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From Solvency II to Solvency UK: The PRA Provides Further Details of Its Post-Brexit Solvency II Reforms

Overview

- As discussed in the November 2022 edition of *The Standard Formula*, following the UK's departure from the European Union on December 31, 2020, the UK is moving away from the EU's Solvency II regime, adapting Solvency II to the needs of the UK insurance market.
- As part of this process, on 29 June 2023, the UK's Prudential Regulation Authority (PRA) released Consultation Paper CP 12/23 (CP) setting out its proposals across a wide range of areas.
- The CP is clearly intended to deliver the UK government's reform agenda in areas such as the reduction of reporting burden, raising the application threshold of Solvency UK, and the "mobilisation" regime to encourage new insurance start-ups.
- It remains more circumspect in other areas, *e.g.*, around internal models (where it will move to a perhaps less certain principles-based system) and capital add-ons (where it will largely retain the Solvency II approach).
- That said, although the reforms are arguably just "second order" in magnitude when viewed individually, we expect them to have a significant cumulative impact across the UK market. This is expected in turn to confer a significant benefit for the UK market overall, both in terms of its operation and future attractiveness.
- This is a further example of the thoughtful yet relatively low-key approach to financial services reform that has now emerged in the UK. In the fullness of time, we would expect aspects of these reforms to be copied or emulated in Europe and elsewhere. To an extent, we are seeing a degree of nascent re-emergence of UK thought leadership in insurance prudential matters.

UK Government Measures

The EU's Solvency II regime came into force in the UK on 1 January 2016, following many years of development in which the UK was deeply involved. In June 2020, post-Brexit, the government announced a wide-ranging review of the Solvency II framework in the UK.

As part of the sweeping changes which have been proposed as a result of that review, the UK government in June 2023 released draft statutory instruments that will require the PRA to:

- Reduce the required "risk margin" (an additional reserve required to be maintained by an insurer above its best estimate of liabilities (BEL)) and below its solvency capital requirement (SCR), reducing the risk margin by around 65% for long-term life business and 30% for non-life business, and enabling a modified cost-of-capital approach to its calculation.
- Liberalise rules around the "matching adjustment" (MA) (a capital benefit to insurers that hold long-term assets that match the cash flows of similarly long-term insurance liabilities), in particular to:
  - Adopt a margin (referred to as the "fundamental spread') that is more sensitive and tailored to better measure credit risk.
  - Liberalise MA eligibility criteria for assets and liabilities.
  - Adopt a more proportionate approach to MA breaches by carriers, moving away from the current draconian consequences of breach.

PRA Consultation Paper

The CP covers a number "second order", yet highly important, reforms in areas where the UK government has not chosen to legislate directly (see above). These are as follows:

Transitional Measures on Technical Provisions (TMTP)

Currently 24 life insurance firms benefit from transitional measures to assist with the move from Solvency I (the precursor regime) to Solvency II (the current regime). TMTP allows the Solvency II regime to be phased in on a straight line basis over a 16-year period for liabilities that were in force when Solvency II was introduced on 1 January 2016.

These measures will be simplified with a view to a complete transition to Solvency UK by 2032. They will also benefit any firm that is granted TMTP permission in the future after accepting business that already benefits from TMTP (*e.g.*, by portfolio transfer or 100% reinsurance transactions).

In summary, the PRA reforms will:

- Introduce a simplified new default method for calculating TMTP (new TMTP method).
- Permit firms for which the new TMTP method would be inappropriate to continue to use the existing calculation approach with some modifications (legacy approach).
- Remove the financial resource requirement (FRR) test.
- Require all firms to amortise TMTP so that it decreases to zero by the end of the transitional period.
- Introduce an expectation that firms consider risks to meeting their solvency risk appetite in the medium term due to TMTP runoff.
- Allow firms to calculate TMTP at the final day of each reporting period, and remove the requirement for firms to seek the PRA's permission for a recalculation.
- Remove the expectation for TMTP calculations to have audit committee sign-off.
- Introduce a more consistent approach to TMTP methodology changes where business is transferred or 100% reinsured.
- Only grant any new permissions to apply TMTP in circumstances where a firm without an existing TMTP permission acquires or accepts business that already benefits from TMTP.
- Remove the ability for third-country branches to use TMTP (which is a corollary of the branch reforms referred to below).

Internal Models (IMs)

Under the proposals, the PRA will move away from a number of prescriptive requirements towards a smaller number of more principles-based requirements, *e.g.*, around modelling standards. The PRA will also introduce an alternative to outright rejection of an IM application, namely imposition of one or two new safeguards: a residual capital add-on tool, and model use requirements.

In summary, the PRA reforms will:

- Streamline the tests and standards required for new IMs and changes to IMs, while ensuring that appropriate internal modelling standards are maintained.
- Introduce more flexibility when the PRA grants new permissions and variations to enable firms to use IMs to calculate their SCR.
- Implement a range of IM approval safeguards that could be used to bring an IM that is not wholly compliant into compliance with the calibration standards and mitigate the risks arising from such non-compliance in all other circumstances.
- Introduce an ongoing IM review framework, building on the PRA's existing supervisory review processes.

Capital Add-Ons (CAOs)

As noted above, the PRA's proposed approach for setting capital add-ons (a regulatory tool to address a deviation in a firm's risk profile) broadly reflects the current Solvency II approach. The changes are intended to support the PRA's proposed new flexible approach to internal models (discussed above).

In summary, the PRA reforms will:

- Introduce a new type of CAO as a model permission safeguard, to support granting of an IM permission by the PRA, or variation of an existing permission in the case of a major model change application.
- Introduce a new approach for calculating a CAO for an IM significant risk profile deviation in exceptional circumstances, where the PRA has concerns that an IM is inadequate, or the SCR that the IM generates no longer appropriately reflects the firm's risk profile better than if the Standard Formula were used.
- Maintain the requirement for firms to disclose CAOs set by the PRA.
- Change the frequency with which the PRA reviews CAOs, from (at least) annually to on a regular basis.
- Introduce the publication of regular reports by the PRA, summarising its use of CAOs at an aggregate industry level.

Group SCR

The proposals will introduce more flexibility in the methods available to calculate the group SCR (whether via a group internal model or otherwise) for any group for which the PRA is group supervisor. The changes are intended to address certain situations where the existing calculation may lead to a higher group SCR than is necessary to cover group risks adequately.

In summary, the PRA reforms will:

- Temporarily allow a group to add the results of two or more different calculation approaches when calculating the consolidated group SCR (*e.g.*, IM and IM; or IM and Standard Formula).
- Allow a group to bring in its overseas sub-group's group SCR under Method 2.

Third Country Branches

The proposals will remove 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 130-plus branches of foreign insurers (except Swiss general insurers) immediately, as well as any other branches that seek authorisation to operate as a branch in the UK in the future.

Reporting and Disclosure

The proposals will overall reduce reporting requirements in the medium term. These proposals will benefit all insurers to a certain extent, in particular, through the proposed deletion of the Regular Supervisory Report (RSR), with more significant reductions proposed for insurance groups and UK branches of international insurers.

Solvency UK Thresholds

The proposals will increase the thresholds before the Solvency UK regime applies up to £15 million in annual gross written premiums (triple the current threshold) and to £50 million in gross technical provisions (double the current threshold), which is aimed at nurturing insurtech businesses.

Mobilisation

The proposals will involve a new regime for startup 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.

Initially, to qualify, firms must meet these criteria:

- A total net policy exposure of £50,000 or less.
- Policies that are short-term in duration (maximum policy term of two years).
- Policies are on a "claims-made" basis.
- Policies have no exposure to liability, large or long-tail risk.

Initial authorisation would be for a period up to 12 months, during which time firms are expected to focus on funding, recruitment, operationalising their business plan, infrastructure and risk and controls.

Next Steps

Responses to the issues outlined above are requested by 1 September 2023. The proposed implementation date for the majority of the reforms in this CP is 31 December 2024.

A second PRA consultation paper is planned for September 2023, which will set out the PRA's proposals for life insurers regarding investment flexibility and the MA within the UK government's framework discussed above.

The PRA also intends to consult in early 2024 on transferring the remaining firm-facing Solvency II requirements from retained EU law into the PRA Rulebook and other policy materials.