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NEWSLETTER

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INSURANCE NEWSLETTER

QUICK LINKS

Regulatory reform and the insurance sector

The Treasury's consultation on the reform of UK Solvency II closes on 21 July. In the meantime, the financial sector is still awaiting final legislation arising out of the Future Regulatory Framework review, the second consultation on which was published back in November. Recent press reports have suggested that No. 10 is frustrated by the slow pace of change on financial regulatory reform, particularly for the insurance sector, which seems to be at least partly the result of differing views of Government and the regulators on elements of the reform package.

In the Solvency II context, the key debate appears to be around the extent of changes which should be made to the matching adjustment calculation. The PRA's proposed changes are likely to offset a material part of the benefit of reforms to the risk margin. In the wider context, the Treasury has proposed changes to the objectives of the regulators and the extent of oversight of their activities by Government and Parliament, which has given rise to some debate.

Economic growth and competitiveness

Treasury has proposed giving the PRA and FCA new secondary objectives for economic growth and competitiveness, although detailed wording has not yet been articulated. In its recent report on the Future of financial services regulation, the House of Commons Treasury Committee recommended that there should be a secondary objective for both the FCA and the PRA to promote long-term economic growth but that (i) the wording will be crucial and weakening of standards should be avoided; and (ii) calls for a primary economic growth or competitiveness objective should be resisted.

Some views expressed in evidence given to the committee included:

- the Director of Markets and Wholesale Policy, FCA, told the Committee that a new secondary objective of competitiveness would give the FCA the ability to make rule changes solely for the purposes of advancing competitiveness - which is currently not possible as all rule changes must advance one of their objectives
- others, including a group of 58 economists, have expressed concern about the possibility that introduction of a competitiveness objective could lead to excessive risk-taking and a race to the bottom on regulatory standards
- the ABI is supportive of introducing an economic growth objective, and suggested in evidence to the Committee that this should be a primary rather than a secondary objective

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- evidence from the PRA suggested that the precise formulation of the objective would be crucial, and that it would need to focus on long-term growth.

Separately, the House of Lords Industry and Regulators Committee wrote to John Glen, Economic Secretary to the Treasury, at the beginning of April on the question of the proposed competitiveness objective. In particular, it proposed that that the regulators should regularly review their rulebooks in general – and not just new rules – against this objective, and that there should be clearly established criteria and performance measures against which the competitiveness objective can be measured.

Regulatory independence

As well as the concerns around erosion of standards, there also remain risks of conflict between an objective to promote economic growth and the primary safety and soundness and consumer protection remits of the PRA and FCA respectively. These could be exacerbated should the Treasury decide to introduce the policy framework legislation which was discussed in its first consultation paper in October 2020, which could also have an impact on regulatory independence. Treasury suggested that the legislation would include an explanation of specific policy priorities, set out in regulatory principles, that the regulator should take into consideration when developing policy and designing regulatory requirements. For insurance it suggested this might include:

- the role of insurance business in facilitating sustainable growth in the UK economy, including the supply of finance for infrastructure projects;

- the socially important role that a viable and sustainable life insurance sector plays in retirement provision for UK citizens; and

- the desirability of innovation in insurance, reinsurance and alternative insurance risk transfer services.

The Treasury Committee sees regulatory independence as a priority and has suggested that Government "must not pressure the regulators to weaken or water down regulatory standards, or to accept changes to the regulatory framework which could impede the regulators' ability to achieve their primary objectives".

Meeting customer needs – policy exclusions and target markets

The COVID-19 pandemic highlighted issues around coverage and exclusions in business interruption and travel insurance. This is, however, an issue which raises wider questions about coverage of risks connected with systemic events, including climate change and cyber attacks.

In May EIOPA published a consultation on a supervisory statement addressing exclusions in insurance products related to risks arising from systemic events. In particular, EIOPA focuses on pandemics, climate change and cyber-attacks as examples of potentially systemic events. Interestingly, the focus of the draft supervisory statement is not on what insurers should or should not provide cover for, but on communications to customers and ensuring that products suit their markets. Key points raised in the draft include:

- manufacturers should assess, and NCAs should review the assessment by manufacturers of, whether exclusions from coverage are clear, taking into account the target market's characteristics and level of understanding of insurance products

- if risks become uninsurable, insurers must be careful about how they draft and communicate exclusions – for example, avoiding listing some examples of systemic events that could suggest others are covered when they are not and being clear of the extent to which cover relates to direct and/ or indirect losses

- exclusions should be properly addressed at product design stage not just at point of sale. Insurance manufacturers should take exclusions into account when identifying the target market for a product, test whether the product still offers value to that market and test whether the way in which exclusions are presented could lead to an expectation gap on the part of customers

- from a regulator perspective, NCAs should monitor their markets where systemic events may apply and consider whether low claim acceptance rates may arise as a result of poor wording which may have led consumers to believe a risk was covered. This has clearly been an issue in relation to non-damage business interruption cover and COVID-19. EIOPA recommends that where issues have been identified "NCAs should take actions to address them, as relevant and appropriate considering their powers and legal tools as well as national insurance contract law".

Whilst these suggestions may reduce the risk of customers buying insurance which does not meet their needs, they do not ultimately address the potential issue of cover not being available for some risks. Over time if the availability of coverage reduces this may give rise to a backlash from industry and consumers, and possibly the need for government action similar to the UK Flood Re scheme to address other risk areas.

Uncertainty over insurance cover was also recently highlighted in portfolio letters written by the FCA to (i) Lloyd's and London Market Insurance Intermediaries (LLMI); and (ii) Personal and Commercial Lines Insurance Intermediaries (P&CLII). In the LLMI letter, the FCA expressed the concern that uncertainty over insurance cover due to ambiguous contract terms is a more widespread issue than just in business interruption cover, and that a wide-reaching incident such as a cyber attack could expose uncertainty of insurance coverage for a large number of customers. In addition, inadequate communication could lead to customers taking out insurance that does not provide the level of cover they thought they had. The FCA's focus is on firms (both manufacturers and distributors) having adequate product governance arrangements in place to ensure that customers receive insurance products that deliver when they need. A similar issue was raised in the P&CLII letter, although there was a stronger focus in that letter on ineffective oversight of remuneration giving rise to instances of harm for customers.

Update on the EU review of the Solvency II Directive

The EU review of Solvency II is further ahead, at least in theory, than the UK review. Formal reform proposals were published in November 2021 but the legislative process can be lengthy and a final version of the reform package has yet to be agreed by the EU institutions.

On 10 June the European Parliament's Economic and Monetary Affairs Committee (ECON) published a draft report on the European Commission's legislative proposal amending the Solvency II Directive and on 2 June the EU Council published its compromise text on the proposal. The next step in the process is for the European Parliament to adopt a position at first reading, including its proposed amendments to the original Commission proposal. This may be preceded by trialogue discussions between the Commission, the Parliament and the Council to reach an agreed position on some of the points discussed below.

Level 1 vs Level 2 measures

In the accompanying explanatory statement to the ECON report, the rapporteur in particular highlights the views of the committee that key aspects of the Solvency II framework, in particular those relating to the long-term guarantees measures, should bet set out in the Level 1 Directive and not in delegated regulations. As a result, changes to the Level 1 are proposed by ECON to:

- include new provisions in Article 77 specifying the formula for calculating the risk margin and the cost of capital rate to be used
- include in Article 77a the formula for determining the extrapolated risk-free rate, where relevant
- include in Article 77d a formula for calculating the spread to be used in the volatility adjustment

- introduce a new Article 105a dealing with the treatment of long-term equity investments in the SCR. This sets out criteria such as average holding period of the investments and the ring-fencing of the investments to meet certain liabilities.

These are areas which are either currently addressed in the Level 2 Delegated Regulation or where the Commission has suggested additional provisions may be included in the Level 2 as part of the overall review.

A similar debate over the location of key provisions took place when the Omnibus II Directive was being negotiated. At the time, many were surprised that so much detail on the long-term guarantee measures, particularly the matching adjustment, was included in what is intended to be a framework directive. Including these provisions in the Level 1 does, however, allow the Parliament more say over the detail of the provisions.

Other key changes

Many of the other changes from the Commission's draft suggested by ECON aim to remove what it perceives as unnecessary additional burdens placed on insurers. Key changes include:

- removing the proposal that, as part of the ORSA, undertakings should consider and analyse the activities of the undertaking that may affect the macroeconomic and financial markets' developments and have the potential to turn into sources of systemic risk. This is on the basis that it is disproportionate since few insurers pose systemic risk. The proposal that undertakings should consider the reverse – i.e. consider the macroeconomic situation and possible macroeconomic and financial developments that may affect the undertaking's risk profile and solvency needs – is largely retained, although the Parliament suggests this should only be in response to a reasoned request by the supervisory authorities

- deleting the reference to climate change, pandemics and other mass-scale events and catastrophes from the Commission's proposed definition of "macroeconomic or financial markets' developments"

- deleting the proposed requirement for undertakings to carry out climate change scenario analysis as part of the ORSA

- deleting all of the Commission's amendments to the structure and format of the SFCR, which would split the SFCR into a consumer facing section and a markets facing section

- deleting the Commission's proposal to require undertakings to assess the extent to which their investment strategy may affect macroeconomic and financial markets' developments and have the potential to turn into sources of systemic risk, and to incorporate such considerations as part of their investment decisions. This is on the basis that most undertakings are too small to be a source of systemic risk

- a number of changes to the Commission's proposed new provisions regarding liquidity plans

- deleting the Commission's changes to make insurance holding companies or mixed financial holding companies directly responsible for aspects of the internal arrangements of the group and structural organisation of the group affecting supervisability, as well as associated references to insurance holding companies and mixed financial holding companies in the group supervision rules.

The Council's proposed amendments are in general less material although fairly extensive in terms of drafting. Proposals include

- the addition of an undertaking-specific adjustment to the risk-corrected spread used in the volatility adjustment. This was originally considered by EIOPA in its consultation on the 2020 Review of the Directive

- changing the new concept of "low risk profile undertakings" to refer instead to "small and non-complex undertakings" and introducing some changes to the criteria for identifying these undertakings. The Council also proposes that EIOPA should monitor the appropriateness and effects of the applicable criteria and submit a report to the Commission by three years after application of the proposed changes; and

- introduction of a proposed five year phasing in period in respect of adjustments to the interest rate risk sub-module – which was suggested in an earlier set of advice from EIOPA to the Commission but did not appear in the final opinion on the 2020 Review

- amendments to the proposed new insurance holding company definition, in particular to include ancillary services undertakings within the test. This would correspond to recent changes to the definition of insurance holding company in the UK regime proposed by the PRA.

Trends in transactions

We have remained busy throughout Q2 this year. There are undoubtedly signs, however, that the headwinds into which the M&A market is sailing are starting to have an effect on the broader market. Increasing risk free rates, the opening out of spreads, inflation and difficult listed markets are all having an effect on the financing of deals. While financial sponsors remain highly active in the sector, we are tending to see more deferred consideration (as a percentage of deal size), increased rollover into acquirer equity and greater use of in-house credit funds. That said, several lending banks who had been sitting out of the financing market for a while are now keen to debt fund insurance deals again, so that may lead to a greater degree of competition for the credit funds in sponsor-backed transactions and for regulatory capital provision.

Looking at specific sub-sectors of the market, the non-life brokerage consolidators remain hungry. Full or partial non-life founder exits to sponsors continue to be strong. The effect of the FCA's general insurance pricing reforms now shows some signs of stabilising. We continue to see considerable appetite in the non-life back book consolidation market both inside and outside Lloyd's and around Europe. The increase in rates has woken up the European life savings market - we are now seeing material deal flow getting going again. In the pensions derisking market, there is a feeling of optimism – if carried through into legislation, the HM Treasury risk margin and asset eligibility reforms to Solvency II should help with pricing (unless unwound by countervailing change to the matching adjustment fundamental spread) and the increase in discount rates should have a directly positive effect on the market.

So, while especially in these uncertain times, we can never be sure what the future will bring, we are reasonably confident that the transactional market will remain positive, albeit that the type and composition of deals we will see is likely to evolve.

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