BRIEFING NOTE

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THE FUTURE OF UK INSURANCE REGULATION

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OVERVIEW

On 19 October HM Treasury published a call for evidence on possible future changes to the Solvency II regime in the UK. This was published alongside a first consultation on stage 2 of the Financial Services Future Regulatory Framework Review (the "**RFR Review**"). Together the two documents set out significant potential changes for the future regulation of insurers.

THE CALL FOR EVIDENCE

HM Treasury announced in June that it would be publishing a call for evidence on a review of Solvency II this autumn. The aim is to make changes to the current regime where these are deemed appropriate to reflect the particular characteristics of the UK insurance market.

The call for evidence covers specific topics but also invites feedback on any aspects of the prudential regulatory regime on which stakeholders may wish to comment. This is therefore an important opportunity for industry to influence the shape of the post-Brexit regime.

There is a clear theme throughout the call for evidence - also reflected in the HMT's consultation on the RFR Review, as discussed below - that HMT wants to explore ways in which the insurance sector can be encouraged, through changes in regulation, to support Government objectives such as sustainable investment and investment in infrastructure. In the introduction to the call for evidence HMT states that the review is underpinned by three objectives:

> *to spur a vibrant, innovative and internationally competitive insurance sector;*
>
> *to uphold high standards of policyholder protection and promote the safety and soundness of firms; and*
>
> *"to support insurance firms to provide long-term capital to underpin growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets", as well as investment consistent with the Government's climate change objectives.*

Only the second of these objectives is currently an objective of insurance regulation.

The desire to encourage investment by insurers in long-term assets to support sustainable investment and the "real economy" is consistent with the approach of the European Commission in its recent consultation on the Solvency II review. This is, however, in contrast to the approach of EIOPA. In its consultation on advice on the Solvency II review, EIOPA did

not propose any changes to the regime to encourage sustainable or long-term investment, and in some cases has proposed changes which would have the opposite effect (such as changes to the methodology for calculating the risk free rate).

Risk margin

The risk margin has been one of the most controversial aspects of the Solvency II in practice. HMT considers that the current methodology for calculating the risk margin may result in a risk margin that is excessively high in a low interest rate environment and excessively volatile. It notes that the impact of the risk margin on firm's balance sheets will become more significant over time as transitional provisions on technical provisions run off. This may mean insurers having to hold an unnecessarily large amount of resources which may impact on their ability to provide long-term capital to the economy or to offer a wide choice of products to customers. HMT also suggests that the impact of the risk margin has led to firms reinsuring longevity risk overseas, which increases the complexity of supervision.

EIOPA reviewed the risk margin as part of its consultation on the Solvency II review but concluded that the methodology for its calculation should not be changed.

HMT does not make any specific proposals for how the risk margin should be reformed; rather, it invites views on how this might be done to better adapt it to the UK insurance sector.

Matching adjustment

HMT is broadly supportive of the way in which the matching adjustment works but asks for views on:

- introducing more flexible eligibility requirements, to avoid the need for restructuring of assets
- any changes needed to the way in which the MA is calculated to ensure adequate protection for policyholders
- possible simplifications to the approval process
- how the MA could be amended to better reflect climate change-related risks and therefore contribute to sustainable investment.

SCR

The call for evidence asks for views on "the role that the determination of the SCR can play to support insurance firms to deliver long-term capital to support growth, including investments in infrastructure, venture capital and growth equity, and other long-term productive assets", as well as delivery of the Government's climate change objectives. As mentioned above, this is also an area of interest for the European Commission in its review of Solvency II. It is not clearly argued, however, that preferential treatment under the SCR for these types of asset is prudentially justified. There is potential for conflict between HMT and the regulators in this area.

HMT also suggests that a more flexible approach to calculation of the SCR is required, to allow firm specific characteristics to be reflected in the SCR without the need for firms to develop a full internal model. It is also concerned that the one year time horizon on which the SCR is based may not be well suited for long-dated risks such as those arising from climate change.

Branch capital requirements for foreign insurance firms

Currently, third country branch prudential requirements are determined by the Solvency II regime and include the calculation of a branch SCR and localisation of assets. HMT would like to increase the attractiveness of the UK as a destination for third country branches and therefore seeks views on prudential regulatory reforms which could be introduced for this purpose. It comments that branch requirements "may provide limited prudential benefit because the branch cannot fail independently of the insurance firm".

The logic of this approach is not entirely clear since the UK regulator has no oversight of the insurance firm in situations where the UK branch is a branch of a third country firm. It is also worth noting that, in a Brexit context, the PRA has been wary of approving third country branches with significant consumer insurance liabilities, instead proposing that such firms should subsidiarise. This does not seem entirely consistent with HMT's approach,

although HMT may be more interested in streamlining regulation of third country branches carrying out wholesale insurance business.

Other issues

HMT discusses more briefly a number of other issues where it would like feedback

"Mobilisation" of new insurance firms	HMT would like to introduce a "proportionate regime for new insurance firms", which might involve making changes to the requirements for new insurance firms which are expected to exceed thresholds for size in Solvency II within five years of authorisation. These firms are currently required to comply with the full rules from authorisation.
Calculation of the consolidated group SCR using multiple internal models	The way in which the internal model rules work at present can result in temporary increases in group SCR following M&A activity. HMT invites views on how the requirements for calculation of the consolidated group SCR following merger or acquisition could be improved.
Transitional Measure on Technical Provisions	HMT proposes that amendments could be made to the application of the TMTP to avoid the need for firms to maintain "legacy" models for its calculation.
Reporting requirements	HMT requests views on the possible removal of some reporting requirements and extension of existing reporting waivers.
Thresholds for Solvency II regulation	HMT asks views on the threshold for full Solvency II regulation. It is worth noting that EIOPA has proposed increasing the thresholds in its draft advice on the Solvency II review.
Risk free rates - transition from LIBOR	HMT asks for views on the factors which should be considered as part of the proposed transition of insurance firm discount curves from LIBOR to overnight indexed swap rates.

THE FINANCIAL SERVICES FUTURE REGULATORY FRAMEWORK REVIEW

The Financial Services Future Regulatory Framework (FRF) Review was launched in July 2019 with a call for evidence on regulatory coordination. Phase II of the review has now been launched with the publication on 19 October of a consultation setting out Government's proposed "blueprint" for future financial services regulation. A second consultation will follow in 2021 which will set out a final package of proposals. The current consultation is open until 19 January 2021.

The essence of HMT's proposals is that the structure originally set up under FSMA for financial services regulation should be reinstated once we have left the EU and full powers for making financial services legislation have therefore been returned to the UK. Amongst other things, this would mean that onshored financial services rules, which will initially be part of legislation following the end of the transition period, will in the main be incorporated into the PRA Rulebook and FCA Handbook. This will allow firms and their advisers to have access to a consolidated set of rules and ensure flexibility for regulatory requirements to be amended without the need for a Parliamentary process.

HMT does, however, propose some changes to the FSMA structure which are likely to be significant to how firms are regulated in the future, discussed below.

The proposed structure

They key aspects of HMT's proposed future structure are:

- As is the case now (other than in respect of directly applicable EU legislation), Government and Parliament will be responsible for setting the regulatory framework through legislation and the regulators will be responsible for setting the specific requirements for firms
- The majority of retained (onshored) EU provisions would therefore be transferred to regulator rulebooks
- Some retained EU legislation would remain on the statute book, for example with respect to equivalence arrangements
- New policy framework legislation covering key areas of regulation (at a high level) should be included in the new regime, allowing for more strategic policy input by Parliament – e.g. legislation stating the overall purpose and regulatory approach for the prudential regulation of insurance business. This is discussed further below
- New requirements may be needed to ensure transparency regarding the obligations of the regulators under the new policy legislation.

HMT illustrates its proposed approach with the example of the prudential regulation of insurance business. It suggests that the policy framework legislation might, among other things, require the PRA to be obliged to have regard to the following principles in exercising its regulatory functions:

(a) the role of insurance business in facilitating sustainable growth in the UK economy, including provision of sustainable finance and a supply of long-term investment to support UK economic growth;

(b) the socially important role that a viable and sustainable life insurance sector plays in retirement provision in the UK; and

(c) the desirability of innovation in insurance to help maintain the UK's leading position as a centre for excellence in insurance, reinsurance and alternative risk transfer.

The consultation document states that this is intended as an illustration only of how the proposed framework might work and is not at this stage intended to propose the direction of policy for prudential regulation of insurers. The degree of overlap between the illustrative principles above and the content of the call for evidence on Solvency II do, however, suggest that these are the kind of principles which HMT would wish to establish for insurance.

HMT goes on to invite comments on whether changes should be made to the regulators' statutory objectives. It put forwards the view that the statutory objectives should remain unchanged but that the use of activity-specific regulatory principles (as described above) could "bring about enhanced regulator focus on a broader range of public policy issues".

There is clearly a risk that the type of public policy principles which might form part of the new legislative framework could conflict with the regulators' statutory objectives and with what constitutes prudent supervision of insurers. A similar conflict may emerge within the EU reform of Solvency II reflecting the differing approaches of the European Commission and EIOPA.

Accountability

HMT discusses scrutiny and accountability at length but in general concludes that existing arrangements, including challenge to the regulators by the Parliamentary select committees, is broadly fit for purposes. It does suggest some changes, such as an increased use of open "remit" letters from HMT to the regulators. It also considers that HMT should be consulted at an earlier stage on regulatory policy developments, before public consultation, but stresses that this should not impinge on the independence of the regulators.

Public engagement

There is also discussion in the consultation of stakeholder engagement with the policy-making process, including:

- existing and future use of statutory panels representing the interests of consumers and industry practitioners
- more routine reviews of new policy changes after a period of implementation
- the establishment of a new external, independent committee to scrutinise regulators' proposals and the evidence on which they are based – HMT is, however, sceptical about the efficiency and desirability of this.

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