses that is not published will be retained for three calendar years after the consultation has concluded.

Your Rights

You have the right to request information about how your personal data are processed and to request a copy of that personal data.

You have the right to request that any inaccuracies in your personal data are rectified without delay.

You have the right to request that your personal data are erased if there is no longer a justification for them to be processed.

You have the right, in certain circumstances (for example, where accuracy is contested), to request that the processing of your personal data is restricted.

You have the right to object to the processing of your personal data where it is processed for direct marketing purposes.

You have the right to data portability, which allows your data to be copied or transferred from one IT environment to another.

How to submit a Data Subject Access Request (DSAR)

To request access to personal data that HM Treasury holds about you, contact:

HM Treasury Data Protection Unit

1 Horse Guards Road

London

SW1A 2HQ

dsar@hmtreasury.gov.uk

Complaints

If you have any concerns about the use of your personal data, please contact us via this mailbox: privacy@hmtreasury.gov.uk.

If we are unable to address your concerns to your satisfaction, you can make a complaint to the Information Commissioner, the UK's independent regulator for data protection. The Information Commissioner can be contacted at:

Information Commissioner's Office

Wycliffe House

Water Lane

Wilmslow

Cheshire

SK9 5AF

0303 123 1113

casework@ico.org.uk

Any complaint to the Information Commissioner is without prejudice to your right to seek redress through the courts.

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk