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THE PRA RESPONSE TO THE TREASURY COMMITTEE'S INQUIRY INTO SOLVENCY II

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In October 2017, the Treasury Committee of the House of Commons (the Committee) published its report on the Solvency II Directive and the upcoming issues generated by Brexit for the UK insurance industry. As part of its report, the Committee made a series of recommendations to the PRA, which we highlighted in our previous note in November of last year. The Committee asked the PRA to produce a report containing commentary on any substantive progress made on the recommendations by 31 March 2018.

The PRA has now published its report, parts 3 and 4 of which detail its response on the issues raised by the Committee's report. In addition, Sam Woods, Deputy Governor of the PRA, has recently delivered a speech addressing certain elements of the PRA's response. This note explains the key points raised by the PRA and the likely consequences for the industry. The PRA also took the opportunity to explain progress made on certain recommendations made by the Association of British Insurers, which we have not addressed in this note.

THE PRA'S RESPONSE TO THE COMMITTEE'S RECOMMENDATIONS

Competition and industry engagement

The Committee asked the PRA to review its approach to competition. In particular, the Committee recommended that the PRA's secondary competition objective (the "SCO") should be elevated to primary status, with equal importance as its general prudential objective.

While the PRA reemphasised its continuing commitment to promoting effective competition in its response, it stated that it is not in favour of the Committee's recommendation. The PRA considers that a primary competition objective would create "significant overlaps with the activities of the existing competition regulators", such as the Financial Conduct Authority and the Competition Markets Authority. Noting the wide remit of the powers given to and competition assessments undertaken by those regulators, the PRA considers that the SCO currently gives it a distinct role in the industry that may become difficult to define if the PRA were required to pursue competition as an objective in its own right.

The PRA's response also pointed to a link between prudential regulation and effective competition. Sam Woods expressed much the same in his speech, stating that prudential regulation is "integral to competition" and prevents imprudently run firms from using uncompetitive practices to drive out better-managed firms. This is a running theme within the PRA's response to the competition issue – that its general prudential objective and the SCO are mutually complementary, but that the SCO should not be allowed to become a freestanding objective operating separately to the prudential one. It was suggested in the PRA's report that this would detract from its main objective and "dilute focus" within the PRA.

Separately, the PRA now plans to enhance industry engagement. It will do this by increasing PRA presence at industry conferences and launching an insurance sub-committee to the current Practitioner Panel, among other initiatives.

A further dimension that was not fully addressed is the impact of prudential regulation on competition as between UK insurers regulated by the PRA and firms which subject to prudential regulation by regulators in other jurisdictions. On one view, any additional requirement that the PRA imposes in its interpretation of Solvency II potentially puts UK insurers at a disadvantage as compared to EU competitors whose regulators do not impose the additional requirement. On the other hand, the PRA might respond that it has granted by far the most internal model and matching adjustment approvals of any EU regulator, suggesting a greater willingness to use the discretions available to it to the advantage of UK insurers – although some insurers might argue that the use of the discretions is only necessary because the Solvency II rules themselves are inappropriately designed for UK insurers.

The Risk Margin

The PRA was asked by the Committee to provide a solution for improving the calibration of the Risk Margin under Solvency II. In our previous notes here and here we examined some of the issues and concerns that have been raised by the industry and the Committee in relation to how the Risk Margin operates. In its response, the PRA agreed that the Risk Margin under Solvency II is not working as intended and that it supports improvements in this area. However, it has not put forward a solution. Instead, the PRA is "actively looking at further steps" and will "provide a fuller update in due course".

Matching Adjustment (MA)

The Committee asked the PRA to carry out a fundamental review of the Matching Adjustment, in order to create a more principles-based approach. The PRA published a consultation paper on 25 October 2017 with an aim to give further clarity on the MA requirements.

In its response to the Committee, the PRA stated that the MA requirements in Solvency II provide "little scope for flexibility" and a regime that avoids firms having to restructure assets in order to secure the benefit of MA would be preferred. However, it concluded that the PRA does not have unilateral power to change the MA assessment criteria towards a more principles-based approach. That being said, the PRA has put forward further proposals on how firms can demonstrate that assets are eligible for the MA as part of its consultation on the MA. The PRA has issued updated guidance, particularly in relation to the consequences of breaches of MA requirements and determining when MA approvals need to be updated. Other areas where additional guidance has been published for firms include restructuring assets, managing portfolios and applying for approvals in relation to the MA.

It will be interesting to see if these proposals go far enough to address the Committee's concerns. As with any new guidance, there is always a risk that what appears, from one perspective, to be clarification aimed at removing uncertainty may, from another perspective, appear to impose additional requirements that did not previously apply.

Volatility Adjustment (VA) and Dynamic Volatility Adjustment (DVA)

The UK is one of a number of EU Countries that have exercised an option to require prior supervisory approval for use of the Volatility Adjustment. This requirement for the PRA's prior supervisory approval was one of the issues highlighted by the industry in the Committee's report. In its response, the PRA noted that the VA is already easier to access in comparison to the MA, given that the PRA has used a principles-based approach and the VA is not subject to the same strict eligibility criteria. The PRA is of the view that if applied "without appropriate control", use of the VA could create risks, especially in relation to insurers with more unpredictable liabilities.

A DVA is an approach that would allow firms to anticipate future increases in the VA when modelling their capital position. As to the use of a DVA, the PRA considers that a DVA would have the effect of simply reducing capital that firms hold against credit spread risk, instead of reducing volatility. The PRA in its response did not confirm whether it would allow firms to use a DVA, but rather stated that the PRA is reviewing its approach in the light of EIOPA's recently published opinion which addresses the supervisory assessment of a DVA. In the light of this, the

PRA has said that it will provide a fuller update on the use of a DVA to the Committee in due course.

Reporting requirements – proportionality

The PRA was asked to reduce the amount of reporting required from insurance firms, having due regard to proportionality. The PRA's response on this point focused on the source of reporting requirements – the response states that "the majority (80-90%) of reporting to the PRA" was developed by EIOPA and not within the PRA's power to change. The PRA has outlined reporting reform proposals in its consultation paper published on 11 January 2018, which if implemented would reduce, in the PRA's view, the reporting which is under the PRA's control by up to a half and lead to the automatic granting of quarterly reporting waivers to smaller firms. Nevertheless, given that the PRA has said the majority of reporting obligations are not under its remit, it remains to be seen whether the reform proposals will have a significant effect.

Transitional Measure on Technical Provisions (TMTP)

In its report, the Committee remarked on the PRA's narrow interpretation of the application of TMTP and asked that the PRA simplify the calculation of and approval process for TMTP. The PRA did not address the narrow interpretation of TMTP in its response (i.e. that the TMTP can only be applied to business written prior to 1 January 2016), focusing instead on the latter issue. The PRA recognised that the current operation of TMTP is burdensome for firms, and the PRA is "continuing to assess the feasibility of simplifying the recalculation of transitionals", but did not detail any proposals for such simplification. The PRA will consult on proposed changes in 2018.

Internal models

The Committee asked the PRA to maximise proportionality for the approval of internal models and to simplify the approval process for changes to internal models. In its response, the PRA pointed to its current consultation on proposals on the model change process. Among other proposals, the PRA highlighted plans to allow accumulated "minor" model changes to be reset to zero annually. This would remove the current requirement for firms to apply for a "major" model change arising from accumulated "minor" changes, unless the number of "minor" changes exceeds a defined threshold within 12 months. The PRA noted that it keeps its internal model process under review to avoid imposing an excessive burden on firms, but also that it has to respect the constraints of the Solvency II regime.

Post-Brexit: contractual continuity and regulation

In its report, the Committee asked the PRA to develop a solution for firms which may no longer be able to rely on passporting rights to manage existing insurance policies post Brexit. The PRA has not put forward a solution in its response, rather focusing on the Financial Policy Committee's continuing assessment of the risks of disruption to the industry due to Brexit, and the PRA's own consultation paper on its proposed approach regarding insurance branches of third country insurers. The PRA noted that some UK insurance companies are planning to transfer insurance contracts to legal entities located in the EEA via the Part VII procedure, and that EEA insurers would need to ensure that business activities in the UK are performed by UK entities with the appropriate authorisations, but did not advance its own solution to the issue of post-Brexit contractual continuity.

It is notable that the government separately stated in a written statement to Parliament on 20 December 2017 that, if necessary, it will legislate to ensure that as a matter of UK law existing contractual obligations, such as insurance contracts, can continue to be met by EEA insurers following Brexit.

Areas not under the remit of the PRA: procyclicality and regulatory forbearance, contract boundaries and the Solvency II standard formula

The PRA expressed in its response that it is unable to make changes or put forward solutions in relation to certain issues, due to constraints under Solvency II and the lack of a clear view of the future regulatory landscape post-Brexit.

The Committee suggested in its report that the current approach to determining contract boundaries is too legalistic. The PRA responded that Solvency II prescribes the definition of contract boundaries and so there is no scope for changes. The PRA also recognised that there are limitations in the standard formula under Solvency II, but similarly concluded that Solvency II is prescriptive on this point. The European Commission is undertaking a review of the standard formula and the PRA has said that it would consider its position further once it has concluded.

Other issues, such as proposals for developing regulatory forbearance at the national level to deal with procyclicality, were mentioned in the PRA's response but were not accepted by the PRA. These issues were deemed to be more suitable for consideration once the UK's future relationship with the EU becomes clearer.

WHAT'S NEXT AFTER THE PRA'S RESPONSE?

The PRA's report does not show much progress on the issues raised by the Treasury Committee last year. Despite stating in its report that there "is a lot of common ground between the Committee, the industry and the PRA", many of the PRA's replies to individual recommendations and issues seem to culminate in one of a few responses – "we can't", "we tried" or "we'll have to wait and see". To a certain extent it would be unfair to criticise the PRA for its response, especially when the PRA have shown a willingness to demonstrate flexibility when matters are within its control (such as in its ability to help firms restructure their assets so that they are eligible for the Matching Adjustment, something which strictly speaking Solvency II is silent on).

The PRA is keen to show that it is supportive of improvements to insurance regulation, and has pointed to several of its consultations and reform proposals as evidence of its willingness to further engage with the industry. Unfortunately, until there is clarity on the terms of the UK's withdrawal from the EU, it seems reasonable that the PRA has taken the approach that it has in its response to the Committee. We will now have to wait to see how its approach develops prior to Brexit day and how the Committee will respond to the PRA.