HM Treasury

Review of Solvency II:

Consultation – Response

November 2022

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Chapter 1
Introduction

Background

1.1 The Government published its Solvency II consultation on 28 April 2022. The consultation closed on 21 July 2022. It sought views on the following proposals:

- releasing capital by changing the calculation of the risk margin and cutting the risk margin substantially, including by 60-70% for long-term life insurers in recent economic conditions;
- reforming the fundamental spread of the matching adjustment;
- unblocking long-term productive investment by making it easier to include a wider range of assets in matching adjustment portfolios; and
- reforming reporting and administrative requirements to reduce EU-derived burdens.

1.2 The consultation received 67 responses. These included responses from life insurers, general insurers, and composite insurers, as well as consultancies, industry groups, and members of the public. This document summarises the responses received to the consultation, sets out the Government's final reform package, and outlines the plans for implementing it.

1.3 The UK's financial services regulatory framework must adapt to the UK's new position outside of the European Union. The Government notes that these changes to Solvency II are being announced at the same time the outcomes of the Future Regulatory Framework Review are being delivered through the Financial Services and Markets Bill. That includes new secondary objectives for the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) to facilitate the growth and international competitiveness of the UK economy, including the financial services sector, and enhanced accountability measures to reflect the regulators' new responsibilities.

1.4 The Bill also repeals retained EU law so that it can be replaced with an approach to regulation designed for the UK. That means repealing certain legislation which incorporated the Solvency II Directive in UK law, so that it can be replaced with a new framework within which insurance and reinsurance will be regulated going forward.

1.5 This new Solvency UK regime is part of the Government's wider reform programme to tailor financial services regulation to UK markets in order to bolster the competitiveness of the UK as a global financial centre and deliver better outcomes for consumers and businesses.

1.6 The Government will legislate as necessary to implement this new regime.

Reform Package

1.7 The Government has considered the evidence provided by consultation respondents and the PRA as well as its own analysis. The Government has weighed the impacts on its objectives for the review:

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

1.8 The Government is confident that the package set out in paragraphs 1.16-1.17 best fulfils its objectives, striking an appropriate balance between them. It will enable insurers to invest tens of billions of pounds in long-term productive assets and will help to spur an internationally competitive insurance sector, while retaining high standards of policyholder protection.

1.9 The evidence collected supported the majority of the proposals as set out in the consultation, so the Government will take these proposals forwards.

1.10 The most challenging element of the debate has been about the matching adjustment, including both its eligibility requirements and the fundamental spread component. Having considered a wide variety of different views, the Government has concluded that the eligibility requirements for the matching adjustment should, in addition to the proposals set out in the consultation document, be broadened to allow the inclusion of assets with highly predictable cashflows, subject to a number of safeguards which the PRA will implement.

1.11 As set out in the Consultation paper in April 2022, there has been no consensus on the best approach on reform of the fundamental spread. The Government has carefully considered the case for reform, has analysed the expected impacts of a variety of options put forward (including a number of proposals by the PRA), and has decided to leave the design and calibration of the fundamental spread as it stands today. It will, however, increase the risk sensitivity of the current fundamental spread approach to allow different notched allowances to be made within major credit ratings (for example, different allowances for assets rated AA+ or AA- compared with AA).

1.12 These steps on the fundamental spread, when combined with other changes to the matching adjustment, will enable insurers to increase their investment in productive assets, fuelling the UK economy. Although the Government has decided not to take forward the PRA's proposals for reform of the fundamental spread, the Government recognises the importance of policyholder protection. With this in mind, the Government recognises that the rules set out in legislation must work in close combination with supervisory tools held by the regulator.

1.13 Accordingly the Government will support the PRA both by ensuring it has the powers necessary to take forward the following additional measures and by being clear that it supports the PRA's use of these measures to hold insurers to account in maintaining safety and soundness and policyholder protection. The Government also supports the PRA in expecting that at all times insurers will apply high standards of risk management and will cooperate fully with the PRA in the use of these supervisory tools. The PRA will use these tools consistent with the legislation and will report to Parliament on how well they are working to meet the PRA's risk tolerance. The additional measures are:

- to require insurers to participate in regular stress testing exercises prescribed by the PRA to test insurers' resilience to scenarios the PRA will set out, and to allow the PRA to publish individual firm results;
- to require nominated senior managers with formal regulatory responsibilities and sanctions under the Senior Managers Regime to attest formally to the PRA whether or not the level of the fundamental spread on their firm's assets is sufficient to reflect all retained risks, and that the resulting matching adjustment reflects only liquidity premium, on the basis of a rigorous assessment of the characteristics and valuations of assets held in their matching adjustment portfolios, including the results of the stress testing exercises described above;
- to allow insurers to apply a higher fundamental spread through an add-on where they conclude that the standard allowance is insufficient taking into account the work undertaken to support the attestations set out above; and
- to update its matching adjustment rules as appropriate to reflect the Government's decision to widen the eligibility requirements to include assets with highly predictable cashflows (for example, to specify increases to the fundamental spread allowances to take into account the additional risks from non-fixed cashflows, portfolio limits etc).

1.14 As the regime transitions from an EU regime to a UK one, the PRA will also need to publish technical information for the calculation of the matching adjustment reflecting the assets held by UK firms, following the matching adjustment methodology and calibration specified in legislation.

1.15 Given the significance of the matching adjustment and the wider reforms to the Solvency II rules, the Government has also asked the PRA to keep use of the matching adjustment under close scrutiny. The Government will review whether the calibration of the fundamental spread remains appropriate in 5 years' time. Prior to the Government's review the PRA will undertake an evaluation of its assessment of the impact on its statutory objectives of the Solvency II reforms, including the impact of the additional measures listed above, and its assessment on whether further changes are needed. The Government will take into account the results of the PRA's evaluation when undertaking its review. The PRA will also take forward a review jointly with the FCA to assess whether changes may be needed to the Financial Services Compensation Scheme or FSCS levy for insurers, to reflect the Government's reforms.

1.16 The Government will legislate as necessary, including in particular to:

- ensure the risk margin is changed to reduce the risk margin for long-term life insurance business, including Periodic Payment Orders, by 65%, and for general insurance business by 30%, under recent economic conditions and to enable a modified cost of capital approach to its calculation;

- maintain the existing methodology and calibration of the fundamental spread, while allowing for the use of notched ratings; and
- broaden the matching adjustment eligibility criteria to include assets with highly predictable cashflows, subject to adjustments to the fundamental spread allowance and safeguards to be implemented by the PRA;

1.17 The Government will work with the PRA to enable changes to its Rulebook and other requirements to:

- ensure that the PRA can seek assurance on firms' internal ratings, and require changes and adjustments where appropriate;
- introduce the other investment flexibilities consulted on. These include broadening the liabilities eligible for the matching adjustment and removing the disproportionately severe treatment of assets in matching adjustment portfolios whose ratings are below investment grade (BBB); increasing flexibility in the treatment of matching adjustment applications and breaches; and setting up a mechanism for the PRA to report on application timelines and approval rates;
- update approval requirements for firms' internal models to streamline the number of requirements while maintaining high modelling standards, and allow the PRA to exercise more supervisory judgement in assessing the adequacy of firms' models;
- ease burdens by reducing reporting and administrative requirements;
- remove branch capital requirements for foreign firms with appropriately capitalised parents; and
- introduce a new mobilisation regime for insurers and at least double the premium and reserve thresholds before Solvency UK applies.

1.18 By choosing to retain some aspects of the package within legislation, the Government is providing insurers with the required regulatory certainty to make long-term productive investments. The Government is confident that this package and implementation plan delivers on its objectives, setting the UK insurance sector up for success with a tailored and stable regulatory regime.

Chapter 2
Risk margin

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.

2.1 Almost all respondents agreed with the principle that some level of risk margin is required to transfer a book of insurance business if a firm becomes distressed. Almost all respondents also considered the existing risk margin to be far larger than is necessary to fulfil its purpose (to provide additional protection for policyholders). There was broad consensus that cutting the risk margin for long-term life insurance business by 60-70% in recent economic conditions would not materially reduce policyholder protection. Several respondents also noted that retaining the Solvency Capital Requirement will ensure policyholders remain well protected.

2.2 As expected, respondents agreed that cutting the risk margin by 60-70% would increase insurers' own funds and improve balance sheet stability. Respondents noted that the capital release would be muted initially by historic Transitional Measures on Technical Provisions and by recent interest rate rises. Expectations of the impact on pricing were therefore mixed – with some respondents predicting a positive impact on pricing, but others expecting not to reduce prices should the risk margin be cut.

2.3 Respondents considered that a 60-70% cut to the risk margin would have little impact on levels of longevity reinsurance. Some respondents suggested that a larger cut of 75% or above would be required to make longevity reinsurance decisions economically neutral. However, many respondents stated that they would continue to reinsure some level of longevity risk no matter the size of the risk margin, as reinsurance would remain a valuable risk management tool in any scenario.

Government Response

2.4 The Government will legislate as necessary to reform the risk margin in a way which will reduce the risk margin for long-term life insurance business, including Periodic Payment Orders, by 65% under recent economic conditions. This will:

- free up substantial amounts of capital, removing a barrier to lower product prices and higher annuity yields;
- reduce the volatility of life insurers' balance sheets;

- safeguard against the risk margin becoming too large and too volatile during future periods of low interest rates; and
- retain a risk margin that ensures that insurers hold sufficient assets to transfer their liabilities to another insurer if required.

2.5 Policyholders will remain protected by the Solvency Capital Requirement, requiring insurers to hold enough capital to withstand a 1-in-200-year shock, and the PRA's existing supervisory powers, coupled with the additional measures that the PRA will take forward as set out in Chapter 1. The Financial Services Compensation Scheme will remain in place as a further safeguard for policyholders.

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.**

2.6 Respondents confirmed that the size and volatility of the risk margin is a less important consideration for general insurers than for life insurers, predominantly due to differences in the duration of their liabilities. As such, a reduction in the risk margin would have only a limited impact on business decisions, including reinsurance, investment, and pricing. Several respondents considered that cutting the risk margin for general insurers is appropriate and that 30% is an appropriate cut. Moreover, nearly all respondents agreed that there would be no negative impact on policyholder protection.

Government Response

2.7 As supported by consultation respondents, the Government's reforms will cut the risk margin for general insurance business by around 30% and will legislate as necessary to implement this change. This change reduces extraneous capital requirements that do not meaningfully increase policyholder protection.

Question 2.3 Do you agree that a modified cost of capital methodology should be used to calculate the risk margin?

2.8 Almost all respondents who expressed a preference supported the use of a modified cost of capital methodology to calculate the risk margin. Respondents saw this approach as theoretically sound and highlighted that it would align with the current approach, easing the move to the new regime.

Government Response

2.9 The Government agrees that a modified cost of capital method should be used to calculate the risk margin. The Government will legislate as necessary to enable such a methodology.

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?

2.10 Many respondents suggested that no further information required consideration when finalising the calibration of the risk margin. Several respondents noted that the observed transfer values of insurance risk depend on the regulatory regime under which they occur and, as such, should not be relied upon as independent measures of transfer values. A small number of respondents suggested that there should be consideration of the price to reinsure risk commercially.

Government Response

2.11 The Government notes these consultation responses. It considered the price of longevity reinsurance when deciding the appropriate risk margin calibration.

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?

2.12 Several respondents argued that competition in insurance markets would incentivise insurers to use any released capital to reduce product pricing: the capital would be used to increase the size of the market rather than being distributed to shareholders or parties within firms. There were concerns that any restrictions on commercial decisions about capital allocation could have significant unintended consequences, especially for insurers active in specialist markets.

Government Response

2.13 The current risk margin calibration overstates technical provisions, leading to higher than necessary prices for potential policyholders. The Government will continue to work with the insurance sector so that benefits are passed on to consumers through the provision of a greater range of more affordable products. The Government has no intention to restrict commercial decisions about capital allocation.

Chapter 3
Matching adjustment

Rationale and current calculation

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?**

3.1 Many respondents considered that the current methodology was prudently calibrated, allowing for around 2.5 times the historical average rate of defaults. These respondents judged that the fundamental spread fully accounts for retained risks.

3.2 Where respondents explicitly addressed the risks associated with assets with the same credit rating but different market measures of retained risks, they generally agreed that there was some cause for concern. This was also true for risks around internally rated assets.

3.3 Many respondents strongly suggested that ratings were a better measure than prevailing credit spreads of the risks faced by users of the matching adjustment. These respondents suggested that credit spreads capture market sentiment fluctuations alongside credit risk expectations. In their view, long-term life insurers who hold assets to maturity are not affected by market sentiment fluctuations, so relying on ratings is more appropriate.

Government Response – see combined response to Questions 3.1-3.4

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.

3.4 Respondents argued that any model that used a methodology based on a credit risk premium derived from market spreads would have strongly adverse impacts, no matter the calibration. These respondents provided evidence that incorporating a credit risk premium would:

- increase the best estimate liability, reducing own funds and increasing capital buffers;
- increase balance sheet volatility, causing insurers to hold extra capital buffers;
- reduce incentives to provide annuities, increasing prices for consumers; and
- disincentivise investment in illiquid assets, including infrastructure.

Government Response – see combined response to Questions 3.1-3.4

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?

3.5 Several respondents asserted that any increase in the fundamental spread via a methodology based on a credit risk premium would negatively affect long-term productive investment and new business prices by increasing capital requirements and introducing volatility. Only a very small number of respondents suggested that a modest increase in the fundamental spread could be achieved without these significant negative impacts.

Government Response – see combined response to Questions 3.1-3.4

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%?

3.6 Many respondents considered that policyholder protection was sufficiently high under the existing regime and that the case for reform had not been made. Some respondents advised that the volatility introduced by a credit risk premium could negatively affect policyholder protection by undermining otherwise sound firms by introducing instability into their balance sheets.

Government Response to Questions 3.1-3.4

3.7 Solvency UK will not include current spreads in the fundamental spread. The Government will instead legislate as necessary to maintain the existing methodology, which only relates to spreads over long time periods. The Government agrees that the incorporation of current spreads into the calculation of the fundamental spread would have significant negative impacts. Responses provided ample evidence that making the fundamental spread reliant on current spreads would increase capital requirements and introduce significant volatility onto insurers' balance sheets, especially if they invest in illiquid assets. Analysis showed how this would disincentivise long-term productive investment, clearly hindering the Government's objectives to support long-term investment and international competitiveness while missing the opportunity to boost growth. These negative impacts more than offset any benefit of changing the fundamental spread methodology. Analysis also showed that credit ratings are a key basis for assessing the credit risk of assets held to maturity.

3.8 As set out in the Consultation paper in April 2022, there has been no consensus on the best approach on reform of the fundamental spread. The Government has carefully considered the case for reform, has analysed the expected impacts of a variety of options put forward (including a number of proposals by the PRA), and has decided to leave the design and calibration of the fundamental spread as it stands today. It will, however, increase the risk sensitivity of the current fundamental spread approach to allow different 'notched' allowances to be made within major credit ratings (for example, different allowances for assets rated AA+ or AA- compared with AA). See also paragraphs 3.17 to 3.18.

3.9 These steps on the fundamental spread, when combined with other changes to the matching adjustment, will enable insurers to increase their investment in productive assets, fuelling the UK economy. Although the Government has decided not to take forward the PRA's proposals for reform of the fundamental spread, the Government recognises the importance of policyholder protection. With this in mind, the Government recognises that the rules set out in legislation must work in close combination with supervisory tools held by the regulator.

3.10 Accordingly the Government will support the PRA both by ensuring it has the powers necessary to take forward the following additional measures and by being clear that it supports the PRA's use of these measures to hold insurers to account in maintaining safety and soundness and policyholder protection. The Government also supports the PRA in expecting that at all times insurers will apply high standards of risk management and will cooperate fully with the PRA in the use of these supervisory tools. The PRA will use these tools consistent with the legislation and will report to Parliament on how well they are working to meet the PRA's risk tolerance. The additional measures are:

- to require insurers to participate in regular stress testing exercises prescribed by the PRA to test insurers' resilience to scenarios the PRA will set out, and to allow the PRA to publish individual firm results;
- to require nominated senior managers with formal regulatory responsibilities and sanctions under the Senior Managers Regime to attest formally to the PRA whether or not the level of the fundamental spread on their firm's assets is sufficient to reflect all retained risks, and that the resulting matching adjustment reflects only liquidity premium, on the basis of a rigorous assessment of the characteristics and valuations of assets held in their matching adjustment portfolios, including the results of the stress testing exercises described above;

- to allow insurers to apply a higher fundamental spread through an add-on where they conclude that the standard allowance is insufficient taking into account the work undertaken to support the attestations set out above; and
- to update its matching adjustment rules as appropriate to reflect the Government's decision to widen the eligibility requirements to include assets with highly predictable cashflows (for example, to specify increases to the fundamental spread allowances to take into account the additional risks from non-fixed cashflows, portfolio limits etc).

3.11 As the regime transitions from an EU regime to a UK one, the PRA will also need to publish technical information for the calculation of the matching adjustment reflecting the assets held by UK firms, following the matching adjustment methodology and calibration specified in legislation.

3.12 Given the significance of the matching adjustment and the wider reforms to the Solvency II rules, the Government has also asked the PRA to keep use of the matching adjustment under close scrutiny. The Government will review whether the calibration of the fundamental spread remains appropriate in 5 years' time. Prior to the Government's review the PRA will undertake an evaluation of its assessment of the impact on its statutory objectives of the Solvency II reforms, including the impact of the additional measures listed above, and its assessment on whether further changes are needed. The Government will take into account the results of the PRA's evaluation when undertaking its review. The PRA will also take forward a review jointly with the FCA to assess whether changes may be needed to the Financial Services Compensation Scheme or FSCS levy for insurers, to reflect the Government's reforms.

Question 3.5 What is the impact of selecting an averaging period (n) of 0.5, 1, 2, 5, 10 and 30 years?

3.13 In general, respondents agreed that a very short averaging period of 0.5, 1 or 2 years would introduce material volatility onto balance sheets. Insurers would need to hold additional capital buffers to mitigate this effect, reducing their competitiveness and increasing barriers to the provision of affordable products. Respondents raised concerns that a fundamental spread that closely tracked credit spreads would not reflect insurers' actual exposure to risks, as they often hold their assets to maturity and will not be forced to sell them at low market prices. A very short averaging period might capture excessive volatility rather than useful information about risk.

3.14 Many respondents considered that a medium-term averaging period of 5 to 10 years could lead to undesirable outcomes, counterintuitively leaving insurers holding lower levels of capital before an increase in risk, and higher levels of capital some years later. Many respondents preferred a longer averaging period of more than 15 years to mitigate concerns around volatility and undesirable outcomes.

Government Response

3.15 The Government will maintain the long-term average spread component of the fundamental spread methodology. The Government agrees that the lagged nature of using a short- to medium-term moving average of the credit spread would likely create undesirable outcomes, including volatility or procyclicality. Therefore, the Government will legislate as necessary to maintain the current averaging period of 30 years.

Question 3.6 Are there other ways to achieve the same outcomes that changes to the fundamental spread would have?

3.16 Most respondents suggested that notched credit ratings would increase the granularity of risk measurement by better reflecting the risk profile of each asset. Several respondents suggested increased scrutiny of internally-rated assets, including through PRA supervision and external validation. Others suggested a fundamental spread based on stochastically modelled credit loss projection or moderately increasing the fundamental spread for assets with acute rating uncertainty or significant temporary spread increases.

Government Response

3.17 The Government has decided to enable the introduction of a more granular approach to credit risk by incorporating notched ratings into the calculation of the fundamental spread. Assets with higher credit risk would usually have a lower notched credit rating, leading to a more tailored fundamental spread. This increased sensitivity will increase policyholder protection. The Government will legislate as necessary to allow for the use of notched ratings.

3.18 The Government will also ensure that the PRA has sufficient powers to seek assurance on internal ratings. The Government supports the PRA using these powers where they are needed to ensure that the fundamental spread takes adequate account of risks associated with holding internally rated assets.

Chapter 4

Increasing investment flexibility

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.

4.1 Many respondents welcomed the proposals, considering that these reforms would support innovation and competition while increasing incentives to invest in long-term productive assets. Several respondents suggested infrastructure was particularly likely to benefit, as construction phase flexibility would materially improve investment. Several respondents also noted that the removal of the 'BBB cliff' should lead to increased investment in green and digital assets.

4.2 Several respondents called for reforms to go further, including by replacing the requirement that eligible assets generate cashflows that are fixed in terms of timing and amount with a requirement that they generate highly predictable cashflows. Respondents suggested that this reform could increase long-term productive investment and reduce product pricing, while also future proofing the regime against new developments.

4.3 Some respondents also noted that, while these reforms may promote long-term productive investment, the reforms did not target any type of asset specifically, and firms will ultimately invest according to their own economic interest rather than by prioritising assets that contribute to the Government's objectives.

Government Response

4.4 The Government confirms that it will introduce the changes to broaden matching adjustment eligibility, including flexibility to include assets with prepayment risk or construction phases. This reform will enable insurers to invest significantly more in long-term productive assets, especially in infrastructure.

4.5 To take full advantage of the opportunity to boost growth, the Government will also replace the requirement that all eligible assets have fixed cashflows with a more flexible requirement that they have highly predictable cashflows. The PRA will require firms to have adequate risk management of such assets including concentration limits and the Government would still expect the vast majority of assets in matching adjustment portfolios to have fixed cashflows.

4.6 Under the current fixity requirement, insurers receive the matching adjustment on assets with highly predictable cashflows only if these assets are restructured to create fixed cashflows. While the PRA judgement is that fixed cashflows protect policyholders by ensuring that promises to pay annuities are matched by insurers' income, the Government considers that the reform makes it more attractive to invest in those assets by removing or reducing the cost of asset restructuring. The Government agrees with respondents that this will incentivise investment in long-term productive assets, which could boost growth even more than the originally proposed package. It could also help to future proof the regime against evolution in asset features. This would reduce regulatory friction and foster innovation. The Government will legislate as necessary to make these changes.

4.7 Additionally, the Government will introduce the other proposals to increase investment flexibility, all of which were welcomed in consultation responses. These include:

- extending the range of liabilities eligible for the matching adjustment to include products that insure against morbidity risk, such as income protection products;
- removing the disproportionately severe treatment of assets in matching adjustment portfolios with ratings below BBB; and
- introducing greater flexibility in the treatment of matching adjustment applications and breaches.

4.8 The Government will work with the PRA to enable the implementation of these reforms.

4.9 As set out in the National Infrastructure Strategy, the Government is committed to supporting private investment in productive finance sectors. Accordingly, the Government established the UK Infrastructure Bank to co-invest alongside the private sector to support more than £40bn of infrastructure investment. The UK Infrastructure Bank will work closely with institutional investors, like insurers to explore opportunities for further expansion of investment into UK infrastructure.

4.10 The Government will continue to work with the insurance sector to better understand the role Government can play in reducing the barriers to investing productively, including strengthening the pipeline of investable productive assets.

Question 4.2 What are the additional risks that these reforms may pose to policyholder protection?

4.11 There was no consensus about the consequences for policyholder protection. The PRA views fixed cashflows as an important means of ensuring that cashflows to meet promises to policyholders are matched by income received from investments. Several respondents reported that there would be no threat to policyholder protection and that the existing protections are sufficient. Additional risks considered by respondents ranged from lack of data for new asset classes leading to an inappropriate capital treatment, to less secure cashflows leading to less close matching of assets and liabilities. Some respondents noted that the change in eligibility criterion from fixed to highly predictable cashflows could be introduced in such a way that policyholder protection was not negatively affected.

Government Response

4.12 The Government considers that making the fundamental spread more granular and risk-sensitive using notched credit ratings will maintain high standards of policyholder protection alongside the investment flexibility reforms. Under Solvency UK, insurers' matching adjustment-eligible assets will remain subject to existing high standards of risk management, the Solvency Capital Requirement, and expert PRA supervision, coupled with the measures that the PRA will take forward as set out in 3.10.

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?

4.13 As noted above, several respondents viewed the reforms as presenting no extra risk to policyholder protection. Many respondents argued that the existing safeguards, including the Prudent Person Principle and the Solvency Capital Requirement, were sufficient to maintain high standards of policy holder protection.

4.14 Other respondents thought that additional measures were appropriate to safeguard policyholder protection or support other government objectives, including the introduction of firm-specific exposure limits, closer supervision of sub-investment grade assets and internally rated assets, and generally empowering the PRA to make further interventions where necessary.

4.15 A few respondents noted that matching tests, cashflow or yield haircuts, and additional capital requirements could mitigate any risks to policyholder protection introduced by the introduction of a criterion allowing for highly predictable cashflows.

Government Response

4.16 The Government recognises that changes will be needed to manage the additional risks that arise from the change to introduce assets with highly predictable cashflows into matching adjustment portfolios. The government will ensure that the PRA has the powers necessary to adapt the matching adjustment regime to reflect these issues including through a higher fundamental spread allowance for assets without fixed cashflows, risk management requirements to ensure close cashflow matching of portfolios is retained, and the use of the Prudent Person Principle to ensure firms avoid undue concentrations of risk. The Government supports the PRA making active use of the range of measures set out in 3.10 – including requiring senior manager attestation, allowing for the application of higher fundamental spreads, and performing stress-testing – and will work with the PRA to ensure they have the powers to mitigate risks as necessary.

Question 4.4 What impact will these reforms have on insurers providing a greater range and more affordable pricing of products?

4.17 Most respondents reported that the reforms would likely lead to more competitive pricing, especially for products that insure against morbidity, such as income protection products. Respondents also considered that the reforms would help to boost both the retail and bulk purchase annuity markets, benefitting UK pensioners.

Government Response

4.18 The Government notes these consultation responses and took them into consideration when deciding on an appropriate reform package.

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?

4.19 Respondents called for a greater degree of transparency in the matching adjustment approval process, as well as standardisation and a principles-based approach to approvals.

4.20 Respondents submitted a variety of suggestions to improve the matching adjustment approval process, including:

- automatic approval for non-complex assets;
- no approval requirements for minor changes to existing applications;
- a fast-track for applications with a limited exposure to new sources of credit risk;
- simplification of new asset classes, and less granular definitions of asset classes; and
- the PRA publishing and updating a register of fully approved assets and features.

Government Response

4.21 The Government supports two key measures to improve matching adjustment approval processes, facilitating long-term productive investments: a new streamlined eligibility application process for less complex assets; and provision of greater flexibility for how innovative assets are treated. However, the Government remains of the view that approval assessments should continue to be made at firm-level to ensure they take into account specific risks and mitigations.

4.22 The Government will now work with the PRA to implement these reforms. The Government will also ask the PRA to provide regular reports on matching adjustment approval rates and times, with a particular focus on long-term productive investments.

Chapter 5

Reducing reporting and administrative burdens

Question 5.1 What is the impact of these reforms on regulatory costs incurred by insurers?

5.1 Respondents strongly supported the proposals to reduce reporting and administrative burdens, stating that reforms will unlock significant efficiency savings. There was widespread support for removing extraneous or duplicative reports, which was preferred to rearrangement of templates.

5.2 Some respondents raised concerns that a reporting reduction could lead to an increase in ad-hoc reporting requests. Others welcomed the long-term saving the reforms will offer but pointed out potential transition costs, calling for reforms to be implemented as a block. Some respondents expressed concern that divergence with the EU's reporting requirements could increase costs for those firms required to produce reports for both jurisdictions.

5.3 Several respondents voiced support for the proposal to simplify the calculation of Transitional Measures on Technical Provisions, both in respect of the calculation and the governance around maintaining the measure. This would reduce the burden of maintaining legacy capital models.

Government Response

5.4 The Government welcomes the expected efficiency savings these reforms will unlock, by reducing the burden on firms. This includes updating approval requirements for firms' internal models to streamline the number of requirements while maintaining high modelling standards, and allowing the PRA to exercise more supervisory judgement in assessing the adequacy of firms' models. Some reforms to reporting have already been made and a further consultation has been launched by the PRA in November. Further PRA consultations on other reforms will follow the passage of the Financial Services and Markets Bill.

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?

5.5 The majority of respondents strongly supported the proposal to remove branch capital requirements. Many suggested that this reform would make the UK more attractive to new business, boosting competition and bolstering the country's reputation as a global insurance hub.

5.6 Most respondents asserted that the reform did not reduce policyholder protection if the parent firm is subject to equivalent regulatory requirements, since a branch cannot fail independently of its parent.

5.7 A few respondents asserted that removing the requirements could give foreign insurers a competitive advantage in cases where home markets are not equivalent, possibly leading to regulatory arbitrage. A few respondents argued that this could result in capital flows out of the UK, leading to reduced investment.

Government Response

5.8 The Government has decided to remove branch capital requirements and will legislate as necessary to enable the PRA to do so. This reform will make the UK even more attractive as a location for insurance business, spurring competition and advancing the UK's position as a world-leading insurance market. This will benefit branches of foreign insurers based in the UK immediately upon implementation, as well as reducing barriers for foreign insurers wishing to establish a UK branch in the future.

5.9 The Government agrees that branch capital requirements do not support policyholder protection if the parent firm is itself appropriately capitalised. The Government is confident that this will not disadvantage UK firms or result in regulatory arbitrage, as branches operating in the UK will need to continue to meet the relevant regulatory requirements.

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?**

5.10 Respondents welcomed proposals to establish a new mobilisation regime and change the applicability of Solvency UK, agreeing that this would boost competition and innovation. These respondents expected that this would result in a wider range of products, including innovative insurance technology offerings, opening up to consumers. A small number of respondents noted their preference for a single regime exercising proportionality in its application rather than separate regimes.

Government Response

5.11 The Government has decided to introduce a new mobilisation scheme for insurers, consistent with that used for the credit institutions sector, and intends to legislate as necessary to enable the PRA to do so. Such a regime would create an optional stage in a prospective insurer's entry to the market, including adjusted entry requirements such as a lower capital floor, lower expectations for key personnel and governance structures, and exemptions from some reporting requirements. The mobilisation regime should:

- facilitate potential start-up firms raising the capital they need for authorisation and market entry;
- boost competition in the sector; and
- support firms to launch new innovative products.

5.12 The Government has decided to increase the thresholds for the size and complexity of insurers before Solvency UK applies to £15 million in annual gross written premiums (triple the previous threshold) and to £50 million in gross technical provisions (double the previous threshold). Firms below this threshold will still be able to opt into Solvency UK should they choose to. This reform will boost competition and innovation, reducing barriers to market entry and allowing smaller firms to grow more quickly.

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