Review of Solvency II:

Call for Evidence

October 2020

HM Treasury

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Foreword

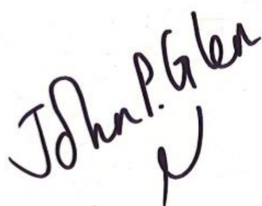
The UK insurance sector is one of the largest and most important in the world and plays a critical role in the UK economy. It provides a wide array of vital products and services for households and businesses that facilitate the management and reduction of risk. An appropriate prudential regulatory regime for the insurance sector underpins its ability to fulfil its important role.

On 23 June 2020, the Government announced that it would review certain features of the prudential regulatory regime for insurance firms, known as Solvency II. As set out in that announcement, the financial services sector plays a crucial role in supporting the wider economy, creating jobs across the UK, supporting SMEs, contributing taxes, driving regional growth and investment, tackling climate change and embracing technology and innovation.

We are undertaking this review to ensure that Solvency II properly reflects the unique structural features of the UK insurance sector. By design, the current regime is tailored to the EU insurance sector as a whole but, in several important ways, the UK insurance sector is different. The review will be guided by our objectives: to ensure a vibrant and prosperous insurance sector, to provide long-term capital to support growth, and to uphold high standards of policyholder protection and promote the safety and soundness of firms.

This review emphasises potential areas for reform of Solvency II that could not only improve the efficiency and effectiveness of the application of the UK prudential regulatory regime, but also allow it to better recognise the unique features of the UK insurance sector. As a result, households and businesses should benefit from a wider choice of competitively priced products and services and the Prudential Regulation Authority should have the tools that it needs to supervise the safety and soundness of the UK insurance sector.

This call for evidence is the first stage in the review of Solvency II. I invite all interested stakeholders to use this opportunity to share their views on the issues set out in this call for evidence and any other areas in which they think that the prudential regulation of insurance firms can be enhanced.



John Glen, Economic Secretary to the Treasury

Chapter 1
Introduction and context

Purpose

1.1 The UK insurance sector is the fourth largest in the world. It provides a wide array of vital products and services for households and businesses that facilitate the management and reduction of risk. It is a world leader in the provision of complex and bespoke forms of insurance and reinsurance. UK insurance firms held around £1.9 trillion in invested assets as at Q1 2020[1].

1.2 A robust framework for the prudential regulation of the insurance sector supports the contribution that the insurance sector makes to the economy and helps secure a high degree of policyholder protection. Solvency II is the regime that governs the prudential regulation of the insurance sector in the United Kingdom[2].

1.3 The over-arching aim of this review is to ensure that the UK's prudential regulatory regime for the insurance sector is better tailored to support the unique features of the sector and the UK regulatory approach. The Government and the Prudential Regulation Authority (PRA) continue to support the fundamental principles and framework underlying Solvency II[3].

1.4 The UK has been at the forefront of the development of an international framework for the consistent prudential regulation of the insurance sector across countries, namely the Insurance Capital Standard (ICS), which has been facilitated by the International Association of Insurance Supervisors (IAIS). International agreement to the ICS was achieved in November 2019. The current Solvency II regime is compatible with emerging international standards. The review of Solvency II will be informed by recent international prudential regulatory developments.

1.5 However, there are certain areas of Solvency II that could better reflect the particular structures, products and business models of the UK insurance sector. There may be scope to better balance the relatively prescriptive and rules-based model with a mix of judgement and rules which can be operated

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1 Source: PRA.

2 Solvency II is an EU regime which came into operation in 2016. The regime has been 'onshored' as part of the UK's preparations to leave the EU, that is, the relevant legislation has been brought into UK law, and legal changes have been made to ensure that Solvency II reflects the circumstances of the UK's withdrawal from the EU and will continue to apply effectively in the UK after the end of the transition period that is, from 1 January 2021.

3 Solvency II provides for a market consistent calculation of insurance liabilities and risk-based calculation of capital. It also sets out the supervisory review process and reporting and transparency requirements for insurance firms.

more effectively by the PRA within the existing principles and framework of Solvency II and be more efficiently applied by insurance firms.

1.6 This call for evidence is the first stage of the review of Solvency II. The review will consider how the current prudential regulatory framework can be improved to ensure that it provides for an appropriate amount of capital for the insurance sector as a whole, a high degree of policyholder protection and suitable standards of governance, risk management and transparency. The current level of capital in the industry has contributed to the insurance sector's overall resilience to recent events as well as to the outcomes of the PRA stress tests[4].

Objectives

1.7 The review is underpinned by three objectives:

- 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 underpin growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the Government's climate change objectives.

A thriving insurance sector

1.8 The prudential regulatory regime should underpin a vibrant and prosperous insurance sector. A vibrant and prosperous insurance sector is one in which competition works well and which promotes innovation. Competition and innovation are beneficial for both households and businesses by delivering better choice and affordable products. The regulatory regime should ensure that households and businesses continue to have access to a wide choice of competitively priced insurance products and services offered by a variety of innovative providers. It is, therefore, particularly important to ensure an appropriate regulatory system that meets the needs of small and medium-sized insurance firms, including new entrants to the market, thereby boosting competition.

1.9 A robust and proportionate prudential regulatory regime is necessary for the UK to remain a world leader as an open 'hub' in the provision of insurance products and home to an insurance sector which is internationally competitive. This means that the regime should take into account UK insurance firms' ability to be competitive in international markets and the UK's attractiveness as a place for foreign insurance firms to do business. It does not mean that the regime should allow scope for regulatory arbitrage between the UK's prudential regulatory regime and that in other jurisdictions.

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[4] See https://www.bankofengland.co.uk/prudential-regulation/letter/2020/insurance-stress-test-2019-feedback

1.10 The Government seeks views on how the prudential regulatory regime can best support a thriving insurance sector, characterised by high levels of innovation and competition and one that remains a world leader and internationally competitive.

Protection of policyholders

1.11 The prudential regulatory regime should ensure high standards of policyholder protection and promote the safety and soundness of firms. The PRA is responsible for the prudential regulation and supervision of insurance firms and insurance groups that are authorised in the UK. The PRA has two primary statutory objectives relating to insurance sector supervision: to contribute to the securing of an appropriate degree of policyholder protection and to promote the safety and soundness of firms[5].

1.12 A robust, proportionate regulatory regime for insurance firms is necessary not only to advance those objectives, but also to underpin a vibrant insurance sector and to support long-term investment in productive assets. Prudential regulation is necessary to address market failures and provide confidence in insurance firms' ability to make good on their commitments, which, in many cases, will come due in an unpredictable manner and/or many years after premiums have been received. A robust, proportionate system of regulation is also integral to healthy market competition, ensuring that all insurance firms competing for business are adhering to adequate standards to fulfil those commitments. Appropriately designed and calibrated regulations are necessary safeguards that promote the effective management of risks taken on by insurance firms. In this way, regulation ensures that insurance firms can continue to provide vital services to the real economy, including after severe shocks.

1.13 Recent experience has highlighted the importance of the insurance sector in remaining resilient and able to meet its commitments to policyholders, even after significant unforeseen events. The need for ongoing resilience is, therefore, a key objective for the Government, as it considers ways to spur innovation and competitiveness, as well as the provision of long-term capital to support growth. The calibration of the capital standard in Solvency II has contributed to the insurance sector's overall resilience to both recent events and PRA stress tests and is compatible with emerging international standards.

1.14 The Government seeks views on how to:

- tailor Solvency II to the specific features of the UK insurance sector without compromising policyholder protection and the safety and soundness of firms; and
- ensure that there is sufficient scope for regulators to apply supervisory judgement when considering the overall financial soundness of firms, given the inherent limitations of modelling events long into the future.

[5] The PRA also has a secondary objective to promote effective competition in the markets for services provided by PRA-authorised firms.

The provision of long-term capital to support growth

1.15 The prudential regulatory regime should enable the insurance sector to play a significant role in supporting the Government's objectives in relation to the provision of long-term capital to support growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets. The insurance sector invests in various types of longer term and illiquid assets, and investment in certain types of illiquid assets has grown in recent years, particularly among life insurance firms that invest in longer term assets to back long-dated liabilities. In this way, insurance firms' investment decisions can play a significant role in contributing to the Government's objectives. A robust, proportionate regulatory regime is necessary to support insurance firms' provision of long-term capital.

1.16 The Government is committed to 'levelling up' the UK by raising productivity and growth in all nations and regions, creating opportunity for all, and addressing disparities in economic and social outcomes. Investment, particularly in infrastructure, is central to this agenda. Infrastructure investment underpins long-term economic growth and productivity: it is essential for markets to function effectively, supports jobs, attracts investment, and boosts the standard of living of households and communities across the UK. In autumn 2020, the Government will publish a National Infrastructure Strategy which will set out plans for investment in the UK's economic infrastructure[6]. Insurance firms, alongside other financial institutions, have an important role to play in the provision of these priorities.

1.17 While the UK provides opportunities for world-leading innovation, the 2017 Patient Capital Review exposed a 'patient capital' gap, which means the UK lags behind some of its competitors in scaling up its most innovative firms[7]. Access to long-term capital, including venture capital and growth equity, can enable small firms, particularly those that are unlisted, to grow into large, world-leading businesses. The Patient Capital Review Industry Panel was clear[8] that the lack of institutional investment into venture capital and growth equity is one of the barriers to growth. Insurance firms, alongside other financial institutions have an important role to play in the provision of venture capital and growth equity.

1.18 The Financial Policy Committee of the Bank of England (FPC) has also drawn attention to the importance of 'productive finance' for long-term growth and productivity. As the FPC states, productive finance can include financing in liquid instruments (e.g. listed equity) and illiquid instruments (e.g. unlisted private equity)[9]. Insurance firms have an important role to play in investment

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[6] In 2019, the Government published the Infrastructure Finance Review, a consultation on the role of private investment in infrastructure: https://www.gov.uk/government/consultations/infrastructure-finance-review

[7] The Government's consultation response is available at: https://www.gov.uk/government/consultations/financing-growth-in-innovative-firms

[8] Patient Capital Review, Industry Panel Response: https://www.gov.uk/government/publications/patient-capital-review

[9] See Box 4, The supply of finance for productive investment, Financial Stability Report, August 2020: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/august-2020.pdf

in both liquid and illiquid instruments that support long-term growth and productivity.

1.19 The Government seeks views as to how the prudential regulatory regime can better enable insurance firms to contribute to the Government's objectives to provide long-term capital to support growth across the UK and the Government's climate change objectives.

Climate change, the Green Finance Strategy and the insurance sector

1.20 The prudential regulatory regime should help the insurance sector support the Government's objectives in relation to climate change. Changes in climate have profound implications for the economy, including the insurance sector, and the costs of climate change are already affecting the insurance sector's underwriting strategies and pattern of claims. In the long term, increasing levels of physical risk due to climate change could present significant challenges to general insurance business models and some insurance firms' long-term assets could be affected by the transition to a low carbon economy.

1.21 In response to the challenge of climate change, last year the UK became the first major economy to legislate to reach net zero emissions by 2050. In parallel, the Government published its Green Finance Strategy[10] which recognises the importance of the financial services sector in tackling climate change. The Green Finance Strategy sets out a comprehensive approach to aligning private sector financial flows with clean, environmentally sustainable and resilient growth and, in the process, strengthen the competitiveness of the UK financial sector. Reflecting their long-term investment horizon, insurance firms, and life insurance firms, in particular, can play an important role in contributing to these outcomes.

The interaction between the Solvency II Review and the Future Regulatory Framework Review

1.22 This call for evidence is a targeted review of the regulatory approach taken under key aspects of the UK's Solvency II regime. Separately, the Government is conducting a long-term review - the Future Regulatory Framework (FRF) Review - to determine how the overall framework for financial services regulation will need to adapt to the UK's position outside the EU. The FRF Review will examine the allocation of regulatory responsibilities between Parliament, HM Treasury and the financial services regulators. The aim is to explore how the UK's expert, independent regulators can take the lead in designing, and implementing, the specific requirements that apply to firms, while ensuring that there is appropriate policy accountability to democratic institutions. It will consider what the role of the Government and Parliament should be in deciding how important public policy issues are to be addressed in key areas of financial services sectoral regulation.

1.23 In relation to any reforms to the UK Solvency II regime taken forward, the Government will need to decide how those reforms are delivered, taking into

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10 See https://www.gov.uk/government/publications/green-finance-strategy

account any adaptations made to the UK's regulatory framework as a result of the Future Regulatory Framework Review.

Who should respond to this call for evidence?

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

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

Responses and next steps

1.26 Consistent with the purpose of this call for evidence, the Government welcomes responses to the major areas for review as set out below. However, the call for evidence is not limited to these major areas for review. Respondents are encouraged to raise any issue concerning the prudential regulation of the insurance sector in their responses. To support robust evidence-based policy making, respondents are asked to include high quality supporting evidence in their responses. Quantitative evidence, as well as evidence on the costs and benefits of any proposals, is particularly welcome.

1.27 Responses should be submitted to SolvencyIIReview@hmtreasury.gov.uk or online via https://www.smartsurvey.co.uk/s/0M5L6H/ by 19 January 2021. Please also send any comments or enquiries to SolvencyIIReview@hmtreasury.gov.uk. More information on how HM Treasury will use your personal data for the purposes of this call for evidence is available on the Solvency II Review webpage.

1.28 The Government will carefully consider the responses to this call for evidence before announcing its response. The Government will respond to this call for evidence consistent with the Government's guidelines for the timing of responses to public consultations.

1.29 Some proposed changes to the prudential regulatory framework arising from this call for evidence may inform further analysis by the PRA, including whether changes to the PRA's rules should be considered. If so, and where appropriate, the PRA would consider what further, more technical, consultations would be appropriate, consistent with its own consultation practices. Other proposed changes may require legislation. The Government will set out how the reforms will be taken forward in its response to the call for evidence and consult further if necessary.

Areas for review

Chapter 2

Risk margin

2.1 *The risk margin is additional resource that an insurance firm is required to hold on its balance sheet. The Government and the PRA support the objective underpinning the risk margin and the protection that it provides to policyholders over and above other provisions in Solvency II. However, the design of the risk margin in the UK can be improved to better meet its objectives, without reducing policyholder protection.*

2.2 *The Government intends to work with the PRA to reform the risk margin. Reform could reduce the volatility and pro-cyclicality of insurance firms' balance sheets and enable them to increase the choice and affordability of products available to businesses and households. It could also release additional resource over the medium-term which insurance firms could use to provide long-term capital to support growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets. The Government seeks views as to the preferred way to reform the risk margin in the UK.*

2.3 The risk margin is additional resource required, over and above the expected cost of claims, to ensure that an insurance firm holds the market price of its liabilities. Its purpose is to ensure that an insurance firm has sufficient resources to either raise capital to restore its solvency position, or to transfer liabilities to a viable third party, even when under stress. In this way, the risk margin protects policyholders by giving them a high degree of confidence that they will continue to have a claim on a continuing viable business, as well as boosting the safety and soundness of an insurance firm[11].

2.4 However, concerns have been expressed about the size and the volatility of the risk margin as currently designed. For instance, the PRA has previously acknowledged that[12], since its introduction, the risk margin has been larger, and more volatile, than had been anticipated for life insurance firms, especially in relation to their long-term business with guarantees such as annuities. Other commentators[13] have called for the risk margin to be reformed.

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11 This outcome is further supported by the Solvency Capital Requirement which is designed to ensure that such a transfer could still occur even in an extreme scenario.

12 Letter from Sam Woods to the Chair of the Treasury Select Committee: Solvency II Risk Margin: https://www.bankofengland.co.uk/prudential-regulation/letter/2018/solvency-2-risk-margin

13 See, for example, Treasury Select Committee (2017): https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/324/32402.htm

2.5 The methodology currently used to calculate the risk margin is referred to as the 'cost-of-capital method'[14]. It is possible to adopt different methodologies to calculate the risk margin, for example, to better align it with the specific features of the UK insurance market, while preserving its function and continuing to provide additional protection to policyholders[15].

2.6 The current methodology may, at times, result in a risk margin that is excessively high in a low interest rate environment, especially for insurance firms that write long-term business. As a result, life insurance firms are required to hold additional resources on their balance sheet, which increases the cost of these activities and results in a sub-optimal allocation of resources in the form of an excessively high risk margin.

2.7 In addition, this methodology may result in a risk margin that is volatile. The risk margin may be too sensitive to changes in interest rates and move in a pro-cyclical manner, that is, as interest rates fall, the risk margin rises in an exaggerated way. Such sensitivity is particularly pronounced in an environment of prolonged low interest rates. As a result, life insurance firms' balance sheets may be exposed to a greater level of volatility than necessary so that their ability to manage their balance sheets in a stable manner is adversely affected.

2.8 To reduce the size and volatility of the risk margin, life insurance firms have increasingly engaged in activities to reduce the impact of certain risks, specifically, longevity risk[16], which affect the risk margin. In particular, life insurance firms have increasingly reinsured longevity risk in order to reduce the expense that writing that risk exerts on their balance sheets, including in the form of a higher risk margin. Such reinsurance is most cost-effective in reducing the risk margin if the provider of the reinsurance is outside the UK. This activity increases the complexity of the supervision of insurance firms by the PRA and may affect the risk profile of the firms' balance sheets in other ways[17].

2.9 The adverse short-term impact of the risk margin on insurance firms' balance sheets is relatively muted at present as transitional provisions[18] in Solvency II reduce its effect in the short term in relation to insurance business written before 2016. However, the benefit of those transitional provisions diminishes each year, and ceases altogether from 2032. As the impact of these temporary transitional provisions fades, and as the proportion of an insurance firm's business written since 2016 increases, the benefits of reform

[14] Under this method, the risk margin is defined as the cost of holding the capital related to the liabilities which a third-party might require to take on the liabilities.

[15] For example, the Insurance Capital Standard for internationally active insurance groups, developed by the International Association for Insurance Supervisors, includes a similar concept to the risk margin which fulfils the same fundamental role. However, its construction and calibration are very different to those of the Solvency II risk margin and, as a result, reacts differently to changes in economic conditions. These formulations fulfil the same fundamental role in the balance sheet but have very different characteristics and sensitivities to economic factors.

[16] This is the risk that policyholders live for longer than expected and, therefore, require more annuity payments than expected.

[17] For example, it increases exposure to counterparty default risk which may be more difficult to identify and manage if the counterparty is subject to different prudential and supervisory regimes in the countries where they are established.

[18] See Chapter 6 "Calculation of the Transitional Measure on Technical Provisions" for more detail.

to the risk margin will become even more apparent. The risk margin applies in full to all insurance business written since 1 January 2016.

2.10 The methodology to calculate the risk margin was designed with the structural features of the EU insurance sector, as a whole, in mind. However, the adverse impact of the current design of the risk margin is likely to be disproportionately felt in countries, such as the UK, in which significant quantities of long-term life business with guarantees, such as annuities, are written and are discounted at lower long-term discount rates[19].

2.11 The Government seeks views on how the risk margin might be reformed to be better adapted to the UK insurance sector. The Government also seeks views on the benefits and costs of the existing methodology used to calculate the risk margin. Views are also sought as to the preferred means of modifying the current 'cost of capital' approach to reduce the size, and volatility, of the risk margin and to ensure that its application better reflects the structural characteristics of the insurance sector.

2.12 As a result of the reforms, insurance firms should be able to manage their balance sheets more efficiently and effectively. In addition, insurance firms should be able to increase their provision of long-term capital to the economy and/or offer wider product choice or increased provision of more affordable products. The safety and soundness of the insurance sector, and policyholder protection, would also potentially be enhanced by reduced reliance on reinsurance outside the UK.

Question 1

2.13 What is the impact of the current design of the risk margin?

Question 2

2.14 What changes, if any, should be made to the methodology to improve the operation of the risk margin?

Question 3

2.15 What are the benefits, and costs, of any proposed changes to the methodology to calculate the risk margin?

[19] This is particularly acute in the UK, where the GBP discount rate curve used to value insurance liabilities is based on market rates for 50 years. Other currencies, such as the Euro, only use 20 years of data. This leads to lower long-term discount rates in the UK relative to other currencies.

Chapter 3
Matching adjustment

3.1 *The matching adjustment ensures that the prudential regulatory regime recognises that insurance firms which meet certain conditions – including close 'matching' of long-term assets and liabilities – are exposed to less risk than other firms. Use of the matching adjustment boosts the provision, and affordability, of annuities. Deployment of the matching adjustment also supports the provision of long-term finance to the economy.*

3.2 *The Government and PRA support the objectives of the matching adjustment. The Government seeks views on whether the matching adjustment is operating optimally including the criteria used to determine the eligibility of assets and liabilities. Moreover, the Government seeks views on the role that the matching adjustment could play to better support delivery of its climate, 'levelling up' and long-term investment objectives, including in appropriate infrastructure or other long-term productive assets. It also seeks views on the application processes for the use of the matching adjustment.*

3.3 The matching adjustment enables the prudential regulatory regime to recognise how insurance firms which meet certain eligibility conditions are exposed to less risk than otherwise identical firms. Subject to PRA approval, the matching adjustment applies to business in which an insurance firm:

- sells liabilities with fixed duration and cash flows, for example, annuities; and
- backs these liabilities by buying 'to hold' assets with highly predictable cash flows and durations that closely match those of the liabilities.

3.4 An insurance firm that meets these conditions is less exposed to the risk of asset price movements, because the short-term volatility of asset prices does not affect its ability to make contractual payments on its liabilities as they fall due. The matching adjustment achieves an estimate of future policyholder payments, in a way that best reflects the nature of annuity (or annuity-like) business and the risks to which it is exposed. It is used to a considerable extent by life insurance firms, given the long-term and fixed nature of many of their liabilities[20].

3.5 Use of the matching adjustment boosts the provision and affordability of annuities, providing clear benefits for households. Deployment of the matching adjustment also supports the provision of long-term finance to the economy via incentives to invest in long-term and/or illiquid assets.

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20 The matching adjustment delivered a benefit of c£68 billion to the insurance sector as at YE2018.

3.6 Nevertheless, despite the matching of long-term assets and liabilities, an insurance firm remains exposed to some long-term risks, principally credit defaults. Under the matching adjustment, insurance firms need to hold sufficient assets to cover such losses with a very high level of confidence and to cover the uncertainty over the cost of replacing assets that default. The purpose of the conditions governing the eligibility of assets is to reduce the risk of a reduction in value of an insurance firm's 'matching assets', such as would occur in the event of a default, and the consequent impact on its ability to meets its liabilities.

3.7 The Government is considering the eligibility criteria for assets used in the matching adjustment. The matching adjustment has a clearly defined rationale; there is a need for eligibility requirements to prevent it being used inappropriately. At the same time, the current requirements are relatively inflexible which has had unintended consequences.

3.8 For example, some insurance firms restructure assets[21] to meet the current requirements. This is a costly activity that may not be available to all insurance firms and may, therefore, represent a barrier to smaller insurance firms seeking to benefit from the matching adjustment. An alternative approach could be to introduce more flexible eligibility requirements. This would, however, require revised consideration of how to allow for risks and how to protect policyholders, especially if a wider range of assets become eligible for the matching adjustment.

3.9 Although the matching adjustment plays an important role in supporting long-term investment, and the provision of annuities by life insurance firms, there are risks associated with its use. The existing methodology may, in some cases, under-estimate the risks which insurance firms retain because of the wide range of assets commonly held. In considering potential reforms, there is a need to balance the recognition of the matching adjustment benefit, which supports the provision of long-term capital, with an appropriate allowance for the risks to policyholders and the safety and soundness of insurance firms.

3.10 In addition, the Government seeks views on the approval processes that need to be followed. In order to be able to use the matching adjustment, insurance firms and the PRA must operate a complex application process that, in practice, requires substantial resource from both parties. There may be scope to make the process simpler, more efficient and with more options available to the regulator, particularly given that approval decisions are currently 'binary yes/no' decisions.

3.11 Insurance firms that hold assets for a long period may be exposed to increased levels of transition risk arising from climate change. One key risk is that assets may become 'stranded' (that is, unexpectedly or prematurely devalued or written down) because of environmental and political developments. For example, present or future climate commitments may cause some fossil fuel reserves to be left permanently unexploited, resulting in an unexpected downgrade (and potentially defaults) for assets of

[21] For example, insurance firms may securitise assets in order to facilitate their inclusion in matching adjustment portfolios. Under securitisation, floating cash flows are converted to fixed cash flows by use of a securitisation vehicle.

companies that rely on the exploitation of these resources. Transition risks are longer-term risks and, therefore, are especially relevant to insurance firms that use the matching adjustment. The Government seeks views on how the matching adjustment could be amended to recognise these emerging risks and better enable insurers to contribute to sustainable investment.

3.12 The Government seeks views on whether the matching adjustment is operating optimally and whether reforms are required so that it can better meet its objectives. The Government wants to ensure that it operates to better enable insurance firms to play an appropriate role in the provision of long-term, productive finance to the economy and the provision of sustainable finance, consistent with the Government's 'levelling up' priorities and its objectives to address climate change.

3.13 The Government also seeks views as to whether there are barriers in the current processes in the use of the matching adjustment that could be removed to enable the PRA to operate a more tailored and flexible regime, or so that its use can support insurance firms to provide long-term capital to support growth and investment in appropriate infrastructure or other long-term productive assets. Responses to this call for evidence would also inform any further analysis and consultation by the PRA regarding detailed design and calibration of the matching adjustment.

Question 4

3.14 What changes, if any, should be made to the eligibility of assets for the matching adjustment?

Question 5

3.15 What changes, if any, should be made to the calculation of the matching adjustment?

Question 6

3.16 What changes, if any, should be made to the matching adjustment approval process?

Question 7

3.17 What changes, if any, to the matching adjustment could be made to support insurance firms' provision of long-term capital to support growth, including investment in appropriate infrastructure or other long-term productive assets?

Question 8

3.18 What changes, if any, to the matching adjustment could be made to better reflect climate change-related risks arising from investments and contribute to sustainable investment?

Question 9

3.19 What are the costs and benefits of any changes proposed in response to the above questions? How should any risks to the safety and soundness of insurers and/or to policyholder protection be mitigated?

Question 10

3.20 What changes, if any, should be made to the PRA's powers to manage risks to the safety and soundness of firms, and policyholder protection, arising from the use of matching adjustment?

Chapter 4

Calculation of the solvency capital requirement

4.1 *The size, and calculation, of the solvency capital requirement (SCR) is a critical part of Solvency II. The SCR needs to be determined in such a way that balances a number of objectives, including policyholder protection and ensuring the safety and soundness of insurance firms, while having regard to any potential barriers for insurance firms to innovate, compete and provide long-term capital to support growth.*

4.2 *The Government seeks views on whether the current approach can be made less prescriptive, less complex and increase the ability of regulators to apply supervisory judgement. In addition, the Government seeks views on the role that the determination of the SCR can play to support insurance firms to deliver long-term capital to support growth, including to invest in infrastructure, venture capital and growth equity, and other long-term productive assets. Moreover, the Government seeks views as to the role that the determination of the SCR could play to support delivery of its climate change objectives, the delivery of its Green Finance Strategy and to address the risks posed by exposure to 'stranded assets'.*

4.3 Solvency II permits an insurance firm to calculate its SCR[22] using either a 'standard formula'[23], or to apply to the PRA for approval to customise its calculation of the SCR using an 'internal model' that aims to reflect the specific characteristics of that insurance firm. An insurance firm may apply to use an internal model to calculate the entire SCR, or for only some risk components, and/or business units, with the remaining risk components covered by the standard formula. This 'customised' approach may result in an SCR which differs significantly from that calculated using the standard formula.

4.4 There may be scope to reform the methodologies used to calculate the SCR and to change the approach to regulation from a prescriptive, rules-based approach to a more appropriate mix of judgement and rules.

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22 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.

23 The standard formula is a standardised methodology for the calculation of the SCR prescribed by Solvency II. It is the default approach to the SCR calculation and was designed to capture the material quantifiable risks affecting most European (re)insurance firms. The vast majority of insurance firms use the standard formula to calculate their SCR.

- The standard formula may require some changes so that it more appropriately addresses the risk profile of UK insurance firms.
- Insurance firms, and the PRA, could have more flexibility to make greater use of adjustments[24] to the standard formula to ensure that their SCR better reflects their risk profile, without requiring the development of a costly and complex internal model.
- There may be improvements that can be made to: the requirements that internal models have to meet, the flexibility afforded to insurance firms in designing their internal models[25], how they are assessed and the tools available to the PRA to supervise their use.

4.5 An insurance firm that applies to use an internal model, or make subsequent material changes to it, is required to meet a considerable number of detailed requirements. Demonstration and assessment of compliance with these requirements may result in substantial costs for insurance firms and the PRA. In addition, the PRA must approve a model if the Solvency II requirements are met in full, or otherwise reject it. The binary nature of the approval process restricts other more proportionate approaches in which the standard formula is inappropriate[26].

4.6 The stringency of the internal model requirements reflects: the significant freedom that insurance firms can obtain by using an approved model to set their own regulatory capital requirements; the limited tools available to the regulator to deal with model weaknesses (short of rejection of the application, which may be sub-optimal for a firm with a bespoke risk profile); and the potential capital benefit compared to the standard formula. If internal model capital requirements are substantially lower than those calculated using the standard formula, an overly onerous and inflexible application process can also limit competition and result in sub-optimal outcomes.

4.7 The SCR calculation can never be a complete, or wholly reliable, representation of a firm's risks. It is important that the PRA has the flexibility to assess the adequacy of a firm's financial soundness as a whole, taking into account other relevant factors as well as the standard formula or internal model calculation. Current regulations relating to the calculation of the SCR provide limited flexibility for the PRA and insurance firms. If the standard formula is inappropriate, the PRA can require insurance firms to develop a (partial) internal model. Conversely, if a (partial) internal model becomes inappropriate a firm may be required to revert to using the

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24 For example, if using the standard formula, an insurance firm may apply to use an 'undertaking specific parameter' to modify a limited number of the formula's parameters.

25 For example, firms are not permitted to split risk-submodules for modelling purposes, and the model calibration standards may inhibit the adoption of methodologies based on different time horizons.

26 It can also lead to over-reliance on those models that are approved, characterising models as either entirely correct (if the model is approved) or unusable (if rejected). It is important to strike the right balance between reliance on internal models and other risk management tools, such as stress testing, that help firms and the regulator to understand the risks to which firms are exposed.

standard formula. Only in limited circumstances can a temporary 'capital add-on'[27] be applied.

4.8 Simplification, and an increase in the flexibility of approaches to the capital calculation, should lead to more efficient use of resources by insurance firms, and the PRA, by allowing them both to increase focus on risks in a more proportionate and effective way. Recalibration of the standard formula and expansion of insurance firms' and the PRA's ability to agree adjustments to the standard formula could mean that those options are applicable to more insurance firms, thus reducing the need for complex and costly internal models.

4.9 The SCR is a primary means by which an insurance firm provides for adverse risk, that is, experience being worse than expected. It is intended to capture all material risks to which an insurance firm is exposed. Therefore, it is a logical place for insurance firms to allow for climate change-related risks. However, the one-year time horizon on which the SCR is based may not be well suited for long-dated risks such as those arising from climate change, which may not become apparent for many years.

4.10 The Government invites views on tools that the PRA should have to assess and ensure the overall level of capital held by firms is appropriate. The Government seeks views on whether the current legal requirements concerning the approval of internal models and the use and ongoing supervision of the standard formula, or internal models, could be amended to be more effective, proportionate and flexible. It will also consider the appropriate scope for approaches to internal models and the options available to calculate the SCR – short of a full/partial internal model – for those insurance firms for which the standard formula is not appropriate.

4.11 The Government also seeks views on whether there are internal model requirements that are particularly onerous relative to their role in ensuring policyholder protection or the safety and soundness of firms. Responses to this call for evidence would inform any further analysis and consultation by the PRA.

4.12 The Government also seeks views on the role that the determination of the SCR can play to support insurance firms to deliver long-term capital to support growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets. Moreover, the Government seeks views as to the role that the determination of the SCR could play to support delivery of its climate change objectives, the delivery of its Green Finance Strategy and to address the risks posed by exposure to 'stranded assets'.

Question 11

4.13 What other tools should be available to supervisors to assess and ensure the overall level of capital held by firms is appropriate?

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[27] A capital add-on is a means by which a supervisory authority can increase the SCR of a specific firm to, among other cases, address risks that are inadequately reflected or modelled in the calculation of the SCR. A capital add-on can be imposed by the PRA at its own initiative or upon application by the firm.

Question 12

4.14 What changes, if any, should be made to the current approval process for new internal models and changes to models? What type of supervisory tool would be an appropriate alternative to the rejection of an insufficient model application?

Question 13

4.15 What changes, if any, should be made to the standard formula to better reflect the risk profile of the UK insurance industry? What are the costs and benefits of such changes?

Question 14

4.16 In circumstances in which there is insufficient justification for a full or partial internal model, how might the SCR be calculated for insurance firms or business for which the standard formula is deemed inappropriate?

Question 15

4.17 What changes, if any, could be made to the methodologies that insurance firms can use to calculate the SCR, including by removal of potential barriers, to enable them to provide long-term capital to support growth, including to invest in infrastructure, venture capital and growth equity, and other long-term productive assets, consistent with the Government's objectives?

Question 16

4.18 What changes, if any, should be made to the SCR calculation to promote better measurement and capitalisation of climate change-related risks?

Chapter 5

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

5.1 *Particular rules for the calculation of the solvency capital requirement (SCR) apply at the level of an insurance group[28]. The Government seeks views on the calculation of this group SCR, including circumstances in which the use of multiple internal models may be appropriate.*

5.2 Some insurance firms are members of an insurance group. Most insurance groups are required to calculate a SCR at the insurance group level, in addition to a SCR calculated at the individual insurance firm level. Current requirements only allow for the use of one group internal model in the calculation of the group SCR. This restriction may result in temporary substantial increases in group SCR[29] following merger and acquisition activity[30]. This may, in turn, deter, or increase the costs associated with, acquisitions by insurance groups.

5.3 There may be scope to improve the calculation of the consolidated group SCR for these insurance groups. The Government invites views on the requirements for the calculation of the consolidated group SCR following the merger or acquisition of insurance groups. It also invites views on the possibility of allowing the temporary use of multiple group internal models for the calculation of the consolidated group SCR following an acquisition.

Question 17

5.4 Which issues should be considered in relation to the powers for the PRA to allow for temporary calculation of the consolidated group SCR using multiple group internal models following an acquisition or merger?

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28 The consolidated group SCR reflects the level of capital that the insurance group would need to hold as if it were a single consolidated entity.

29 That is, while the group internal model scope is being expanded and subject to approval by the PRA.

30 Under Solvency II, if an insurance group with a group internal model ("the acquired group") is acquired by another insurance group with a group internal model ("the purchasing group"), the group internal model of the acquired group cannot be used in the consolidated group SCR of the expanded group. By default, the purchasing group must include the acquired group in the consolidated group SCR using the standard formula, but this may not appropriately reflect the enlarged group's risk profile. Alternatively, the purchasing group may seek a waiver to include the internal model SCRs of each of the entities in the acquired group under Method 2 (deduction and aggregation method – the alternative to group consolidation), but this would result in the loss of diversification benefits within the acquired group and the potential double-counting of risks.

Chapter 6

Calculation of the Transitional Measure on Technical Provisions

6.1 *The Transitional Measure on Technical Provisions enables insurance firms to apply a transitional deduction to the value of their insurance liabilities in certain circumstances. The Government seeks views on whether the provisions for the calculation of the TMTP could be improved.*

6.2 The Transitional Measure on Technical Provisions (TMTP) allows insurance firms to apply for a transitional deduction to the value of insurance liabilities written before the introduction of Solvency II. This can be done over a period of 16 years. The deduction is based on the difference in the value of insurance liabilities for business written before 1 January 2016 under the pre-Solvency II UK insurance regime and the value of those insurance liabilities according to the requirements of Solvency II.

6.3 However, the transitional benefit may be restricted to ensure that it does not lead to the overall financial resource requirements under Solvency II falling below those that would have been held under the pre-Solvency II UK regime.

6.4 The use of TMTP has allowed insurance firms to mitigate the immediate impact of moving business written before 2016 to the Solvency II regime. The total TMTP deduction will fall over time, as business written prior to 2016 runs off and as the total benefit insurers are permitted to claim is gradually reduced before being phased out entirely in 2032. However, it remains an important part of the balance sheet of many UK long-term insurance firms, particularly as a result of the impact of the risk margin (which did not feature in the UK's pre-Solvency II regime)[31].

6.5 There may be scope to improve the application of TMTP deductions in the UK. For example, the current application of TMTP deductions requires that insurance firms that wish to use them need to maintain 'legacy' models for this purpose[32]. This requirement may become increasingly onerous and may lead to unproductive review of outdated models and assumptions.

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31 26 firms had approval for use of TMTP, which, as at end-2018, and, of those users, the TMTP resulted in an average increase in the solvency ratio from 114% to 153% in 2018.

32 TMTP deductions are recalculated at least every two years and may be recalculated more frequently if there has been a material change in the insurance firm's risk profile. Under current regulations, this recalculation requires insurance firms to run legacy pre-Solvency II models in order to determine both technical provisions and overall financial resource requirements on this basis and under Solvency II.

6.6 In order to address this issue, the Government seeks views on alternative specifications for the transitional measure in the context of the wider changes that may result from the rest of the review. Additionally, the Government will also consider ways in which the specification and calculation of TMTP could be made more proportionate. Responses to this call for evidence would inform any further PRA analysis and consultation on detailed design of TMTP.

Question 18

6.7 What changes, if any, should be made to the current process for recalculating TMTP deductions? What are the costs and benefits of such changes?

Question 19

6.8 Should the TMTP be integrated into any broader transitional arrangements resulting from the Government's review of Solvency II?

Chapter 7

Reporting requirements

7.1 *Solvency II sets out detailed reporting requirements for insurance firms and branches of overseas insurers. The Government seeks views on whether the reporting requirements for insurance firms are appropriate and deliver benefits that are proportionate to the costs of the preparation of the reports that are required*.

7.2 The reporting requirements under Solvency II are designed to provide supervisors with the information that they need to understand insurance firms' business models and ensure compliance with Solvency II in a consistent way. The package is wide-ranging, and granular, and establishes harmonised reporting requirements across insurance firms. The core areas of reporting cover: 'own funds' (capital resources) calculation, capital requirements, Solvency II balance sheet and underwriting activity, technical provisions, long-term guarantees, granular breakdown of assets, reinsurance and information relating to groups of insurance firms.

7.3 Although around half the reporting templates are submitted by all insurance firms, the reporting requirements are customised when certain criteria are met[33]. Insurance firms and branches report both annually and quarterly, however the proportionality of Solvency II reporting is enhanced by the reporting waiver framework which the PRA has used to waive quarterly reporting for smaller firms.

7.4 Additional national specific templates exist to reflect specific areas of the products and market structure in the UK that are not captured by the harmonised reporting requirements. Furthermore, firms report to the PRA and publicly disclose qualitative reports on their risk management and governance structures, capital management, valuation and solvency.

7.5 There may be scope to refine the reporting requirements for insurance firms and branches of overseas insurance firms. The Government invites views on areas in which the reporting requirements for insurance firms and branches of overseas insurance firms could be amended without compromising the safety and soundness of firms and policyholder protection. For example, reporting requirements could be reduced though the extension of eligibility for existing reporting waivers to cover a larger proportion of the insurance sector or the removal of some reporting requirements. Other possible changes could result in alterations or additions to existing templates, or to formalise existing ad hoc requests. The Government also invites views on

[33] Including those based on organisational structure, type of insurance business undertaken, internal model approval, matching adjustment usage and materiality of asset holdings.

which reporting requirements are most useful in terms of the provision of information to the market.

Question 20

7.6 What changes, if any, should be made to insurance firms' reporting requirements? What are the costs and benefits of such changes?

Question 21

7.7 Insurance reporting comprises several layers: Solvency II templates, National Specific Templates, reporting expectations in supervisory statements, and ad hoc requests. What changes, if any, should be made to bring together the various layers to create a more coherent reporting framework?

Chapter 8

Branch capital requirements for foreign insurance firms

8.1 *The UK has an open, vibrant, outward-facing and internationally competitive insurance sector that is the fourth largest in the world. UK insurance firms are world leaders, especially in the provision of specialist insurance products in world markets. An appropriate branch regime for foreign insurance firms*[34] *can enhance the role of the UK insurance sector as a world leader, and 'hub', in the provision of insurance services and encourage foreign insurance firms to establish branches in the UK.*

8.2 *The Government seeks views on whether the requirements for UK branches of foreign insurance firms are operating optimally and whether reforms are required, in line with the objectives of this review*.

8.3 An insurance firm that is based in a foreign country may operate in the UK by establishing a branch in the UK, subject to approval from the PRA and Financial Conduct Authority (FCA). Branches are subject to particular prudential requirements. For example, branches are required to hold capital in accordance with the SCR and Minimum Capital Requirement (MCR) which are calculated based on a notional balance sheet of insurance business effected by that branch. Branches are also required to ensure that sufficient assets are located in the UK to cover the branch SCR and branch MCR.

8.4 There may be scope to improve the application of requirements for branches. Branch SCR/MCR requirements can impose a regulatory burden on insurance firms operating in the UK as branches. However, these requirements may provide limited prudential benefit because the branch cannot fail independently of the insurance firm. The Government expects a significant increase in the number of insurance firms accessing the UK market through branches in future, including some subsidiaries of UK parent companies[35]. A reduction in regulatory burdens on branches may encourage insurance firms located outside the UK to establish branches in the UK.

8.5 In addition to reform of capital requirements for branches, the Government seeks views on other potential reforms to the regime for these branches to increase the attractiveness of the UK as a destination for such branches.

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[34] For this purpose, a foreign insurance firm means an insurance firm based outside the United Kingdom and Gibraltar.

[35] Once insurance firms' ability to use the 'EU passport' ceases, after 31 December 2020, insurance firms in the Temporary Permissions Regime will have the option to establish foreign branches in the UK subject to meeting the statutory authorisation criteria, and in line with the PRA's branching policy outlined in Supervisory Statement 2/18.

Question 22

8.6 What are the costs and benefits of the removal of capital requirements for foreign branches and consequential changes?

Question 23

8.7 In what other ways could the branch regime be reformed in order to increase the attractiveness of the UK as a destination for foreign branches, while preserving appropriate protections for policyholders?

Chapter 9

Thresholds for regulation by the PRA under Solvency II

9.1 *Although the majority of insurance firms in the UK are regulated under Solvency II, some insurance firms do not meet the thresholds for regulation under Solvency II and are, therefore, exempt from this regime. The Government seeks views on the scope of application of Solvency II in relation to small insurance firms*.

9.2 The PRA is responsible for the regulation of all insurance firms. Small insurance firms, that is, those firms other than certain insurance firms writing some specialist lines, with annual gross written premium not exceeding EUR 5 million, and gross technical provisions not exceeding EUR 25 million, are not regulated by the PRA under Solvency II. These 'non-Solvency II insurance firms' or 'non-directive insurance firms' are subject to a relatively simpler prudential framework[36].

9.3 There may be scope to adjust the thresholds for the application of Solvency II in the UK to reduce the number of insurance firms that are regulated by the PRA under Solvency II. In particular, the current application of the full requirements of Solvency II to the smallest of these insurance firms, that is, close to, but slightly above, the current thresholds, may result in higher costs faced by those firms in complying with regulatory requirements. Such an increase in costs may not be proportionate to the benefits in terms of enhanced policyholder protection.

9.4 The Government seeks views on the appropriate size, and breadth, of insurance firms regulated under Solvency II. Responses to this call for evidence would inform any further analysis and consultation by the PRA.

Question 24

9.5 What changes, if any, should be made to the current regulations on the scope of the application of Solvency II? What are the costs and benefits of such changes?

[36] Non-directive insurance firms that are Friendly Societies are subject to the Friendly Societies regulatory regime. Non-directive firms that are insurance firms are subject a simple regime based on Solvency I, the predecessor of Solvency II. Established in the 1970s, it was a minimum harmonising regime and so was implemented differently across jurisdictions. It differed fundamentally from Solvency II in key respects: the valuation of liabilities relied on local accounting practices; it contained simplistic capital requirements; and asset risk was managed by quantitative restrictions rather than capital requirements.

Question 25

9.6 What should be the key features of a regulatory regime for insurance firms not covered by Solvency II ('non-directive insurance firms')?

Chapter 10
Mobilisation of new insurance firms

10.1 *'Mobilisation' of new firms describes the period immediately after the authorisation of a new firm during which it is subject to a more limited set of regulatory requirements in exchange for some initial restrictions on its activities. This allows the firm some latitude to become established and grow before the other requirements apply. The Government seeks views on the mobilisation of new insurance firms, including whether the current regimes contain barriers to new insurance firms[37].*

10.2 Under current requirements, new insurance firms that are expected to exceed Solvency II minimum size thresholds within five years are subject to the full application of Solvency II from the point of authorisation. This outcome may not be proportionate for 'start-up' insurance firms and may discourage new entrants in the sector.

10.3 There may be scope to improve the mobilisation of new insurance firms. This call for evidence seeks views on a proportionate regime for new insurance firms which reduces barriers for new entrants to the insurance sector while maintaining appropriate protection for policyholders and the safety and soundness of insurance firms. Responses to this call for evidence would inform any further analysis and consultation by the PRA.

Question 26

10.4 What changes, if any, should be made to the requirement that new insurance firms expected to exceed thresholds for size in Solvency II within five years of authorisation, are subject to Solvency II from the point that they begin operations?

Question 27

10.5 What are the key features that should be considered in developing a regime for new insurance firms if the full Solvency II regime is not applied from the point of authorisation?

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[37] The PRA has been operating its New Insurer Start-up Unit since August 2018. The Unit has sought views on perceived barriers to entry in the insurance industry and possible measures to address them: https://www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit

Chapter 11

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

11.1 *Insurance firms currently use discount curves based on LIBOR to value their liabilities in several currencies. However, LIBOR is expected to cease publication at the end of 2021 and be replaced by OIS rates. The Government seeks views on any issues arising for insurance firms from the forthcoming switch from LIBOR to OIS rates*.

11.2 Insurance firms currently calculate liabilities using 'prescribed' discount curves known as the risk-free rate (RFR), using a methodology set in Solvency II and using technical information currently published by the European Insurance and Occupational Pensions Authority (EIOPA). The PRA will become responsible for the publication of RFR curves from 31 December 2020. The PRA is currently consulting on whether to initially use substantially the same methodology as used currently by EIOPA[38].

11.3 RFR curves are currently derived from LIBOR data and a Credit Risk Adjustment (CRA) is applied. However, insurance firms cannot rely on the publication of LIBOR from the end of 2021. It has been recommended that the Sterling Overnight Index Average (SONIA) is used as the preferred replacement for LIBOR for sterling markets[39]. Implementation of this change to the sterling RFR curve may require a legislative and methodological change to the CRA currently applied to LIBOR.

11.4 The Government and the PRA aim to give certainty to insurance firms as soon as possible on any issues arising from the forthcoming switch from LIBOR to OIS, including in relation to timing and the application of the CRA. The PRA plans to consult on various aspects of the transition later in 2020.

Question 28

11.5 What factors should be considered as part of the proposed transition of insurance firm discount curves from LIBOR to OIS rates? When should the transition be introduced?

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38 See CP5/20 Solvency II technical information: The PRA's proposed approach to the publication at the end of the transition period

39 SONIA was recommended by the Working Group on Sterling Risk-Free Reference Rates: https://www.bankofengland.co.uk/news/2017/april/sonia-recommended-as-the-sterling-near-risk-free-interest-rate-benchmark

Chapter 12
Other areas for review

12.1 As set out in the introduction to this call for evidence, the Government is reviewing the application of Solvency II in the UK on a targeted and proportionate basis. However, the Government welcomes comments on areas of Solvency II not covered elsewhere which may be appropriate for inclusion in the review.

Question 29

12.2 What, if any, areas of Solvency II not covered elsewhere should be considered for review?

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