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Client Alert

Commentary

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UK Solvency II Reform — Implications for M&A

The post-Brexit Solvency II reform aims for a more competitive and dynamic insurance sector in the UK.

The UK government's proposals to adapt the Solvency II regime more appropriately to the national insurance market have been in development for some time. The Prudential Regulation Authority's (PRA) recent consultation paper ("CP 12/23 – Review of Solvency II: Adapting to the UK insurance market") delivers proposals that will play a significant role in the overall reform. Whilst the PRA's proposals cover a number of technical areas aimed at reducing the overall cost and complexity for insurers, a number of proposals touch on aspects which are expected to have a positive practical effect in the context of UK insurance M&A. This Client Alert sets out the features of PRA's proposals which would be relevant in an acquisition context.

Transitional Measure on Technical Provisions

When the Solvency II regime was introduced in January 2016, insurers were entitled to seek approval for a transitional relief which would allow them to adapt Solvency II technical provisions for existing business. The transitional relief (the so-called "transitional measure on technical provisions" or TMTP) applies to Solvency I business in force over a 16-year period. The TMTP essentially phases in the risk margin on pre-2016 business and increases available capital during the transitional period. While TMTP has been widely used in the UK, particularly by life insurers, the current Solvency II requirements applicable for calculating and maintaining the TMTP are complex and impose a cost and resource burden for insurers. As all firms must amortise their TMTP on a straight-line basis to zero by 2032, they also need to ensure that they will be capital-ready for the end of the transitional period.

New Calculation Method

The proposals introduce a new method of calculating the TMTP to address two key concerns:

1. The current approach requires a calculation of technical provisions on a Solvency I and a Solvency II basis, which effectively requires firms and the PRA to maintain the resources necessary to perform the Solvency I calculation, which for some insurers may include Solvency I models.

2. Under Solvency I, insurers applied a broad variety of methodologies for calculating their technical provisions; this inconsistency is reflected in the calculation of TMTP under Solvency II.

Under the new proposal, the requirement to report calculations under Solvency I will be dropped and the TMTP will be produced exclusively by looking at Solvency II calculations for the pre-2016 business. From an M&A perspective, this should simplify the actuarial diligence as well as reducing the ongoing cost and burden of maintaining the TMTP. The new method will become the default; however, firms would be entitled to seek permission to continue to calculate the TMTP under the existing approach if the new method will have a material impact on the actual amount of TMTP available or otherwise cause material operational issues. The introduction of the new TMTP method may result in a one-off capital benefit for some insurers.

FRR Test

The PRA further addresses the above concerns by proposing to remove the current cap on TMTP. The cap requires that an insurer's financial resources requirement (broadly speaking the sum of its technical provisions, other liabilities and capital requirements) is no less under Solvency II than it would have been for that insurer under Solvency I (the FRR test). Under the existing regime, the FRR test also requires firms to carry out calculations using their legacy Solvency I models, which leads to inconsistency. The calculation applies to all of the firm's business, not just the business written pre-2016, making it complex to operate. (PRA estimates that removing the FRR test would have resulted in a capital benefit of £990 million to those restricted by the test as at year-end 2022).

Recalculation

Insurers would be allowed to recalculate their TMTP on the final day of each reporting period. Currently they must wait until certain conditions are met and then seek a further PRA approval for the recalculation. This proposal is intended to align the TMTP more closely with the underlying business risk profile at relevant reporting dates and to reduce burden for both firms and for the PRA.

Business Transfers and Reinsurance Transactions

PRA has proposed amendments to the TMTP regime which would apply specifically in the case of insurance business transfers and 100% reinsurance transactions. These are common features of the insurance M&A landscape. Under the proposals, new TMTP method insurers would be required to adjust their TMTP calculation within two months of any "transfer event" to account for the change in their liabilities, although no additional TMTP may be generated between the two parties. Legacy TMTP firms will also be entitled to apply to PRA for permission to recalculate TMTP following a transfer event, again subject to no additional TMTP being generated overall.

The current Solvency II rules pose additional challenges to an insurer who acquires a business of a different type to its own Solvency I business, due to the inconsistent methodologies which likely applied during the Solvency I era. Full quota share reinsurance transactions are often used in an M&A context to move the economic risk in an insurance portfolio prior to an insurance business transfer. Since those transactions have a similar economic effect to a transfer, they will be included as a transfer event under PRA's proposals. A quota share reinsurance below 100% would not usually be considered a transfer event; therefore, a reduction to the risk transferred under a 100% quota share reinsurance agreement will be regarded as a retransfer of the full economic liabilities to the cedent and hence a transfer event. Similarly, any termination or expiry of a 100% quota share reinsurance contract will be captured as a transfer event.

Implementation

The PRA proposes a new limit on insurers' ability to apply for approval to use the TMTP, since by now, those who require it ought to have already obtained the necessary approval. Consequently, the cut-off date would be 31 December 2024, on which date the new proposals would be implemented. However, the PRA also proposes to allow firms without an existing TMTP permission to apply for one if they acquire a business, either through an insurance business transfer or 100% quota share reinsurance, if that business benefits from TMTP on the balance sheet of the transferor or cedent. This exception would benefit those acquiring books of business in an M&A scenario. For insurers considering a disposal of a legacy portfolio for which TMTP approval has not already been sought, there is still some time to consider seeking a TMTP permission before the proposals are implemented.

Group Solvency Capital Requirement

The PRA proposals include greater flexibility for insurance groups in the methods that they can use to calculate their group solvency capital requirement (GSCR). The proposals recognise that in some cases, the existing calculation may result in a GSCR that is higher than necessary to cover group risks. Underlying these proposals is a desire to reduce the regulatory burden and overheads for insurance groups which are growing through M&A, aligned with the government's aim of supporting international competitiveness and growth of the UK economy.

Calculation methods

The current Solvency II regime allows two methods for calculating the GSCR:

- Method 1 calculates the GSCR using a consolidated balance sheets for all relevant members of the insurance group. This consolidation recognises the lack of correlation between different risks in a larger and more geographically and economically diverse group (so-called "diversification benefits").

- Method 2 applies a deduction and aggregation approach under which the solo capital requirements for the relevant entities in the group are added together to provide the GSCR. Method 2 does not provide for diversification benefits between different entities to be recognised and may result in the double counting of risks in the solo entity SCRs and in the calculation of the GSCR. However, the loss of diversification benefits can be a price worth paying in order to bring foreign subsidiaries in equivalent jurisdictions onto the group balance sheet using local rules (rather than on a Solvency II basis).

Implications on M&A Transactions

Another issue with the current rules for calculating GSCR arises in an M&A context, i.e., if an insurance group acquires an insurer or another insurance group which has its own internal model or group internal model in place, which will be specific to the target. Currently, the regime offers little flexibility to accommodate this situation. However, PRA proposes to allow a combination of calculation approaches to provide greater flexibility for insurance groups in acquisition mode.

Similarly, the current rules do not allow a UK insurance group using Method 2 to add an overseas subgroup to the calculation of its GSCR. Any diversification benefits between the entities within that subgroup are therefore lost on acquisition. PRA proposes to allow the overseas subgroup's GSCR to be included under Method 2 for the insurance group, provided that subgroup is subject to equivalent group supervision. Naturally, the PRA seeks to avoid transferring UK risks to an overseas subgroup once this change has taken place.

Conclusion

Despite showing initial conservatism when engaging with the government's proposed changes to the Solvency II regime, the PRA is now working towards delivering the benefits to the UK market which the government is seeking as part of its drive towards greater competition and investment in the UK insurance market. Acquiring insurance businesses subject to "Solvency UK" will still require detailed diligence, but the reduction in complexity and overheads now proposed by the PRA, together with some welcome flexibilities which apply in an M&A context, will hopefully encourage further consolidation in the UK insurance sector.

The next consultation paper from the PRA is expected during September 2023.

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