SLAUGHTER AND MAY/

CLIENT BRIEFING

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SOLVENCY UK
RESULTS OF THE SOLVENCY II REVIEW

HM Treasury has published its response document to the Solvency II consultation launched in April 2022. The headline points are that, in response to significant pushback and lobbying from insurers, it has decided:

- to proceed with the proposed changes to the risk margin;
- to introduce more flexible asset eligibility rules into the matching adjustment, allowing the use of assets with "highly predictable" (not just fixed) cashflows; and
- not to go ahead with proposed changes to the design and calibration of the fundamental spread component of the matching adjustment.

This will result overall in a package of reforms which is significantly more beneficial in terms of capital treatment for long-term insurers than the original proposals. The reforms are seen by the Government as part of delivering on the benefits of Brexit.

The response document has been welcomed by insurers, with a number commenting on the substantial amounts of capital which will be released for investment.

The risk margin

The Government intends to legislate to reform the risk margin in a way which will reduce it by 65% for long-term insurers and 30% for general insurers (under "recent economic conditions"), using a modified cost of capital methodology.

Some respondents to the consultation highlighted the fact that the expected capital release from these reforms would be muted initially by the application of the Transitional Measures on Technical Provisions as well as recent interest rate rises. Some uncertainty around the actual amount of capital which will be released by the reform of the risk margin therefore remains.

In the April consultation, the Treasury queried how it could be assured that released capital would not be distributed to shareholders and paid as remuneration. Respondents argued that the competitive market would incentivise insurers to use the capital to reduce product pricing and increase the size of the market. Whether or not this is the case, the Treasury has confirmed that the Government has no intention to restriction commercial decisions of insurers about capital allocation.

Assets with "highly predictable" cashflows

The ABI, among others, had lobbied for changes to the matching adjustment asset eligibility criteria to allow the inclusion of assets with "highly predictable cashflows". This will potentially promote investment in some categories of long-term productive assets as well as reducing the cost of asset restructuring.

The Government has decided to legislate to introduce this change, whilst also ensuring that the PRA has appropriate powers to manage additional risks which may arise. This may include applying a higher fundamental spread to assets without fixed cashflows, risk management requirements to ensure close cashflow matching is retained, and use of the prudent person principle to avoid concentration risk.

The fundamental spread

Respondents to the April consultation argued that the introduction of a credit risk premium derived from market spreads into the fundamental spread methodology would have strongly adverse impacts, including increasing

the best estimate, increasing balance sheet volatility, reducing incentives to provide annuities, and disincentivising investment in illiquid assets including infrastructure. Respondents also argued that the current methodology is already prudently calibrated, allowing for around 2.5 times the historical average rate of defaults.

The Government has therefore decided to legislate to maintain the existing fundamental spread methodology. It has decided, however, to increase the risk sensitivity of the current approach to allow distinctions to be made between different "notches" within ratings bands, e.g. AA+ and AA- as well as AA. This is a significant win for long-term insurers, particularly annuity writers, who would otherwise potentially have seen large reductions in their matching adjustment benefits.

In order to ensure that policyholders are adequately protected, the Treasury envisages additional measures being applied by the PRA to:

- require insurers to participate in regular stress testing;
- require a nominated senior manager to attest formally to the PRA whether or not the level of the fundamental spread reflects all retained risks on matching adjustment assets, and that the resulting matching adjustment reflects only "liquidity premium"; and
- allow the use of a fundamental spread "add-on" where necessary.

Other changes to the matching adjustment

Asset and liability eligibility

The reforms to asset and liability eligibility consulted on in April will also be taken forward. These involved broadening asset eligibility to include some assets where the issuer has the option to repay the asset early and assets with construction phases, broadening liability eligibility to include products which insure against morbidity risk and with-profits annuities and deferred annuities in with-profits funds, and removing the cap on sub-investment grade assets.

Matching adjustment approvals

Following consultation, the Government has decided to introduce two changes to the matching adjustment approval process:

- a new streamlined eligibility application process for less complex assets; and
- greater flexibility for the treatment of innovative assets.

Other reforms

The Government is going ahead with the other reforms consulted on, which relate to reporting requirements, the removal of branch capital requirements for foreign insurers, the introduction of a new mobilisation regime and increases in thresholds for the application of Solvency UK.

PRA feedback statement

The Bank of England has also published its feedback statement (FS1/22) to its April 2022 discussion paper on the risk margin and fundamental spread. The feedback statement summarises a range of responses received to the discussion paper – both supportive and otherwise of the PRA's proposals – but does not express the PRA's views on the merits of the responses received. The feedback statement rather blandly comments that "The PRA took into account the feedback received to DP2/22 in its discussions with HMT on proposed reforms. HMT has since announced its decisions on the Solvency II Review".

Legislation vs Rulebook

The response document clarifies which aspects of the reforms will be addressed in legislation and which will be included in the PRA Rulebook. The Treasury argues that it is providing insurers with the required regulatory certainty to make long-term productive investments by including some aspects of the new regime within legislation. The reforms which will be included in legislation are:

- the risk margin methodology;

- the fundamental spread methodology including the use of notched ratings; and
- the changes to the matching adjustment to allow inclusion of assets with highly predictable cashflows in the matching adjustment portfolio.

Other reforms will be implemented by the PRA, in some cases with additional powers being given to it by the Government.

Given that the Treasury's reforms are more generous to insurers than the PRA's proposals, the balance between legislation and regulation will probably be welcomed by industry. It does, however, reduce flexibility and arguably the independence of one of the key UK regulators. This is not an entirely surprising development given the additional powers given to the Treasury to direct the regulators in the Financial Services and Markets Bill.

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