SLAUGHTER AND MAY/

INSURANCE BRIEFING

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THE PRA CONSULTS ON SOLVENCY II REFORM

On 29 June the PRA published the first in a series of consultations (CP12/23) setting out details of its proposed implementation of “Solvency UK”. As highlighted in the Treasury announcement accompanying its recent draft statutory instruments, the plan is for the new regime to be in place by the end of 2024, but with reforms to the risk margin and matching adjustment to be implemented earlier. For more details on the Treasury draft statutory instruments please see our briefing note.

The PRA timetable is:

First consultation on implementation (CP12/23)	June 2023
Deadline for responses to Chapter 11 of CP12/23 (administrative changes required to implement reforms to the risk margin)	31 July 2023
Deadline for responses to the remainder of CP12/23	31 August 2023
Consultation on reforms to the matching adjustment	September 2023
Policy statements on all consultations	By the end of 2023
Implementation of risk margin reforms	December 2023
Consultation on transposition of the remainder of the onshored Solvency II regime into the PRA Rulebook and other policy materials	Early 2024
Implementation of matching adjustment reforms	June 2024
Implementation of all other reforms	December 2024

As the proposed reforms have all been previously highlighted in the HM Treasury consultation and response document on the Solvency II review there are no particular surprises in the consultation. It does, however, give firms the opportunity to digest the detail of how the reforms will work and to provide feedback to the PRA. Unfortunately, possibly due to the timing of passage of the Financial Services and Markets Act 2023 and therefore of the publication of Treasury’s draft statutory instruments, the PRA has set an expedited timetable for consultation responses. Firms may find the two-month timescale challenging, particularly as the consultation has been published ahead of the summer period where resourcing may be more stretched. The PRA does, however, state in the consultation that it will consider any representations from stakeholders if they need longer to assess any of the CP proposals.

As noted in the timetable above, we await the PRA’s proposals on matching adjustment reforms, which will be set out in its September consultation. Although the PRA has emphasized that it does not intend to undermine the Treasury’s decision in November not to make changes to the fundamental spread, firms with material matching adjustment portfolios will nevertheless be interested to see the proposed final matching adjustment package.

Key reform proposals

Transitional measures on technical provisions (TMTP)

A new methodology for calculation of the TMTP is proposed which, after an initial "base" calculation, will no longer require the calculation of technical provisions on a Solvency I basis going forwards. This will benefit both firms and the PRA by simplifying the calculation and freeing up resources currently used for the Solvency I calculation. As part of the reform the "financial resources requirement" test, which states that the transitional deduction must not result in the financial resources the firm is required to maintain being less than that which would have applied pre-Solvency II, will be removed. The PRA comments that this will result in an immediate capital benefit for a small number of firms, although this will be smaller than it would previously have been as a result of the risk margin reforms being introduced.

Where use of the new method would have a significant adverse effect on a firm it can apply to use a modified version of the current ("legacy") approach instead.

The PRA also proposes monitoring of the amortisation of the TMTP to ensure it runs off to zero by the end of the transitional period in an appropriate fashion.

Internal models

There are two key strands to the PRA's proposed reforms of internal model rules:

- streamlining of the internal model requirements to remove many of the overly detailed or prescriptive currently applicable rules, which were inherited from the EU regime; and

- a removal of the binary approach to internal model approval by introducing an option for the PRA to give permission for internal models with "residual model limitations", subject to the application of safeguards. A safeguard could include use of a residual model limitation capital add-on or a qualitative safeguard applying to the firm's business practices or internal model use.

The PRA also proposes a new calculation methodology for internal model capital add-ons to be applied in exceptional circumstances, which it envisages can provide an alternative to the need to vary or revoke a firm's internal model permission if concerns with the model develop after permission has been granted.

Other reforms include a new "internal model ongoing review" process to ensure that internal model permissions remain appropriate, including an annual attestation by firms.

Calculation of group solvency

Two relaxations are proposed in respect of the group solvency calculations. The first is to allow groups to add the results of two or more different calculation approaches when calculating the consolidated group SCR for a temporary period (which may apply, for example, where an acquisition has led to changes in the group). The second is to allow a UK group's overseas sub-group SCR to be included in the consolidated group SCR under method 2 where the sub-group is subject to equivalent supervision – this would allow diversification benefits between the entities in the sub-group.

Third country branches

Third country branches will no longer be required to calculate and report on branch capital requirements, hold assets in the UK to cover the branch SCR or establish and report a branch risk margin. The PRA takes the view that the requirement for the legal entity as a whole to maintain adequate worldwide financial resources offers sufficient protection, along with other safeguards such as the PRA's consideration of the supervisory regime in the firm's home jurisdiction as part of the authorisation process and the requirement that UK policyholders of the firm are given appropriate priority in an insolvency.

Corresponding reductions in reporting requirements will apply but some additional more targeted reporting is also proposed:

- a standalone report analysing the distribution of branch assets upon resolution of the legal entity together with a legal analysis and description of the applicable law relating to winding-up in the relevant jurisdiction;
- a new annual template collecting information on the capital and solvency position of the branch legal entity; and
- the extension of some National Specific Templates to apply to third country branches.

Reporting

In addition to the reporting changes for third country branches, a number of additional reforms to reporting and disclosure requirements are proposed aimed at improving the efficiency of reporting for firms and the relevance of reported data to the PRA.

On the whole the reforms will result in a reduction in reporting requirements. Most significantly, the PRA proposes deleting entirely the requirement for firms to submit a triennial free-form narrative Regular Supervisory Report (and annual updates on material changes), which it considers to be burdensome to both firms and the PRA. The PRA's view is that it can obtain the relevant information from other reports under the overall new regime.

The changes set out in this latest consultation should be read alongside the reporting reforms already contemplated by CP14/22 (published in November 2022), which will come into effect for reporting reference dates falling on or after 31 December 2024.

Mobilisation regime

As highlighted in the HMT response document, the consultation includes proposals to establish a new mobilisation regime for the insurance sector. This would allow firms to apply an optional mobilisation stage of up to 12 months beginning at the point of authorisation during which a new insurer would operate with business restrictions but with reduced regulatory requirements, including a lower absolute floor for the MCR.

The PRA comments that the proposals are aimed at facilitating entry into insurance markets for new insurers, particularly start-ups, which may find it difficult to secure all the capital, infrastructure and resources that would be required for authorisation without mobilisation.

To the extent that firms write business during the mobilisation stage this will be subject to restrictions on the overall exposure of the firm and the type of business written (e.g. short term risks only). Firms are expected to focus on working towards full compliance with regulatory requirements. The mobilisation plan should also demonstrate how the firm could exit the market in an orderly and timely way if it failed to meet its targets. By the end of the mobilisation stage firms should either achieve full compliance or apply for their Part 4A authorisation to be cancelled.

Thresholds

The PRA proposes changes to the thresholds for the application of the Solvency II regime as well as changing the denomination of thresholds from Euro to sterling. The proposed changes are:

- the gross written premium income threshold will change from EUR 5 million to £15 million; and
- the technical provisions threshold will change from EUR 25 million to £50 million.

The PRA expects the change to affect nine existing Solvency II firms in the short term as well as future small insurers.

Administrative amendments

Chapter 11 of the consultation deals with what the PRA refers to as "administrative amendments". These are minor consequential changes to the Rulebook to update definitions which refer to the Level 2 Delegated Regulation and which are needed to reflect HM Treasury's proposed reforms to the risk margin.

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