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THE TREASURY COMMITTEE'S REPORT ON EU INSURANCE REGULATION

WHAT'S NEXT FOR THE PRA AND THE UK INSURANCE INDUSTRY?

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In September 2016, the treasury committee of the House of Commons (the Committee) launched an inquiry into EU insurance regulation and to supplement its work on the relationship that the UK might seek to have with the EU following Brexit.

Following the publication of various submissions and further evidence from a variety of market participants and interested parties, we published a note in March of this year, discussing the key issues that had begun to arise from the previous Committee's investigations.

The current Committee has now produced its report, drawing on the evidence gathered under the previous Parliament. This note highlights the outcome of the Committee's review and what this might mean for the PRA going forward.

ISSUES RAISED IN OUR PREVIOUS NOTE

In our previous note we highlighted some of the key issues raised by market participants in relation to the operation of Solvency II and the PRA's application of it. In particular we noted the rarity of such a transparent exchange of views and the PRA's acknowledgement of Solvency II's shortfalls.

THE COMMITTEE'S RECOMMENDATIONS

Interaction between the industry and the PRA

As discussed in our previous note, one of the key themes to come out from the evidence submitted was the industry's dissatisfaction towards the PRA's interpretation and application of Solvency II. The Committee in its report concurred and now asks the PRA to look again at those issues raised by, among others, the ABI in the context of Brexit and the freedom it may provide.

This recommendation reflects a key theme in the Committee's report, that there is a distinct lack of dialogue between the PRA and industry participants and a "disconcerting level" of disconnect between the two's views.

The Risk Margin

Whilst the Committee remarked on both the insurance industry's and the PRA's combined dissatisfaction with the risk margin calculation, it also noted the lack of conformity on the ways in which this could be remedied. As we have highlighted in our previous note, the PRA considers that the transitional measure on technical provisions can assist firms to overcome difficulties with the risk margin calculation. One particular concern of the Committee was the growing trend for business to be reinsured overseas to address the gradual reduction of the benefit of the transitional measure. The Committee now asks the PRA for an update on the best approach for improving the risk margin calibration, irrespective of the EU Commission's own review process. Notably, a recent report of EIOPA has not recommended changes to the risk margin at EU level, despite submissions from regulators, including the PRA, emphasising the need for changes. EIOPA instead hopes to publish a second set of advice in February 2018 which is expected to address, among other things, the risk margin.

Matching Adjustment

The Committee in their report gave its view that the significant costs and time involved in qualifying for Matching Adjustment was unsatisfactory, with such costs capable of being indirectly passed to consumers or reducing the choice of products for consumers. Despite the justifications put forward by both Sam Woods and the PRA as discussed in our previous note, the Committee has asked the PRA to conduct a fundamental review of the Matching Adjustment and its eligibility criteria to create a more principles based approach, working together with the industry.

In response to both the ABI's and the Committee's comments, the PRA has very recently published a consultation paper providing additional guidance on matters such as asset eligibility, the restructuring of assets for Matching Adjustment purposes, trading in the Matching Adjustment portfolio and the consequences of breaches of Matching Adjustment requirements. It remains to be seen whether the proposals put forward by the PRA in the consultation paper will go far enough to address the concerns of the Committee.

Remit, objectives and skills of the PRA

The Committee agreed with the majority of the industry that the competition objective of the PRA should carry as much weight as the solvency objective, and they have asked that HM Treasury immediately review the PRA's approach to competition. They have also asked that the PRA assess its skills in effectively supervising the insurance industry, in particular its insurance directorate.

Procyclicality and Regulatory Forbearance

The Committee remarked that any post-Brexit model should accommodate regulatory forbearance, or the ability for temporary rule amendments in a severe financial crisis, where it can be shown to improve macroeconomic stability and improve consumer outcomes.

Proportionality

The evidence received stressed the tension between the detailed rule based approach of Solvency II and the PRA's ability to provide proportional regulation. The report highlights in particular the difficulties surrounding the review of internal models used in calculating an insurer's capital requirements and the additional reporting requirements imposed by the PRA. The PRA has been tasked with reviewing its approach to proportionality.

Volatility Adjustment

The Committee found the volatility adjustment measure to be "fairly crude" and noted the issues connected with it requiring approval from the PRA. It also considered whether firms should be allowed to use a dynamic interpretation of the volatility adjustment whereby it may vary in assumed stressed conditions.

Transitional Measure on Technical Provisions

The Committee remarked on the limited scope of the PRA's consultation on the transitional measure on technical provisions and indicated that broader issues need to be addressed. In particular, it noted that the PRA has interpreted the transitional measure on technical provisions to be only available on business written prior to 1 January 2016, and it has to run-off on a linear basis to 2032. The Committee wondered whether this interpretation was too narrow, and whether another approach could be justified.

Contract Boundaries

The Committee highlighted the legalistic approach of determining contract boundaries where an insurance contract includes options for extension at an additional premium. Specifically, it said that the approach ignores the accepted accounting convention of matching income to costs.

One Year Value at risk

The Committee noted that there was disagreement about the use of the one year time horizon when calculating an insurer's solvency capital requirement (SCR). The disagreement centred upon the disparity between the one year time value at risk and the potential length of an insurer's liabilities, which would extend well beyond one year.

NEXT STEPS FOR THE PRA

The Committee has highlighted that in light of its report it wishes to see development of a clearly agreed strategy, which provides a roadmap for:

- what changes to insurance regulations can be implemented now, unilaterally, without a change to the Solvency II directive;
- what steps the PRA would like to see taken to refine the directive or its applicability to a post-Brexit UK;
- what action can be taken post-Brexit to foster innovation, competition and competitiveness; and
- how UK insurance regulation will harmonise with international capital standards and emerging accounting standards.

The Committee has specifically asked the PRA to produce a report containing commentary on the extent of any change or substantive progress on these issues by 31 March 2018.

The Committee summarised its recommendations by asking the PRA, working closely with the industry, to:

- provide a solution for the risk margin to improve its calibration;
- develop proposals for the introduction of forbearance at the national level to deal with procyclicality;
- develop proposals for the Matching Adjustment and Volatility Adjustment allowing more flexibility and a more principles-based approach;
- agree with the industry on an approach to illiquid assets;
- set out proposals reducing the amount of data required from firms that is proportionate and necessary;
- develop rules for contract boundaries which reflect economic substance rather than legal form;
- develop proposals for the simplification of calculating and gaining approval for the transitional measure on technical provisions;
- provide a view where it may be possible to align better UK regulation post Brexit with the International Financial Reporting Standard 17;

- develop proposals to remove limitations in the standard formula for both existing and new entrants to the insurance market;
- develop proposals for improving the sophistication and usefulness of internal models, and greater flexibility in amending them; and
- develop a solution for firms who have written insurance policies from another EEA jurisdiction into the UK, or from the UK into another EEA jurisdiction, and which, post Brexit, may no longer be able to rely on passporting rights in order to perform those policies.

CONCLUSION

It has been interesting to see that the views of the current Committee on Solvency II have to a large extent mirrored those of the insurance industry. However, the industry must await the PRA's report next year to see how and to what extent the Committee's recommendations will be followed.

In its discussion of Brexit the Committee urges the government to consider a bespoke reciprocal agreement and to address the urgent issue of post-Brexit cross-border insurance contracts. It states that in the interim the PRA should adopt pragmatic approaches, such as granting provisional recognition to EU branches prior to Brexit. Such a recommendation mirrors the sentiment across this report: that the PRA must act with increased autonomy to both protect and promote the insurance industry.