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Newsflash

PRA Policy Statement 2/24:

Review of Solvency II: Adapting to the UK insurance market

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The PRA published Consultation Paper (CP) 12/23 on 29 June 2023, which marked a major milestone in the development of Solvency UK. On 28 February 2024, the PRA published the subsequent Policy Statement (PS) 2/24, which provides its final policy on the proposed reforms in CP12/23 and outlines the PRA's feedback to responses received.

At a glance

CP12/23 covered proposed changes to the statutory framework across many topics other than the reform to the Matching Adjustment which were provided in CP19/23. We outlined the key changes proposed in a previous newsflash. This PS contains the PRA's final policy associated with CP12/23, other than for reporting and disclosure[1]. Meanwhile a key change, which was to bring forward by a year the removal of the requirement to calculate the Financial Resource Requirement (FRR) test when recalculating the Transitional Measures on Technical Provisions (TMTP), had already been confirmed in a statement by the PRA in December 2023. Also proposed administrative amendments to the PRA rules had already been set out in PS19/23.

The industry can probably feel pleased that their responses have led to a number of improvements to the final policy albeit many of their proposals were rebuffed.

The most material changes to CP12/23 outlined in PS2/24 are:

- Removal of the proposed requirement for firms to disclose residual model limitation capital add-ons (CAOs) and removal of safeguards from the PRA's regular summary report on CAOs.
- Explicit allowance for setting dynamic CAOs which move in line with certain outputs (that will be calculated by each firm) to reflect how risks change over time.
- Allowing insurance groups up to six months after an acquisition to create a plan for integrating Internal Models and two-years following this to implement the plan.
- Increasing the threshold of gross written premiums above which a firm must comply with Solvency II to £25 million (from the £15 million proposed in CP12/23).

The full PS2/24 can be read here.

[1] This has been released today (29th February 2024) along with responses to CP14/22 as PS3/24 – Review of Solvency II: Reporting and disclosure phase 2

A closer look

Transitional Measures on Technical Provisions

CP12/23 proposed changes to simplify the (re)calculation of the TMTP. Respondents were generally supportive of TMTP proposals but encouraged the PRA to consider removing the test at year-end 2023. Some respondents also requested more flexibility around the business in scope of the TMTP calculation.

The PRA released a statement in December 2023 stating that:

- for firms whose TMTP is limited by the FRR test, the PRA would consider removing the test following a case-by-case assessment, and
- for all other firms, the PRA would no longer require the test to be carried out.

PS2/24 confirms this approach and that the FRR test will be removed entirely from the TMTP framework at year-end 2024. Bringing the implementation of this forward has an impact on the 31/12/23 balance sheets of firms where the FRR test was previously biting and will reduce costs associated with this calculation. Cost analysis in CP12/23 suggested that the removal of FRR tests could have a capital benefit of £990m across smaller firms.

There are a number of drafting amendments in relation to the TMTP in PS2/24. For example, PS2/24 speaks about “matching adjustment eligible business”, rather than “annuity business”, to be used to calculate the new dynamic component of the new TMTP. There are also wording amendments to allow flexibility in how MA eligible business is allocated across the dynamic components of the TMTP. For some firms this will increase the scope of business the TMTP can be applied to.

Capital add-ons

CP12/23 proposed changes that would streamline the approval process for Internal Models and introduced some CAO powers for the PRA. Some respondents noted that they were concerned about capital increases resulting from the use of CAOs.

PS2/24 allows firms to set CAOs which move dynamically in line with certain outputs calculated by a firm. CAOs have historically been applied as a fixed amount but the PRA now acknowledges that a dynamic CAO may be more appropriate to reflect how risks change over time, for example due to changes in corporate structure, business strategy or economic conditions.

Among other changes related to CAOs, CP12/23 introduced a new residual model limitation CAO, which aims to act as a safeguard to ensure Internal Models meet the relevant calibration requirements or to mitigate non-compliance. It also introduced the requirement of regular reports by the PRA summarising the use of CAOs at an industry level. PS2/24 states that the PRA will **not** include safeguards in its regular summary report on CAOs but will publish a report on the use of safeguards in 2027.

CP12/23 also stated that the requirement for firms to disclose CAOs in their Solvency and Financial Condition Reports (SFCRs) would be maintained. However, PS2/24 states that firms will not be required to disclose *residual model limitation* CAOs in their SFCRs. The reduced disclosure requirements reduce the risks of revealing proprietary and sensitive information. However the respondents calling for CAOs to be agreed between the firm and the PRA were rebuffed, with no change to the PRA’s position that CAOs were a tool for the PRA to use when needed.

Group capital requirements

CP12/23 proposed changes that would simplify the calculation of group capital requirements. In the consultation the PRA proposed that, following an acquisition, a group could add the results of two or more Solvency Capital Requirement (SCR) calculation approaches (e.g. Internal Model and Internal Model, or Internal Model and Standard Formula) when calculating a consolidated group SCR. The PRA proposed that it would assess the suitability of this temporary calculation approach using a number of factors, including the requirement for firms to submit a plan for developing a group Internal Model application at the point of acquisition.

Respondents to the consultation were generally supportive of this change, stating that it would allow greater flexibility, but had concerns on the factors that would be assessed when granting this. They noted that it is unlikely that they would have sufficient depth of knowledge required to create such a plan prior to the change in control. The PRA has now stated in PS2/24 that firms will have a temporary six-month period to develop a plan to integrate calculation approaches. This six-month period should allow firms more time to obtain data, knowledge and expertise to optimise the integration approach.

Thresholds

In CP12/23, the PRA proposed changes to the various thresholds at which firms are required to comply with Solvency II regulation. Following feedback on CP12/23, the PRA has increased the gross written premium threshold by a further £10 million, to £25 million. The threshold for technical provisions remains unchanged from CP12/23 at £50 million. Similarly, the reinsurance operations thresholds have also been increased from CP12/23, with the threshold for gross written premiums of reinsurance operations increasing to £2.5 million from £530,000, and the threshold for gross technical provisions increasing to £5 million from £2.4 million. This increase should result in a more proportionate application of Solvency II and enable smaller firms to write more business under simpler prudential rules.

Internal Models

CP12/23 proposed removing some of the existing prescriptive requirements for Internal Model permissions and making approvals more flexible. No material changes have been made in PS2/24.

Mobilisation

CP12/23 proposed establishing a "mobilisation regime" for new market entrants. While respondents supported this, many stated they would like more flexibility in the length of the mobilisation period. No changes have been made in PS2/24 to the proposed rules on mobilisation in CP12/23.

Next steps

There were no showstoppers in the updates to CP12/23 outlined in PS2/24 and insurers can now finalise their approach to implementing the regulatory changes outlined in the final policy. Insurers' focus will likely now shift to waiting for the policy statement outlining the finalised rules on the Matching Adjustment reform.

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.

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