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# Solvency II newsflash

**UK Government announcement on Solvency II reform**

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On Monday 21 February the UK Government published the first real indication of what insurers can expect from the much anticipated review of Solvency II in the UK. In this short Newsflash, we discuss some of the highlights of the publication and what they might mean for insurers. The full publication can be found here.

## At a glance

As expected, the key changes proposed are to the Risk Margin and Matching Adjustment. These have the potential to materially impact the level of capital that insurers (particularly annuity writers) are required to hold. The changes do not only impact annuity writers however, with proposed changes to the internal model approval process, simplification of transitional measures, a significant increase in the numbers of firms exempt from Solvency II, simpler requirements for third country branches and a mobilisation regime for new insurers.

We summarise the key changes below:

### Risk Margin

- A reduction in the risk margin of 60-70% has been estimated for long-term life insurers. Although it is not clear, this might point towards adoption of Scenario A in the recent Quantitative Impact Study exercise, the so-called Margin Over Current Estimate (MOCE) approach. This is perhaps a larger reduction than expected and could lead to some insurers re-considering the extent of longevity risk reinsurance – depending on how reinsurer pricing changes.

### Matching Adjustment

- The calibration of the fundamental spread used to calculate the Matching Adjustment will be revised to better reflect asset's credit risk – which may mean that the fundamental spreads will increase, decreasing the Matching Adjustment. The devil will be in the detail on this one with insurers particularly interested in how sensitive the fundamental spreads will be to current economic conditions. Although the announcement highlights that the fundamental spread should not be impacted by short term fluctuations, insurers will continue be slightly wary given the contrary messages that have been heard over the past few months.

- However, the "BBB cliff-edge" will be removed so that the capital treatment of assets falling below BBB is not disproportionately severe. Although we do not anticipate insurers significantly investing in sub-investment grade assets, this could reduce the capital requirement for BBB assets.

- There will be greater flexibility of assets eligible for the Matching Adjustment including assets with optionality surrounding the redemption date such as those with construction phases and callable bonds. There will also be greater flexibility of treatment for new and innovative assets without historical data. Insurers will hope that this genuinely opens up new asset classes eligible for Matching Adjustment without need for restructuring.

- The scope of liabilities eligible for Matching Adjustment will be extended to include income protection and morbidity risk insurance products. This had been a bone of contention for a small selection of income protection writers since the inception of Solvency II.

- There will be an acceleration of approval of new asset classes within the Matching Adjustment portfolio. The announcement noted that this will be achieved by "disconnecting the application process from the review of valuation, rating and capital issues for less complex assets". It will be particularly interesting to see the details behind this and how the definition of "less complex" plays out in practice.

- There will also be a more proportionate approach to Matching Adjustment breaches. Although breaches themselves are typically not too burdensome to correct, this could give more flexibility to collateral arrangements for funded reinsurance and other types of reinsurance.

### Removing burdensome regulation

There is an intention to significantly reduce the EU-derived regulations which currently create a reporting and administrative burden. For example, the measures presented on the government's website include the following:

- A reduction in the number of internal model standards so that the approval process can be accelerated with safeguards to enable the PRA to ensure approved models remain appropriate.
- A simplification of the calculation of the Solvency II transitional measures to reduce the reliance on maintaining legacy systems.
- Allowing consolidated Group capital requirements to be calculated using more than one approach.
- A reform of reporting requirements providing reporting exemptions, removing some reports and reducing reporting frequency for others.
- Removing the requirement of branches of foreign insurers to hold local assets and calculate local capital requirements.
- Reducing reporting complexity for small firms by doubling the thresholds for size and complexity of insurers before Solvency II applies, while maintaining the optionality of small firms to 'opt-in' to Solvency II; and
- Introducing a mobilisation regime for new insurers – this echoes language used in the original Call For Evidence in October 2020 and relates to the requirements of new insurance companies in the first few years of operation.

## What this could mean for insurers

The suggestion that the reforms are expected to result in a material capital release of up to 10% or even 15% of life insurers' capital, which is in direct contrast to previous messages, will be welcomed by firms. Previous messages from the PRA have talked about "capital neutrality" – indicating that any reductions in risk margin might be offset by reduced benefits from the Matching Adjustment. The government's announcement should help to allay such concerns.

Since the implementation of Solvency II, insurers have felt the need to reinsure longevity risk (often off-shore) in order to offer competitive annuity pricing. Whether the reduction in the risk margin will be sufficient to reduce the flow of longevity risk to off-shore destinations remains to be seen and will likely depend upon the relative cost of holding the risk margin compared to the cost of reinsurance. Although the reduction will clearly be welcome, for companies making use of transitional measures, the immediate benefits will be partially offset by reductions in those transitional measures.

The reaction to proposed changes to the Matching Adjustment will depend on the details within the consultation. The removal of the BBB cliff and the greater flexibility in assets and liabilities that can be included will all be welcome – albeit largely expected. Investment in more socially responsible assets such as infrastructure and "green assets" should be possible and, indeed, incentivised. However, the asset optimisation conundrum will still depend on what is meant by ensuring that the fundamental spread's "level, and sensitivity, genuinely reflect an asset's credit risk."

If the first two points primarily impact annuity writers, the remainder of the changes will be beneficial to a wide variety of insurers:

- Reductions in reporting will be welcomed by all.
- Faster internal model change approvals will help Life and Non-Life insurers and could even lead to more companies seeking internal model approval.
- A number of UK Non-Life and reinsurance branches will benefit from reduced reporting burden.
- New entrants could be incentivised – we continue to see significant interest in entering the UK insurance market, in particular the pension risk transfer market. But the challenges of entering the market have ultimately meant no new entrants for some time. We hope that these changes may help reduce the red tape and increase competitiveness for the good of policyholders.

Overall. these changes should allow insurers to cut down time spent on bureaucracy and focus on activities which will add real value to their businesses and the wider society.

Given the above, key winners will be those with relatively large risk margins and no Matching Adjustment or transitional measures. And annuity writers are likely to see some reasonable-sized capital and asset-liability matching benefits. Longevity reinsurers will have been waiting with bated breath over the last 18 months or so and this announcement may not be what they wanted to hear, but it is still very likely that reinsurance will be a key feature of insurer's risk management toolkit.

## What happens next?

The announcement sets out the next steps. There are two proposed consultations to look out for. These are:

- A full government consultation in April, which is expected to include detailed proposals and supporting analysis. This will allow for insurers to provide their own thoughts on the changes; and
- A further detailed technical consultation by the PRA later in 2022.

**We continue to speak to a wide range of insurers across the UK and abroad about Solvency II 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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