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INSURANCE CLIENT BRIEFING

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REFORMS TO UK SOLVENCY II - NEXT STEPS

Overview

HM Treasury has announced its next steps in the upcoming reform of UK Solvency II. In a speech at the ABI annual dinner, economic secretary to the Treasury John Glen outlined some of the topics which will be included in HMT's forthcoming consultation on changes to the regime, now planned for publication in April.

Although the headline to the accompanying press release states that "UK slashes red tape through bold reforms to insurance sector regulation", much of the detail is still to emerge and the real scope of the changes is therefore difficult to judge pending the April HMT consultation, and the subsequent PRA consultation which is not expected until later in the year.

The press release goes on to state that "The reforms are expected to create an opportunity worth in the region of tens of billions of pounds for insurance firms to invest in long-term capital to unlock growth, unleashing greater investment in UK infrastructure". It is not clear, however, how insurers will be pushed towards using unleashed capital for these rather than other valid corporate purposes.

Key proposals

Key points mentioned in the speech to be covered by the April consultation include:

- reforms to the risk margin, which HMT say will reduce it by 60-70% for life insurers. No further detail has been provided yet as to how the risk margin calculations will be amended. HMT hopes that, among other things, these reforms will reduce incentives to reinsure longevity risk offshore
- changes to the fundamental spread methodology in the matching adjustment
- broadening the assets eligible for the matching adjustment to include assets with the option to change the redemption date – e.g. assets with construction phases and callable bonds
- broadening the liabilities eligible for the matching adjustment to include income protection products and products that insure against morbidity risk
- removing the "disproportionately severe" treatment of assets whose ratings fall below BBB in matching adjustment portfolios
- introducing a "significant increase in flexibility" to allow more investment in long-term assets such as infrastructure
- changes to reduce the current reporting and administrative burden, including reforming reporting requirements, removing requirements for branches of foreign insurers to hold local assets and calculate local capital requirements, and simplifying the calculation of transitional measures.

The matching adjustment

Changes to the fundamental spread are likely to restrict the amount of matching adjustment benefit by making insurers recognise more of the risk associated with matching adjustment portfolio assets. The reforms tested by the PRA in the recent QIS exercise have not been popular with industry – in a blog post written in December shortly before standing down as Director General of the ABI, Huw Evans expressed the view that the insensitivity of the fundamental spread to credit spreads is a deliberate part of its design and that "*for this element of Solvency II to suddenly attract such attention from our regulators is baffling*".

The relaxations proposed in terms of asset and liability eligibility are likely to be welcomed, although those referred to in respect of assets are relatively conservative and industry may have been hoping for more widespread changes. There is also a suggestion that greater flexibility will be introduced for including assets without historical data within the matching adjustment portfolio, which may allow new or innovative assets to be added.

Investment in long-term assets

As with the risk margin, no detail is offered as to how more flexibility will be introduced for investment in long-term assets. The expectation, however, is that this will be through changes to capital requirements. A similar proposal has been made at EU level by the Commission, although again at the moment without any accompanying detail.

Regulators remain sceptical as to the justification for using prudential capital requirements to influence the investment behaviour of insurers. In its Climate Change Adaptation Report 2021, the PRA commented, in the context of climate change, that: "*Research shows that the use of capital requirements as a tool to affect financing and investment decisions directly is not likely to be effective unless calibrated at very high levels. These levels could give rise to unintended consequences, such as the erosion of capital in the system or build-up of risks in other areas*." The same principle presumably applies more broadly and not only to investment in green assets. This may continue to be an area of tension between HMT and the PRA in the finalisation of proposed reforms.

Conclusion

The announcement gives a helpful direction of travel in the process of reforming the onshored version of Solvency II. There is clearly a drive to make the most of the increased flexibility afforded through having left the EU, and no mention of any desire to maintain equivalence. It is, however, apparent from the proposed timings that there is still a long way to go before any changes are implemented.

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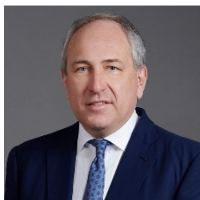

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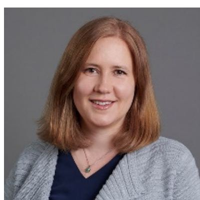

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