Skadden

The Standard Formula
Solvency II for Insurers

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From Solvency II to Solvency UK: The UK Government Announces Its Post-Brexit Solvency II Reforms

Following the UK's departure from the European Union (Brexit) on December 31, 2020, the UK is now exercising its freedom to move away from key EU insurance prudential regulatory standards. These moves include liberalization of the EU Solvency II regime. The reforms are expected to release a considerable amount of regulatory capital from UK carriers' balance sheets. In the UK, the reformed Solvency II regime will be known as 'Solvency UK'.

The reforms are intended to boost innovation in the sector and assist the government's drive for investment, including in areas such as infrastructure and clean energy, as well as its 'levelling up' strategy. These developments can be seen as much political as regulatory, and it is no coincidence that the — at points difficult — discussions between the government and the Prudential Regulation Authority (PRA) were resolved in time for announcement on the same date as the chancellor of the Exchequer's significant 'Autumn Statement' speech of November 17, 2022.

The changes should also be seen in the context of the Financial Services and Markets Bill that is currently making its way through Parliament and that will:

- revoke most EU-derived financial services statute law as it applies in the UK, on the basis that this will instead be covered in PRA and Financial Conduct Authority (FCA) rules; and
- make important amendments to the detail of the framework of EU financial services law/regulation, including a new statutory objective for the PRA and FCA for competitiveness and growth, as well as an important new regulatory principle in support of 'net zero'.

The Solvency II Review

The Solvency II regime came into force in the UK on January 1, 2016, following many years of development. In June 2020, the government announced a review of the Solvency II framework in the UK and, with consultations launched in April 2022, proposed amendments across a range of areas, including:

Risk Margin: The risk margin is an additional reserve required to be maintained by an insurer above its best estimate of liabilities (BEL) and below its solvency capital requirement (SCR). The risk margin is currently calculated using a 'cost-of-capital' approach, which is set at 6% for both life and non-life firms. The government proposed in April 2022 to make deep cuts to the risk margin on the basis that it was larger than required to serve its purpose — *i.e.*, to provide a sufficient buffer above BEL such that if the carrier failed, there would be enough reserves to fund a transfer of insurance liabilities to another carrier.

Matching Adjustment (MA): The MA benefits insurers who hold long-term assets that match the cash flows of similarly long-term insurance liabilities, by allowing them to recognize upfront as capital part of as-yet-unearned future cashflows by means of illiquidity premium. The MA is a particularly material benefit for insurers writing annuity business, which are thereby incentivized to invest in a wide range of long-term, illiquid, fixed-interest assets.

When insurers hold assets matched to maturity they are less exposed to illiquidity risk, but retain credit and other residual risks. These retained risks are reflected by excluding from the MA an allowance for them, referred to as the 'fundamental spread'. The government proposed in April 2022 to make this spread more sensitive and tailored so that it better measures credit risk.

Final Government Proposals

On November 17, 2022, the government announced its final proposals:

Risk Margin: To be reduced, using a modified cost of capital method, by around:

- 65% for life carriers; and
- 30% for non-life carriers.

MA (Fundamental Spread): In a surprise result, which was enthusiastically welcomed by the industry, there will be no change to the design and calibration of the fundamental spread, save for an increase in risk sensitivity to allow a 'notched' approach within credit steps.

This will, however, be accompanied by enhanced governance requirements, *e.g.*, regular stress-testing exercises and attestation by nominated senior managers with formal regulatory responsibilities that residual credit risk is not incorporated within the claimed MA. In relation to the latter requirement, the industry will watch with interest how the PRA uses this regulatory tool — and for individual firms whether it is a way in which the regulator can strengthen reserves that are seen as being overly weakened by significant risk margin release. Likewise, the regulatory approach to internal models and SCR composition will be carefully watched for signs of greater conservatism.

The government will review whether the calibration of the fundamental spread remains appropriate in five years' time.

MA (Eligibility Criteria): Various steps have been taken to liberalize the MA eligibility criteria, including:

- the use of a requirement of 'highly predictable' (rather than necessarily 'fixed') cashflows for investments, although it is stated that in practice the government expects the vast majority of cashflows to remain fixed, which suggests a degree of compromise with the PRA;
- the broadening of eligibility for MA treatment, including:
  - flexibility to include *assets* with prepayment risk, such as callable bonds, or a construction phase;
  - a wider range of *liabilities* eligible for the MA, to include products that insure against morbidity risk such as income protection products; and
  - removal of the disproportionately severe treatment of assets with a rating below BBB.

MA (Other): Other MA reforms include:

- a more proportionate approach to MA breaches by carriers; and
- fast-tracked MA eligibility applications to include:
  - automatic approval for simple assets;
  - no approval requirements for minor changes to existing applications; and
  - a PRA-maintained register of approved assets and features.

Other Proposals:

These include:

- removal of the requirements for UK branches of foreign insurers to calculate branch capital requirements and hold local assets to cover them. This significant reform should benefit around 160 branches of foreign insurers immediately, as well as any other branches that establish in the UK in the future;
- an increase in the thresholds before the Solvency UK regime applies, up to £15 million in annual gross written premiums (triple the previous threshold) and to £50 million in gross technical provisions (double the previous threshold), which is aimed at nurturing insurtech businesses; and
- a new regime for start-up insurers, with adjusted entry requirements such as a lower capital floor, lower expectations for key personnel and governance structures, and exemptions from some reporting requirements, which is also aimed at developing the UK insurtech sector.

Possible Market Impacts

It is too soon to say with certainty what the impacts of the reforms will be as they are still being analyzed by the industry, advisers and commentators. Early speculation suggests the following potential market impacts:

- a degree of investment in infrastructure and clean energy, although perhaps more returns of value to shareholders than the government may have expected;
- a fresh boost for bulk annuity pension deals;
- a move away from reinsurance off-shoring of longevity risk, although perhaps less than might be expected;
- a flourishing of branches, favoring the London Market, possibly with unexpected regulatory arbitrage activity;
- innovative approaches to nonconventional assets;
- a new look at life securitization;
- new opportunities to rationalize the remaining with-profit funds; and
- new opportunities for insurtech, where it is hoped that a new way forward will be found to enable the successful creation of small innovative carriers.

Next Steps

The government will work with the PRA to enable the implementation of these reforms.