SLAUGHTER AND MAY/

NEWSLETTER

JULY 2020

INSURANCE

In this newsletter:

- The future of insurance regulation after Brexit: who will make the rules and will they change post-transition? Will there be a deal with the EU on financial services and what about equivalence?
- Green recovery and the insurance sector: how should the insurance sector respond to calls for it to support a green recovery from the COVID-19 related economic crisis?
- COVID-19 and insurer solvency: the European insurance sector has weathered the crisis reasonably well but there are some concerns around matching adjustment portfolios and the uncertainty regarding business interruption policies

QUICK LINKS

For further information please contact any member of the Insurance Practice or your usual Slaughter and May contact.

One Bunhill Row
London EC1Y 8YY
United Kingdom
T: +44 (0)20 7600 1200

THE FUTURE OF INSURANCE REGULATION

As we head towards the end of the Brexit transition period there has been a renewed focus on what the regulation of financial services will look like in a post-Brexit world.

Who will make the rules in the UK?

The Withdrawal Act provides for a comprehensive but somewhat clumsy onshoring of existing EU legislation, including EU financial services legislation. Under the Act, the Level 2 Delegated Regulation will be onshored as at the end of the transition period with amendments made by statutory instrument – for example, to reflect the fact that all EU countries will be third countries from a UK perspective. This potentially leads to a highly inflexible regulatory regime requiring secondary legislation to make any amendments to the detailed prudential regulatory rules.

Read across from the banking sector suggests that responsibility for the rules currently set out in the Level 2 Delegated Regulation is likely to be delegated to the PRA. The Government has indicated that it intends to delegate responsibility for rule-making in the banking sector to the PRA under the Financial Services Bill. This will involve, for example, deleting articles of the retained Capital Requirements Regulation where appropriate. The delegation of powers will be accompanied by an enhanced accountability framework.

The Government also intends to consult more generally on how financial services policy is made in H2 2020 as part of its Financial Services Future Regulatory Framework Review.

Will the rules change post-transition?

The PRA (in its former incarnation as the FSA) was a major architect of much of the Solvency II regime and it is unlikely that there will be significant divergence from the current regime in the near future. The Government has signalled, however, that it will make amendments to financial services legislation where appropriate to suit the UK market.

Naturally, there will be some defined areas where it is appropriate for the UK - as a large and complex financial services jurisdiction - to take an approach which better suits our market, while remaining consistent with international standards"

(Chancellor's written statement to Parliament (23 June)

The Chancellor gave a written statement to Parliament on 23 June on transposition of EU financial services legislation within the transition period, which indicated this direction of travel. In the banking sector, this is reflected in the Government's decision not to transpose those requirements of the Banking Recovery and Resolution Directive II that do not need to be complied with by firms until after the end of the transition period.

Importantly for the insurance sector, the Chancellor announced in his written statement that the Government would publish a call for evidence on possible amendments to the Solvency II regime in the autumn and that a review of the regime would include the risk margin, the matching adjustment, the operation of internal models and reporting requirements. It will be important for market participants to engage with this call for evidence.

At European level, the Commission is currently undertaking a review of the Solvency II regime, with advice on possible changes expected from EIOPA by December 2020. The Commission has also launched a public consultation on the review – see further under "Other news" below. Although any changes will be implemented after the end of the Brexit transition period the results of the review may influence the future shape of the UK regime.

Will there be a deal with the EU on financial services?

The future agreement is intended to have a chapter on financial services but the content of that chapter remains very much a subject of negotiation. It is worth noting that the UK's proposals (unsurprisingly) fall short of requesting a continuation of the single passport for financial services.

On 30 June Michel Barnier gave a speech to the Eurofi General Assembly on financial services aspects of the EU's negotiations with the UK on the future agreement. He stated that the EU wishes to conclude a deal which would simply prevent discrimination for UK operators establishing themselves in the UK and vice versa. In Barnier's view the UK proposals go beyond this, for example proposing the establishment of a legally enforceable regulatory cooperation framework, and are not acceptable.

The working assumption for firms should continue to be that any deal reached on financial services will be minimal. Firms have already been planning on this basis so this will not come as a surprise.

What about equivalence?

The Government still believes that financial services equivalence between the UK and the EU is mutually beneficial. The EU and UK had originally agreed to use best endeavours to finalise equivalence assessments by the end of June. Treasury minister John Glen confirmed in answers to the EU parliamentary select committee on 2 July that the UK has completed its equivalence assessments in respect of the EU. The EU, however, is still considering its assessments – for which it sent 28 questionnaires to the UK to be completed, running to approximately 1,000 pages.

In his speech on 30 June Michel Barnier observed that, in the EU's view, the equivalence assessments must be forward-looking "*given the UK's publicly stated intention to diverge from EU rules after 1 January 2021*". In view of the size of the UK financial market and this intention to diverge, the EU considers that extra care must be taken in respect of equivalence decisions. Although Mr Barnier commented in his speech that equivalence determinations are independent from the negotiations over the future agreement between the EU and the UK, it does seem likely that the general progress of discussions over financial services will have an impact on the equivalence process.

GREEN RECOVERY AND THE INSURANCE SECTOR

The unusual circumstances in which we all find ourselves have led many to take stock of what constitutes "business as usual" and to consider what changes should be made as we look to head back to normality. Amongst the most vocal have been those lobbying for climate change to be at the forefront of decision-making around plans for a bounce-back from the economic downturn caused by the COVID-19 pandemic.

> *"where taxpayers' money is used to rescue businesses, it needs to be tied to achieving green jobs and sustainable growth" (Antonio Guterres, UN Secretary General)*

As well as national governments, financial institutions such as asset managers and insurers have been lobbied to use their influence to promote the so-called "green recovery". On 29 April a group of NGOs supporting the "Insure Our Future" campaign wrote to insurance industry associations calling on insurers to take action, including lobbying governments and taking actions on their own investments and insurance programmes.

Insurers have a dual role in the campaign against climate change – as investors in and, in some cases, as providers of cover for fossil fuel projects and how they transition those involvements into the green energy sector.

Although many major insurers have publicly stated targets for reducing investment in fossil fuel assets there is more work to be done, as reflected in the recent PRA feedback on its 2019 Insurance Stress Test, which indicated that 16% of UK insurers' investments were in sectors it considers vulnerable to climate change risk, i.e. fuel extraction, energy, power, transport and agriculture.

With respect to insurance cover, Insure Our Future claims that "*Since 2017, 19 insurance companies have ended or restricted insurance for coal projects and some have gone further, with restrictions on tar sands and Arctic oil. Yet none have committed to only insure projects which are consistent with a 1.5 degree C world and several major insurers .. have taken no steps to restrict cover for fossil fuels*".

There is evidence that insurers have joined in lobbying national governments to consider climate change in their recovery plans. In the UK, a number of insurers have been part of a broader group of corporates which wrote to the Government on 1 June calling on it to ensure that recovery efforts:

- drive investment in low carbon innovation, infrastructure and industries, as well as improved resilience to future environmental risks
- focus support on sectors and activities that can best support sustainable growth, increased job creation and accelerate both the recovery and the decarbonisation of the economy
- include within financial support packages measures to ensure receiving businesses are well managed and their strategies are science based and aligned with national climate goals.

THE IMPACT OF COVID-19 ON INSURER SOLVENCY

COVID-19 stress test

On 17 June 2020 the PRA wrote to insurers giving feedback on the Insurance Stress test 2019 and the more recent COVID-19 stress test. Its conclusions on the COVID-19 stress test were that "*Our analysis showed that the sector was robust to downside stresses, with the highest uncertainty centred on certain general insurers' liabilities - particularly those arising from business interruption claims*."

Life insurers

For life insurers, the analysis was in particular aimed at capturing the impacts of credit downgrades, as a key risk for life insurers with MA portfolios

The stress test tested a 50% downgrade of assets by one credit quality step. The PRA commented that "*This 50% downgrade scenario is broadly equivalent to the worst one-year experience in history, felt during the Great Depression in 1932*".

The PRA concludes that most firms are sensitive to this type of severe downgrade stress but that it would be manageable, particularly given that firms have a range of management actions available to absorb losses which tend to arise over a reasonable time frame.

General insurers

For general insurers the stress test focussed on liabilities rather than investment risk including:

- underwriting losses based on GDP path and length of lockdown in the Monetary Policy Report scenario
- stresses on revenues and earnings due to premium holidays, lower economic activity and/ or an increase in bad debts
- further liability stresses, including from BI claims.

The PRA concludes that the general insurance sector is resilient to these stresses under the assumption that insurance policies written work in line with insurers' current expectations. This is obviously potentially a big "if" given the differences between insurers and policyholders as to the interpretation of some business interruption contract wordings in the context of the COVID-19 pandemic. More clarity on this issue is expected as a result of the test case which has been originated by the FCA. The case is due to be held over the second two weeks of July so a judgment is likely at the end of August or the beginning of September, although there will be scope for this to be appealed.

Application of the matching adjustment during COVID-19

Notwithstanding the general conclusions for life insurers arising out of the COVID-19 stress test, on 7 July the PRA issued a statement on the application of the matching adjustment during COVID-19 identifying areas where it considers "clarifications" of policy may be useful. The focus is on the way in which insurers manage their MA portfolios and possible changes in approach as a result of the impact of the current pandemic on financial markets. Key points in the statement include:

1. firms should discuss any change to their strategy for managing the MA portfolio with their supervisors. Any material change to the management or scope of the portfolio will require a new application for MA approval

2. the economic effects of COVID-19 could have an impact on cash flows from assets, which could affect their ongoing appropriateness for the MA portfolio or which "component" of the MA portfolio asset mix they can count towards. Amongst other things, insurers should assess in each case whether disruption in payments is likely to be temporary or more long term
3. where insurers are engaged in direct lending, COVID-19 related payment holidays or loan modifications could have an impact on internal ratings of loans
4. firms are reminded that the fundamental spread should be increased where necessary to ensure that the MA for assets with sub-investment grade quality does not exceed the MA for equivalent assets of investment grade quality. This may be relevant where internal ratings of assets have to be adjusted to reflect current economic circumstances
5. firms are also reminded of the Effective Value Test for equity release mortgages and the requirement to contact their supervisor if the EVT result indicates that an inappropriately large amount of MA benefit may be derived from restructured ERMs.

OTHER NEWS

Other recent developments include:

- the appeal from the refusal of the High Court to sanction the transfer of annuity business from Prudential to Rothesay Life is now expected to be heard in October 2020. If the appeal is successful there will be a further hearing at the High Court to decide whether or not the proposed transfer should be approved
- the European Commission has launched a public consultation on key elements of the Solvency II regime. This is intended to sit alongside the consultation launched by EIOPA in October 2019 and is designed to enable the Commission to obtain stakeholders' views and evidence on the broad objectives and priorities of the review of the European framework. Areas covered in the consultation include: sustainability of insurers' activities; priorities of the European framework; proportionality; transparency; policyholder protection including Insurance Guarantee Schemes; and new emerging risks such as climate change and cyber risk. The consultation is open until 21 October 2020
- the debate on insurer dividends continues with ongoing divergence in practices across Europe. Significantly, we understand that the Dutch regulator (DNB) has relaxed its previous position.

We are delighted by the uptake of our new Solvency II App. A new series of accompanying podcasts are also being created, accessible via the Slaughter and May LinkedIn page. Our first podcast, on Own Funds, is now live and others will follow. If you have not already downloaded the App and need a password or a reminder of your password, do please contact us at solvency.two@slaughterandmay.com.

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650