HM Treasury

Review of Solvency II:
Call for Evidence - Response

July 2021

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Overview

Overview of responses

1.1 On 23 June 2020 the Government announced that it would review certain features of the prudential regulatory regime for the UK insurance sector, known as Solvency II. On 19 October 2020 the Government published a Call for Evidence[1] as the first stage of this Review. The Call for Evidence closed for responses on 19 February 2021. The Government thanks all respondents to the Call for Evidence.

1.2 The Call for Evidence asked respondents to raise any issues relating to Solvency II, including views and evidence on the ten major areas for review set out in that document:

- risk margin;
- matching adjustment;
- calculation of the solvency capital requirement;
- calculation of the consolidated group solvency capital requirement using multiple internal models;
- calculation of the Transitional Measure on Technical Provisions;
- reporting requirements;
- branch capital requirements for foreign insurance firms;
- thresholds for regulation by the Prudential Regulation Authority (PRA) under Solvency II;
- mobilisation of new insurance firms;
- risk-free rates: transition from the London Inter-bank Offered Rate to Overnight Indexed Swap rates.

1.3 The Government received 64 written responses to the Call for Evidence[2]. Responses were received from:

- insurance and reinsurance undertakings (25 responses) of which:
  - combined life and non-life insurance firms (4 responses);

[1] See https://www.gov.uk/government/publications/solvency-ii-review-call-for-evidence

[2] During the period for responses to the Call for Evidence, the Government also held a number of bilateral meetings and roundtables with stakeholders with an interest in the Review.

- predominantly life insurance firms (9 responses);
- specialist (re)insurance undertakings (6 responses);
- predominantly non-life insurance firms (4 responses);
- reinsurance firms (2 responses);

- industry representative bodies (14 responses);
- consultancies, law firms, etc. (12 responses);
- members of the public (7 responses);
- other organisations (6 responses).

1.4 Respondents were strongly supportive of the Solvency II regime. Respondents considered that Solvency II had improved standards of risk management and reporting in the insurance sector as well as the overall standard of prudential regulation. No respondents argued that Solvency II should be replaced by a different regime. Respondents stressed that Solvency II should be retained not least because of the cost and disruption to replace it in full.

1.5 Many respondents considered that the operation of Solvency II could be improved while retaining the current framework. The rationale for Solvency II to evolve included the need for the prudential regime to:

- better reflect the structures and processes of UK insurance firms;
- be more efficient and effective, including the removal of requirements that deliver little benefit;
- be more flexible and agile, and less rules-based and prescriptive;
- enable provision of a wider choice of more affordable products;
- enhance competition and better support smaller insurance firms, and entities that may want to become insurance firms;
- reduce supervisory complexity.

1.6 Of those respondents that commented specifically, all supported the Review's objectives to:

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

1.7 A number of respondents recommended that reforms to the prudential regulatory regime should be considered alongside reforms made as part of the Government's Review of the Future Regulatory Framework for financial services[3].

[3] See https://www.gov.uk/government/consultations/future-regulatory-framework-frf-review-consultation

1.8 Some respondents recommended against making reforms to Solvency II which might be deemed to amount to divergence between the prudential regulatory regimes of the UK and EU.

Response

1.9 Overall, the responses to the Call for Evidence provided extensive evidence that many aspects of Solvency II are overly rigid and rules-based. The Government agrees with this evidence. The Government wants to see a prudential regulatory regime that is more proportionate and flexible so that it works more effectively and outcomes can be delivered more efficiently.

1.10 Such a regime would include a better mix of judgement and rules so that it can be better applied by the PRA, as well as by insurance firms. It would better support a vibrant, thriving and competitive insurance sector. It would also provide a sound foundation for insurance firms to provide long-term capital to the economy including investment in long-term productive assets as well as investment consistent with the Government's climate change objectives. Such a regime would ensure high standards of policyholder protection and the safety and soundness of insurance firms. The evidence is persuasive that reforms to Solvency II are required if the prudential regulatory regime is to be consistent with the Government's objectives.

1.11 There are close interactions and dependencies between many of the areas of potential reform. The impact of potential changes to the Solvency II regime on the balance sheets, solvency positions and the actions of insurance firms in meeting the requirements of the prudential regulatory regime will need to be examined together rather than separately. The Government will work closely with the PRA to identify an optimal reform package that can be implemented as soon as possible.

1.12 For example, there is consensus in the responses to the Call for Evidence that the risk margin is currently too high and too volatile. Unforeseen consequences flow from its design, particularly at current low interest rates. A reduction in the size, and sensitivity of, the risk margin to interest rates would diminish the incentive to reinsure longevity risk outside the UK. It would allow insurance firms greater flexibility to manage their balance sheets and the pricing and range of the products that they provide. Reforms to the risk margin would also affect, and inform, reforms to the Transitional Measure on Technical Provisions (TMTP).

1.13 The Government agrees with the responses to its Call for Evidence that there is a strong case to reform the risk margin. It agrees that reform would free up resource on, and reduce the volatility of, insurance firms' balance sheets. It also agrees that reform would contribute to a dynamic, prosperous and internationally competitive insurance sector.

1.14 In addition, the eligibility of different asset classes with different characteristics for the matching adjustment portfolio is a key determinant of insurance firms' provision of long-term capital to the economy, including in infrastructure investment, and assets that are consistent with helping to combat climate change. The Government thinks that the application process for the matching adjustment needs to be proportionate to the benefits and risks for insurance firms so that they can move flexibly and quickly to invest in assets that are eligible for this adjustment. The Government agrees with the evidence obtained in the responses to the Call for Evidence that supports this case.

1.15 Equally, potential amendments to the matching adjustment need to be informed by the credit and other long-term risks insurance firms are exposed to, including through growing concentrations in illiquid, internally rated assets. Reforms should balance these considerations while supporting the Government's objectives in relation to the provision of long-term capital by the insurance sector to the economy and investment consistent with the Government's climate change objectives.

1.16 Furthermore, the Government agrees with the responses to the Call for Evidence that detail the benefits of reform to the framework for the calculation of the solvency capital requirement. The Government agrees that the framework for the calculation of the solvency capital requirement for insurance firms – whether they use the standard formula or models – needs to operate efficiently and effectively. Potential reforms need to ensure that the requirements in Solvency II do not place disproportionate burdens on insurance firms, either in relation to the calculation of the solvency capital requirement or model application processes.

1.17 The responses to the Call for Evidence identified other areas of reform to Solvency II. The Government agrees that other potential reforms to Solvency II would improve its efficiency and effectiveness. These reforms include the streamlining of reporting requirements. In addition, technical changes to the risk-free rates[4] used by insurance firms to discount their liabilities will provide firms with clarity when the London Inter-bank Offered Rate (LIBOR) is discontinued. The PRA announced further details on these issues on 3 June 2021[5]. Other areas also include reforms to the mobilisation of insurance firms and thresholds for the application of Solvency II. Informed by the responses to the Call for Evidence, the case for branch capital requirements for foreign insurance firms needs to be reconsidered given the costs that they may impose and in light of other ways available to ensure effective supervision of such branches. The Government will take forward reforms in these areas, in conjunction with the PRA, as part of its overall reform package for Solvency II.

1.18 Annexes A-K of this Response provide a summary of responses to the Call for Evidence. They are not intended to be a comprehensive report of all the issues raised by respondents.

[4] The Government laid legislation in April 2021 to allow for an appropriate Credit Risk Adjustment to be applied by the PRA to accommodate the transition from London Inter-bank Offered Rate based to Overnight Index Swap based risk-free rates. This change came into force on 28 May 2021. See http://www.legislation.gov.uk/id/uksi/2021/463.

[5] The PRA published CP1/21 on 7 January 2021 on its proposed approach to deep, liquid and transparent assessments and the transition of Solvency II technical information from GBP LIBOR to the Sterling Overnight Index Average (SONIA) in 2021. The PRA published Policy Statement 12/21 on 3 June 2021.

Chapter 2

Next steps

2.1 The Call for Evidence was broad in scope as the Government sought views on priorities for reform of Solvency II. The responses have confirmed the priorities for reform as set out in the Call for Evidence. The evidence base is compelling. The Government has asked the PRA to model different options to better understand which combination of reforms would best meet the Government's objectives and what the aggregate impact would be. To achieve this, the PRA will launch a quantitative impact study this summer and work with the Government to analyse its results. This study will inform a comprehensive package of reforms for consultation in early 2022.

2.2 In October 2020, the Government published a consultation on the Future Regulatory Framework for financial services. The key purpose of the Future Regulatory Framework Review is to determine how the UK's financial services regulatory framework needs to adapt to reflect our position outside the EU and ensure it is fit for the future. It considers whether changes are required to regulators' objectives and principles; how we ensure regulators' accountability and scrutiny arrangements with the Treasury, Parliament, and stakeholders are appropriate given the regulators' new responsibilities; and how responsibility for designing and implementing rules in areas of retained EU law is transferred to the regulators. The Government will publish a second consultation on the Future Regulatory Framework Review later in 2021.

2.3 Should responsibility for making firm-facing requirements under Solvency II be delegated to the PRA, the Government would set out the scope and core elements that the PRA must establish when amending the firm-facing elements of Solvency II in its Rulebook. The Government may also set out what the PRA must have regard to when establishing and maintaining this regime.

Annex A

Risk margin

The impact of the risk margin and rationale for reform (Question 1)

A.1 Almost all respondents that addressed the risk margin considered that there is scope to reform it. These respondents recognised the case for the risk margin but argued that the risk margin in its current form is flawed and that significant reform is required.

A.2 Respondents identified the following issues with the risk margin as currently designed:

- it is too large and results in inefficiencies and distortions in the balance sheet;
- it is too volatile, that is, it is excessively sensitive to interest rates, especially at a time of low interest rates. It also moves in a pro-cyclical way that incentivises short-term rather than long-term balance sheet management and destabilises balance sheets;
- it results in a transfer of longevity risk outside the UK[6];
- it adversely affects the price and availability of certain insurance products;
- it does not reflect actual market values for the transfer of risk.

Reform of the risk margin methodology (Question 2)

A.3 Respondents gave a range of proposals for the level of the risk margin, amounting to reductions from around 20% to more than 75%. Many respondents, however, did not provide justification for their specific proposals. Of the respondents that argued that the risk margin needs reform, the majority did not express a preference about the method used to effect that reform. These respondents indicated that the quantum of the reform, rather than the method to achieve the reduction in the size of the risk margin, is the priority. A number of respondents proposed specific reforms to the risk margin, as follows:

- reduce the current 'cost of capital' parameter in the existing methodology;
- incorporate a time-sensitive component (a 'lambda' factor);

[6] Longevity risk is treated as a 'non-hedgeable' risk in Solvency II and is included in the risk margin. To remove the impact on the risk margin, such risk can be reinsured outside the UK and EU.

- adopt the percentile methodology used in the international standard under development, the Insurance Capital Standard[7];
- allow for diversification between activities and entities within a group[8];
- treat longevity risk as 'hedgeable' (i.e. exclude it from the risk margin);
- other approaches[9].

The benefits and costs of changes in the risk margin methodology (Question 3)

A.4 Respondents pointed to numerous potential benefits flowing from a reduction in the risk margin, including that it would:

- reduce the size of, and distortions and inefficiencies in, the balance sheet;
- result in a more stable balance sheet including by reducing interest rate sensitivity;
- 'free up' resources and boost investment in infrastructure and the provision of long-term finance to the economy;
- reduce the reinsurance of longevity risk offshore;
- improve the range and affordability of products, including bulk annuities;
- contribute to raising economic growth, tax revenues and the proportion of insurance firms' activity and profits retained in the UK and boosting international competitiveness.

A.5 Many respondents stated that reform of the risk margin was consistent with the three overarching objectives for the Review. The majority of respondents did not identify costs arising from reform of the risk margin. These respondents argued that reform could be achieved without a material reduction in policyholder protection.

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7 This method is known as the Margin Over Current Estimate (MOCE) in the Insurance Capital Standard. The MOCE covers the inherent uncertainty in the cashflows related to insurance obligations and is approximated as a percentile of the distribution of insurance obligations.

8 The current risk margin design does not recognise diversification between life and non-life business and between different legal entities within the same group.

9 For example, redefine the risk margin as a percentage of best estimate liabilities, include in solvency capital (rather than technical provisions), change the discount rate used in the calculation (e.g. add a margin to it, use the same rate as used in the volatility adjustment/matching adjustment) and determine on 'a principles–based approach'.

Annex B

Matching adjustment

B.1 Many respondents stated that they support the principles of the matching adjustment and, therefore, its continued use in the prudential regime. For example, some of these respondents cited their support for the way that the matching adjustment allows insurance firms that write annuities to reflect only the market risks they are exposed to. A few respondents noted that the matching adjustment reduces pro-cyclicality.

B.2 However, a few respondents were sceptical about the continued use of the matching adjustment, arguing that the matching adjustment:

- is imprudent[10];
- has no clear economic rationale[11];
- does not make annuities more affordable;
- does not support the provision of long-term capital to the economy;
- can drive social inequality by restricting the parts of the economy that receive debt financing from insurance firms that use the matching adjustment.

B.3 Some respondents proposed fundamental reforms to the matching adjustment, for example to:

- re-examine the reasons for the creation of the matching adjustment, and whether it remains valid to assume the historically observed liquidity premium continues to exist for certain assets that may be traded competitively;
- reconsider the extent to which insurance firms that write annuities are genuinely free from the risk of forced asset sales;

[10] These respondents argued that the matching adjustment is overstated as the illiquidity premium is 10-20 basis points at most, thus rendering the balance a state subsidy. The matching adjustment allows future uncertain profits stemming from the illiquidity premium to be capitalised upfront and distributed as dividends. These respondents disagreed that insurance firms that use the matching adjustment are less exposed to asset price movements.

[11] These respondents argued that, according to economic theory, there is no rationale for discounting risk-free liabilities at higher than the risk-free rate. The risk profile of an insurance firm's asset investment strategy also has no bearing on the current cost of transferring liabilities to a third party.

- reconsider how to address the overall uncertainty present in the calibration of the fundamental spread[12], due to difficulties in decomposing spreads for liquidity, default and other risks;
- reconsider how to address specific uncertainties present in the calibration of the fundamental spread, due to the use of historic data that does not capture forward-looking risks;
- consider whether limits should be applied to the level of matching adjustment, and/or to certain asset exposures, to take into account uncertainties in areas such as internal credit ratings;
- reconsider making the default provision in the fundamental spread accessible when defaults are higher than the core fundamental spread;
- present the matching adjustment benefit as a separate 'matching adjustment asset' on the balance sheet to increase transparency;
- re-define the matching adjustment as an illiquidity premium or similar concept that is set by the PRA and awarded to all insurance firms based on features of their liabilities rather than returns on their assets;
- increase the strength of the base balance sheet while correspondingly reducing the solvency capital requirement (SCR).

Eligibility of assets for the matching adjustment (Question 4)

B.4 Respondents raised a range of views about whether the eligibility criteria for the matching adjustment should be changed, and if so whether this should be to loosen or tighten the criteria. Several respondents reported that the matching adjustment hinders investment in suitable matching assets. Specific points made by respondents included:

- that the current matching tests should be retained, but varying limits by asset type should be considered;
- that current eligibility rules are unclear, leading to inconsistent application and an un-level playing field;
- that the asset eligibility test should be abolished in order to focus the matching adjustment criteria on liabilities.

B.5 However, in contrast to these views some respondents said that the eligibility criteria should instead be tightened.

B.6 Many respondents raised similar concerns about eligibility, arguing that the current asset eligibility requirements are binary, inflexible and should be more principles-based. Proposals to address these issues included:

[12] The fundamental spread is that part of the credit spread that reflects the expected cost of default and downgrade of assets that insurers retain from holding assets in their matching adjustment portfolio.

- changing the 'fixed' cashflow requirement to 'highly predictable', potentially using alternative risk mitigation mechanisms[13];
- allowing assets with prepayments if mitigating strategies are in place[14];
- applying eligibility rules at portfolio level as opposed to asset level;
- to mitigate the risks of a 'highly predictable' requirement, introducing a quantitative tolerance for uncertainty in the asset cashflow at portfolio level;
- introducing a 'sandbox' concept under which insurance firms can invest in less traditional assets in the matching adjustment portfolio up to a stated limit.

B.7 Respondents also raised a variety of other eligibility-related points, for example that:

- the restructuring of assets to conform with eligibility rules is an unintended consequence that is widespread and undesirable[15];
- the separate management of the matching adjustment portfolio from other business should be notional to cut cost and complexity;
- equity release mortgages (ERMs) are inappropriate for the matching adjustment (whereas another respondent said that they are appropriate for the matching adjustment, subject to certain conditions);
- the eligibility of liabilities for the matching adjustment could be expanded[16];
- other asset-side reforms could be made, such as increased reliance on the Prudent Person Principle and firms' liquidity management to manage liquidity risks in the matching adjustment portfolio.

Calculation of the matching adjustment (Question 5)

B.8 Respondents suggested various amendments to improve the calculation of the matching adjustment. Some respondents argued for changes which would

13 Examples given by respondents of suitable assets with stable (but not fixed) cashflows included infrastructure, affordable housing and lifetime mortgages. Respondents proposed using stress tests to assess the extent of close matching of the timing and amount of cashflows and to use risk provisions to capture risk instead of excluding assets with the fixity requirement. Respondents argued that the 'fixed' definition excludes assets that meet underlying matching adjustment principles, i.e. close matching of asset and liability cashflows and negligible liquidity risk.

14 Respondents stated that the current rules exclude assets with market standard conditions like early repayment clauses. Respondents suggested that prepayment risks could be mitigated by holding capital against prepayment risk or by expanding the definition of the fundamental spread.

15 Respondents said that restructuring is costly, increases complexity for firms, creates barriers for smaller firms wanting matching adjustment benefit and does not enhance policyholder protection. Firms are still exposed to the equity tranche and so there is no change in risk exposure post restructuring, apart from possible increase in operational risk due to increased complexity. Respondents considered that restructured assets are no safer than the underlying assets, and so the underlying assets should be allowed in the matching adjustment portfolio.

16 For example, Periodic Payment Orders (PPOs) liabilities and certain types of deferred annuities which insurers often take on as part of Bulk Purchase contracts.

increase the matching adjustment benefit available to firms. For example, some respondents recommended:

- removing the sub-investment grade cap to avoid the non-risk-based cliff-edge where the matching adjustment benefit of sub-investment grade assets is limited to the matching adjustment benefit on similar BBB assets;
- increasing the granularity of the fundamental spread;
- removing the Long-Term Average Spread (LTAS) floor from the fundamental spread;
- removing the fixed 30% recovery rate and allowing firms to determine the probability of default directly.

B.9 Other respondents noted areas where the current calibration of the fundamental spread might be imprudent, for example some respondents recommended:

- making the fundamental spread more responsive (e.g. to market conditions, prices and emerging risks);
- recalibrating the credit element of the fundamental spread, e.g. by separately specifying the best estimate and risk premium components of credit risk;
- considering how to address uncertainties in the calibration of the fundamental spread.

B.10 A few respondents proposed:

- allowing insurance firms to calculate their own fundamental spread;
- tightening the rules on internal credit ratings, e.g. requiring explicit oversight;
- loosening the rules on internal credit ratings and balancing this with the Prudent Person Principle;
- allowing firms to remove distressed assets from matching adjustment portfolio in order to preserve the portfolio for other business.

Matching adjustment approval process (Question 6)

B.11 Respondents noted a variety of issues and potential reforms to the approval process for use of the matching adjustment, for example, many respondents:

- stated that the regulatory approval process is too costly, resource intensive and time consuming, and thus stifles innovation and prevents insurance firms from undertaking certain investment opportunities;
- noted that some portfolio changes should be allowed without formal regulatory approval, for instance where changes are 'minor' rather than 'major'.

B.12 Several respondents noted that it is not commercial or efficient for firms to be required to hold relevant assets on their balance sheet while waiting for

matching adjustment approval. Several respondents also suggested that the approval process should not simply result in a binary outcome for the portfolio.

Climate change risks and infrastructure investment (Questions 7 and 8)

B.13 Several respondents referred to their evidence on asset eligibility in responses on this topic, and supported reform in this area. Specifically, some respondents suggested that the matching adjustment should be reformed to better reflect emerging climate change risks, such as the risk of stranded assets, or that the matching adjustment should better support sustainable investments. Other respondents suggested that the matching adjustment should be reformed to better support the provision of long-term productive finance. Respondents gave a range of different views about whether and how the regime should be amended to address these issues, including that:

- there should be a reduction in the fundamental spread or capital charge for infrastructure assets;
- there should be a positive incentive to invest in 'green' assets, e.g. a reduction in the fundamental spread or capital charge for green assets;
- there should not be a penalty for investment in 'brown' assets;
- 'green' or 'brown' factors could be captured by credit rating processes;
- there are likely to be better ways or tools to address climate objectives than reforming the matching adjustment;
- the calibration of the fundamental spread or matching adjustment should be based on technical considerations rather than to provide direct investment incentives;
- assets for which cashflows rely on fossil fuel or greenhouse gas emitting activities should be deemed ineligible for the matching adjustment portfolio due to their heightened transition risks.

Managing risks with the matching adjustment (Questions 9 and 10)

B.14 Some respondents stated that the PRA does not require additional powers to manage potential risks to insurance firms and policyholders from the use of the matching adjustment. Instead, several respondents recommended that current rules (including the penalty) for insurance firms in breach of matching adjustment portfolio requirements are too strict and should be reformed. However, one respondent suggested that the PRA should have a power to investigate cases in which a significant matching adjustment benefit is being earned on assets with low capital charges, and be able to compel firms to use external credit ratings where it appears its internal credit ratings are too optimistic.

Annex C

Calculation of the solvency capital requirement (SCR)

C.1 The majority of respondents addressed the SCR calculation. Overall, respondents supported the risk-based nature of the framework. However, there were divergent views in relation to the 1 in 200 Value at Risk (VaR)[17] over a one-year horizon calibration standard, with some commenting that a 'to ultimate' time horizon for the SCR would be more useful for non-life firms, as it is consistent with standard actuarial techniques. Respondents also recognised that the SCR is not sufficient, in itself, to deliver an appropriate level of resilience, and that additional requirements on insurance firms' own governance and risk management arrangements and reporting and disclosure are also important.

Tools to assess and ensure that capital levels are appropriate (Question 11)

C.2 Several respondents stated that the PRA should already have all the information, tools and powers required to assess whether the level of capital held by insurance firms is appropriate. Some respondents cautioned against significant additional powers for the PRA (for example, when approving internal models) if it leads to reduced international competitiveness or additional resource burden on insurance firms.

C.3 One respondent considered that the current system for assessing the level of capital held by insurance firms works well, as does the interaction between insurance firms and the PRA. In contrast, some respondents commented that the PRA's assessment of capital adequacy under Solvency II could be more transparent. In particular, some respondents suggested that the PRA could better communicate which tools and metrics it uses when assessing firms' SCRs, including when the PRA monitors 'model drift'[18].

C.4 Some respondents commented that the PRA's monitoring activities could be more efficient. For instance, some respondents conveyed concerns in relation to 'voluntary information requests' that can be resource intensive to complete, and supported higher quality, rather than quantity, of reporting. One respondent cautioned against the over-reliance on benchmarking as a tool to assess the appropriateness of capital levels.

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[17] The SCR is calibrated as the Value-at-Risk of an insurer's basic own funds (a Solvency II-specific measure of surplus capital) at a confidence level of 99.5% over a one-year period. Value-at-Risk is a statistical measure used for financial risk management to estimate the amount of assets needed to cover possible losses. It is defined as the maximum amount expected to be lost over a given time horizon, at a pre-defined confidence level.

[18] Model drift is the risk that capital requirements calculated using an internal model may gradually weaken over time such that they no longer remain reflective of the risks to which the firm is exposed.

C.5 The use of capital add-ons (CAOs)[19] was raised by respondents in their responses to a number of questions. Specifically, several respondents supported greater use of CAOs, suggesting that they could help ensure that model approval is more flexible[20]. In a similar vein, a small number of respondents supported the use of CAOs as a long term solution to adjust capital requirements calculated via the standard formula (SF)[21]; in particular, in instances in which it does not accurately reflect an insurance firm's risk profile and it would be disproportionate for the firm to develop a model. A few respondents were in favour of more regular use of CAOs as a supervisory tool, rather than as a measure of last resort.

C.6 Some respondents argued for a cautious approach towards changes to the CAO framework[22]. A minority of respondents recommended that parts of the CAO process should be further formalised, for example, the addition of specific conditions for the removal of CAOs. Several respondents commented that the level of transparency of CAOs should be maintained or increased[23]. Some respondents cautioned against a reversion to the previous Individual Capital Adequacy Standards (ICAS) regime, as they considered that the Individual Capital Guidance[24] was unclear, reported privately to the regulator, and hence unsuited to the more public nature of the Solvency II reporting regime. One respondent endorsed the use of CAOs to address concerns beyond Pillar 1 capital, such as governance and culture.

C.7 Some respondents suggested that the PRA could make additional use of stress testing across the entire SCR distribution and extend its use to insurance firms that use the standard formula. Other respondents cautioned against wider use of stress testing, because of the resource burden that it places on insurance firms and the potential for over-capitalisation if it would bring the SCR calibration beyond the 1 in 200 VaR measure. Respondents recommended a number of other tools to assess the appropriateness of capital levels[25]. Some respondents suggested that the calibration of the SCR should be assessed as part of the Own Risk and Solvency Assessment (ORSA) to increase the quality of oversight and avoid the calibration being weakened when solvency is reduced. Finally, some respondents suggested that the PRA should place more reliance on ensuring accountability through the Senior Managers and Certification Regime.

Internal Model (IM) and Partial Internal Model (PIM) approval and change process (Question 12)

C.8 There was broad support for insurance firms to calculate their SCRs using approved IMs. One respondent noted that the use of IMs had improved its

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19 A capital add-on is an increase in the SCR of an insurance firm that can be imposed by the PRA. Under Solvency II, it can only be used in specific circumstances.

20 E.g. by allowing a model to be approved while the firm addresses an area of challenge.

21 Either as positive or negative loadings, where the SF understates or overstates risk, respectively.

22 E.g. caution against over-capitalisation through CAO; caution against a CAO possibly causing a firm's model to fail the use test.

23 E.g. the PRA should provide clear rationale for CAO with transparent calculation methodology. The PRA should also provide a clearly defined and achievable pathway for the removal of CAO; there is a need for public disclosure of CAO.

24 The ICAS regime's Individual Capital Guidance was the equivalent of Solvency II's CAO.

25 E.g. calibrating the SCR to ultimate for non-life firms to provide the PRA with an additional reference point; increasing the granularity of SF lines of business to better distinguish risk; introducing liquidity risk assessment to assess the suitability of assets to meet expected and unexpected demands on liabilities; and implementing climate change risk related analysis.

understanding of risk and capital adequacy. Many respondents suggested ways to improve the current IM approval requirements.

C.9 One respondent supported the current well-defined approval process. Another acknowledged that the initial approval of IMs should undergo rigorous review by the PRA, given the role that an approved model plays in allowing an insurance firm to calculate its own regulatory capital requirement. Many respondents highlighted limitations of the current model application requirements and process, noting that these can be burdensome, lengthy and costly[26], can hinder timely updates to models to reflect current conditions, and that documentation requirements are onerous[27]. One respondent cautioned that, without coordination between the PRA and other regulators in relation to IM approval, different approval outcomes could increase the operational complexity of models of cross-border insurance groups.

C.10 Respondents advocated for a more proportionate and flexible approach, either by changing the structure of the framework, or the PRA's implementation of the framework.

C.11 Respondents suggested changes to the structure of the framework to:

- replace rigid rules with principles, flexibility and pragmatism, and improve transparency;
- allow a more modular approach to IMs to improve agility;
- allow the use of SF components in IMs;
- amend the focus of model change approvals from major vs. minor to complex vs. simple;
- create a new 'significant minor' model change category;
- introduce a graduated fee structure (for IM application, approval and maintenance) to better reflect the range of firms.

C.12 Respondents suggested reforms to improve the proportionality in implementation approaches, including:

- a faster IM application process, including a more flexible pre-application process[28] and shortening the six-month statutory review period (although one respondent supported maintaining the current review period to ensure consistency with EU regulation);
- a more tailored and proportionate PIM approval and supervision process;
- a reduction in documentation requirements.

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26 E.g. the binary nature of the model approvals; the need for pre-application; and the need for disproportionate time from non-executives to understand the model. Smaller insurance firms are forced to hold higher SF SCR as an IM is too costly to develop due to high compliance and maintenance costs.

27 E.g. extensive documentation required for model approvals, quarterly reporting of model changes, submission of SF SCR calculation by IM firms.

28 E.g. to only require pre-application for complex changes and make pre-application less formal with less documentation.

C.13 Respondents also suggested that there should be an increase in the PRA's resources in the approval and supervision of IMs and PIMs.

C.14 Some respondents raised concerns relating to the binary nature of model approval[29]. These respondents suggested the following to minimise the risk of model application rejection and resulting consequences:

- the use of CAOs as part of an IM decision, provided their use is transparent and appropriately justified (as discussed in Question 11). Some respondents recommended that CAOs could be used in combination with a lower bar for model approval.
- operating IMs on modified assumptions i.e. approval of the model subject to the firm using different assumptions or parameters, as specified by the PRA.

C.15 One respondent commented that the governance of IMs is costly and time consuming, especially as it is required at board level, suggesting that it is unrealistic to expect non-executives to have the deep technical knowledge needed to use IMs.

C.16 Several respondents suggested that the assessment of models against the requirements in Solvency II should be more transparent[30]. They argued that the use of internal industry benchmarks (e.g. the PRA's Quantitative Indicators) has several drawbacks including: the benchmarks are not detailed enough to be useful; increased systemic risk (i.e. may lead to firms adopting similar methods, which could amplify the negative impact if those methods inadequately capture the associated risks); and that they could result in lack of buy-in and ownership by firms.

C.17 Several respondents suggested that insurance firms with IMs should not be required to submit SCR numbers on a SF basis, because: it is costly; of limited benefit (given the deviation of the risk profile from SF assumptions); and that there are better measures to monitor model drift (e.g. IM outputs).

Changes to the SF (Question 13)

C.18 Respondents had varied views on the role of the SF. Some respondents suggested that the SF should remain the default option for most firms; one respondent considered it to be onerous for small firms[31]; and some commented on the limited flexibility and discretion for insurance firms and the PRA to adapt the SF.

C.19 Several respondents supported a simpler, less prescriptive and more flexible SF, for instance:

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29 I.e. the 'all-or-nothing' approach of the current framework, whereby the PRA can only approve a firm's model application if it meets all of the requirements.

30 This could be achieved by the PRA sharing templates, standard guidance and best practice based on common factors identified across IM submissions. This would support a smoother, quicker and more efficient IM application process.

31 E.g. high compliance costs as external auditors are required to validate the SCR. The respondents noted that this requirement is inconsistent with many EU jurisdictions in which reliance is placed on the internal audit function.

- expanding the scope of Undertaking-Specific Parameters (USPs)[32] and Group-Specific Parameters (GSPs)[33] in instances in which insurance firms' risk profiles deviate significantly from the standard parameters;
- introducing a more proportionate approval process for PIM or USP where SF is inappropriate;
- allowing the SF to be combined with external or proprietary models (e.g. catastrophe risk models), without requiring application for a PIM;
- relaxing the requirements for derivatives to be held for a period of time to qualify as investment hedging in order to improve risk management in the short term.

C.20 Respondents cautioned against adapting the SF, arguing that it would no longer be 'standardised'. However, a potential benefit was also recognised, i.e. the creation of an intermediate approach between the SF and IM.

C.21 Many respondents supported the recalibration of the SF to reflect UK insurance firms' risk profiles. A minority of respondents stated that divergence from the current calibration and design of the SF would be of limited benefit.

C.22 Respondents set out specific and detailed limitations of the SF, including:

- that some risk charges are inappropriate[34];
- inappropriate assumptions driving the risk charges in several SF risk modules[35];
- insufficient modelling granularity[36] of the SF components;
- risk mitigation (e.g. reinsurance) not appropriately taken into account[37];
- that diversification and the relationship between risks are not appropriately taken into account[38];
- insufficient recognition of the benefits of hedging strategies;
- that some risks are omitted (examples include property yield risk, inflation risk, commercial mortgages, adverse development covers, negative interest rates);

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32 Solvency II allows insurance firms, subject to supervisory approval, to use their own data to calibrate a sub-set of the parameters in the life, non-life and health underwriting risk modules of the SF, instead of the standard parameters in the SF, to calculate the SCR.

33 A GSP is USP applied at the group level.

34 E.g. equity risk, longevity risk, morbidity risk, mass lapse risk, property risk charge of internationally diversified portfolio, securitised assets, asset backed commercial paper, non-life premium and reserve risk. One respondent said that the currency risk in the SF produces distorted results and suggested aligning this with the proposed Insurance Capital Standard. Some respondents identified the catastrophe risk and the operational risk modules of the SF as being weak, while at least one other respondent stated that the SF tends to overstate capital required for counterparty risk.

35 E.g. unrealistic assumption for mass lapse risk and overly simple calibration method for longevity risk.

36 E.g. insurance risk classification, lines of business classification, market risk components and asset types.

37 E.g. international reinsurance, non-life excess of loss non-proportional reinsurance and stop loss reinsurance not fully recognised.

38 E.g. diversification assumptions for natural catastrophe risks, casualty business, operational risk with the Basic SCR.

- that the treatment of restructured assets (in the matching adjustment portfolio) under stress is not well captured;
- that the SF does not take into account prevailing market conditions.

Alternatives to SF, IM and PIM (Question 14)

C.23 Several respondents acknowledged that the SF can already be modified with USPs and, therefore, the existing regulatory framework already provides sufficient flexibility. However, some respondents noted that USPs are too difficult to apply (e.g. they are costly or disproportionate) and that the requirements are too prescriptive and narrow in their application[39]. Many respondents noted that the USP framework could be expanded to address possible existing inflexibilities within the SF, citing operational risk and credit risk as examples. However, other respondents cautioned that the tailoring of the SF would remove the benefit that it provides as regards comparability between firms and suggested that the tailoring of the SF would be better captured in Pillar 2 in Solvency II.

C.24 Some respondents suggested that an expansion of the USP framework could reduce the need for PIMs, and therefore reduce the costs associated with model approval – although it was also noted that USPs themselves are subject to an approval process.

C.25 One respondent suggested introducing the concept of 'Undertaking Specific Methodology' (USM), which would differ from a PIM in that the USM would have a strong resemblance to the existing SF method. For example, under a USM, an insurance firm could increase the granularity of existing SF risk modules and use USPs for any additional risk categories created.

Climate change risks and the provision of long-term capital (Questions 15 and 16)

C.26 Several respondents noted that a 1-year VaR framework does not adequately capture long-term risks associated with productive assets and climate change. Conversely, some respondents said that the current framework already incorporates climate change risks and therefore should not be changed.

C.27 Respondents suggested that a more flexible and principles-based regime which permits forward-looking, judgement-based assessments would better reflect the risks from assets for which risks are difficult to evaluate due to scarce data (e.g. non-vanilla credit risky assets, 'green' assets).

C.28 Some respondents suggested recalibrating the risk charges[40] to encourage investments in long-term productive assets and 'green' assets (or to discourage investments in 'brown' assets). A similar number of respondents cautioned against changing the prudential requirements without legitimate justification and warned about the potential implications of encouraging investment in specific assets (e.g. increase in the prices of the assets targeted by any potential reforms).

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39 The current scope of USP/GSP is limited to specific parameters relevant to life, non-life and health underwriting risk modules.

40 E.g. a lower calibration standard on additional marginal investments in productive assets; or use of a 'to-ultimate' basis.

C.29 Respondents also suggested changes outside Solvency II for both long-term productive assets and climate change risks[41].

C.30 Some respondents said that, although the current framework already allows investments in long-term productive assets, in practice, requirements and supervisory processes can be onerous, disproportionate and rigid, thus creating barriers to investments in long-term productive assets.

C.31 Numerous respondents cited SF calibration issues[42] as barriers to investing in long-term productive assets. Some respondents pointed out that, although Solvency II applies a lower equity capital charge for infrastructure and strategic equities[43] it is unclear as to how beneficial this is given the existing restrictions on its use. Respondents proposed that the scope of the provisions should be broadened to include more productive assets.

C.32 Many respondents supported the PRA's current approach to focus on climate change risks in the ORSA, scenario analysis[44], the governance framework and disclosure. A minority of respondents said that external credit ratings already allow for climate change risks and cautioned against potential double-counting.

41 E.g. a government remediation vehicle to manage issues in infrastructure investments, and/or a government sponsored reinsurance vehicle that pays an additional recovery rate on defaulting long-term productive assets. For climate change risks, respondents recommended: the creation of a rapid taskforce to tackle climate change; higher reliance on ratings by credit rating agencies; an additional objective for the PRA on climate change.

42 E.g. internal credit ratings are not recognised in the SF and diversification benefits are viewed as insufficient to incentivise investments.

43 Article 171 of the Solvency II Delegated Regulation, Article 170 of the Solvency II Delegated Regulation and Article 304 of the Solvency II Directive.

44 Including the upcoming Climate Biennial Exploratory Scenario exercise.

Annex D

Calculation of the consolidated group solvency capital requirement (SCR) using multiple internal models

Internal models following an acquisition or merger (Question 17)

D.1 Several respondents supported increased flexibility in the calculation of the consolidated group SCR, citing that:

- changes would allow a group to calculate a group SCR that more appropriately reflects its risk profile in the interim period before a group internal model covering the enlarged group has been developed and approved;
- reversion to the standard formula under Method 1 (i.e. the 'accounting consolidated-based method') would likely be inappropriate for an enlarged group's risk profile and could result in inappropriate risk management strategies and operational inefficiencies.

D.2 Some respondents also identified issues in relation to the use of Method 2 (that is, the 'deduction and aggregation method'), including:

- the loss of diversification benefits between the Method 2 entity and other group entities;
- that planned intragroup transactions might be hindered if they are sufficiently significant as to affect the group's ability to obtain a Method 2 waiver;
- the possibility of SCR double-counting that may only be avoided by restructuring the group;
- reduced transparency of the group balance sheet;
- limited use if Method 2 cannot be applied to subsequent acquisitions.

D.3 Respondents identified other issues to be considered, including:

- the possible use of group capital add-ons to address any deficiencies and operational risks associated with merger and acquisition activity;
- the maximum period within which the use of multiple internal models would be allowed;
- the application of appropriate internal model certification processes before a group is allowed to use multiple internal models;

- the transparency of any conditions, including the maximum period allowed;
- the scope for the PRA to exercise supervisory discretion;
- the appropriate aggregation methodology and the factors to be considered;
- the potential use of a simpler 'factor-based' approach to calculate group SCR.

Annex E

Calculation of the Transitional Measure on Technical Provisions (TMTP)

Changes to the current process for recalculating TMTP deductions (Question 18)

E.1 A majority of the respondents that addressed issues relating to the TMTP argued that the requirements governing the calculation of the TMTP could be improved, citing the following reasons:

- the existing process for recalculation is excessively long, complex and time-consuming to apply;
- the requirements to retain, and maintain, 'legacy'[45] models are burdensome;
- the frequency of recalculation is artificial, specifically, that the TMTP should be recalculated on a continuous basis rather than a discrete and stepped basis and, hence, updated more frequently thus aligning calculated capital levels with the 'true' level of capital;
- the current formula leads to a doubling of the run-off profile of the TMTP[46];
- sensitivity to credit spread movements due to differences between the illiquidity premium and matching adjustment.

E.2 Most respondents noted, however, that reform of the calculation of TMTPs should be informed by possible reforms to the risk margin (given that this is a significant determinant of the size of the TMTP) and other aspects of Solvency II such as potential changes to the matching adjustment. These respondents noted that the reforms to Solvency II need to be considered as an integrated package. However, a few respondents noted that insurance firms applied TMTPs in a variety of ways, complicating the assessment of the impact of any changes in this area.

E.3 Respondents suggested the following reforms in relation to the calculation of TMTPs:

- reduce the burden of maintaining and applying 'legacy' models;
- remove the 'double run-off' issue in the calculation;

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45 That is, models used in the Solvency I ICAS regime, before the introduction of Solvency II in 2016. These models are required to value business written before 2016 because the application of TMTP delays the full requirements of Solvency II on such business.

46 The natural attrition of pre-2016 business used to calculate TMTP combined with the forced 1/16 per year reduction in Solvency II results in the "double run-off" effect.

- allow calculation on a continuous basis rather than on a step basis at fixed points;
- remove the Financial Resource Requirement test.

Integration of TMTPs into broader transitional arrangements (Question 19)

E.4 As noted above, most respondents argued that reforms to TMTPs should be taken forward consistently with other reforms to Solvency II.

Annex F

Reporting requirements

F.1 Respondents' general comments on Solvency II reporting requirements can be summarised as follows:

- over half of the respondents stated that reporting requirements are onerous and need to be reformed to reduce the volume of data submitted in order to achieve a UK-focused framework;
- however, a number of respondents considered the requirements, as a whole, to be appropriate and should be retained (either in specific areas or in full) to limit the costs of regulatory divergence with other jurisdictions;
- some respondents provided examples of specific areas in which reporting requirements could be increased, for example, information on products and new business that had been required under the reporting framework prior to Solvency II.

F.2 The respondents that called for an overall reduction in Solvency II reporting requirements noted:

- the associated cost, size and 'burden' involved in the preparation of reports;
- the potential duplication between regulatory reports required under Solvency II, and between Solvency II reports and accounting disclosures (e.g. International Financial Reporting Standards (IFRS), UK Generally Accepted Accounting Principles (GAAP));
- the frequency and granular nature of certain quarterly and annual reporting items as being disproportionate relative to risks, and costly to prepare;
- the need for financial services regulators to justify how reporting is used, particularly in cases in which insurance firms consider reporting to be of limited internal use to their operations, and when ad-hoc reporting requests are made by the PRA;
- the need for greater flexibility in reporting deadlines which can be too close to the end of the quarter;
- the number of data requests collected by the PRA which sat outside of the reporting rules requirements (ad-hoc requests);
- despite supporting the need for an overall reduction in reporting requirements, implementation costs associated with the preparation of

reports had already been incurred. As a result, there was little appetite to incur the additional cost needed to change existing reporting requirements, including the reduction of the content of templates. Instead, entire reports should be abolished.

F.3 The respondents that called for some, or all, of the current reporting requirements to be maintained emphasised that:

- there may be benefits to maintaining international consistency. Far-reaching reform of reporting requirements could introduce frictional costs for international insurance groups, thus reducing the attractiveness of the UK as a location for business;
- data in the quarterly and annual Solvency II reports support broader statistical analysis of the UK economy and is critical to the generation and publication of key national figures (e.g. Gross Domestic Product and the national accounts). This data also supports the UK's international participation with organisations such as the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF).

F.4 The issues above applied to most of the reports required under Solvency II.

Options for reform (Question 20)

F.5 Many respondents put forward options to reduce existing reporting requirements, including:

- a reduction of the frequency of reporting, for example, eliminating quarterly reporting so that firms submit data on either a half-yearly or annual basis, or removal of fourth quarter reporting only;
- an improvement in proportionality by a reduction in the volume of data reported within existing templates, including a review of reports to identify duplication with accounting disclosures;
- the alignment of supervisory reporting with the internal information used in the day-to-day management of firms;
- the abolition of certain reports altogether;
- greater use of the PRA's supervisory flexibility in granting waivers;
- an extension of reporting deadlines to enable firms to improve the quality of information reported.

F.6 The stated benefits resulting from such reforms included:

- 'releasing' resources for insurance firms;
- improving the clarity and usefulness of reports;
- increased international competitiveness of the UK market.

F.7 While some respondents provided estimates for the time and resources potentially saved from the reforms, the majority did not, and emphasised the need for the PRA to conduct cost-benefit analysis for each report. Several respondents opposed making potential improvements that would result in revisions within

reports, even if these reduced the long-term reporting burden, citing the need to avoid near-term increases in costs.

F.8 Some respondents stated that in some areas, more information should be collected or disclosed to the market than is currently required including:

- profit reporting to support the analysis of financial performance;
- the reporting of cyber underwriting risk;
- information in relation to climate change risk.

F.9 Generally, respondents did not provide information on costs associated with their proposals. Other suggestions from respondents included that insurance firms should be provided with sufficient time to implement changes before the next reporting date, and that the PRA and the insurance industry should work together to review the potential for reforms to reporting requirements in more detail.

Changes to the layers of reporting to improve coherence (Question 21)

F.10 In general, the respondents to this question noted that:

- the 'onshored' Solvency II reporting requirements and the PRA's National Specific Templates should be merged to form a single layer of insurance reporting;
- ad-hoc reporting should be kept to a minimum as such requests are often onerous and completed under a short timeframe.

Annex G

Branch capital requirements for foreign insurance firms

Capital requirements for branches of foreign insurance firms (Question 22)

G.1 The majority of respondents on this topic supported the removal of branch capital requirements for foreign insurance firms:

- several respondents highlighted that branch capital requirements offer only limited prudential benefits for policyholders because a branch is not a separate legal entity and the requirements impose a regulatory burden on insurance firms;
- some respondents also noted that branch capital requirements do not account for diversification benefits at the whole-firm level;
- a number of respondents stated that reform would increase the attractiveness of the UK as a destination for branches of foreign insurance firms and maintain the UK's position as a leader and hub in the provision of insurance services.

G.2 Some respondents raised concerns about the removal of branch capital requirements for foreign insurance firms entering the UK from jurisdictions with less robust supervisory regimes, suggesting this might place UK-domiciled insurance firms at a competitive disadvantage and reduce policyholder protection. A few respondents opposed the removal of branch capital requirements on this basis. Other respondents cautioned that the regime must ensure that there is no opportunity for 'regulatory arbitrage' in the UK, or potential costs to the Financial Services Compensation Scheme from any resulting increase in the possibility of failure of branches of foreign insurance firms.

G.3 Many respondents suggested that the prudential supervision of branches of foreign insurance firms should have a high degree of recognition of home state supervision of the whole insurance firm. If the home jurisdiction of the foreign branch has been assessed as robust and there is a high degree of regulatory and supervisory co-operation, respondents considered that branches should be exempt from branch capital requirements in the UK. Other respondents suggested there should be no additional regulation at the branch level.

G.4 Some respondents suggested other ways of reducing capital requirements for branches of foreign insurance firms, including:

- retaining branch capital requirements as a default position but taking a case-by-case approach to removing these requirements in cases in which insurance firms meet, or agree, to certain conditions;

- removing only the branch solvency capital requirement (SCR), but not the branch minimum capital requirement (MCR);
- amending the calculation of branch capital requirements so that it takes into account underwriting activity in relation to UK risks only.

Other reforms (Question 23)

G.5 A number of respondents suggested other ways that the branch regime could be reformed beyond removing branch capital requirements:

- some respondents advocated removing reporting requirements (e.g. the requirements for the branch balance sheet, branch Own Risk and Solvency Assessment (ORSA), or other standalone branch reporting);
- some respondents suggested that pure reinsurers should be subject to very limited, if any, requirements at the UK branch level;
- one respondent suggested adopting a more flexible threshold for subsidiarisation that accounts for branch risks and financial strength.

Annex H

Thresholds for regulation by the PRA under Solvency II

Level and design (Question 24)

H.1 Some respondents suggested that the thresholds[47] for the regulation of an insurance firm by the PRA under Solvency II should be increased, while others considered that they should not. Some respondents suggested that improving proportionality in the Solvency II regime (e.g. by using waivers) may be as important as the level of the thresholds.

H.2 Among those respondents that favoured increasing the thresholds, views differed as to how much or the approach to do so. Respondents suggested that:

- the current thresholds should roughly double (i.e. to GBP 10 million in annual gross written premiums and to GBP 50 million in gross technical provisions);
- a threshold of GBP 50 million in gross written premiums should be applied;
- the thresholds should be increased to a level at which 80-90% of insurance assets are regulated under Solvency II.

H.3 One respondent suggested that the thresholds should rise in line with the level of inflation in future. Another respondent suggested the use of a banding approach under which insurance firms that sit between two size thresholds could be subject to Solvency II or the non-Solvency II regime depending on the type, complexity and risk of their business.

H.4 Increasing the proportionality of the overall prudential regime was the rationale for those respondents that indicated that the Solvency II thresholds should be increased. This would be achieved via the removal of some of the smallest firms from Solvency II. As a result, regulatory and supervisory requirements would become more proportionate to the nature, scale and complexity of these insurance firms. Some respondents noted that this change would be positive since small insurance firms no longer subject to Solvency II may no longer be required to be audited as Public Interest Entities[48].

H.5 The following points were made by respondents that supported the retention of the current thresholds:

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47 Insurance firms with annual gross written premiums not exceeding EUR 5 million, and gross technical provisions not exceeding EUR 25 million, are regulated under a simpler prudential framework known as the 'non-Directive firms' regime.

48 Public Interest Entities are specific types of entity which are subject to particular rules regarding their audits and auditors. These entities are set out in section 494A of the Companies Act and include insurance firms.

- Solvency II should apply to all but the very smallest insurance firms in the UK as this supports strong risk management and supervision;
- the current scope of Solvency II provides for a level playing field between insurance firms;
- the principle of proportionality is already embedded in Solvency II, for example in relatively less burdensome reporting requirements for smaller insurance firms and the ability of insurance firms to use the standard formula if appropriate for their business.

The regulatory regime for insurance firms not covered by Solvency II (Question 25)

H.6 Several respondents noted that proportionality should be a key feature of the regime for non-Solvency II firms. A few respondents suggested that:

- the regime should be based on risk rather than whether a certain size of firm could afford to comply with Solvency II;
- the regime should ensure a consistent level of policyholder protection;
- any alternative regime should not give non-Solvency II firms an unfair advantage.

H.7 Some respondents were keen to maintain the option to select the regime under which an insurance firm of a certain size was supervised. They suggested that insurance firms which no longer meet increased Solvency II thresholds should be able choose whether to remain under the Solvency II regime, since the costs of adapting to a different regime may outweigh the benefits. One respondent reported that insurance firms potentially affected in this way would not wish to be regulated under the full Solvency II regime or the existing non-Solvency II regime, and that a 'Solvency II lite' regime should be established, which should include simplified reporting.

Annex I

Mobilisation of new insurance firms

I.1 A number of respondents considered that Solvency II contains barriers to new market entrants, with many citing the complexity and associated cost of compliance. Other issues highlighted included:

- the difficulty of raising the necessary capital ahead of authorisation;
- the authorisation process being excessively lengthy and generating uncertainty for firms and their investors;
- the need for clearer guidance and more tailored processes for start-up business models;
- documentation and system requirements for authorisation being excessive;
- the use of the matching adjustment and volatility adjustment not being approved until after authorisation.

I.2 However, some respondents also noted that barriers to entry for firms are a necessary feature of the regulatory regime, so that policyholders are appropriately protected.

Key features of a mobilisation regime (Questions 26 and 27)

I.3 A few respondents suggested that firms should not, as is currently the case, be required to comply with Solvency II rules from the outset if they are expected to exceed the Solvency II thresholds within the next five years. Rather, Solvency II should apply in full only once the Solvency II thresholds have been crossed or if the firm is forecast to exceed them within three years.

I.4 Several respondents suggested that:

- newly authorised insurance firms could be subject to more limited regulatory requirements in exchange for initial restrictions on their activities. However, one respondent raised concerns about this approach, such as a constraint on the volume of insurance business not reflecting a firm's capital position, which already acts as a constraint on writing new business;
- there should be no 'cliff-edge' requirements for new insurance firms;
- a more proportionate approach should be taken to capital requirements, in particular, in recognition of the unique challenges faced by start-up insurance firms;

- the regulatory 'sandbox' approach[49] should be expanded to PRA regulated activities.

I.5 Several respondents emphasised that ensuring a consistent level of policyholder protection should remain a key consideration for any mobilisation regime.

I.6 Many respondents noted the potential benefits of greater proportionality for new insurance firms by, for example, reducing regulatory cliff-edges and helping to ensure a smoother path into the market. Other benefits of reforms to support mobilisation included:

- enhanced competition and innovation;
- benefits to consumers via lower prices and an increased range of products;
- more insurance business being written from, and regulated in, the UK.

[49] See https://www.fca.org.uk/firms/innovation/regulatory-sandbox

Annex J

Risk-free rates: transition from the London Inter-bank Offered Rate (LIBOR) to Overnight Indexed Swap (OIS) rates

Factors to consider for the transition (Question 28)

J.1 Several respondents addressed the transition of Solvency II risk-free rates from the London Inter-bank Offered Rate (LIBOR) to Overnight Indexed Swap (OIS) rates. These respondents recommended a number of factors to be considered as part of the transition, for example:

- insurance firms should be provided with clear guidance as soon as possible in order to minimise uncertainty, cost and disruption;
- the transition to OIS rates should aim to have no, or low, impact on insurance firms' balance sheets;
- an upward adjustment should be applied to SONIA (Sterling Overnight Index Average) in order to reduce any impact on the balance sheet arising from the transition.

J.2 A number of respondents suggested that, in order to smooth the transition, insurance firms could be allowed to choose whether to use LIBOR or OIS risk-free rate curves over a transition period of several months in 2021, or choose to use a blend of the two curves. One respondent suggested that this would reduce the risk of a spike in OIS-based instrument market prices. By contrast, some respondents considered that a single point of transition would be easier to manage.

J.3 Views differed on the timing of the transition. Some respondents said that the transition should be enacted as soon as possible, while other respondents suggested that the transition should occur at, or around the end of, 2021.

J.4 Several respondents noted that the current methodology for determining the Credit Risk Adjustment applied in the calculation of LIBOR-based risk-free rates would not be appropriate for OIS-based risk-free rates because OIS rates are considered to contain negligible credit risk.

J.5 Respondents made several other suggestions in relation to risk-free rates, for example that:

- insurance firms should be able to calculate their own risk-free rates based on principles set by the PRA;

- gilts should be permitted, where appropriate, to be used as the basis of risk-free rates;
- there may be a case to use different discount rates for life and non-life insurance business, to allow for difference in the nature and duration of the risks.

Annex K

Other areas of Solvency II

Other areas to consider for review (Question 29)

K.1 Respondents raised a number of other issues in addition to those areas for review identified by the Government. Some issues, such as contract boundaries, risk mitigation techniques and the treatment of with-profits funds, were the subject of several responses. Most other issues were raised by only one respondent and covered such areas as:

- reforms to the volatility adjustment;
- the treatment of items in 'own funds';
- the regulation of Insurance Linked Securities;
- collateral arrangements and requirements for reinsurance firms;
- aspects of Pillar 2 of Solvency II;
- certain technical aspects of technical provisions;
- tax assumptions in the calculation of the solvency capital requirement (SCR);
- the Financial Services Compensation Scheme's requirements for insurance firms;
- the treatment of syndicated loans/securitisations in the standard formula;
- the treatment of 'captive insurers'[50];
- general issues relating to the prudential regulatory regime as a whole.

50 A captive insurance company is typically set up and wholly owned by a non-insurance company to act as a direct insurer or reinsurer for the parent company and wider group.