HYMANS ROBERTSON

Newsflash

PRA Consultation on Solvency UK Reform
'Review of Solvency II: Adapting to the UK Insurance Market'

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Iain Macintyre
Head of Capital Management
iain.macintyre@hymans.co.uk

Matthew Thomson
Senior Insurance Consultant
matthew.thomson@hymans.co.uk

Ryan Boldick
Insurance Consultant
ryan.boldick@hymans.co.uk

The first of two PRA consultation papers was published on 29 June 2023, marking the next major milestone in the development of Solvency UK. In this newsflash, we discuss some of the key changes included in the consultation paper and what they might mean for insurers. You can find the full consultation paper here.

At a glance

The first instalment in the PRA's summer duology of consultation papers covers proposed changes to the statutory framework including reporting requirements and regulatory application processes. Changes to the Risk Margin have already been laid out in a draft statutory instrument published by the UK Treasury, and the changes to the Matching Adjustment will be covered by the second instalment in September.

The consultation paper contained few surprises, but provided more detail on the suite of changes that the industry have been broadly supportive of. There are over 175 pages but we have boiled the key changes down to the handful of bullets below, with some more detail in the subsequent pages.

- The (re)calculation of the **Transitional Measure on Technical Provisions** – a proposed simplification aimed at reducing the resource required, increasing consistency of approach and monitoring any risks from run-off.
- **Internal Model approvals and permissions** – removing some of the existing prescriptive requirements and making the approvals process more flexible, while introducing some new capital add-on powers for the PRA.
- **Insurance groups and third-party branches** – simplifying the calculation of group capital requirements and removing the need for branches to calculate capital requirements.
- **Regulatory reporting** – removing overly burdensome requirements, including the Regulatory Supervisory Report, and increasing the thresholds at which insurers have to comply with full reporting requirements.
- The process for **new market entrants** – establishing a "mobilisation regime" which sets out a framework for new insurers, including provisions to allow business to be written earlier in the authorisation process.

The industry has been broadly supportive of these proposals through prior industry engagement, but will be preparing to comb through the finer details over the coming weeks to ensure that there is nothing contained in the small print that they might disagree with.

In our view, the consultation paper contains what we were expecting it to – it sets out a package of changes intended to increase flexibility, reduce the burden of regulation, promote competition and incentivise market entry. As usual, insurers will be hoping that the PRA implements the ultimate requirements in line with industry expectations.

In this newsflash, we draw out some of the key areas of the consultation paper from our perspective and discuss some of their potential impacts.

Reform of Transitional Measure on Technical Provisions

The transitional measure on technical provisions ("TMTP") was introduced in Solvency II to smooth the financial impact for firms in transitioning from Solvency I. The existing implementation is cumbersome and requires firms to retain legacy Solvency I models. The proposed changes aim to reduce the operational effort, increase consistency and place greater focus on managing the run-off of the TMTP.

What is changing?

A new TMTP calculation approach will remove the need to retain legacy Solvency I models. Key changes include:

- Introducing adjustment factors, to be based on one final run of the current approach as at 31/12/24, that will be used in all future recalculations and will **allow legacy Solvency I models to be retired**.
- The requirement to **ensure that TMTP runs-off to zero by the end of the transition period** in 2032 – avoiding a sudden drop. Where this is not the case, firms will need to adjust the amortisation accordingly.
- **Removing the need for firms to seek PRA permission to recalculate their TMTP**. This, and the new calculation approach will allow firms to recalculate TMTP on an ongoing basis (e.g. quarterly) to align with the same effective date as other regulatory balance sheet components.
- Moving the oversight of the TMTP calculation from the audit committee to the Chief Actuary.
- **Increasing flexibility around treatment of TMTP following business transfers**, by giving firms 2 months following the transfer to adjust their TMTP calculation to account for changes to their liabilities.
- Introducing a requirement for firms to **assess if there are any risks arising from the run-off of TMTP** that will impact their Solvency risk appetite over the medium term, at least annually.

The changes are intended to simplify the calculation while not materially changing the amount of TMTP benefit. For this reason, firms can choose to continue to apply the old approach if they feel the additional complexity better captures their risk profile.

No new application for TMTP permissions will be allowed and existing approvals will continue through to the end of 2032. The only potential exception is when a firm without approval acquires business that does have TMTP approval.

What will it mean for insurers?

The new approach should **reduce the costs** associated with the TMTP recalculation compared to the current approach. This benefit could be relatively large. A cost assessment in CP12/23 suggests that maintaining Solvency I models accounted for around 30% of the overall annual cost of applying TMTP and that the removal of FRR tests could have a capital benefit of £990m across smaller firms.

There will also be **some firms for which TMTP will reduce**, for example, due to an immediate increase in their amortisation. For these firms, capital ratios will be reduced, although this is limited to a 5 basis point impact on SCR as the proposal suggests firms that breach this can continue to apply the existing calculation methodology.

Those with unique risk profiles are expected to be required to continue using the existing approach – although the PRA will need to agree to this. They will need to maintain Solvency I models and be subject to additional annual monitoring to prove they are materially impacted by adopting the new approach, increasing their workload rather than reducing it. **Deciding whether to move to the new approach or not will therefore be a key decision for firms.**

Finally, audit committee agendas may shorten with the removal of the requirement for them to approve the TMTP. With more resting on the Chief Actuary, more thorough Line 2 review of the TMTP calculation may be sought.

Internal Models & Capital

The consultation sets out the intent to make significant changes to approach to Internal Model approvals. At a high level these changes:

- **reduce the level of prescription in regulations** originally intended to promote consistent standards across multiple EU member states, whilst;
- **introducing new regulatory safeguards** to ensure that high standards of modelling are maintained and that the quantum of capital held adequately reflects the risk profile of the firm.

The aim is for a more flexible approach to model approval, shortening the approval timeline and reducing the costs of model change. The key changes are set out below.

What is changing?

- The number of prescribed **tests and standards** to be met when submitting an application as set out in the existing "Self-Assessment Template" will be significantly reduced. **Certain standards, such as the statistical quality standards and specific data standards, are being removed altogether**. Other standards will be incorporated as regulatory expectations in supervisory statements. Oversight of general requirements relating to governance and risk management frameworks will be carried out through the PRA's BAU supervision, rather than being assessed as part of a model application.
- The PRA still expects firms to meet **high modelling standards**. Models will continue to need to cover all quantifiable risks calibrated to a 99.5th percentile 1-year Value-at-Risk and reflect a firm's risk profile.
- **Additional flexibility** is being introduced to the Internal Model approval process. Currently, decisions on approval are somewhat binary and require firms to meet all prescribed tests and standards. Under the proposed framework, the PRA **may** grant approval for models with residual limitations which might not meet the standards in full, with new safeguards introduced to maintain high standards. However, models which are not considered to adequately reflect a firm's risk profile will continue to be rejected.
- These new safeguards include **powers for the PRA to apply a capital add-on** in respect of model limitations and qualitative requirements restricting model use or business practices (e.g. limits on volumes of business or investment in new asset classes where model limitations are present)
- The PRA retains existing powers to impose broader capital add-ons in **exceptional circumstances** for both Internal Model and Standard Formula firms. However, there are changes to the methods for calculating exceptional add-ons for Internal Model firms intended to provide greater flexibility.
- The existing Profit & Loss Attribution (P&LA) is being replaced with a new **analysis of change** in capital requirements. Results will be submitted via a new template accompanied by supporting narrative.

What will it mean for insurers?

The changes are intended to reduce **the burden and timeline for model approval** which should be of benefit to both firms and the PRA. The consultation paper quotes potential cost savings of up to 25% based on responses from the previous quantitative impact study. Given the desire to maintain the existing high modelling standards, the extent of actual cost savings in developing fully compliant models may be debatable. Developing and maintaining robust models will still take significant amounts of specialised resources and rely heavily on expert judgement. However, the reduction in prescribed tests and consequently the burden of documentation should result in some savings.

We expect the real benefit will come from the **increased flexibility in the approval process** which has the potential to significantly reduce the approval timeline, giving firms the opportunity to implement changes in a more agile way. The trade-off will be accepting temporary add-ons or business restrictions, which may limit the business benefits of change at initial approval. Appropriate implementation of this flexibility is the key – for example, the PRA using limits and approving subject to conditions are not new concepts, but could be significantly simplified for insurers.

Firms should not under-estimate the implementation costs of updating model change processes, but in general the changes should result in simplifications. Whilst the proposed analysis of change in capital requirements is a new regulatory requirement, most firms already carry out such analyses for internal control and external disclosure. Insurers with Matching Adjustment approval will be interested to know what the removal of the P&LA means for Matching Adjustment surplus extraction.

Measures Designed to Increase Competition & International Competitiveness

One of the key motivations behind the reform has been to grow the UK insurance market by **removing barriers to entry and facilitating increased competition**. This will be particularly important within the Bulk Purchase Annuity ("BPA") market. Demand from pension schemes for buy-ins and buy-outs has never been higher and could outstrip capacity provided by the current players in the coming years. We have worked with a number of firms in recent years looking to enter the UK BPA market and are currently working with six potential new entrants, however for various reasons there have been very few successful market entries

More generally, the Government and regulators will hope that increased competitiveness will help to deliver value for consumers through lower prices/premiums and the development of new products tailored to consumer needs.

What is changing?

Changes that are intended to reduce or remove barriers include:

- **Establishing a "mobilisation regime"** which will allow new insurers to conduct business at an earlier stage of maturity (subject to certain restrictions) while allowing 12 months to build up operational capabilities. The floor for the Minimum Capital Requirement will also be reduced from €4million to £1million over this period.
- **Increasing the thresholds at which insurers have to comply with the Solvency UK regime**. The gross written premium threshold will increase from €5million to £15million and the technical provision threshold will increase from €25million to £50million.
- **Removing the requirement for UK branches of international insurers** to calculate and report capital requirements and Risk Margins.

As well as these changes specifically intended to attract new market entrants, the Government and PRA will hope that **streamlining the Internal Model application process**, **reducing reporting requirements** and **introducing more flexibility into the approaches used to calculate group capital requirements** will also make the UK insurance market more attractive.

What will it mean for insurers?

We'd expect that the **mobilisation scheme** will be an attractive incentive to firms looking to enter the insurance market. Being able to write business earlier in the process will be welcome, but the new business restrictions as currently drafted appear to lean more towards general insurers than life insurers which will be a disappointment to potential new BPA market entrants.

The clearer pathway to full authorisation may help new firms to **attract experienced employees** who may be otherwise wary of joining a firm that has not yet been authorised.

The reduction in operational effort that the **increase in thresholds** will bring are unlikely to be significant enough to benefit those looking to insure particularly high-value risks or to write life insurance contracts covering groups of lives. Instead, the changes would benefit smaller firms looking to establish themselves in niche areas of the market which could encourage more **innovation in new and unique products** tailored to particular types of policyholders.

The consultation paper states that **removing certain branch requirements** will benefit over 130 branches of international insurers that are currently operating in the UK. These changes will result in direct capital releases and operational benefits – the aim being to both incentivise overseas insurers to establish UK branches and to encourage the growth of existing branches. Given the large reliance on the capital position of the legal entity (which will still be required to be appropriately capitalised), the PRA believes that the removal of the requirements will not materially impact policyholder protection.

An area mentioned in the consultation paper in relation to insurance group supervision but not addressed directly is that of **equivalence** – i.e. the overseas prudential regimes that the PRA has adjudged to provide a sufficiently equivalent level of security to the UK. The PRA's ability (and willingness) to agree mutual equivalence with regimes in key jurisdictions such as the European Union, United States and Bermuda could be an important factor in how attractive the UK is to overseas insurers in the long-term.

Overall, these changes are clearly important for certain parts of the market and types of insurance. However, the lack of true benefit for potential BPA entrants may be seen as a disappointment for some.

What happens next?

Insurers are invited to provide feedback on the proposed changes, their expected costs and benefits and the implementation timeline by 31 July 2023 for the relatively minor changes included under the "administrative amendments" section and by 1 September 2023 for everything else in the consultation paper.

We can expect the second consultation paper to arrive in September. While the June paper confirmed many of the changes that the industry were expecting and broadly supportive of, the September paper will focus on changes to the Matching Adjustment – the area which has seen the most debate since the review of Solvency II kicked off. A consultation period will follow and run to the end of the year. It is expected that the changes will be finalised in time to become effective from Q2 2024.

Changes to the Risk Margin calculation previously published by the PRA should take effect from 31 December 2023 and we can expect a final publication of the topics included in the June consultation paper at the start of 2024, with an expected implementation date of 31 December 2024.

We continue to speak to a wide range of insurers across the UK and abroad about Solvency UK developments and how this could impact their business. If you would like to discuss these points further, please get in touch with your usual Hymans Robertson contact or any of the authors of this Newsflash.

HYMANS # ROBERTSON

London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | www.hymans.co.uk

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