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CLIENT BRIEFING

JANUARY 2022

INSURANCE OUTLOOK 2022

In this Insurance Outlook we look ahead to legal and regulatory developments likely to be of interest to insurers over the next 12 months, focussing on:

- changes to the prudential regime
- recovery and resolution
- climate change
- the new consumer duty of care.

We also consider the increasing involvement of private capital in the UK and EU insurance sectors.

Spotlight on the insurance sector and private capital – a continually changing landscape

Looking back a generation, the UK and European insurance industry was almost exclusively dominated by listed companies and mutuals. Today, insurance industry ownership and funding by private capital has emerged fully as an increasing force in the sector and is growing strongly.

That said, private capital investment into the sector is not new, as such. Back in the mid-2000s, Clive Cowdery's privately-funded first Resolution vehicle bought up a series of back books from traditional insurance groups. More recently, nearly all the major investment houses have made significant investments into the sector.

On the life side, the trend has been for divestment by traditional insurers of capital-intensive business, particularly closed books. The stable cash-flows associated with this type of business can be attractive to private equity, along with the substantial assets under management. Examples include Apollo's Athora vehicle and its purchase of Vivat, on which we advised, Blackstone's investment into Rothesay Life (now exited) and the investment by CVC into Pension Insurance Corporation, on which we also advised. There is a general expectation in the market that as interest rates start to rise again, this will unlock a series of transactions in the European life savings market this year, which will be closely contested by a variety of financial sponsors and their portfolio companies.

Private equity investment in the non-life insurance sector is a more recent development. By way of illustration, we advised Markerstudy on its recapitalisation by Pollen Street Capital and CVC and on its recent purchase of the BGLi insurance business, and Blackstone's Tactical Opportunities business on its investment in Ki, the first fully digital and algorithmically-driven Lloyd's syndicate. Both of these investments reflect an interest in technology-driven businesses. We have also been heavily active in other aspects of the Lloyd's market, such as acting for private capital backed businesses such as RiverStone on back-book deals, advising OMERS on its investment in BRIT, and helping MCI to launch its syndicate in a box.

In many ways, the investment in non-life typically involves a classic PE playbook – the roll-up opportunity. The non-life sector – both carriers and intermediation – remains highly fragmented. Financial sponsors have been hungry to find an initial acquisition which they can then use as a platform for market consolidation through a programme of acquisitions and subsequent optimisation. We expect 2022 to be another busy year in the GI sector, given the visible deal pipeline, and notwithstanding the introduction of the general insurance pricing remedies from 1 January.

Some remain concerned about this growing trend. There is an ongoing process of adjustment, reaching mutual understanding and finding solutions between financial sponsors and regulators. Particularly in the case of life insurance business, there is arguably a mismatch between the long-term nature of liabilities and the relatively short-term business model for private equity investment. By investing through consolidator vehicles, however, the capital providers retain flexibility to move to an exit through a secondary transaction or – as in the case of, for example, the previously TDR Capital-owned Phoenix Group – a listing, assuming sufficient scale can be attained.

Policyholders and those seeking to protect them remain nervous. In August 2020, the High Court refused to sanction a transfer of life business from the Prudential to Rothesay Life, partly due to concerns regarding the likelihood of Rothesay's backers standing behind the business in the event of financial difficulties, although that judgment was ultimately overturned on appeal. More recently, in December LV members rejected the acquisition of the mutual by private equity firm Bain Capital.

From a wider regulatory perspective, the concern is as much about supervisability as compatibility of business models. In the EIOPA consultation on the 2020 Review of Solvency II, for example, concern was raised about leveraged buy-out structures where debt is inserted outside the EEA-regulated perimeter. EIOPA's concern is this could create pressure on the insurance undertaking to generate sufficient cash flows to service that debt. Concerns have also been expressed about whether the EEA-regulated perimeter will capture what are perceived to be the genuine controllers of a group where private equity is part of the structure. The European Commission has proposed amendments to the Solvency II directive which would widen the scope of group supervision.

The bigger picture is that, in the UK at least, diversification away from the past dominance of large listed insurance groups is likely to continue. Meanwhile, those large groups continue to streamline their businesses to focus on core areas. This has been seen in the past couple of years in particular with divestments and portfolio rebalancings by Prudential and Aviva, on which we have advised.

The year ahead

Changes to the prudential regime

HM Treasury published a call for evidence on potential changes to the UK Solvency II regime in October 2020, alongside a consultation on the ongoing Future Regulatory Framework Review. A summary of feedback was published in July 2021 and it is anticipated that a consultation on proposed changes will be published in **early 2022**.

Implementation of changes is likely to sit alongside broader changes to the regulatory framework, with the PRA being given the power to move onshored Solvency II rules into its Rulebook.

Key areas where changes are likely to be proposed include the risk margin, the matching adjustment, reporting requirements and capital requirements. Recent speeches by the Executive Director of Insurance at the PRA and the Governor of the Bank of England have suggested that reforms to the matching adjustment may include some relaxations of asset eligibility requirements, but accompanied by changes to the fundamental spread to make it more risk sensitive.

In its call for evidence, HM Treasury asked for feedback on possible changes to capital requirements to encourage investment in the real economy and in "green assets". It is worth noting, however, that in the PRA's Climate Change Adaptation Report 2021 the PRA clearly indicated that it does not support the use of green supporting factors/ brown penalising factors as part of a prudential regime to influence the investment behaviour of financial institutions.

Any changes to the regime will potentially lead to increased divergence from the current Solvency II framework, which will affect the prospect of future equivalence determinations from the EU and introduce additional complexity for cross-border insurance groups.

Recovery and resolution

HM Treasury consulted in May last year on amendments to the current insurer insolvency arrangements, specifically clarifications and enhancements to the court's existing power under section 377 of FSMA to order a reduction of the value of an insurer's contracts in certain circumstances. Final proposals have not yet been published.

In addition, HMT plans to introduce a specific resolution regime for insurers aligned with international agreed standards and best practice – **timing yet to be announced**. This was mentioned in the consultation on section 377 and was also added to the Regulatory Initiatives Grid in November. No insurer resolution regime has previously applied in the UK. At European level, in September the European Commission put forward proposals for a new Recovery and Resolution Directive to sit alongside the Solvency II Directive.

There remains some scepticism in the industry as to whether such a regime is really necessary for the sector, given the very different business model from the banks and the relatively low number of past insurer insolvencies. It does seem, however, that this is an inexorable direction of travel.

Climate change

There are currently a number of different climate-related initiatives with an impact on the insurance sector, each with their own distinct timeline. This is in addition to voluntary initiatives with which many insurers are engaged.

PRA supervisory expectations for managing climate-related financial risks

In April 2019, the PRA published its expectations for how banks and insurers should enhance their approaches to managing the financial risks from climate change (SS3/19). As confirmed in a subsequent Dear CEO letter, the PRA expects all firms to have embedded fully these expectations by the end of December 2021. Firms can therefore expect the PRA to want firms to be able to demonstrate how they have implemented the expectations set out in SS3/19 as part of its supervision of firms from **January 2022** onwards.

TCFD disclosure under the Listing Rules

Climate-related disclosure requirements, based on the framework established by the Task Force on Climate-related Financial Disclosures (TCFD), already apply to premium listed companies in respect of financial periods starting on or after 1 January 2021. The FCA consulted on proposals to extend these requirements to standard listed companies in June 2021 and final rules were published in December 2021. The requirements will apply to standard listed companies for financial periods starting on or after **1 January 2022**.

Mandatory climate-related financial disclosures in the Strategic Report

In October 2021, the Department for Business, Energy and Industrial Strategy (BEIS) published the response to its March consultation on mandatory climate-related financial disclosures by publicly quoted companies, large private companies, and LLPs, together with two proposed statutory instruments to implement the relevant changes. The proposals apply to, among other companies, all UK companies that are currently required to produce a non-financial information statement, which includes insurance companies (as "relevant public interest entities"). Under the proposals, companies will be required to report climate-related financial information in the non-financial information statement which forms part of the Strategic Report. Unlike under the Listing Rules requirements, the disclosures will be mandatory for companies within scope of the rules.

Subject to Parliamentary approval, the requirements will come into effect on **6 April 2022** and will be applicable for accounting periods starting on or after that date.

There is a degree of overlap between the Listing Rules disclosure requirements and requirements to be implemented as a result of the BEIS consultation. BEIS is expected to publish a Q&A document in **early 2022** to support relevant in-scope companies in considering compliance with their obligations, which will also consider how the Companies Act requirements interact with the Listing Rules.

FCA requirements for climate related disclosures by asset managers, life insurers, and FCA-regulated pension providers

In December 2021 the FCA published final rules requiring client and customer-facing climate-related disclosures by asset managers, life insurers, and FCA regulated pension providers (PS21/24). The new rules will require two sets of disclosures: (i) an annual TCFD entity report on how the firm takes climate-related risks and opportunities into account in managing or administering investments on behalf of clients or consumers; and (ii) an annual set of consistent, comparable disclosures in respect of the firm's relevant products and portfolios, either in the form of a TCFD product report or disclosed on request to relevant institutional clients, depending on the nature of the business of the firm.

The rules will apply to larger asset managers and owners (covering 34 asset management and 12 asset owner firms, and capturing 98% of relevant assets under management) from **1 January 2022**. They will be extended to the remainder of in-scope firms from **1 January 2023**. Asset managers and asset owners with less than £5 billion in assets under management or administration (calculated on a 3-year rolling average basis with respect to specified 'TCFD in-scope business') are excluded from the requirements, although the FCA intends to review this after 3 years.

The Sustainability Disclosure Requirements (SDR) regime

In October 2021, ahead of COP26, the Government published its roadmap to sustainable investing ("Greening Finance"). The SDR is intended to create a holistic approach for listed issuers, asset managers and asset owners to report on their sustainability risks, opportunities and impacts. There are a number of strands to implementation of the SDR, some of which involve initiatives already completed or commenced. The introduction of a UK Green Taxonomy, associated mandatory financial disclosure requirements in annual reports and mandatory SDR disclosure requirements will be subject to consultation over the next 1-2 years.

In November the FCA published a discussion paper on sustainability disclosure requirements and investment labels (DP21/4) as part of the path to implementation of the SDR. The FCA intends to use feedback to the discussion paper to inform policy proposals to be issued for consultation in **Q2 2022**. Proposals discussed in the paper include:

- the introduction of product labels reflecting the sustainability characteristics of financial products, possibly supported by consumer-facing product level disclosures and an additional level of more detailed disclosures for use by institutional investors. The FCA suggests some possible product labels, including "transitioning", "aligned" and "impact" labels

- expanding the disclosure requirements implemented by PS21/24 to include a broader category of sustainability risks, not just climate-change risks, and to cover the impact of firms and investment products on the environment and society.

Solvency II requirements

From **August 2022**, as a result of changes to the Level 2 Delegated Regulation, firms subject to Solvency II will be required to (i) take into account sustainability risks as part of their risk management processes and prudent person principle assessments; (ii) take into account the potential long-term impact of their investment strategy and decisions on sustainability factors; (iii) ensure that their investment strategy reflects the sustainability preferences of its customers taken into account in their product approval processes; and (iv) include information in their remuneration policy regarding how the policy takes into account the integration of sustainability risks in the risk management system.

The consumer duty – a return to outcomes-focussed regulation

On 7 December the FCA published its second consultation on the introduction of a new Consumer Duty (CP21/36). Final rules are due to be published **by 31 July**. Under the proposals, the FCA plans to introduce a new Principle (to apply to retail business) that "A firm must act to deliver good outcomes for retail clients". This Principle will be supplemented by specified cross-cutting rules and rules supporting four key customer outcomes.

Outcomes-focussed regulation is not new – the FSA was discussing outcomes for customers back in the 2000s as part of its Treating Customers Fairly initiative. The FCA does, however, see the introduction of the new Consumer Principle as part of a "reset" which it wants to lead to higher expectations and standards. For firms trying to understand what additional standards they will need to meet, particularly those who have already had to implement the recent changes to the PROD requirements for non-life insurance products, the introduction of the new duty will potentially add an additional layer of complexity. It is worth noting that an element of retrospective regulation will apply in that firms will need to consider the interaction of the new duty with existing (including closed book) products.

Some key dates

General insurance pricing remedies come into force	1 January 2022
Requirement for PRA supervisory expectations for managing climate-related financial risks (SS3/19) to be fully embedded	From 1 January 2022
New climate-related disclosure requirements for large asset managers and asset owners	From 1 January 2022
Extension of Listing Rules TCFD disclosure requirements to standard listed companies	For financial periods starting on or after 1 January 2022
HMT consultation on changes to UK Solvency II	Q1 2022 (expected)
New operational resilience and outsourcing rules come into force	31 March 2022
PRA Brexit Transitional Direction expires	1 April 2022
Mandatory requirements for climate-related financial disclosures in the Strategic Report	For accounting periods starting on or after 6 April 2022
Final FCA policy statement on the Consumer Duty	By 31 July 2022
Additional Solvency II sustainability requirements come into force	August 2022

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