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Insurance developments: Solvency II reform and value reporting rules

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Solvency II, which came into effect in January 2016, has been controversial. European-headquartered insurers have criticised its capital requirements for being too onerous, especially in a low interest rate environment. Some claimed it threatened their overseas subsidiaries' competitiveness. The UK government has shared some of this scepticism and last October HM Treasury issued a call for evidence for a review of the Solvency II regime.

Solvency II has three pillars: capital requirements, governance and risk management, and reporting and disclosure. Pillar I set a solvency capital requirement (SCR), calibrated to ensure 99.5% confidence that a firm will meet its obligations in the coming year, and a lower minimum capital requirement (MCR) equalling about 85% confidence. Breaching SCR will lead to supervisory intervention; unless remedied quickly, breaking MCR will result in a firm's authorisation being lost.

Insurers are required to calculate their liabilities using a risk-free interest rate. Solvency II, art 77b lets firms, subject to prior regulatory approval, apply a "matching adjustment" to that rate when calculating the best estimate of a portfolio of eligible long-term obligations, such as annuities. This mechanism has been criticised because tight rules on eligibility for inclusion in a matching adjustment portfolio in effect block investment in some long-term assets.

The Treasury's call for evidence stated that the government and the Prudential Regulation Authority (PRA) still supported the fundamental principles and framework of Solvency II but there was scope for change. There were three objectives for this: to spur an innovative, internationally-competitive insurance sector, to maintain the protection of policyholders and to support insurers in providing long-term capital to underpin growth and for climate change objectives.

Two forces

There are two forces behind the Solvency II review, said Jeremy Irving, head of financial services at the law firm Browne Jacobson. One was political, the other was technical regulatory oversight concerns about the regime's impact on UK insurers and the unintended consequences of the matching adjustment, Irving said.

"The unintended consequence of detailed prescriptive rules [in Solvency II] has led to levels of reliance … on non-UK reinsurers in relation to managing the 'risk margin', which is of concern to the PRA; and on illiquid assets in relation to sustaining the matching adjustment," Irving said.

"Further, the 'present value' of steps taken in sustaining the matching adjustment have resulted in substantial dividend payments to investors, generating investment returns in insurance markets which are at the higher end [in the overall low-interest environment]."

The political forces behind the review are linked to ensuring a bright future for insurance post-Brexit. Chapter 8 of the call for evidence discussed the prospects of reforming capital requirements for foreign branches, talking about changes to enhance the UK's role as an insurance 'hub' and encourage overseas firms to establish UK branches. Reading between the lines, that sounds like making the rules less onerous.

In a speech to the Association of British Insurers this March, Sam Woods, the PRA's chief executive, sought to calm firms' expectations about the review. He outlined the closer supervisory role the PRA would have under the UK's proposed Future Regulatory Framework and said Solvency II reform would be more akin to tailoring it, particularly with regards to risk margins and life insurers, than slashing capital requirements.

"For us risk margin reform in isolation is not synonymous with discontent about the overall levels of capital in the system," Woods said. *"Some big numbers are being bandied about in lobbying for an overall weakening of prudential standards. I have to say that I think these numbers … are a little speculative."*

Another factor may also limit the scale of changes. The UK plans to tailor the Solvency II regime to suit its industry better, but it is unlikely to diverge sharply from the EU model so soon after Brexit. Indeed, last December's PRA policy statement PS24/20 almost exactly replicated European Insurance and Occupational Pensions Authority (EIOPA) technical information rules on reporting risk-free rates, matching adjustment spread calculations and portfolio volatility adjustments.

Solvency II is also under review by the EU. An EIOPA appraisal of its operation published in December 2020 concluded that the framework was working well but needed a few adjustments. These included tweaking the interest rate risk capital requirement to reflect recent low, even negative, rates and increasing proportionality exemptions for low-risk undertakings across the three pillars. No fundamental change by Brussels makes London branching down a radically different path less likely.

Widening gap?

"It's possible to envisage a situation in which such a gap might appear and possibly even widen over time," Irving said. *"However, it's clear that the UK played a key role in drafting Solvency II regulations and the PRA is actively considering maintaining alignment with EIOPA reporting standards. There is also a potential interest on the part of the insurance industry more broadly in maintaining alignment."*

Insurers' PRA regulatory burden should ease but the opposite applies to the FCA. It has long castigated the sector's poor value for general insurance customers and is mid-way through introducing new restrictions. A policy statement on pricing rules, consulted on in CP20/19, has been postponed until late May but PS20/9 has already introduced new product governance and value reporting rules; these have been partly in force since January, with the rest applying this summer.

SUP 16.27, coming into force on July 1, 2021, requires insurers which sell any of a range of general insurance products (listed in SUP annex 48R) to send the FCA an annual "value measures report" on such products. This is to include data on claim rejections and complaints, average pay-outs, etcetera. New product governance provision PROD 4.5 requires manufacturers of new and existing insurance products caught by SUP 16.27 to ensure that they offer fair value to customers in the target market.

Shining a light

The FCA intends to "shine a light on value" by publishing the SUP 16.27 reports and says it will use the data when supervising firms, especially with regards to product governance. That could be a powerful inducement for firms to improve products, especially as the FCA has become more interventionist about insurance matters. An example is its successful test case on business interruption policies, for which it recently issued guidance on proving the presence of COVID-19 to speed claim settlements.

The circumstances of the test case were so unusual it was easy to envisage it as a "one-off", but the FCA's continuing work on general insurance was a different matter.

"The FCA has been addressing the concept of customer value in general insurance regulation for several years," Irving said.

"Whether the FCA would wish to take further steps in relation to firms distributing products which are the subject of particular value reporting, or indeed expand the range of products subject to such reporting, seems likely to depend on its view of the initial data received."

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