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Slaughter and May Podcast
HMT consultation on its review of Solvency II (May 2022)

Robert Chaplin	Hello and welcome. I'm Robert Chaplin, one of Slaughter and May's corporate insurance partners. With me is Beth Dobson, our insurance PSL counsel. In this podcast we discuss the recently published HMT consultation on its review of UK Solvency II. For more information on Solvency II please see our Solvency II App. If you don't already have the App please email solvency.two@slaughterandmay.com to request access. The Government announced back in June 2020 that it planned a post Brexit review of the Solvency II regime to make it fit for purpose for the UK insurance sector. A call for evidence was published in October 2020 and a feedback statement in July 2021, but it has taken until April of this year for an official consultation on proposed reforms to emerge. Even now, the consultation itself is relatively light on detail. Proposals for changes to the risk margin and the fundamental spread are reasonably well developed, although still subject to comment, but most of the other proposed reforms are only set out at a high level. It is important to acknowledge the context of the current review. The Government has made clear on a number of occasions, including in a February speech to the ABI by John Glen, economic secretary to the Treasury, that it wants reforms to UK Solvency II to allow increased investment by insurers in UK assets - in particular infrastructure assets and other investments which will help the Government to meet its climate change objectives. Another, and complementary, objective is to promote the international competitiveness of UK insurance firms. The PRA, meanwhile, has its own views on Solvency II reforms. It is, understandably, more focussed on financial stability and policyholder protection than economic aims, and this has created an element of tension between the Treasury and the PRA.
Beth Dobson	The key proposal in the HMT consultation is the reform of the methodology for calculating the risk margin component of technical provisions. Treasury wants to achieve a 60-70% reduction in the risk margin for life insurers, which it anticipates could release as much as 15% of the capital currently held by these insurers, amounting to tens of billions of pounds. This would be achieved by an adjustment to the calculation, to introduce a tapering approach, reducing the weight given to future projected SCRs, and a reduction in the cost-of-capital rate itself. For general insurers a more modest reduction to the risk margin of around 30% is proposed. Industry has long been pushing for reforms to the risk margin so these proposals will be welcome. In a discussion paper published at the same time as the Treasury consultation, the PRA has also supported the reforms, recognising that the current methodology is too sensitive to movements in interest rates. It considers, however, that without accompanying changes to the matching adjustment, a cut of 60% to the risk margin for life insurers is not prudentially justifiable – and in particular not supported by such data as is available about

	market pricing for transfers of longevity risk. Robert will talk about the changes to the matching adjustment in a moment. Assuming a 60% cut in the risk margin is implemented, there remains the question of what insurers will do with the resulting release of capital. One of the questions specifically raised in the Treasury consultation is "how can the Government be assured that this released capital would not be distributed to shareholders or paid as increased remuneration to employees?" Without specific safeguards (none of which have so far been proposed) it is difficult to see how Government can be assured of this. The PRA assumes in its discussion paper that insurers would be free to choose how to use any released capital and might therefore return some to shareholders. Proposed relaxation of asset eligibility rules for the matching adjustment, discussed later, may create some incentive for insurers to use infrastructure assets for matching adjustment purposes but no changes to capital requirements have been proposed which would make investment in, for example, "green assets" a more attractive option. In contrast, the European Commission is not proposing to relax asset eligibility rules for the matching adjustment but is considering changing its rules on the treatment of long-term equity investments to make it easier for equity investments, including via infrastructure funds, to attract preferential capital treatment.
Robert Chaplin	As Beth has touched on, the second key proposal in the Treasury consultation is for reform to the matching adjustment, which involves changes to the methodology for calculating the fundamental spread. The fundamental spread part of the matching adjustment calculation is intended to capture the retained risks of the insurer in respect of matching adjustment portfolio assets – principally default risk and the cost of having to replace downgraded assets. The PRA is concerned that the fundamental spread inadequately captures the risks which insurers are exposed to in respect of matching adjustment assets. It has three principal concerns: • firstly, that the fundamental spread does not sufficiently take into account the uncertainty around expected losses from defaults, which it says should be reflected in the fundamental spread as a "credit risk premium"; • secondly, that it is not sensitive to differences in risks across assets with the same ratings, which incentivises insurers to invest in assets with a higher than average spread for their ratings; and • thirdly, that it does not adjust to reflect structural shifts in the credit environment over time unless there are actual defaults or downgrades. A new methodology was tested in the recent QIS exercise which included a credit risk premium. This was not entirely well received. In a blog post shortly before

	leaving his position as Director General of the ABI last December, Huw Evans suggested that it was "baffling" for the fundamental spread to suddenly attract such attention from regulators, given that it has been a central part of the design of Solvency II since it was implemented, and that "it is clear that the insensitivity to credit spreads is a design intent, not an unintended consequence". The Treasury consultation proposes a new methodology for the fundamental spread under which it would be calculated as the sum of allowances for expected loss plus a credit risk premium. The credit risk premium would be the sum of a proportion of the averaged spread for a comparator index over a set number of years and a proportion of the difference between the spread of the actual asset and that of the comparator index. In its discussion paper, the PRA expresses the view that in order to meet its objectives of safety and soundness and policyholder protection, a cut in the risk margin for life insurers of 60% should be accompanied by reforms to the fundamental spread including a credit risk premium calibrated at a minimum of 35% of credit spreads. By contrast, in his blog post Huw Evans points out that large amounts of prudence are already built into the Solvency II capital regime and that the UK insurance sector is in any event significantly over-capitalised compared with regulatory requirements. The Treasury, for its part, is open to the views of stakeholders at the moment over the correct calibration. It states in its consultation that a lower calibration may be appropriate if this delivers significant benefits to the wider economy (while also preserving policyholder protection and ensuring the continued safety and soundness of firms). It is worth noting that at least part of the background to the PRA's attitude towards the fundamental spread is its concerns about the use of restructured illiquid, unrated assets by insurers in their MA portfolios. This is a long-standing concern which has been reflected in a series of supervisory statements, initially focussed on equity release mortgages but applying more broadly. The PRA has taken a number of steps to avoid insurers taking what it sees as an excessive matching adjustment benefit in respect of these restructured assets, but has been hampered by the inflexibility of the fundamental spread methodology which is mainly driven by ratings - in the case of restructured assets, set by the insurers themselves using internal methodologies.
Beth Dobson	Other proposals in the Treasury consultation are less significant. There are proposals to relax matching adjustment eligibility criteria for certain classes of asset but these are relatively modest in nature. There is nothing, for example, suggesting a change to the rules to allow equity release mortgages to be included in the matching adjustment portfolio without the need for restructuring. What Treasury does propose is a relaxation to allow some assets where the issuer has the option to repay the asset early to be included – this would include callable bonds, commercial real estate lending, housing association bonds and loans,

	infrastructure assets and local authority loan portfolios. Some amendments to the treatment of assets with construction phases are also proposed. There are also a number of proposals aimed at streamlining various procedural requirements, including in respect of the matching adjustment, internal models and supervisory reporting. We summarise these proposals in our briefing note – "HM Treasury consultation on its Review of Solvency II", available on our website.
Robert Chaplin	So what next in the reform process? Both the Treasury consultation and the PRA discussion paper are open for comments until 21 July. Once the Treasury has considered the responses we would expect it to publish a feedback statement, but it is not clear whether – given the relative lack of detail in the April consultation – it will also issue a further consultation. In particular, it has said that it has not decided how much of the new rules will be set out in legislation and how much will be the responsibility of the PRA. Given the tension in respect of calibrations of the risk margin and the fundamental spread, Treasury may be tempted to embed the methodologies for these in applicable legislation rather than the PRA rules. The PRA will ultimately also need to consult on the changes it needs to make to the Rulebook as a result of the review. It is likely that this will involve incorporating a version of most of the rules currently set out in the onshored Level 2 Delegated Regulation, which is a fairly weighty task, as well as any new or amended rules arising out of the Treasury consultation. It will also be interesting to see whether the PRA goes beyond the scope of that consultation and includes any changes currently being considered at a European level. Some of the changes to Solvency II proposed by the European Commission last September which were less policy driven, such as clarifications around group supervision rules and the restructuring of the SFCR, are not covered by the Treasury consultation but could perhaps be picked up by the PRA at this later stage. Thank you for listening. That bring us to the end of our podcast.