Financial Services Regulatory Insights

PRA consults on new Solvency UK framework

HOT TOPIC

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Highlights

The PRA set out major reforms to Solvency II in the first of two consultations this year; removing onerous requirements, and increasing flexibility and competitiveness.

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Summary

Following the UK's withdrawal from the European Union (EU), the UK Government has been working with regulators to adapt the UK's financial services regulatory framework to the UK's new position outside of the EU. The Financial Services & Markets Act 2023 (FSMA 2023) received royal assent on 28 June 2023, and enables the revocation of retained EU law, including legislation which incorporated the Solvency II Directive into UK law.

Reforms to Solvency II will be delivered through a combination of legislation and PRA rules. In its first step to deliver a tailored UK insurance and reinsurance framework, the PRA issued a consultation (CP12/23) on major reforms to Solvency II on 29 June 2023. The PRA believes the new Solvency UK (SUK) regime will lead to a more competitive and dynamic UK insurance sector, without compromising high standards of policyholder protection. In doing so, the PRA considers the proposals will advance its new secondary objective of international competitiveness and growth under FSMA 2023.

The PRA's proposed rules are consistent with the Government's response to its Solvency II review (see our At a glance summary); and so the PRA states these two publications should be read together. Changes to PRA rules will require secondary legislation to be laid by the Government. The Government has already started this process by publishing draft statutory instruments (SIs) on 22 June 2023 which outline changes to the risk margin (RM), fundamental spread and matching adjustment (MA) (see our At a glance summary).

Overall, the PRA expects the proposals in the first of its two major consultations on Solvency II to simplify some requirements, allow improved flexibility, and encourage entry into the UK insurance market. The PRA considers that the proposals will continue to maintain strong prudential standards for the UK insurance sector while allowing a meaningful reduction to the existing administrative and reporting requirements to decrease compliance costs and reduce regulatory complexity. The PRA's proposals seek to achieve the following:

- Remove onerous requirements: by streamlining reporting requirements by building on previous PRA reporting reforms (see our At a glance summary) and simplifying the calculation process for the transitional measure on technical provisions (TMTP).
- Greater flexibility: by reducing the number of prescriptive requirements that insurers must meet for approval of their internal models (IMs) and replacing these with a principles-based approach for assessing IMs. There will be more flexibility in the calculation of group capital requirements in certain circumstances.
- Increased proportionality: by increasing the size thresholds at which insurers are required to enter the SUK regime.

- Encourage entry and increase competition: by launching a new 'mobilisation' regime designed to allow authorisation and trading to commence at an interim state of readiness, which means insurers would be able to, for example, secure further investment while being authorised.
- Increase competitiveness: by removing some requirements for branches of international insurers operating in the UK, which includes the removal of branch capital requirements and branch RM.

Additionally, the PRA proposes to make minor amendments to its rules for clarity and coherence as a consequence of the Government's proposed reforms to the Solvency II RM. The PRA considers the proposed amendments would also provide insurers with legal certainty on the interaction between the Government's SIs and its rules.

The PRA's second major Solvency II consultation is expected in September 2023, which will cover reforms specifically relevant to life insurers in relation to investment flexibility and the MA.

We discuss the PRA's proposals in CP12/23 in further detail below.

Transitional measure on technical provisions

The purpose of the TMTP and the transitional measure on the risk-free interest rate (TMIR) is to smooth the financial impact of the transition from the previous Solvency I regime to Solvency II on insurers. TMTP and TMIR allow insurers to apply temporary reductions to the amount of technical provisions for business written before 2016, and increase available capital.

Under the new TMTP method, the PRA proposes that the TMTP would be derived in each reporting period exclusively from figures produced under Solvency II, and there would no longer be any reliance on Solvency I models.

The PRA expects the proposals to reduce the costs associated with calculating the TMTP for insurers and the PRA, and that they will drive greater consistency in how TMTP is calculated. Further, the proposals are expected to put greater focus on insurers' management of the run-off of TMTP during the transitional period, which ends in 2032.

However, the PRA recognises that for some insurers the proposed new TMTP method could have adverse impacts. For example, the new TMTP method could lead to a material financial impact under certain economic scenarios. Therefore, the PRA proposes that insurers affected in this way would be able to apply to vary their TMTP permission to allow them to continue to calculate TMTP using the existing approach, referred to as the 'legacy approach'. Insurers would need to submit an application to the PRA at least six months in advance of the PRA's proposed implementation date of 31 December 2024 if they wish to continue to use the legacy approach. In addition, the PRA proposes to remove the financial resources requirements (FRR) test for TMTP calculations so that approvals will be unaffected by the reduction in FRR arising from the RM reforms.

The PRA proposes that it would be more proportionate for the Chief Actuary to assume oversight of the TMTP calculation, instead of the Audit Committee.

Internal models

The PRA proposes to streamline the tests and standards for insurers to meet when making changes to existing IMs and for new IMs. The current IM framework is highly prescriptive and detailed as it was designed to harmonise regulation across the EU. Following the UK's exit from the EU, the PRA considers insurers can continue to demonstrate high internal modelling standards with less prescriptive rules. The PRA proposes to retain certain principle-based requirements, with expectations set out in a Supervisory Statement (SS) which would collectively provide greater flexibility and reduce burden for insurers.

The PRA intends to only retain risk management requirements in IM submissions that directly relate to the scope of IMs. Otherwise the PRA proposes to remove the requirement to include risk management and governance in IM submissions as the PRA assesses risk management and controls standards through other ongoing supervision means.

Insurers are currently required to maintain a directory of data used in IM frameworks, and this needs to include the source, characteristics and usage of the data. The PRA considers compliance with this prescriptive minimum documentation of data used requirement may be disproportionate in some cases, and therefore proposes to replace this requirement with expectations in a SS.

The PRA further proposes to remove the profit and loss attribution exercise from IM validation processes, and replace this with a new IM requirement for insurers to carry out an annual analysis of change (AoC) exercise. The PRA considers an AoC exercise would be a more efficient tool to understand the changes in solvency capital requirements (SCR) over time, further it is aligned to what insurers regularly do in practice.

The PRA additionally proposes to implement safeguards. By applying certain safeguards, the PRA would be able to grant IM permission where the IM is substantively sound, but which has residual model limitations (RMLs). The PRA proposes introducing two types of safeguards where RMLs exist. The PRA would have the ability to set: 1) an RML capital add-on (CAO) where the deviation from an insurer's or group's risk profile of assumptions underlying the SCR are not considered significant, and 2) a qualitative requirement safeguard that would apply to an insurer's business practices or IM use.

Further, to allow the PRA to check that insurers' IMs remain appropriate, the PRA intends to introduce an internal model ongoing review (IMOR) framework which would build on the PRA's existing supervisory review processes. The IMOR framework would consist of four strands: 1) PRA driven thematic work, 2) a new annual report to share the results of the AoC exercise, 3) an annual attestation by the Chief Risk Officer in relation to the IM requirements which would form part of an insurer's IM validation report, and 4) monitoring of the use of any insurer safeguards for which the PRA provided permission.

Capital add-ons

The PRA's proposals on CAOs support the PRA's proposals for a new flexible approach to IM frameworks. The PRA intends to introduce a new type of CAO as a model permission safeguard, to support the PRA's ability to grant permission to insurers to use an IM with a RML. The PRA further proposes a new approach for calculating a CAO for an IM significant risk profile deviation in exceptional circumstances, where it has concerns that part or all of an insurer's IM is inadequate or the SCR that the IM generates no longer reflects the insurer's risk profile better than if the Standard Formula were used.

The PRA confirms that where CAOs are set at group level, it would consider whether the rationale for the CAO also applies at entity level, and where this is the case, the PRA would consider setting a further CAO at the entity level.

Insurers would continue to be required to disclose CAOs set by the PRA within their Solvency and Financial Condition Report (SFCR). The PRA's reviews of CAOs would occur more frequently; from at least annually to on a regular basis. The regularity of the PRA's reviews would depend on case-specific circumstances, which would include the materiality of the CAO. The purpose of this approach would be to allow the PRA to make more proportionate and effective use of its resources. Further, the PRA proposes to regularly publish its use of CAOs at an aggregate industry level to develop a more consistent and transparent approach.

Flexibility in calculating the group SCR

When calculating the consolidated group SCR, the PRA proposes to allow a group to add the results of two or more different calculation approaches, for a period of up to two years (for example IM and IM; or IM and standard formula). Nonetheless, the PRA states it remains important for a group to develop a single approach to the group SCR calculation to provide a more holistic view of the group's risk profile, and to reduce the risk of regulatory arbitrage. The PRA considers this temporary flexibility would increase competitiveness and growth of the UK economy, as regulatory burden and costs would reduce for insurance groups looking to grow through mergers and acquisitions.

The PRA also proposes to allow a group to bring in its overseas sub-group's group SCR under method 2 (deduction and aggregation method), which would allow diversification benefits between the method 2 entities within that sub-group. To ensure that this proposal does not incentivise insurers to offshore UK risks to an overseas sub-group, the PRA proposes to allow insurers to apply for this only where the relevant sub-group is subject to equivalent group supervision.

Third country branches

The PRA proposes to remove the requirement for third country branches to calculate and report branch SCR and branch minimum capital requirements. Consequently, the proposals include removal of the branch RM and the requirement to hold assets in the UK to cover the branch SCR. However, the PRA confirms that it expects third country branches to have under £500m of insurance liabilities covered by the FSCS.

The PRA considers that the proposals to remove certain third country branch requirements are a proportionate approach to insurer safety and soundness and policyholder protection, given a branch cannot fail independently of the third country insurance undertaking. For example, the PRA explains that when assessing branch authorisation, the PRA must be satisfied that the home jurisdiction's prudential supervision regime is 'broadly equivalent'. Further, the third country branch undertaking must maintain adequate worldwide financial resources to meet the requirements for branch authorisation and ongoing supervision. Additionally, when assessing branch authorisation, the PRA must satisfy itself that in an insolvency branch policyholders will be given appropriate priority, and will not be disadvantaged in the event of a winding up.

Reporting and disclosure

The PRA's proposals build on reporting reforms set out in PS29/21 and CP14/22 (see our At a glance summary), and aim to remove, amend and introduce new reporting requirements for insurers. The PRA considers that overall, the proposals would result in a net reduction of reporting for insurers (with 55 reporting templates to be removed) . And while the PRA's proposals focus on supervisory reporting reforms, the PRA indicates it may review the SFCR going forward.

The PRA proposes to remove the requirement for insurers to submit the Regulatory Supervisory Report (RSR). This is due to it being burdensome for insurers to prepare; time consuming for the PRA to analyse; duplicative given a subsidiary and a group can submit the same information; and untimely due to it being a report that is required to be submitted every three years. However, the PRA states it intends to introduce a short standalone resolution-focused report for all third-country branches given it will no longer be receiving this information through the RSR.

The PRA proposes to streamline existing SCR reporting by insurance groups, as well as amend third country branch reporting given the proposed removal of branch capital requirements and RM, which would render some existing reporting obsolete.

Given third country branches are required to maintain adequate worldwide financial resources, the PRA presently reviews the adequacy of these worldwide financial resources by collecting information on the third country branch undertaking as a whole, as part of the authorisation process and then on an ad-hoc basis. The PRA proposes to formalise this requirement, requiring third country branches to report information of the capital and solvency position of the branch legal entity on an annual year-end basis and on a three-year forecast basis.

Mobilisation

The PRA proposes to introduce an optional 12-month mobilisation period for new insurers, particularly start-ups. During this time the PRA would apply proportionate regulatory requirements to insurers which includes a proposal to lower the absolute floor to the minimum capital requirement to £1m.

During mobilisation, the PRA proposes to restrict the business an insurer can carry on to limit risks to policyholders. For example, insurers should be limited to effecting insurance contracts so that the insurer's total net exposure remains below an aggregate sum insured / assured of £50,000 and should not include liability insurance. And to exit mobilisation, insurers would need to apply to the PRA for a Variation of Permission, demonstrating that they can meet regulatory requirements in full going forward, including applicable capital requirements.

The PRA considers the proposals would facilitate entry of prospective insurers into insurance markets by providing insurers with the certainty of being authorised as they complete the final stages of their set up. For example, this would allow insurers to secure further investment, recruit new personnel, and strengthen operational capabilities while being authorised.

Thresholds

The PRA proposes to increase the size thresholds for determining whether an insurer is regulated under Solvency II or the non-Directive firm (NDF) sector rules. The thresholds would increase from:

- €5m to £15m for an insurer's gross written premium
- €25m to £50m for insurer and group technical provisions.

Insurers would benefit from the Solvency II exemption to the extent they do not exceed the thresholds for three consecutive years and do not expect to exceed the thresholds in the following five years. Further, under this proposal, insurers that do not exceed the new increased thresholds would continue to be able to operate within the Solvency II regime should they wish to, by applying for a voluntary requirement.

The PRA considers these proposals would result in a more proportionate approach to the regulation of smaller firms, as NDFs generally benefit from simpler requirements, including simpler capital standards, reporting forms, and governance requirements.

Currency redenomination

Following the UK's withdrawal from the EU, the PRA states it would be more appropriate to redenominate monetary values in its Solvency II PRA rules from EUR to GBP. The PRA also considers this would lead to more consistency for insurers.

What do firms need to do?

Given the PRA has indicated insurers will have approximately 18 months from the date of CP12/23 to implement a number of changes, including to the RM and TMTP, insurers should begin planning now for any system changes required to ensure timely implementation. At this stage insurers may wish to consider which of the areas of review set out in CP12/23 are most relevant for their business and decide if they want to respond.

Several proposals provide insurers with the option to tailor how the rules will apply to their specific business models on a temporary basis. For example, the PRA is able to grant permission for insurers to use a safeguard where RMLs exist in their IM. Insurers should therefore consider which of these proposals they wish to take advantage of, and pursue early engagement with their PRA supervisors on these areas.

With the reduction in the RM, reinsurance and capital management strategies will need to be reviewed along with hedging levels. Life insurers may wish to model the changes to the RM, TMTP and the MA as these are likely to impact their reinsurance, capital management and investment strategies going forward.

International insurers looking to set up operations in the UK might wish to consider how the removal of branch capital requirements could impact their optimal capital structures. Insurers with operations in the UK and the EU will need to consider whether divergences in prudential rules will require changes to systems and the set up of control functions.

Next steps

The consultation period for the PRA's substantive proposals in CP12/23 closes on 1 September 2023, with the final policy expected by the end of this year. The PRA proposes to give insurers until 31 December 2024 to implement the majority of the reforms in CP12/23.

CP12/23 also proposes minor amendments to the PRA's rules to align them with the implementation of the Government's RM reforms by 31 December 2023, as set out in the recent draft SIs. These minor amendments are subject to a shorter consultation period of one month.

Beyond this, the PRA expects to consult in September 2023 on reforms for life insurers relating to investment flexibility and the MA rules, including to eligibility rules, new attestation requirements and certain changes to its calculation, and reporting. The PRA plans to further consult on non-substantive changes in early 2024 to transfer the remaining Solvency II requirements from retained EU law into PRA rules.

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