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Pollyanna Deane's insurance column: November 2020

by Pollyanna Deane, Partner, Financial Services Regulatory Team, Fox Williams LLP

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Pollyanna Deane, is a Partner in Fox Williams LLP's Financial Services Regulatory Team, and is also a member of Practical Law Financial Services' Consultation Board.

In her column for November 2020, Pollyanna considers work at both the UK and EU levels on reviewing the regime under the Solvency II Directive (*2009/138/EC*).

HM Treasury's Solvency II call for evidence: the "B-word"

On 19 October 2020, HM Treasury published a call for evidence in its review of Solvency II. While the B-word is never explicitly mentioned, this is a consultation permeated by Brexit. The review, which looks at how Solvency II could be tailored to "the unique features of the UK insurance sector", is not only made possible by the UK's departure from the EU, but is underpinned by an implicit objective to maintain a strong insurance sector in a post-Brexit world. I would also point out a, possibly, even more intriguing development to be found in the consultation issued by HM Treasury in October 2020, the Financial Services Future Regulatory Framework Review, where the insurance market is focused on and the new approach being advocated by HM Treasury is expressed in terms of the insurance market. This nearly made me fall off my chair. It is fascinating and very useful to see the way in which the future of regulation is discussed and the way it is intended to apply to the insurance sector, instead of being, as so often, seemingly made for banks and then adjusted for insurance.

In the Review, we find HM Treasury acknowledging the shortcomings of the EU approach to financial services regulation. Indeed, one of my clients expressed some frustration over how the single market has never really worked well. Here, we see the UK assessing its original framework for regulation and considering it robust enough to be adapted, rather than thrown out and starting again. The FSMA model is, therefore, to be the basis of regulation going forward and the Financial Services Bill is based on this approach.

The Review seems to be suggesting a high-level role for Parliament and government, providing the policy framework subject to what is clearly highlighted as a democratic review and oversight function – distinguishing the approach from the European model – with a role for HM Treasury in using secondary powers to update the framework and consideration of the roles of Select Committees. The regulators would be focusing on their speciality, regulation and designing and applying the direct regulation to be implemented in the light of the policy framework. The original idea behind FSMA is approved and the new approach is to concentrate on the regulator operating with flexibility. A lighter touch on the law, but an ever-changing regulatory regime. It is anticipated that the retained EU provisions would be transferred to the regulatory rule books.

These proposals include the government and Parliament also setting the policy approach for specific areas of financial services regulation, so with insurance, they would set out the overall purpose and regulatory approach needed for the prudential regulation of insurers. The policy approach would be high level only but long term in nature to assist with stability, with the regulators making their rules to take account of the then-current regulatory challenges. If I am honest, I read this with some excitement, but also trepidation if the regulators consider that they might find themselves responsible for meeting the challenge of those never-shrinking rule books. However, with the express intention of proportionality and streamlining – it still seems to me that there is a desire to have simpler financial services regulation, which applies across the board. We may well find the dual system for non-Solvency II and Solvency II insurers is turned into a single regime. Taking that as a starting point, it would be wonderful to have a clearer and less complex system, using the skillset of the regulators, appropriately, with an eye to their expertise, but not requiring them to respond without having an eye to practical common sense and market requirements. While not expecting them to be an easy touch, it would be useful to see our regulators distinguished for their ability to support the market and the consumer. This, after all, is something to be aspired to post-Brexit.

However, in the Solvency II call for evidence, HM Treasury have made a conscious effort to avoid becoming embroiled with Brexit rhetoric and instead focus on lauding the UK insurance sector and the UK financial sector as a whole, which John Glen MP, Economic Secretary to the Treasury, notes:

> "plays a vital 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".

It is interesting, however, to note the differing perception of Solvency II between the UK and the EU insurance markets. I have been working with my associate, Georgina Candy (who has put together much of this) to look at the way in which the continental European review compares and contrasts with the UK review of Solvency II. For EIOPA too has been busying itself with a review project and has already been consulting on future changes, with the consultation now closed. There is a stronger sense of reticence from EIOPA and some respondents to radically reform the Solvency II regime. The Department of Finance of Ireland (responsible for the administration of public finances in the Republic of Ireland) has praised the regime, submitting that:

> "Solvency II has shown itself to be very important to the stability of the European insurance market and an important piece of legislation in strengthening the Single Market and augmenting the European Union's Four Freedoms ... this is particularly the case in view of the departure of the United Kingdom from the European Union".

The Federation Francaise de l'Assurance gives Solvency II a slightly more ambivalent accreditation, noting that the "Insurance industry has welcomed the application of Solvency II directive" but goes on to plead that EIOPA ensures "stability both in the design and the outcome of Solvency II". This a recurring theme from submissions, many of which seek that any reforms are not disproportionately costly. The submissions are, however, a mixed bag and as we shall see later some respondents feel that certain reforms do not go far enough.

However, despite the differing enthusiasm for the Solvency II regime at large, there is clear alignment between the reforms proposed by EIOPA and those proposed by HM Treasury.

Matching adjustment

A notable area of reform is the eligibility requirements of assets and liabilities that qualify under the matching adjustment (MA).

UK life insurers, in particular, have relied on the MA to meet their requisite capital requirements. Notably, many restructure their assets for MA qualification purposes. Methods like securitisation have been used to convert floating cash flows into fixed cash flows and subsequently meet the eligibility requirements. However, HM Treasury states that this practice is an "unintended consequence" which is "costly ... and may represent a barrier to smaller insurance firms seeking to benefit from the matching adjustment". The government therefore proposes to ease the eligibility requirements, which could suggest a departure from the EU regime.

EIOPA has also considered the practice of restructuring assets, acknowledging that "the process to assess the MA suitability of a complex restructured asset ... requires NSA resource". As such, it proposes to streamline the supervisory process through the introduction of the "look-through" approach, which will guide NSAs in determining whether certain restructured assets are eligible under the MA. The "look-through" principle will comprise of relevant considerations as to the underlying (unrestructured) asset and others relevant to the nature of the restructuring, including whether the cash flows concerned are sufficiently fixed term.

SCR calculation

Another area under review is the solvency capital requirement (SCR) calculation. HM Treasury proposes greater use of adjustments to the standard formula to provide for SCRs that better reflect firms' risk profiles, allowing them to avoid the use of complex internal models. EIOPA is also working on a proposal for simplifying the calculation.

Additionally, HM Treasury is looking at allowing the PRA greater flexibility in setting capital requirements. Such flexibility will allow capital requirements to better reflect the risk profile of the firm in question, and subsequently (HM Treasury hopes) prompt re-allocation of resources into long-term investment options.

Reporting requirements

HM Treasury acknowledges that there may be scope to refine the reporting requirements without compromising the safety of policyholder protection. This could entail the extension of existing reporting waivers or the removal of certain reporting requirements.

The concern of disproportionate reporting requirements is also felt on the continent, but certain respondents feel that it is not being addressed adequately. ACA Luxembourg Insurance and Reinsurance Association submit that "the current proposals do not meet these objectives [of ensuring that the reporting burden on firms is proportionate], particularly for internal model firms, for which the additional reporting requirements are particularly onerous".

Thresholds for regulation by the PRA under Solvency II and mobilisation of new insurance firms

Both HM Treasury and EIOPA propose to raise the thresholds determining which firms are within Solvency II. This will be welcomed by smaller insurance companies who currently pay high costs to comply with the regulatory requirements in return for disproportionate benefits in terms of policyholder protection.

HM Treasury has paired this adjustment with proposed reform of the requirement that new firms that expect to reach the threshold within five years are subject to the full application of Solvency II from the point of authorisation.

These potential reforms may allow new players and InsurTech firms into the UK market, an aim bolstered by the PRA's "New Insurer Start-Up Unit" (NISU).

Risk margin

Notably, HM Treasury lists "Risk Margin", the capital buffer insurers hold for non-hedgeable risks, as the first area of reform.

A particular driver for this reform is the unanticipated volatility of the risk margin (particularly when interest rates are low) for those conducting long-term business. Such volatility has led UK life insurers to rely on the purchase of offshore reinsurance in a bid to reduce such impacts. However, the impact of these reinsurance practices on policyholder security is debated. The Institute and Faculty of Actuaries report that there may be a desire from global reinsurers to acquire UK longevity risk as a way of diversifying their portfolio of US mortality risk. If this view is accepted, then increased reinsurance may well increase policyholder protection since the longevity risk is ending up with firms that are better placed to handle the risk than UK direct insurers. On the other hand, the report also warns that such reinsurers may not fall within the jurisdiction of Solvency II, thereby holding lower (if any) risk margin. Such transfer of risk would amount to regulatory arbitrage and lower protection for policyholders. Notwithstanding this potential impact on policyholder protection, HM Treasury has also noted that these practices increase the complexity of supervising life insurers.

Contrastingly, EIOPA has maintained that it will not be recalibrating the risk margin calculation. While multiple non-UK supervisors have previously downplayed the need to reform the risk margin, this laissez-faire is not welcomed by all non-UK insurers. Finance Norway have submitted that they are:

> "disappointed by EIOPA's decision to maintain the status quo. The risk margin is excessively high, especially for long-term business and its sensitivity to interest rates is another source of artificial volatility ... EIOPA should put more effort into this area as mandated in the CFA".

Branch capital requirements for foreign insurance firms

Perhaps another Brexit-fuelled reform is HM Treasury's argument that the imposition of capital requirements on non-UK firms operating as branches is of limited use because the branch cannot fail independently of the insurance firm. Removing such requirements would encourage insurance firms located outside the UK to establish a branch in the UK as it would become a less burdensome and less costly task.

HM Treasury has also made an open call for any additional reforms that could ensure the continued attractiveness of the UK as a destination for branches of non-UK firms. I can think of several here, which I shall be looking to promote. The first would be that HM Treasury should facilitate access to, and provide analysis of, all the data that the regulators have collected to date from Solvency II. I have long thought that the seeds of the next financial crisis will be found in all that information and a systematic review and use of it can only give the industry more certainty and detailed information in the future, which surely will assist their planning and strategy. I would also seek feedback on the valuation of assets. If EMIR can drive a uniform approach to valuation of assets, then the same system would make it easier for insurers to identify and assess their assets. If the regulator wants to ensure that the firms operate in a level playing field then managing the data will definitely go a long way toward achieving that.

Conclusions

The call for evidence presents a promising agenda to bolster the UK insurance sector and, indeed, the wider UK economy.

Ensuring greater proportionality in the maintenance of capital requirements will not only free up resources for re-allocation into long-term UK-centric investments (like infrastructure and venture capital) but will level the playing field for those smaller firms seeking to disrupt and modernise the UK insurance market. Allowing for proportionality must, however, be done with caution. It is, after all, the current level of capital that has enabled the sector to face COVID-19 with such resilience. There is a balance to be struck between innovation and protection.

However, while considerable reforms are proposed, they do not appear to be so far-reaching as to endanger the UK regime's potential equivalence status. Although, it has to be said, equivalence is no Holy Grail, providing simply a few means of reducing what might be the worst excesses of the third-party regime. It is not, as some commentators have fondly imagined, a replacement passport of services.

While the review remains at an early stage, it is hoped that HM Treasury continue to err on this side of the line moving forwards. It is helpful to have a positive approach to the new world, but there still needs to be some caution exercised. Reform of financial services regulation is clearly important, but there is no desire to throw the baby out with the bathwater and completely start afresh. Indeed, to undergo reform only to lose hopes of equivalency would arguably land the UK insurance sector with a Pyrrhic victory and, perhaps, even heftier capital and regulatory requirements.