The Future of UK Prudential Supervision

22 June 2020

This update provides an insight into the future of UK prudential supervision of (re)insurers, informed by a speech to the Association of British Insurers ("ABI"), titled "*Life beyond Solvency II: A view from the top of the regulator*" and delivered by executive director for the insurance sector, Charlotte Gerken.

BREXIT

In terms of Brexit-related prudential reform, the view of the Prudential Regulation Authority ("PRA") is that "*revolution is less likely than evolution*", not least because Solvency II is based on the same principles as the preceding UK regime. Any such reform in the UK, the EU or globally through the International Association of Insurance Supervisors is likely to be on a longer timetable due to the coronavirus.

REVIEW OF SOLVENCY II

The PRA recognises that certain elements of the Solvency II regime do not fit well with the specificities of the UK market. As such, the regulator has set out its key priorities in reviewing the regime, including those set out below.

The Risk Margin

The PRA is committed to reform of the Risk Margin and recognises the industry sentiment that this should be its first priority in reviewing Solvency II. The Risk Margin is one element used in calculating an insurer's technical provisions and is designed to ensure that they are at least equivalent to the potential cost of transferring insurance obligations to a third party should an insurer fail.

The PRA notes that, as currently calibrated, the Risk Margin is too large and too sensitive to interest rate fluctuations, particularly in relation to business subject to long-term guarantees such as annuities. The UK's prudential insurance regulator also notes that this has had the unintended consequence of driving longevity risk on new business offshore, especially to Bermuda to take advantage of that jurisdiction's Solvency II equivalency but more flexible capital rules.

The Matching Adjustment

The PRA is looking to reduce the prudential risks, complexity and operational burdens associated with the Matching Adjustment. Under Solvency II, insurers are required to calculate the value of their liabilities using a risk-free interest rate; the Matching Adjustment is an upward adjustment to the risk-free rate where insurers hold certain long-term assets with cash flows that match the liabilities.

One issue with the Matching Adjustment has been that it was designed for liquid, traded assets with fixed cash-flows. This has meant that its suitability is more difficult to assess in relation to assets that are illiquid or have risks to receipt of cash-flows. Further, the level of benefit a firm can draw from the Matching Adjustment is driven by the credit rating assigned to the issuing firm's assets, so there is prudential risk in modelling the behaviour of long-dated, illiquid assets.

Nonetheless, the PRA remains supportive of the concept of the Matching Adjustment on the basis that it incentivises insurers to invest in assets that are suitable to their particular business models.

Reporting Requirements

The PRA is ready to consider "*short-term suspensions in some aspects of [Solvency II and PRA-owned] reporting*". Short-term options being contemplated include the expansion of quarterly reporting waivers and some group reporting. Longer-term changes to the reporting package will be made with full and proper consultation with stakeholders.

In response to the coronavirus, the PRA has already implemented changes to its reporting requirements to allow delays to various aspects of Solvency II and PRA-owned reporting, and this flexibility has been well-received by firms.

COUNTERCYCLICAL BUFFERS AND INTERNAL MODELS

The PRA is contemplating increased supervision "*through a cycle*", such as requiring UK insurers to hold more capital in benign times that could be released during a market downturn. One lesson learned from the coronavirus period is that buffers held in excess of the solvency capital requirement ("SCR"), which is the total amount of capital that EU insurers are required to hold, are determined by each insurer's risk appetite for breaching the SCR, making capital less likely to be applied in a stress situation.

Regarding Internal Models, the PRA has hinted at increased supervisory involvement in the calibration of the overall capital requirement and a decreased emphasis on assessment against tests and standards.

CLIMATE CHANGE

Addressing climate change is one of the Bank of England's strategic priorities. The coronavirus has disrupted the PRA's ongoing climate change stress-testing, leading it to withhold the results of an ongoing consultation exercise with firms. Nonetheless, the PRA has revealed certain findings:

- Firms are struggling to identify and allocate their investments to sectors identified as having different levels of vulnerability to climate change.
- Current model designs constrain scenario outcomes.
- Climate risk management is not yet embedded; firms' responses to the questionnaire in Climate Supervisory Statement 3/19 suggest higher adherence than indicated by the stress test.
- The PRA notes that, in addition to appointing a Senior Manager responsible for climate risks, "[b]oards collectively need to understand the impact of climate change on their firm's business strategy". Also, scenario analysis remains a key tool for insurers when taking account of climate risks on balance sheets and in formulating business strategies.

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Please do not hesitate to contact us with any questions.

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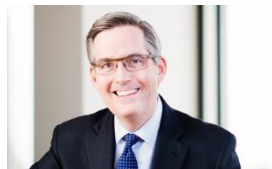
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