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Solvency II

Continuity, change and divergence in a post-Brexit world

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Foreword

What this report seeks to achieve

On 23 June 2016, a mere six months after the biggest overhaul of insurance regulation in Europe brought about by implementation of the Solvency II directive – the people of the UK voted in a referendum to leave the EU. The UK's decision to leave the EU has of course raised many far-reaching questions; but foremost among these for the insurance sector, and one that emerges frequently in our dialogue with clients, is whether, or how far, the UK will stick to the current Solvency II framework once it is out of the EU, or will it instead choose to reform the current framework, and in what ways, to adapt it better to the UK market.

On the continent, post-Brexit the UK authorities will no longer be around the negotiating table, and so, depending on the final date and form of Brexit, will be limited in their ability to influence the EU's planned wide-ranging review of Solvency II in 2020. A further parallel and pressing question of interest, therefore, is how, following Brexit, the Solvency II regime might change or develop in Europe following the withdrawal of the UK influence from EU decision-making fora, and whether it may change in ways that may not be in the UK's interest.

This report seeks to shed light on these key issues in two ways:

- Firstly, it examines potential future scenarios within which the UK regulatory framework may evolve. This report focuses most particularly on the role and likely perspectives and priorities of the UK Prudential Regulation Authority (PRA) as it seeks to develop the UK prudential insurance regime, and the level of practical flexibility that it may have compared to the Solvency II regime, recognising of course that the PRA operates entirely within the parameters and context of the UK government's financial services policy and wider regulatory strategy.
- Secondly, this report looks at the relatively recent negotiating process that forged Solvency II, the reception Solvency II has encountered in the last few years across Europe, and at current key issues being debated in the UK and EU, including ongoing discussions involving the UK Parliamentary Treasury Committee (Treasury Committee). In doing so, our aim is to identify key national perspectives and priorities, and what pointers they may provide as to likely future developments in insurance prudential regimes on both sides of the channel.

Our objective throughout is not to predict specific outcomes, but to identify potential broad directions of travel as well as the individual reforms we think most likely to emerge in both the UK and EU. Where we refer to "Brexit" in this report, we are referring to the moment at which the UK becomes a "third country" for the purposes of EU regulation.

But firstly, a vital caveat

At the time of writing the outcome of Brexit negotiations between the UK and EU remains deeply uncertain. The future direction of broader UK government policy and strategy on financial services regulation, which this report does not set out to predict, will, of course, ultimately determine the UK regulatory framework.

These factors introduce a significant degree of uncertainty as to the future scope or appetite of the UK government and PRA to reform Solvency II within the UK, as they seek to balance the UK's potential interest in remaining equivalent to Solvency II with a desire to have a UK domestic regime that is more tailored to the UK insurance market. Any material change in the UK government's overall emphasis and priorities for financial services regulation, in particular with regard to equivalence with EU regulation, would inevitably substantially affect the various regulatory decisions and priorities discussed in this report.

These tensions are perhaps best illustrated by the PRA's June 2018 announcement that, notwithstanding having promised to resolve issues with the risk margin at the UK level, and despite considering its proposed changes to be consistent with Solvency II, the PRA would not be able to implement changes to the risk margin in the UK due to "the ongoing uncertainty about our future relationship with the EU in relation to financial services". The PRA has hitherto openly identified the risk margin as its top Solvency II priority, and the Treasury Committee has also pushed for it to be reformed. Given this, this latest stance is a striking illustration of the potentially limited room for manoeuvre that the PRA faces.

To whom will this report be of interest?

We think that, notwithstanding the above key caveat, the analysis in this report will be useful for UK and European Union 27 (EU27) insurers carrying out post-Brexit scenario planning. This report is also relevant for firms, supervisors and regulators interested in learning from the UK and European experience of implementing Solvency II to date; analysis that may, inter alia, be useful for supervisors and firms as they prepare for the two-phased implementation of the expected International Association of Insurance Supervisors (IAIS) Insurance Capital Standard (ICS) 2.0.

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Executive summary

This report sets out to consider how the insurance prudential regime in the UK might evolve post-Brexit. To do this, we consider two important moving parts in the debate, which are those that we expect to have the most bearing on future developments. Throughout, our central focus is on the **potential reform priorities and activities of the PRA**, as the primary rulemaking body for the UK prudential regime, but considered within the context, and potential constraints, of the following two factors:

- Firstly, **potential future scenarios within which the insurance regulatory framework may evolve in the UK**, recognising that insurance regulation is just one part of the UK government's future overall approach to financial services regulation.
- Secondly, **areas of substantive policy debate in the run-up to Solvency II and subsequently, and the perspectives of UK and EU27 authorities and regulators** on these issues, including the recommendations made by the UK Treasury Committee.

As insurers look ahead beyond Brexit, we expect the UK prudential regime to develop and diverge from Solvency II to some extent, However, we consider it would be unwise to treat a significant degree of UK flexibility as a foregone conclusion, and there are certainly reasonable scenarios in which the PRA may have limited or no discretion to depart from Solvency II as implemented in the EU.

The potential significance of the **UK's absence from EU decision-making fora** is also worth highlighting. In our view, this creates a substantial risk that Solvency II will develop in the future in ways not aligned to the UK's interests.

Throughout, it is vital to note that there is **substantial uncertainty** as to any changes that will ultimately occur. There is, at present, and in general, **broad agreement** on the key principles of Solvency II, including in the UK. We therefore expect Solvency II to **continue in its essential features** in both the UK and EU27, with some **adjustments and refinements** that are nonetheless important. However, there are plausible scenarios in which much more profound changes could take place, in particular should there be a broader shift in UK policy towards financial services regulation.

In this report we discuss the views of UK and EU27 regulators, policymakers and industry participants on following areas of Solvency II, and consider the pressures that may come to bear for adjustment or reform in each of these areas:

- Risk margin
- Long term guarantee measures
- Regulatory reporting and public disclosure
- Internal models
- Role and powers of EIOPA
- Capital, including standard formula methodology and calibration
- Loss-absorbing capacity of deferred taxes
- Environmental, social and governance factors
- Macroprudential features of Solvency II, including recovery and resolution framework
- Cross-sector consistency in regulation and supervision
- Transitional measures

Summary of key findings

Within the context set out above, the following are the policy areas in which we expect to see the most pressure for **policy divergence** in the future, and the key considerations for the PRA's approach in each area discussed in this report:

Risk margin

Interest rate sensitivity inherent in its design and methodology

- We would expect the PRA to place high priority on pursuing its "management actions" approach, although its ability to pursue a contrary interpretation of the Solvency II rules may be very limited.
- With complete discretion over the UK framework, we expect the PRA would prefer to redesign the risk margin to remove its interest rate sensitivity altogether, for example by using a floating cost of capital rate.
- The scope of the 2020 Solvency II review raises the potential for significant changes to the design of the risk margin to be made at the EU level. However, changes could also prove to be limited given European Commission support for the cost of capital approach. Any changes affecting valuation are likely to be phased in over a period of time.

Long term guarantee measures

Asset and cash flow eligibility criteria for the matching adjustment (MA), the use and effect of the volatility adjustment (VA) and dynamic volatility adjustment (DVA), and the extrapolation of risk-free discount rates

- We expect the PRA's main priority, with sufficient discretion, would be to relax the MA asset cash flow eligibility requirements to remove the need for restructuring of some MA portfolio assets, including potentially through greater flexibility and application of judgment around the modelling of cash flows and duration matching.
- On the VA, the PRA may look to revert to its former policy position prohibiting the use of the DVA in the UK. On the other hand, with sufficient flexibility in how it implements the MA, the PRA may prefer to de-emphasise the use of the VA in the UK altogether.
- In the EU, it is not altogether unlikely, in our view, that the Solvency II review will result in the MA being phased out altogether in favour of a VA that is more tailored to insurers' own asset portfolios. Such a "single adjustment mechanism"[i] might capture some, but not all, of the benefits of the MA, although such an approach would likely meet with some resistance among users of the MA in the EU27.
- We expect Solvency II review work on the Solvency II risk-free rates and last liquid points (LLPs) to be of significant interest, in particular in the context of ongoing IBOR benchmark rate transition.

Regulatory reporting and public disclosure

Volume and detail of the standardised reporting package, and whether it is proportionate

- We expect the PRA to review the standardised Solvency II reporting package in view of its specific needs to supervise the UK market, building on the review being carried out by EIOPA for the Solvency II review.
- We expect the PRA to be supportive in the first instance of changes carried out at EU-level, to the extent they achieve the objectives of the Solvency II review to improve the proportionality and fitness-for-purpose of the reporting package.
- Depending on the final package of changes, we expect the PRA may still explore the potential to broaden further the scope to exempt smaller and less complex insurers from certain aspects of reporting, in addition to tailoring the reporting further to the UK market, should it have the flexibility to depart from the Solvency II package.

Summary of key findings (cont.)

Internal models

The internal model approval process, and ongoing supervisory discretion over modelled capital requirements

- If unconstrained by Solvency II, we would expect the PRA to target greater supervisory discretion over modelled capital requirements (i.e. capital add-ons), which may be coupled with some relaxation in the detailed requirements for internal model approval, in particular around ex ante approval of methodologies, assumptions and data.
- Where more constrained by Solvency II, it is unlikely, in our view, that the PRA will make substantial changes to the internal model approval process beyond limited process simplifications.
- In the EU, we expect any substantive changes to internal model requirements to be focused on increasing convergence in modelling and supervisory consistency.

Role and powers of the European Insurance and Occupational Pensions Authority (EIOPA)

The potential for further consolidation of powers at the level of EIOPA, in particular to promote supervisory convergence

- Following Brexit, the PRA may have greater flexibility to depart from EIOPA guidance, opinions and determinations.
- However, in most cases we would expect the PRA to continue to pay due regard to the implementation of Solvency II in the EU, and the UK would likely come under pressure if its implementation decisions were seen to provide a competitive advantage to UK insurers.
- In our view, it is unlikely that significant further powers will shift from national supervisory authorities to EIOPA, beyond what has already been agreed by the European Parliament, absent a significant external catalyst such as a major market shock originating in the insurance sector.

Capital, including standard formula methodology and calibration

How the standard formula can better capture the risks facing insurers, and reduce undue complexity

- Given the likely importance of capital in any future discussions on equivalence and/or regulatory divergence, any UK departure from the standard formula methodology and calibrations is likely to be scrutinised closely.
- With significant flexibility, we expect the PRA would examine a broader scope of standard formula components than the European Commission is considering for the 2020 Solvency II review, with a view to establishing whether the methodology and calibrations can better capture specifics of the UK industry. This may include considering the role of undertaking-specific parameters (USPs), which are currently used to a very limited extent in the UK.
- At the EU level, further changes are likely to methodologies, assumptions and calibrations to capture specificities of the European industry. We would expect these, in particular, in areas linked to Capital Markets Union (CMU) priorities.
- In both the UK and EU, further simplifications of methodologies are likely where justified on proportionality grounds.

Loss-absorbing capacity of deferred taxes

Convergence in national practices

- The PRA has pushed in the past for convergence, and we expect will have limited appetite to change its approach significantly.
- Recent changes to the Delegated Acts are intended to standardise the calculation to a greater degree at EU level. However, the effect of these changes remains to be seen, and divergence with the PRA's approach remains possible going forwards.

Summary of key findings (cont.)

Environmental, social and governance (ESG) factors

How ESG factors are recognised by the Solvency II framework, including sustainability and climate change

- The PRA has already placed a great deal of focus on UK insurers' recognition and management of the financial risks from climate change. We do not expect any essential change in UK approach following Brexit.
- The EU focus has predominantly been on insurers' roles in delivering a sustainable economy, including through sustainable infrastructure financing. We expect this approach to continue absent the UK's influence.
- This could potentially include changes to the EU capital framework to steer insurers' investment decisions towards sustainable investments. While the PRA will also look at prudential capital requirements in the UK, any changes to the capital framework may give rise to divergent views between the UK and EU, reflecting slight differences in objectives and priorities on sustainability between the UK and EU regulators.

Macroprudential features of Solvency II, including recovery and resolution framework

Solvency II's approach to macroprudential policy issues, including recovery and resolution and insurance guarantee schemes

- If unconstrained by Solvency II, the PRA would be likely, in our view, to introduce much greater scope for regulatory forbearance, including over capital, in times of severe market stress.
- At the EU level, we consider significant changes to be unlikely on recovery and resolution and insurance guarantee schemes. Furthermore, the departure of the UK from relevant decision-making fora is likely to reduce the drivers for major work and harmonisation on macroprudential policy issues, absent other factors.
- However, we expect the European Commission to adopt limited macroprudential enhancements to Solvency II through the Solvency II review, changes that the UK is likely, in our view, to support.

Cross-sector consistency in regulation and supervision

The elimination of unjustified differences in approach between the insurance and banking frameworks

- We expect support for further alignment between insurance and other sector frameworks to exist in principle in both the UK and EU.
- However, issues of cross-sector alignment have proven complex in the past. This creates a risk, in our view, that different decisions and perspectives in the UK and across the EU will create future pressure for policy divergence.

Transitional measures

Assessment of the ongoing appropriateness of the measures applied by insurers

- While we expect limited appetite to challenge the transitional measures in either the UK or EU27, given the significance in particular of the transitional measure on technical provisions (TMTP), a review of the measures is nonetheless included in the scope of the Solvency II review.
- We would expect any changes proposed to generate a very significant volume of debate.

Overall perspectives on Solvency II in the UK

The UK was amongst the strongest proponents of Solvency II during the negotiations that preceded Solvency II implementation. In the previous decade, the UK had radically reformed its own prudential insurance regime, through what was known as the Tiner reform process, in response to the problems highlighted, inter alia, by the Equitable Life case.

The "jewel in the crown" of this reform programme was undoubtedly the creation of a market consistent economic capital-based capital adequacy regime known as "ICAS". In many ways it was the UK's overriding objective to consolidate and develop this regime at a pan-European level through embodying it in Solvency II.

The ICAS regime was generally held in high regard by both UK regulators and the market. It was seen as having achieved well its essential aim of capturing, within the capital adequacy framework, sensitive and potentially volatile liabilities on a robust and realistic basis, and the consensus was that it left the insurance industry and regulators well positioned to weather the storm of the financial crisis that broke in 2008.

In the last two years, whilst identifying some areas for reform in the light both of operating experience and economic conditions, a succession of senior PRA regulators have stated that they consider that Solvency II is broadly a success and working well. Overall, therefore, and not least given that it was to a large extent modelled on the UK's previous ICAS framework, we expect the UK regulatory authorities to want to maintain the core elements of the Solvency II framework that were UK priorities during the Solvency II negotiations, namely:

- A robust **market consistent framework** based around three pillars, covering quantitative requirements (Pillar 1), risk management and governance (Pillar 2), and supervisory reporting and disclosure (Pillar 3);
- Strong pillar 2 requirements on **high-quality governance** and risk management;
- Appropriate **"illiquidity premium"** for long-term insurance business and to reflect the nature of illiquid liabilities; and
- An **outcomes-based equivalence** framework for third country regimes.

That said, as discussed in this report, there are areas of Solvency II which both the UK regulators and market participants agree could sensibly be reformed without departing from the core elements of the regime. More broadly, ICAS afforded supervisors a degree of judgmental flexibility that Solvency II largely precludes. In our view, and in principle at least, the UK regulators would like to recapture at least some of that flexibility in line with their post-crisis "judgement-led" approach to supervision.

"Solvency II is a welcome modernisation of European regulatory standards. You will be familiar with the UK's ICAS regime. Solvency II recognises many of the principles that form the basis of that regime, and therefore introduces a level playing field with the rest of the EU."

David Rule, Executive Director, Prudential Policy, Prudential Regulation Authority, speaking at the PRA Solvency II Conference, October 2014

Scenarios for the future development of Solvency II

Inevitably, how Solvency II will develop in the UK depends to a very great extent on developments in negotiations between the UK and the EU. Without drawing any conclusions on the eventual outcomes of these negotiations, there are two main broad scenarios that we consider most useful for future planning by insurers:

- Firstly, a Brexit scenario in which the UK may have limited scope to diverge from the EU common rulebook (for example, under an approach which includes close regulatory alignment or EEA membership). It is feasible that the UK would have limited influence in EU rule-making which would almost certainly be less than it has had in the past, and it would therefore be a reasonable planning assumption for Solvency II to evolve in ways that will not necessarily reflect the UK's interests. Alternatively, or in addition, aspects of Solvency II that the UK pushed most for may come under review once the UK no longer has a strong voice in the various decision-making fora.
- Secondly, a future relationship with the EU that provides the PRA with reasonable through to substantial scope to reform the insurance regulatory regime in the UK (for example, a no-deal WTO (World Trade Organisation) scenario or under a limited, shallow free trade agreement). Whatever the circumstances of the UK's eventual departure, given the UK regulators' strong historic support for Solvency II, and a likely objective to retain equivalence, it is reasonable to suppose that any reforms in the UK would retain the key elements of Solvency II, namely economic capital measurement, market consistency and extensive use of internal models. But the PRA could potentially still have reasonable scope to tailor Solvency II according to its own supervisory preferences and the UK market, in some of the areas discussed in this report.

Solvency II equivalence

Ultimately, the question of whether and how the UK maintains **equivalence** with Solvency II will be a major factor affecting the future of insurance regulation in the UK. There are a number of important precedents for Solvency II equivalence, which illustrate the flexibility of the assessment, the wider political influences bearing heavily on it, and hence the degree of latitude in how closely a non-EEA regulatory regime must technically mirror Solvency II in order to be considered equivalent:

- **Switzerland** has a national solvency regime that is conceptually similar to Solvency II, but takes a technical approach that is materially different from Solvency II in some areas, illustrating the focus on regulatory outcomes in the assessment.
- **Bermuda** sets an interesting precedent for the bifurcation of an equivalence decision, in that the Solvency II equivalence determination excludes the rules applicable to captives and special purpose insurers. This illustrates the targeting of an equivalence assessment at the most relevant segments of a national market.
- **The United States of America** has signed a bespoke bilateral agreement with the EU that falls outside the Solvency II equivalence framework.[1] However, in substance, it achieves almost the same outcomes as equivalence under the Solvency II provisions relating to reinsurance and group supervision (the United States is also separately "provisionally equivalent" with respect to its local solvency calculation, a designation that must be renewed every ten years). This illustrates that, in principle, equivalence-type outcomes can be achieved through alternative agreement mechanisms.

In its July 2019 *Communication on Equivalence in the Area of Financial Services*, the European Commission reiterates the flexible, unilateral and, most importantly, discretionary nature of the equivalence assessment, stating, for example, that "[t]hird-country regimes do not need to be identical to the EU framework, but they do need to ensure in full the outcomes as set out in that framework" and that "[a]s part of its discretion the Commission may decide to formally adopt, suspend or withdraw an equivalence decision, as necessary". Any future equivalence assessment of the UK carried out following Brexit will inevitably be carried out in the context of many factors beyond the technical and outcomes alignment of the UK regime with Solvency II, including, for example the perceived impact of the UK on the EU industry, and potential financial stability implications.

1. The United States and the UK have subsequently signed a "U.S.-UK Covered Agreement" to bring consistent measures into force once the UK is no longer subject to the bilateral agreement between the United States and the EU.

Scenarios for the future development of Solvency II (cont.)

Solvency II equivalence and European single market access

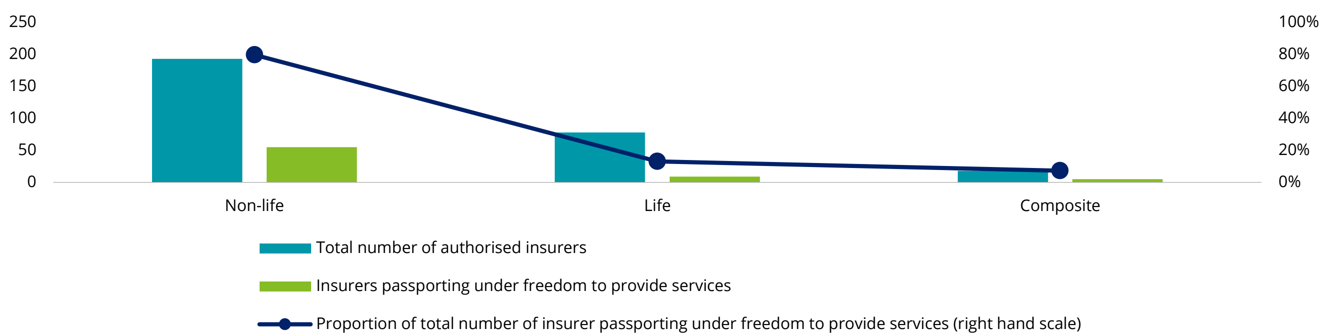
Unlike some financial services activities, equivalence is not the only requirement to access the single market for most types of insurance. The partial exception in Solvency II is reinsurance, for which equivalence secures equal treatment for reinsurance contracts with third country reinsurers as for reinsurers subject to Solvency II. However, direct insurers wishing to access the single market must establish a local subsidiary or branch authorised under Solvency II, regardless of whether their home country regulation is deemed equivalent.

However, Solvency II equivalence nonetheless secures some substantial practical advantages that make it significantly easier to operate cross-border with the single market. In addition to the treatment of reinsurance discussed above, a non-EEA jurisdiction may be equivalent with respect to the supervision it exercises over insurance groups, and with respect to its local solvency standard. These can have the effect of simplifying and removing duplication in supervision and compliance processes, allowing for a more coordinated approach to supervising a group and complying with regulation.

In practical terms, the extent to which ease of access to the single market is important to UK insurers, and therefore the priority likely to be placed on equivalence with Solvency II, varies across the UK industry. This is particularly the case as Solvency II also affects different segments of the market differently (for example, the interest rate sensitivity of the risk margin is generally of much greater concern to the long term life sector than for non-life insurers). Equivalence is also relevant to insurers incoming to the UK market, for example those with subsidiaries in the UK which may look to rely on the future UK solvency standard for their Solvency II compliance.

Passporting, in practice, is used to a much greater extent by the UK non-life sector than by the life sector. This has already created some divergent views among different industry participants about the benefits of the UK remaining closely aligned to Solvency II. Ultimately, these benefits will fall differently for different parts of the UK industry, potentially creating some contradictory influences on the regulatory and political agendas.

Use of "freedom to provide services" passport by UK insurers



Source: Template a – for the disclosure of aggregate statistical data with regard to insurance and reinsurance undertakings supervised under Directive 2009/138/EC, PRA, November 2018, showing data as at 31 December 2017

Planning for future Brexit scenarios

In sum, it appears a reasonable planning assumption, though not a foregone conclusion, that the UK authorities will have some discretion over how Solvency II is implemented in the UK, even where equivalence needs to be maintained. However, in our view, insurers should at least be planning for scenarios in which the UK has no or very limited capacity to diverge from or influence Solvency II as implemented in the EU. In any event, we expect the PRA is unlikely to seek to depart wholesale from Solvency II, though there are a number of important changes, as we discuss in this report, that we expect will be high in the PRA's priorities, should it have the scope to tailor the insurance regulatory framework more closely to the UK industry.

Just as importantly, if not more so, insurers should not under-estimate the effect of UK influence in the development and implementation of Solvency II. We therefore expect there is potential for Solvency II to develop in the future in ways not wholly aligned to the UK's interests, with such pressures most likely to arise, in our view, in the areas discussed in this report.

Current issues of substantive debate

In the following sections of this report we discuss those areas of Solvency II that are currently subject to live policy debate, either because they were controversial in the run-up to Solvency II, or because they have emerged as key policy issues since implementation.

In each case, we discuss the current views of UK and EU27 regulators, policymakers, and industry participants as relevant, and consider the various pressures that may come to bear for adjustment or reform in the course of the Solvency II review. In addition, we consider areas of difference between UK and EU27 policymakers, which may point to future pressure for divergence between UK regulation and Solvency II following Brexit.

It is important to note that the priorities for reform of Solvency II across the EU27 Member States differ. Some EU Member States would prefer to maintain the status quo and are against radical changes to the framework given the potential cost associated with such changes so soon after implementation of Solvency II. However, some Member States appear to support a more fundamental review of Solvency II. These differences are likely to come to bear both in the development of any legislative proposal following the conclusion of the Solvency II review, and in that proposal's subsequent passage through the European Parliament and Council.

Priorities are also likely to reflect to some extent the nature of the industry and its supervision in each jurisdiction (for example, internal model or group supervision aspects may or may not be priority issues in different jurisdictions).

Risk margin

Solvency II introduced an explicit "risk margin" into the valuation of insurance liabilities, as an addition to a best estimate of future net liabilities. Prior to Solvency II (including under the UK's previous ICAS regime), reserves tended to be set at "prudent" levels, implicitly capturing a premium over a pure best estimate.

In practice, the Solvency II "cost of capital" approach has proven to be highly sensitive to interest rates. While the UK authorities supported, and continue to support, the concept of the risk margin in Solvency II, the Bank of England has stated strongly its view that this sensitivity is undesirable from both microprudential and macroprudential points of view.

The European Commission is re-examining the design of the risk margin as part of the 2020 Solvency II review. The scope of considerations set out in its request for advice to EIOPA is fairly broad. While indicating that the risk margin will not move away fundamentally from the cost-of-capital approach, the Commission asked EIOPA to consider the design and calculation of the risk margin, as well as the assumptions used to derive the cost of capital rate, and indeed whether use of a fixed cost of capital rate continues to be appropriate.[ii]

"[B]ecause of its design under the current legislation, the risk margin is very sensitive indeed to risk-free rates. This level of volatility is not justified by the historical evidence and does not in my view serve a useful purpose. Rather, it may be dangerously procyclical. So in the immediate aftermath of the referendum, we invited – indeed encouraged – firms to apply for transitional measures to smooth the impact of the risk margin during a time of market turbulence, and I also very much welcome the European Commission's request for EIOPA to review the risk margin's role more broadly."

Sam Woods, Deputy Governor, Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority, speaking at the City Banquet, Mansion House, London, October 2016

Current issues of substantive debate (cont.)

"Frankly, the judgment we have made is that to enter into that protracted legal battle at this point seems self-defeating, because none of the firms would be able to use it while that was going on. Also, of all the various moments to have such an argument, now seems pretty much the worst. We thought it was better just to bide our time."

Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority, providing evidence to the UK Treasury Committee, July 2018

This raises the potential, at least, for a significant re-design of the risk margin, for example through the use of a floating cost of capital rate. If taken forward, this could address a number of the concerns of regulators and the industry with the calculation, though it is by no means guaranteed that substantial changes will be made. As with any significant change to valuation, a transitional phasing in period would be likely.

In practice, a significant level of concern with the risk margin calculation exists in the UK compared to many other national jurisdictions, given the importance of the long-term life insurance sector within the UK. This has made improving the risk margin design a top priority for UK authorities. However, it is notable that the risk margin is also very significant relative to the size of overall capital in many EEA markets.[2] We would therefore expect a change to the cost of capital methodology that reduces its interest rate sensitivity, in particular to introduce a floating rate, to be supported in principle across large parts of the EEA insurance market, including in the UK, where we would expect such a proposal to receive strong support.

In the UK, in addition to its engagement with the Solvency II review, the PRA has also explored the scope to apply a "management action approach" in its implementation of the risk margin, to improve the implementation of the risk margin in the UK within the limits of the Solvency II rules.

However, in evidence to the UK's Treasury Committee in July 2018, the PRA's Sam Woods noted the potential for other national regulators to disagree with the PRA's interpretation, which "leads you down a process of challenge and, eventually, potentially, infraction risk." The PRA, therefore, took what is likely to have been a finely-balanced decision not to pursue changes at this stage, "in the context of the ongoing uncertainty about [the UK's] future relationship with the EU in relation to financial services".[iii] However, it is likely the PRA would look, in principle, to explore this interpretation again for the UK, if and when feasible.

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2. For example, data published in EIOPA's second set of advice for the Solvency II review showed that the risk margin exceeded 20% of the capital requirement for life insurers in 24 out of 27 EEA states for which data was available as at Q3 2016, with the highest result being in the Netherlands where the risk margin comprised 76% of the SCR.

Current issues of substantive debate (cont.)

Long term guarantee measures

Matching adjustment

The MA has strict rules on the eligibility of backing assets, including a requirement that cash flows be "fixed". This contrasts sharply with the UK's former regime which required broad duration matching rather than strict cash flow matching, and can create a cliff edge effect, i.e. either the asset is eligible or it is not.

This has incentivised some firms in the UK to securitise assets, such as equity release mortgages, to make them eligible for the MA criteria. The PRA has stated publicly that it is supportive, in principle, of such securitisations to enable insurers to take into account in MA portfolios, types of assets that the PRA considers suitable to back annuities. However, the PRA has also been clear that it would prefer a MA regime in which such securitisations were unnecessary, stating, for example, that it would "prefer a regime that avoids the incentive for firms to re-structure assets in order to secure the benefit of the MA, given the additional complexity this inevitably brings."[iv] It is entirely possible that the PRA would look, if feasible, to introduce changes to the design of the MA that would avoid the need for asset restructuring, potentially bringing the UK approach some way closer to the previous ICAS approach in some areas.

The European Commission has asked EIOPA to include the criteria for eligible assets in its consideration of the MA for the Solvency II review. The European Commission's April 2018 Request for information on the impact of Solvency II on long-term insurance and reinsurance activities – and EIOPA's associated October 2018 request for feedback – also illustrate the importance attached to the issue of whether and how to recognise an illiquidity premium in the Solvency II valuation.

Similar to the risk margin, the issue of MA is likely to be relatively a high priority in the UK, given the critical importance of the MA to solvency in the UK compared to most other markets.

In the UK, applying the MA has had the effect of increasing the average Solvency Capital Requirement (SCR) ratios of UK insurers that use it from 75% to 154%[v]. The PRA has estimated the capital created by the MA at £58 billion, compared to total capital requirements for the life sector in the UK of £80 billion.[vi] Outside of the UK, in contrast, the MA is used by 15 insurers in Spain, creating an increase in average SCR ratio from 170% to 249%. In each case, insurers applying the MA represent slightly over half the national market by technical provisions.[vii]

Volatility Adjustment

The VA is an adjustment to the risk-free curve which is used to discount insurance liabilities. The measure is intended "to prevent pro-cyclical investment behaviour" by allowing insurers to adjust the discount rate used to value insurance liabilities "to mitigate the effect of exaggerations of bond spreads."[viii] The VA is, therefore, intended to address a financial stability concern by providing capital relief in times of exaggerated bond spreads, but its calculation and effect bear many similarities to an illiquidity premium.

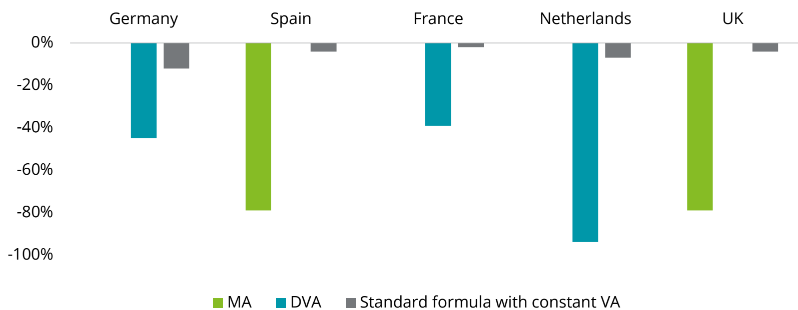
While the UK life industry makes extensive use of the MA, the VA, by contrast, is widely used by life insurers in many other EEA countries.[3] The UK's previous regime recognised an illiquidity premium but did not include an explicit counter-cyclical adjustment. The PRA has previously stated that the VA, if applied without appropriate control, could create additional risks, especially for insurers with highly unpredictable liabilities, including those that contain options for policyholders to surrender their policies at short notice (i.e. risks could arise if the VA, in effect, applies an illiquidity premium to liabilities that are not necessarily illiquid).[ix] This is likely to indicate, in our view, a preference on the part of the PRA for an adjustment tied more closely to insurers' own asset portfolios, i.e. for insurers to apply an adjustment more similar to the MA than to the current VA.

3. In contrast to the MA, EIOPA's *Report on long-term guarantees measures and measures on equity risk 2018* indicates that the VA is used by 696 undertakings in 23 countries, covering between them 75% of the national amount of technical provisions. The VA is used by 23 undertakings in the UK, representing around a third of UK technical provisions.

> "These things have to be restructured to meet the Solvency II requirements for the matching adjustment. That is a complexity that we somewhat regret, but that is part of Solvency II. They have to be restructured to create fixed cash flows through internal securitisation."
>
> **David Rule, Executive Director, Insurance Supervision, Prudential Regulation Authority, providing evidence to the UK Treasury Committee, January 2019**

Current issues of substantive debate (cont.)

Average impact on SCR ratio of removing the MA and VA/DVA, for insurers applying the measures



Source: Report on long-term guarantees measures and measures on equity risk, EIOPA, December 2018, showing countries with more than 100 authorised insurers in which more than 20% of insurers apply the VA, or in which insurers apply the MA.

This debate on the relative risks of the adjustments is illustrated by discussions on the use of the DVA, which recognises the movement in the VA within the modelled credit spreads in the one-year SCR stress scenario. The VA is kept constant in the standard formula calculation, and the PRA has previously required the same of internal model firms in their modelled calculations. However, other national regulators have permitted internal modelling of the DVA, and EIOPA has since issued an opinion in support of this dynamic, modelled approach.

While the PRA has converged with EIOPA's opinion, it is unlikely this has changed its preference for its former policy position. It is likely, moreover, that the effect on solvency coverage will change quite significantly for those UK insurers which choose to use the DVA following the PRA's change in policy, potentially reinforcing the PRA's views of the risks created. Illustrating the potential effect, EIOPA's *Report on long-term guarantees measures and measures on equity risk 2018* indicates that the "constant" VA creates a 3% increase in SCR solvency coverage ratio in the UK, from 162% to 165%. However, it shows a significantly increased effect where the DVA has been used by insurers in other countries. For the EEA as a whole, for example, removing the DVA resulted in a 57 percentage point change in SCR ratio for those insurers using the measure, compared to a 6 percentage point change for internal model firms applying the constant VA.

The European Commission is re-examining the VA and DVA for the Solvency II review. In particular, the Commission has asked EIOPA to assess the impact of alternative approaches that would be expected to track more closely an insurer's own asset and liability profiles, and specifically notes the possibility of a single adjustment mechanism covering both the VA and the MA.

A single adjustment mechanism would represent a more radical redesign of the long term guarantee (LTG) measures, and not an altogether unlikely one given the limited use of the MA outside of the UK, although a wholesale phasing out of the MA would likely still meet with some resistance. A meaningful comparison may be drawn with the risk-free curve adjustment applied by the IAIS in its draft ICS methodology, which applies progressively more tailored adjustments reflecting different "buckets" of an insurer's assets.[x]

On the DVA, it is notable that the Commission has asked EIOPA to consider the appropriateness of modelling of the DVA, and potential criteria to improve harmonisation in the modelling. This is despite EIOPA already having issued an opinion on the topic, suggesting that the Commission may see the need for further development or refinement in the approach currently being followed.[xi]

Given evidence of substantive differences of views between the European Commission, EIOPA, the PRA and other national regulators, the VA and broader use of the DVA (for example, by standard formula firms) may well be points of future debate and potential divergence.

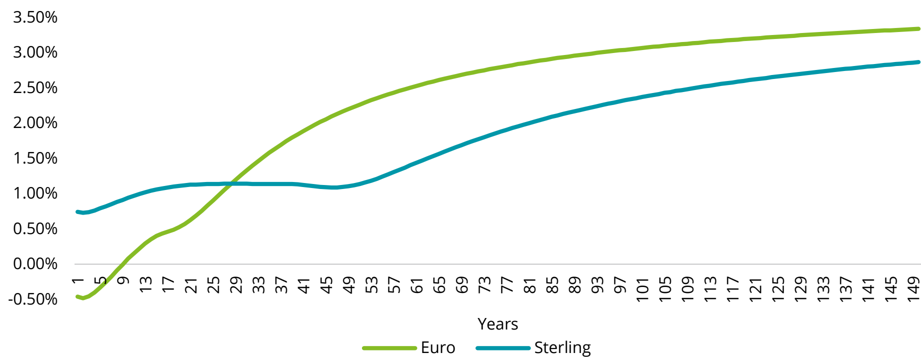
Risk-free discount rates

The European Commission has asked EIOPA to consider the criteria applied to determine the LLP for all the currencies of the Union, for the purposes of extrapolation of the Solvency II risk-free interest rate term structures. Given the substantial differences in quantum and volatility between the sterling and euro risk-free curves in the current interest rate environment, and the criticality of the LLP to the overall shape of the curves,[4] we expect this aspect of the Solvency II review to be of significant interest to the UK industry and its regulators.

4. At the time of writing, the LLP for the euro is 20 years compared to 50 years for sterling. This earlier extrapolation to the ultimate forward rate (UFR), currently set at 3.9% for both currencies, leads to an overall shallower and more volatile discount curve for sterling, given current long term interest rates.

Current issues of substantive debate (cont.)

Solvency II basic risk-free discount curves for sterling and the euro



Source: Risk-free interest rate term structures, Monthly technical information as at 30 June 2019, EIOPA, July 2019

Further focus is also likely as a result of transitioning of the various IBOR rates that sit behind the market swap segments of the discount curves, with the benchmark rate transition potentially affecting both the quantum of the market rates and the LLP, to the extent that the depth, liquidity and transparency of available market rates changes significantly.

Regulatory reporting and public disclosure

Solvency II introduced a significant increase in the volume of data and reporting provided by EEA insurers. Whether the extent of information reported is excessive, and the use that is made of it by regulators, were, and remain, important issues of debate.[5]

The UK was, in principle, supportive of reporting and public disclosure requirements within Solvency II when the regime was being developed. The PRA further introduced additional "National Specific Templates" to capture information that it requires for supervision that is not captured in the standard reporting package, and, subsequent to the implementation of Solvency II, has argued in support of the harmonised reporting package and the supervisory analysis that it enables.[6]

However, it is notable that the final Solvency II reporting requirements went significantly beyond what was required under the UK's previous ICAS regime, and the PRA has also stated that the harmonised part of the Solvency II quantitative reporting, delivered primarily through "Quantitative Reporting Templates", is not perfectly tailored to the PRA's supervisory needs for the specifics of the UK insurance market.[xii] The PRA has, also, since the implementation of Solvency II, enacted changes to the reporting requirements in the UK to reduce the reporting burden on insurers, where those requirements are within the PRA's discretion.[xiii]

Therefore, while we do not expect the UK authorities to move away wholesale from a detailed reporting and disclosure regime, we may expect the PRA, in the future, to review the harmonised reporting package, considering in a similar way whether the reporting burden is proportionate and suited to the UK insurance market.

For the EU as a whole, EIOPA issued a public consultation on the reporting requirements in 2019,[xiv] building on a 2018 call for input on the reporting and disclosure requirements,[xv] and will provide technical advice on reporting and disclosure to the European Commission for the 2020 Solvency II review.

> "There is not very much we can do under the directive about the annual load of reporting. That is pretty much locked down in the directive. We should come to whether it is sensible or not, but that is a fact."
>
> **Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority, providing evidence to the UK Treasury Committee, February 2017**

5. For example, the UK Treasury Committee in its report *Solvency II and its Impact on the UK Insurance Industry*, states "Regular reporting is of a different order of magnitude from that under the previous regulatory regime. Annual and quarterly returns requiring immense detail are obligatory. To these the PRA has added UK requirements which the ABI said were "over and above the EU requirements", which many respondents claimed had imposed a "very significant UK-specific burden"." In this paragraph, the Committee quotes responses received from the Association of British Insurers (ABI) and Lloyd's of London.

6. For example, in its *Response to the Treasury Committee's inquiry into Solvency II*, the PRA noted: "The reporting package under Solvency II is extensive. It gives the PRA the opportunity to develop much richer management information and metrics that speak to firm-specific and thematic risks."

Current issues of substantive debate (cont.)

We expect continued challenge from the industry on the scope, breadth and detail of reporting. Indeed, in its 2019 consultation EIOPA notes, in relation to its previous call for input, that "[t]he feedback provided identified that the majority of insurance undertakings are currently unsatisfied with proportionality implementation by legislation and respective national supervisory authorities and see an urgent need for improvement"[xvi]. EIOPA's 2019 consultation indicates the potential for quite widespread changes to some aspects of reporting, including to the standardised reporting templates and the SFCR (including new template reporting on cyber risks), as well as widening the scope for exemptions.

Overall, we would expect the UK to be supportive of changes that make the reporting package, as EIOPA intends in its review, more proportionate, standardised, consistent and "fit-for-purpose"[xvii]. However, it is wholly possible that the changes made during the Solvency II review will not fully address the needs of the UK market, raising the possibility that the PRA will, in due course, seek to make further changes specific to the UK.

Internal models

Both Solvency II and the UK's previous ICAS regime allow(ed) firms to calculate capital requirements using internal models in order to capture a firm's specific risk profile. The UK has the greatest number of firms using approved internal models in the EEA, and overall the UK was a major proponent of internal models during Solvency II negotiations.

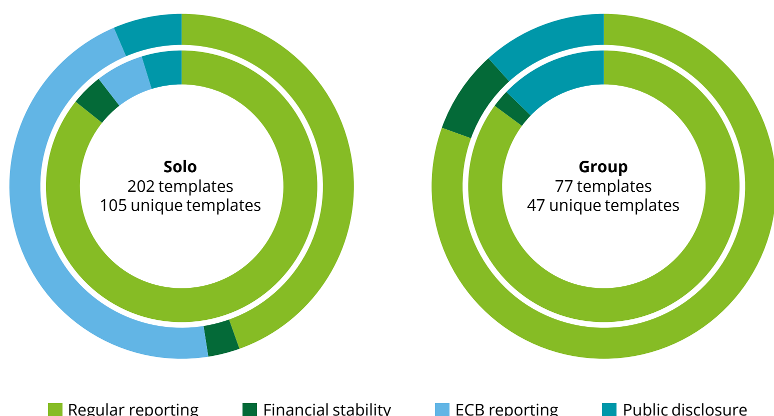
Solvency II introduced specific criteria and requirements for the supervisory approval of internal models, and limits supervisory discretion to impose capital add-ons to modelled capital requirements to very specific circumstances, in both cases in contrast to ICAS.[7] In its review of Solvency II, the UK Treasury Committee noted "widespread and consistent concerns expressed by firms over the proportionality of the PRA's approach, particularly with regard to the review and approval of internal models and amendments to those models."[xviii]

However, in its response to the Treasury Committee, the PRA defended the internal model approval process, stating that the requirements "are rigorous because an approved internal model determines an insurer's capital requirements" and that the PRA keeps "our model approval processes under review in order to ensure they do not impose an excessive burden".[8]

We may, therefore, expect limited appetite in the UK to change the approach and substance of the model approval process itself, although it is notable that the PRA refers in its response to the Treasury Committee to the need to "[respect] the constraints of the Solvency II regime", which may indicate the potential for future discussion in the UK on relaxing some of the more prescriptive requirements for internal model approval.

More likely, and with sufficient flexibility, we would expect the PRA to consider allowing back some supervisory discretion on the quantum of capital requirements calculated by models. Such an approach would bring the insurance framework more in line with the banking framework, and may serve from a practical perspective to shift the balance in the approval process slightly towards review of the model's outputs, and away from the detailed approval of model methodologies, assumptions and data.

Reporting templates submitted for the Solvency II standardised reporting package



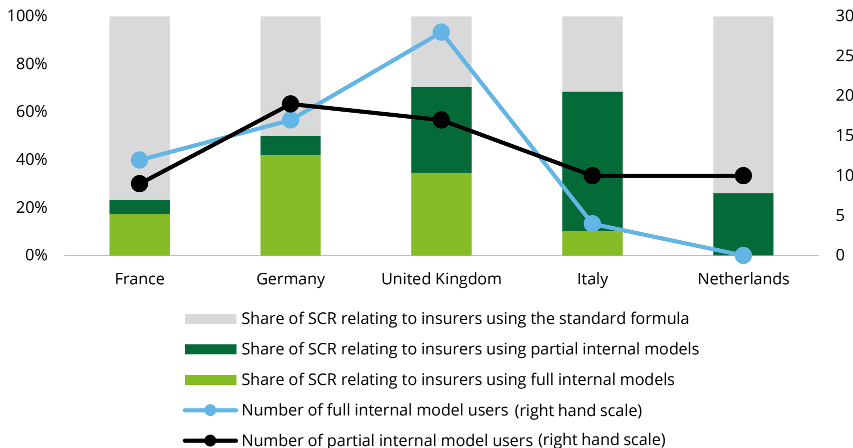
7. ICAS was not prescriptive on internal model requirements, but supervisors had the option to impose a capital add-on if they considered that there were deficiencies present in the model or control process.

8. The PRA further notes some specific changes to the model change process that it was consulting on at the time of its response, and which it has since enacted.

Source: Release notes for the 2.4.0 release of the EIOPA Solvency II DPM and XBRL taxonomy, EIOPA, June 2019, showing templates included in the scope of EIOPA's taxonomy for use for Solvency II reporting for reference dates starting 31 December 2019

Current issues of substantive debate (cont.)

Share of SCR calculated by insurers using full or partial internal models



Source: Data on the share of SCR extracted from Template A for the disclosure of aggregate statistical data with regard to insurance and resinsurance undertakings supervised under Directive 2009/138/EC, as published by each relevant national regulator, showing data as at 31 December 2017. Data on internal model use by insurance entities extracted from EIOPA's Insurance statistics on own funds (annual), EIOPA, November 2018, showing data for 2017. Data is shown for countries with aggregate national SCR exceeding £30bn.

This is not a debate which we would expect to see take place at a European level, where the direction of travel in relation to internal models has so far been towards greater convergence.[9] It is notable that the internal model approval process is not one of the topics on which the European Commission has asked for EIOPA's technical advice for the 2020 Solvency II review.

Role and powers of EIOPA

The future role and powers of the ESAs have been actively debated at EU level. For the insurance sector, a key question has been the extent to which EIOPA may assume further powers in order to facilitate convergence and to oversee certain aspects of insurance supervision at EU-level.

It is notable that the final package of reforms to the ESAs adopted by the European Parliament in April 2019 was reasonably limited with respect to EIOPA, in stark contrast to earlier European Commission proposals that would have updated EIOPA's powers more comprehensively. This would have included EIOPA taking a more active role with regards to internal models, and receiving more data and information from national supervisors, and in some cases, for example stress testing, directly from insurers.

The UK's departure from the relevant decision-making bodies should, in principle, bolster any future efforts to shift further powers and responsibilities from national supervisory authorities to EIOPA, as this is something that the UK (along with some other member states) has actively opposed in the past. However, absent a significant catalyst for further change (for example, a market shock originating in the insurance sector), the European Commission's proposals are likely, in our view, to represent a high water mark of appetite to consolidate further powers within EIOPA.

However, notwithstanding the limited nature of these reforms, EIOPA's practical powers over Solvency II implementation are still significant, through its Guidelines, Opinions, and Question & Answer (Q&A) process. Following Brexit, the PRA may have greater flexibility to depart from interpretations and determinations made by EIOPA (for example, the PRA may look to revert to its previous policy on the DVA, as discussed above). However, we would expect the PRA, in most cases, to continue to pay due regard to EIOPA's interpretations and implementation guidance.

The UK is, moreover, likely to come under some pressure should its implementation of the prudential framework be seen to provide a competitive advantage to UK insurers over EU insurers, in particular if the UK seeks to maintain equivalence to Solvency II.

Capital, including standard formula methodology and calibration

So far, review activities on the standard formula have tended to fall into two broad categories:

1. Risk sensitivity and calibration: whether the standard formula captures the risks facing insurers completely and appropriately. As an important subset of this, the European Commission has given and continues to give extensive consideration to methodology and calibrations which are considered to present unjustified constraints to certain investment activities of insurers, in particular long-term investment in infrastructure and SMEs. While the standard formula is intended to capture accurately the risks facing insurers, the European Systemic Risk Board (ESRB) has previously expressed concern that "reductions of capital charges for certain investments to stimulate those investments" could result in insurers

9. For example, convergence in the supervision of internal models is one of EIOPA's stated priorities for 2019. EIOPA highlights, inter alia, the risks posed by model drift to the internal market and level playing field, and the increased risks of supervisory arbitrage where internal model outcomes diverge.

Current issues of substantive debate (cont.)

being unable to meet their liabilities.[xix] Standard formula refinements being considered for the Solvency II review include, for example, treatment of equity investments and reinsurance.[xx]

2. Simplifications to the standard formula methodology and calibrations, where existing approaches are unduly complex, or where justified on proportionality grounds.

We expect this topic to be a major focus for the 2020 Solvency II review, and, in general, addressing shortcomings and undue complexity in the standard formula are likely to be common objectives across the UK and EU27.

However, the PRA also noted in its response to the Treasury Committee's report on Solvency II that a number of the risks that the Treasury Committee had referred to were not within the scope of the Solvency II review, including "inflation risk, gilt spread risk and operational risk",[10] although for now the PRA has stated that it will "[engage] in the review and will consider our position further once it has concluded."

We may therefore expect the PRA to look to give broader consideration in due course to the methodology and calibrations of the standard formula than is likely to take place through the Solvency II review (including potentially considering the role of USPs, which are currently used to a very limited extent in the UK[11]). However, it is unlikely that any significant changes will be discussed further in the UK until well after the conclusion of the 2020 review. Given the likely focus that will be placed on capital in any future discussions of equivalence and/or supervisory divergence, any departure in the UK from the Solvency II standard formula methodologies and calibrations is also likely to be scrutinised closely.

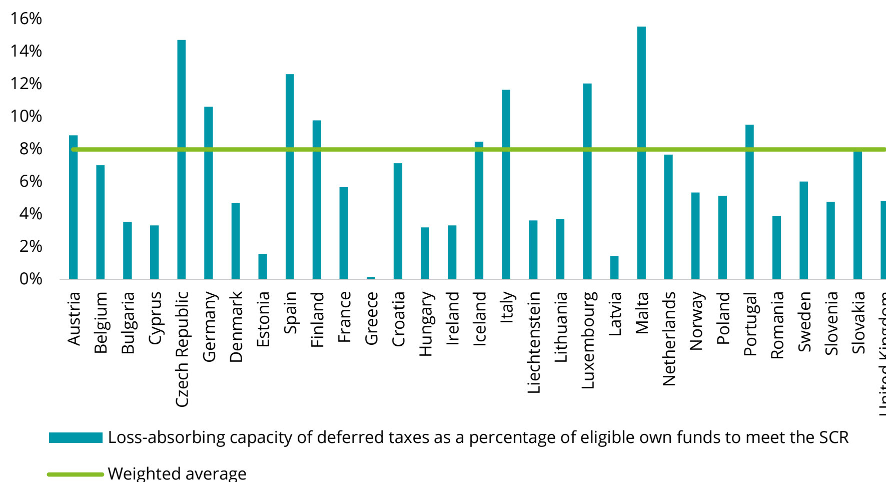
Loss-absorbing capacity of deferred taxes

The PRA has released UK-specific guidance on the recognition of deferred tax,[xxi] and has previously supported work aimed at the convergence of national practices with regards to the loss-absorbing capacity of deferred taxes (which recognises the contribution made to capital by deferred tax in the SCR shock scenario).

At EU-level, changes have recently been made to the Solvency II Delegated Acts to "[standardise] the setting of assumptions to be put in place for the projection of future profits, hence reducing the degree of subjectivity in the calculation, which is not due to the existence of different tax regimes."

These requirements, which also strengthen reporting and disclosure requirements on deferred tax, are arguably more prescriptive in places than the PRA's supervisory guidance, by placing some firm limits on assumption-setting where the PRA's approach is more judgement-led. However, it remains to be seen whether the implementation of these changes will ultimately align deferred tax practices between the UK and EU, or whether some scope for material divergence will remain. We would not expect the PRA to have significant appetite to change its approach to deferred tax in the UK.

Loss-absorbing capacity of deferred tax assets as a percentage of eligible own funds to meet the SCR



Source: European Insurance Overview 2018, EIOPA, November 2018, showing data for standard formula users only; weighted average calculated using data on eligible own funds from EIOPA insurance statistics on own funds, EIOPA, November 2018; data is shown with a reference date of 31 December 2017

10. While the PRA's response was published prior to the European Commission's formal request to EIOPA for technical advice on the Solvency II review, these risks were not subsequently included in the European Commission's request for technical advice.

11. The PRA's *Consolidated list of Solvency II Approval Written Notices as of 1st July 2019* lists only one insurer having received approval to use USPs under Solvency II Directive Article 104(7).

Current issues of substantive debate (cont.)

Environmental, social and governance factors

The manner in which institutional investors like insurers approach ESG issues, including sustainability and climate change, has gained significant attention across the EU.

At the EU level, a primary focus of the European Commission's action plan on sustainable finance is to encourage capital to flow towards sustainable investments, in particular towards infrastructure, in order to close the investment gap required to achieve EU climate and energy targets by 2030.[xxii] The EU is paying significant attention to how regulation can enable sustainable investment, for example through incorporating consideration of sustainability factors and preferences explicitly into product distribution, with a key plank of its approach being the development of an EU-wide taxonomy for classifying sustainable activities.

The Commission is also focused on how insurers manage sustainability-related financial risks, and on fostering transparency and "long-termism" in financial and economic activity, and has asked EIOPA to carry out further work on both of these issues. This includes considering how capital rules affect insurers' sustainable investments, and how the Solvency II Pillar 1 and Pillar 2 frameworks incentivise insurers to take account of sustainability factors in product design and pricing.[xxiii]

In the UK, the PRA, alongside other UK authorities, has also been engaged on the regulatory response to climate change for a number of years.[12] Broadly, the UK has been a leading voice internationally on the response of the financial services industry to climate risk, and this appears highly unlikely to change following Brexit.

So far, the PRA's response has been focused primarily on the strategic approaches of banks and insurers to managing the financial risks from climate change, including through modelling and scenario testing, governance, risk management and mitigation. While the regulatory response is, in practice, likely to be common to a large extent (and will include PRA consideration of how financial risks from climate change may be included in UK prudential capital requirements)[xxiv], the PRA's focus on managing firm risk exposures stands somewhat in contrast to the EU-level focus on facilitating the flow of investment capital to sustainable investments.

It is possible that these differences in perspective could lead to divergent pressures over time, for example in whether and the extent to which the capital framework may be used to encourage or discourage investment in certain sectors.

Macroprudential features of Solvency II, including recovery and resolution framework

The UK has in the recent past highlighted perceived shortcomings in Solvency II's approach to macroprudential policy issues, including recovery and resolution and insurance guarantee schemes. For example, in its response[xxv] to the UK Treasury Committee's report on its review of Solvency II,[xxvi] the PRA highlights concerns with the ability of regulators to respond from a macroprudential perspective to a period of substantial market stress.

The PRA refers to its contribution to work, at the EU level, to make the process by which regulators exercise forbearance over capital requirements in such stressed conditions function "as well as possible", as well as work to address risks of procyclicality in Solvency II. However, it appears reasonably clear, in our view, that macroprudential policy and the scope for regulatory forbearance, including over capital, would be priority topics for the PRA to address following Brexit, should it have flexibility depart from the Solvency II approach.

EIOPA has also been strongly supportive of further work on these issues, in particular calling for minimum harmonisation of recovery and resolution frameworks for insurers in the EU,[xxvii] and more recently launching a series of papers on systemic risk and macroprudential policy,[xxviii] and a consultation paper on the harmonisation of national insurance guarantee schemes.[xxix]

So far, there has been more limited momentum for major work on macroprudential policy at the European Commission level. The European Commission has most recently asked EIOPA to consider macroprudential enhancements to Solvency II in a limited set of areas, namely the Own Risk and Solvency Assessment (ORSA), systemic risk planning, liquidity risk planning and reporting, and the prudent person principle, as well as to give further consideration to the development of rules on recovery and resolution and insurance guarantee schemes. EIOPA's 2019 Discussion Paper on systemic risk and macroprudential policy, and its consultation paper, mentioned above, on the harmonisation of insurance guarantee schemes, are intended to inform EIOPA's responses to these requests.

However, on macroprudential policy specifically, the European Commission's closed list of enhancements is narrower than the scope of issues considered by EIOPA, and it is likely that EIOPA's ultimate view across all of these areas will be broader than the Commission's appetite to change the Solvency II framework.

12. For example, the PRA released a report on the impact of climate change on the UK insurance sector in 2015.

Current issues of substantive debate (cont.)

At face value, we would expect the PRA to be broadly supportive of the macroprudential enhancements to Solvency II under consideration by the European Commission. Given its support for developments to macroprudential policy, the UK's departure could, however, potentially further reduce the drivers for major work and harmonisation.

Cross-sector consistency in regulation and supervision

Solvency II takes a broadly similar approach in many areas to the EU regulatory framework applicable to banks under the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR). However, the frameworks differ in many detailed respects – appropriately, in concept, if reflective of differences in nature and risk profile between the two sectors.

The European Commission has asked EIOPA to consider the cross-sector consistency of the tiering of own funds between banks and insurers for the 2020 Solvency II review, including whether differences are justified, and whether the tiering structure used for Solvency II may generate undue volatility in own funds. In principle, we would expect the PRA to support changes to Solvency II that improve cross-sector consistency. Indeed, the PRA has recently made UK-specific changes to its insurance regulatory framework that apply methods comparable to its approach to bank supervision to insurers carrying out lending-type activities.[13]

However, consistency between the insurance and banking frameworks has proven a complex issue to deal with in the past, for example in relation to systemic risk reduction measures, and accordingly may not prove straightforward for the Solvency II review. In our view, this creates a risk of policy divergence in the future, should perspectives and decisions differ between the UK and the EU.

Transitional measures

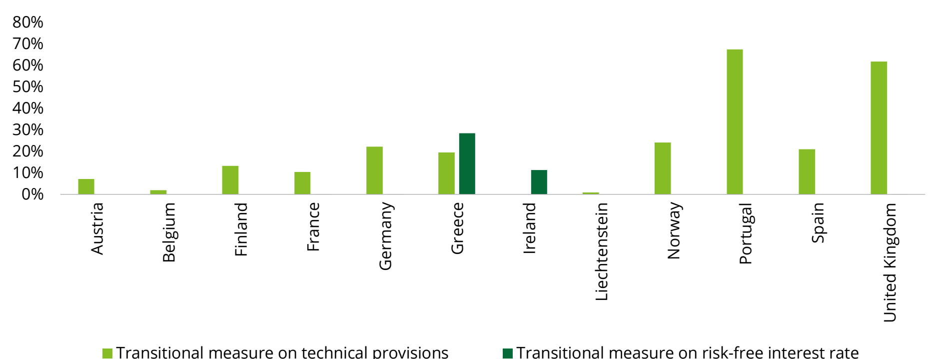
The European Commission has asked EIOPA to "assess the ongoing appropriateness" of the Solvency II transitional measures, including whether it should continue to be possible for insurers to apply newly for the transitional measures. The review is expected to cover at least the transitional measures on technical provisions, risk-free interest rates, and certain parameters used in the calculation of the standard formula capital requirement.[xxx]

Of the various Solvency II transitional measures, the most important at an aggregate level is arguably the TMTP, which EIOPA reports is applied by 162 insurers from 11 countries, representing 24% of total technical provisions in the EEA (in contrast, EIOPA describes the market share by technical provisions of insurers using the transitional measure on risk-free interest rates (TRFR) as "negligible at both EEA and national level, except in Greece where the aggregated market share of the three undertakings using the TRFR is approximately 20% of the national market"). Of the total 24% across the EEA, almost 14% relates to insurers in the UK, representing around 55% of the UK market by technical provisions. The TMTP is also used extensively in Germany, representing around 5% of EEA technical provisions.[xxxi]

The TMTP provides a significant solvency benefit for those insurers using it. Removing the measure would reduce solvency margins for those insurers using it by 75 percentage points across the EEA, with the most significant drops in Germany (244 percentage points), Belgium (163 percentage points), France (128 percentage points) and Austria (122 percentage points). In the UK, the TMTP accounts for 37 percentage points of solvency margin, taking SCR coverage ratios for those insurers using it from 116% to 153%.[xxxii]

The UK PRA has supported the TMTP strongly in the past, describing transitional measures as "an integral part of the Solvency II regime" and "high-quality capital". [xxxiii] Given their importance across the EEA and in-built amortisation, in our view significant changes to the measures currently applied appear relatively unlikely in either the UK or EU. Any changes that were proposed, however, would likely generate a very significant volume of debate.

Contribution of the transitional measures on technical provisions and risk-free interest rates to surplus eligible own funds



Source: Data from EIOPA insurance statistics on use of transitional and LTG measures for Y2017, EIOPA, November 2018, showing countries in which insurers use at least one of the measures shown

13. For example, in PRA Supervisory Statement 3/17 *Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages.*

Annex

The Solvency II project; a brief history, and some pointers for the future

The Solvency II project was launched in the early 2000s to harmonise and overcome limitations in insurance regulation in Europe. It was implemented on 1st January 2016, after several delays from its original planned implementation in 2012.

Among the causes of the delay, the most significant was arguably the extended debate on the regulatory valuation of long term insurance (an issue that EIOPA refers to as "[o]ne of the most debated issues before the Solvency II implementation and still nowadays"[xxxiv]). A critical issue for many life insurers, the current LTG package of measures, in addition to transitional measures on technical provisions and the risk-free rate, was finalised in April 2014[xxxv], paving the way for implementation.

However, whilst still a relatively new regime, Solvency II is already generating policy debate, including substantive questions as to its future direction. Chief among the reasons for this are:

- The LTG package remains controversial, particularly in the UK. As a market, the UK has arguably been the most affected by the LTG measures given the importance of long term annuity business to the UK life sector, and is by far the greatest user of the MA among those jurisdictions that have implemented Solvency II.
- Solvency II is considered variously by industry and regulators to have had a number of unintended consequences, and areas where implementation could be improved. In particular, the UK Treasury Committee has investigated the implementation of Solvency II in the UK and has made a series of related recommendations to the PRA.
- Despite being a maximum harmonising directive with detailed implementing measures, there are many aspects of Solvency II that have been interpreted or implemented differently in different jurisdictions. Investigated areas of divergent implementation and increasing supervisory convergence have been core objectives for EIOPA throughout the development and implementation of Solvency II, and remain in focus for the Solvency II review. EIOPA has considered, for example, the consistency of internal modelling of credit risk, sovereign exposures and the DVA. In relation to the Solvency II review, the European Commission's February 2019 request for technical advice to EIOPA included, inter alia, convergence issues relating to group supervision and the best estimate.
- A number of policy issues have also risen up the regulatory agenda since the implementation of Solvency II. A number of changes to Solvency II have been made in the context of the EU CMU initiative (and the European Commission has asked EIOPA to continue these considerations for the 2020 review), and further changes are being debated in the context of developing issues such as sustainability and climate change, macroprudential policy and operational resilience.

As is common for EU Directives, Solvency II contains a number of review clauses. These provide for certain aspects of Solvency II to be re-evaluated a short period of time after implementation, and the European Commission is required, in most cases, to present a report to the European Parliament and Council by the end of 2020. The relevant reviews are: an assessment of the LTG measures (Article 77f); the appropriateness of the methods, assumptions and standard parameters used for the SCR standard formula (Article 111); the application and supervision of the duration-based equity risk sub-module of the standard formula (Article 304); and the rules and supervisory practices adopted with respect to the calculation of the MCR (Article 129). In addition, the Commission produced two required reports in 2017 and 2018 on the Solvency II group supervision rules (Article 242), and carried out a review, assisted by EIOPA, of certain aspects of the SCR standard formula calculation, completed in 2018 (Recital 150 of the Delegated Acts).

Brexit has also placed questions on Solvency II implementation into sharp relief, given the potential that may exist for the UK to depart from Solvency II post-Brexit.

The IAIS ICS framework also provides a comparison to Solvency II. The IAIS has tested a number of approaches to market consistent valuation that differ from Solvency II, in particular in relation to the risk margin. These may provide an interesting counterpoint to the Solvency II methodologies in the course of the Solvency II review.

However, within this context, and as discussed in this report, it is it also important to note the overall broad agreement among European regulators on the principles and essential features of Solvency II, and the generally positive view of Solvency II that exists among regulators and large parts of the European industry.

Endnotes

i. Formal Request to EIOPA for Technical Advice on the Review of the Solvency II Directive, European Commission, February 2019

ii. Formal Request to EIOPA for Technical Advice on the Review of the Solvency II Directive, European Commission, February 2019

iii. Evidence to the Treasury Committee on the work of the Prudential Regulation Authority, 11 July 2018, and Letter from Sam Woods to the Rt Hon. Nicky Morgan MP, Chair of the Treasury Committee, on the Solvency II risk margin

iv. PRA Response to the Treasury Committee's Inquiry into Solvency II, February 2018. This position was also set out, for example, in David Rule's evidence to the Treasury Committee on the work of the Prudential Regulation Authority, 23 January 2019. In the UK's previous ICAS regime, the illiquidity premium was granted extensively on the basis of judgement around asset eligibility and broad, often modelled duration matching.

v. Report on long-term guarantees measures and measures on equity risk 2018, EIOPA, 18 December 2018. The importance of the MA to the solvency of the life industry in the UK has also been highlighted in evidence provided by the PRA to the UK Treasury Committee.

vi. Evidence to the Treasury Committee on the work of the Prudential Regulation Authority, 11 July 2018

vii. Report on long-term guarantees measures and measures on equity risk 2018, EIOPA, 18 December 2018

viii. Directive 2014/51/EU (Omnibus II Directive) Recital 32

ix. PRA response to the Treasury Committee's inquiry into Solvency II, PRA, 2018

x. Public 2019 IAIS Field Testing Technical Specifications, IAIS, June 2019

xi. Opinion on the supervisory assessment of internal models including a dynamic volatility adjustment, EIOPA, November 2017

xii. PRA response to the Treasury Committee's inquiry into Solvency II, PRA, 2018

xiii. Policy Statement 16/18, Changes in insurance reporting requirements, PRA, July 2018

xiv. Consultation paper on proposals for Solvency II 2020 Review, Package on supervisory reporting and public disclosure, EIOPA, June 2019

xv. Call for input on the Solvency II reporting and disclosure review 2020, EIOPA, December 2018

xvi. Consultation paper on proposals for Solvency II 2020 Review, Cover Note – Package on supervisory reporting and public disclosure, EIOPA, June 2019

xvii. Consultation paper on proposals for Solvency II 2020 Review, Cover Note – Package on supervisory reporting and public disclosure, EIOPA, June 2019

xviii. PRA response to the Treasury Committee's inquiry into Solvency II, PRA, 2018

xix. ESRB report on systemic risks in the EU insurance sector, ESRB, 2015

xx. Formal Request to EIOPA for Technical Advice on the Review of the Solvency II Directive, European Commission, February 2019

xxi. Supervisory Statement 2/14 Solvency II: recognition of deferred tax, PRA, November 2016

xxii. Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, The European Economic and Social Committee and the Committee of the Regions, Action Plan: Financing Sustainable Growth, European Commission, 8 March 2018

xxiii. Request to EIOPA for an Opinion on Sustainability within Solvency II, European Commission, 28 August 2018

xxiv. Summary table of the Bank of England's response to the van Steenis recommendations, PRA, June 2019

xxv. PRA response to the Treasury Committee's inquiry into Solvency II, PRA, February 2018

xxvi. The Solvency II Directive and its impact on the UK Insurance Industry, House of Commons Treasury Committee, 25 October 2017

xxvii. Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re) insurers across the Member States, EIOPA, 5 July 2017

xxviii. Systemic Risk and Macroprudential Policy in Insurance, EIOPA 2017; Solvency II Tools with Macroprudential Impact, EIOPA, 2018; Other Potential Macroprudential Tools and Measures to Enhance the Current Framework, EIOPA, 2018; Discussion Paper on Systemic Risk and Macroprudential Policy in Insurance, EIOPA, 29 March 2019

xxix. Consultation Paper on Proposals for Solvency II 2020 Review, Harmonisation of National Insurance Guarantee Schemes, EIOPA, July 2019

xxx. Formal Request to EIOPA for Technical Advice on the Review of the Solvency II Directive, European Commission, February 2019

xxxi. Report on long-term guarantees measures and measures on equity risk, EIOPA, 18 December 2018. In practice, the overwhelming majority of insurers applying the TMTP in the UK are life insurers, meaning that the proportion of life industry technical provisions covered by the TMTP would be much higher.

xxxii. Report on long-term guarantees measures and measures on equity risk, EIOPA, 18 December 2018

xxxiii. PRA response to the Treasury Committee's inquiry into Solvency II, PRA, 2018, and Evidence to the Treasury Committee on the EU insurance regulation, 25 February 2017

xxxiv. Request for Feedback on Methodological Considerations regarding Illiquid Liabilities, EIOPA, 2018

xxxv. Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 (Omnibus II). The Omnibus II Directive was published in the Official Journal of the European Union on 22 May 2014.

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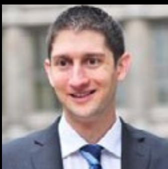

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