



Rt Hon. Nicky Morgan MP  
Chair of the Treasury Committee  
House of Commons  
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3 January 2018

Dear Ms Morgan,

### **Interim response to the Treasury Select Committee's report on Solvency II**

I thank the Committee for its report "The Solvency II Directive and its Impact on the UK Insurance Industry". We are considering the recommendations carefully and will provide a full progress report, as requested, before the end of March 2018. In the meantime, I thought it might be useful to the Committee for me to set out my preliminary views in response. Before turning to the detail (provided in Annex 1), I would like to make three broader observations.

First, Solvency II is based, in many respects, on the principles underlying the previous UK Individual Capital Adequacy Standards (ICAS) regime<sup>1</sup>. The two regimes have many similarities: market valuation of assets and liabilities; the concept of an 'illiquidity premium'<sup>2</sup> to incentivise firms to invest in long-dated illiquid assets; risk-based capital requirements; use of internal models; and requirements for good governance and strong risk management.

But that said, I do think there is a lot of common ground between the Committee, the industry and the PRA about aspects of Solvency II which do not work well. The most glaring of these is the 'Risk Margin', on which we are actively looking at further steps we might take. But there are many other areas (for instance in relation to the Matching Adjustment) where the common source of concern for regulators and firms alike is a degree of over-specification in the Directive. For these areas, the question is how we can improve things while delivering our statutory objectives and remaining within the constraints of the law. We are making progress on this, and we are already in the process of bringing forward policy proposals on many of the issues raised by the Committee (more detail is provided in Annex 1).

Second, as the Committee has highlighted, it is important that we have regard to the broader international context of insurance regulation when considering any changes to domestic rules. The PRA is actively involved in the work of the International Association of Insurance Supervisors (IAIS) and our Executive Director for Prudential Policy, Vicky Saporta, currently chairs the IAIS Executive Committee. The IAIS leads the development of the insurance capital standard for internationally active insurance groups. The IAIS insurance core principles apply to insurance supervision in all jurisdictions and set out a globally accepted framework for the supervision of the insurance sector. The ultimate aim for these standards is to be incorporated into existing national frameworks, analogous to the role of the global Basel standards for banks.

Third, the Committee has raised the question of the status of the PRA's competition objective. Parliament has given the PRA two primary objectives: a general objective to promote the safety and soundness of the firms it regulates, and an objective specific to insurance firms, to contribute to securing an appropriate degree of protection for policyholders. In 2014 the PRA was given a secondary objective to facilitate effective competition in the markets for services provided by PRA-authorized firms. The PRA must also

<sup>1</sup> As noted in written evidence to the previous Committee on 30 November 2016, available at: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/eu-insurance-regulation/written/43626.pdf>

<sup>2</sup> Known as the 'Matching Adjustment' in Solvency II

'have regard' to statutory regulatory principles and a number of considerations set out in the Chancellor's letter on recommendations to the Prudential Regulation Committee.<sup>3</sup>

The secondary competition objective (SCO) informs decisions about new regulation or supervision policies. The existence of the SCO means that where there are choices to be made by the PRA as to how it advances its general objectives, the PRA's consideration of those options should include its objective of facilitating competition. The PRA's competition responsibilities avoid overlap with the much wider remits of the Financial Conduct Authority (FCA) and Competition and Markets Authority (CMA). These bodies have statutory responsibilities to promote and enable competition and have wide-ranging toolkits and specific powers to achieve this.

Facilitating competition is given a high priority in the PRA and has a strong, practical influence on our policy and supervisory approach for insurance, within the constraints of Solvency II. Some specific examples include:

- We have worked closely with HM Treasury, the FCA and industry to design a new, commercially viable framework for insurance special purpose vehicles (ISPVs)<sup>4</sup> in the UK. That framework launched in December 2017 and the first ISPV has been authorised. It is an example of the PRA both pursuing its secondary competition objective and having regard to the competitiveness of the UK in what is a global market.
- Solvency II includes a 'default' approach to calculating technical provisions and setting capital requirements, based on a standard formula. It also includes a number of alternative approaches that require regulatory approval – for example, using an internal model to calculate capital requirements or the Matching Adjustment to calculate technical provisions. The PRA has issued over 500 such approvals under Solvency II. This has helped achieve a better fit between regulation and firms' particular business models, fostering a UK market which comprises a very wide range of businesses, by size and line of business. For example, we have approved many more internal models than any other EEA jurisdiction – small as well as large firms are able to use internal models, and of 23 internal models approved to date, 8 were for smaller firms.
- The PRA regulates and supervises smaller firms in a proportionate manner. We have used waivers to exempt them from some Solvency II requirements and plan to make even greater use of our waiver powers under the Directive, for example with regard to quarterly reporting. We have also implemented a streamlined and tailored regime for firms (including very small firms) that fall outside the scope of Solvency II.
- The Financial Services Compensation Scheme (FSCS) is a powerful enabler of effective competition as it provides confidence to policyholders and allows customers to choose more freely between firms on the basis of price and quality of the product. We have chosen to include effectively all direct life insurance as well as the classes of direct general insurance that are compulsory (motor and employers' liability) within the FSCS, going beyond the protection in almost all other EU countries. But in the event of an insurer failing, we recognise that ultimately the costs are borne by the remaining firms (and their policyholders) who would have to fund the FSCS ex-post to cover any losses.
- Finally, the PRA continues to support new firm authorisations, having authorised 25 new insurance firms since its creation in 2013.

We are considering areas in which we can do more to facilitate effective competition, and will provide a fuller report by March.

More generally, I see prudential regulation as an essential pre-requisite for effective competition in insurance markets (see also Annex 2). In a typical insurance contract, an insurer receives premiums upfront and invests them in assets. These policyholder premiums then sit on insurers' balance sheets until they are paid out (sometimes decades later for life policies). Since losses can take a long time to emerge,

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<sup>3</sup> In March 2017, the Chancellor of the Exchequer sent a letter to the Governor of the Bank of England recommending that the PRA should have regard to considerations including: competition; growth; competitiveness; innovation; trade; and better outcomes for consumers.

<sup>4</sup> ISPVs are the vehicles central to the structure of 'insurance linked securities' which provide (re)insurers a capital markets-based form of risk transfer as an alternative to traditional reinsurance and is a growing, innovative market.

insurers might be encouraged to undertake risky behaviour (e.g. by pursuing risky investment strategies or engaging in aggressive pricing based on under-reserving) in the knowledge that in the event of failure, the policyholder would bear the costs. And policyholders themselves do not typically have sufficient information to assess whether their insurer is engaging in risky behaviour and how likely it is that they will receive their pay-out when needed.

Without minimum standards, imprudent firms might provide too little protection for policyholders, enabling them to drive prudent firms out of the market by cutting prices. In accordance with the main objective under Solvency II, the central part of the PRA's regulatory framework is the requirement for an insurance firm to have a prescribed minimum amount of own funds to act as a buffer against unexpected losses. Such a capital stake ensures that firms are dis-incentivised from taking excessive risks, as funds are costly to raise and will be first in line to be lost should the firm fail. However, even a reasonable amount of capital may be insufficient protection against the failure of a poorly run firm, and therefore firms are also held to robust standards of risk management and governance. Reporting and disclosure, another major element of insurance regulation, aims to enable the wider market better to monitor, assess, and where necessary impose discipline on insurance firms.

### **Next steps**

We are reviewing the wider set of the Committee's recommendations and will provide a fuller response by the requested deadline of end-March.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Woods', written in a cursive style.

Sam Woods  
**Deputy Governor and CEO, Prudential Regulation Authority**



## Annex 1: Preliminary view in response to specific recommendations

### ***Provide a solution for the risk margin to improve its calibration***

EIOPA recently completed a review of the cost of capital assumed in the risk margin calculation, which recommended no change. Following a consultation period, EIOPA will issue final advice to the European Commission by end-February 2018. The PRA contributed to the EIOPA review and presented credible arguments for a lower cost of capital assumption. We are disappointed with the outcome of EIOPA's review.

The PRA continues to believe that the risk margin is too sensitive to the level of market interest rates. With interest rates currently low, the risk margin is (in our view) too high, particularly for long-dated insurance products such as annuities. This gives rise to financial stability and supervisory concerns. Potentially it may encourage pro-cyclical investment behaviour as the Financial Policy Committee previously noted. The most prominent consequence currently has not been higher capital held by insurers but rather a sharp increase in reinsurance of the associated longevity exposure offshore. We are considering possible options to address our concerns in our supervisory implementation of Solvency II and will provide a fuller update by March 2018.

### ***Develop proposals for the Matching Adjustment and the Volatility Adjustment which allow more flexibility and a more principles-based approach, and which reduce the requirement for insurers to develop complex structures in order to achieve the regulatory treatment that they warrant<sup>5</sup>***

The Matching Adjustment (MA) results in a significant benefit for UK firms. Removing it would result in a decrease in the aggregate SCR ratios<sup>6</sup> of UK insurers using the MA from 155% to 65%. But the eligibility requirements in the Solvency II Directive are detailed and prescriptive. Whilst Solvency II remains the applicable regulatory regime in the UK, the PRA does not have the power unilaterally to change the criteria upon which the MA is assessed in line with more principles-based requirements. We are legally required to consider MA applications against each of the Directive's eligibility criteria, including the requirement that assets have 'fixed' cash-flows.<sup>7</sup> Set against this requirement, we have where possible taken a flexible view of the Directive, for example, by allowing firms to restructure otherwise ineligible assets (such as equity release mortgages) in order to meet the eligibility requirements in relation to the fixity of cash-flows. In general we do not encourage widespread use of asset restructuring as this introduces additional risks and complexity.

On 25 October, we published CP 21/17, which set out proposals that aim to give further clarity on interpretation of the MA requirements<sup>8</sup>. The CP includes additional proposals on how firms can demonstrate that assets can be considered eligible, including loans with a "construction phase" and assets which include early repayment options for the borrower. We have also included additional guidance on restructuring asset cash flows, processes for managing an MA portfolio and approval applications. The CP also gives updated guidance in two areas where MA requirements might previously have seemed burdensome for firms: the consequences of detecting breaches of MA requirements; and determining when MA approvals need to be updated. The CP was developed as part of the PRA's work on adjustments to the insurance prudential framework in the light of experience following the UK introduction of Solvency II, including in areas recommended for reform by the ABI.

Until now, the PRA has taken the view that the Solvency II text rules out so-called dynamic volatility adjustment (DVA), i.e. the Directive requires that a firm's Solvency Capital Requirement (SCR) shall not cover the risk of loss of basic own funds due to changes in the Volatility Adjustment (VA). The recent

<sup>5</sup> As further background, the MA and VA are alternative adjustments to the value of insurance obligations that are included in the Solvency II long-term guarantees package. Annuities are the main product in the UK to which the MA can be applied. In contrast with other EU insurers, UK insurers make much more extensive use of the MA in preference to the VA, having received aggregate benefit of £59 billion from the MA versus only £1bn from VA. For firms using the MA, 'dynamic' modelling of the MA in stressed conditions is permitted and UK firms already benefit significantly from this.

<sup>6</sup> The SCR ratio is the ratio of eligible own funds and the SCR. Firms are required to hold an SCR ratio that is 100% or higher.

<sup>7</sup> Article 77b of the Solvency II Directive, as transposed in Regulation 42 of the Solvency II Regulations 2015 SI 2015/575.

<sup>8</sup> See CP 21/17, Solvency II: Matching Adjustment. Available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-ii-matching-adjustment>

issuing of an Opinion on the subject by EIOPA Board of Supervisors is clearly a material policy development, and the PRA will be reviewing its interpretation of the legislation in the light of that Opinion.

***Agree with the industry on an approach to the treatment of illiquid assets, balancing prudential concerns with the desire not to create unreasonable barriers to insurers investing in long term assets***

The MA has helped to enhance strong incentives for UK life firms to invest in long-term illiquid, fixed income assets, such as commercial property financing, equity release mortgages and infrastructure financing. Whilst the eligibility criteria are tighter than under the previous ICAS regime, the MA is more generous than the illiquidity premium under ICAS in terms of the size of the benefit available and therefore strengthens these incentives.

***Set out proposals which reduce the amount of data required from firms to the level that the PRA can clearly demonstrate is proportionate and necessary for prudential safety***

The majority (80–90%) of reporting to the PRA relates to the harmonised package under Solvency II, over which the PRA has comparatively little discretion. For the remaining 10-20%, the PRA has been working with the ABI to design the most extensive possible package of reforms to reduce insurers' reporting burdens while allowing the PRA to meet its statutory objectives. The specific items in scope of the PRA's review have included:

- a) Aspects of the harmonised package where the PRA does have some discretion, namely: our application of quarterly reporting waivers<sup>9</sup>; the extent to which firms need to look through to underlying assets held via investment funds; and the PRA's guidance in SS40/15, 'Solvency II: reporting and public disclosure – options provided to supervisory authorities'.
- b) All aspects of reporting that fall exclusively within the scope of the PRA's discretion – with a particular emphasis on National Specific Templates, and to a lesser extent Internal Model Outputs, given industry feedback about where the burden is highest.<sup>10</sup>

The PRA plans to consult on its proposed reporting reforms in January 2018.

***Develop proposals for simplifying the calculation of, and approval process for, the Transitional Measure on Technical Provisions provided for in the Directive***

We recognise that it is burdensome for firms to have to maintain multiple systems and processes for 16 years in order to be able to calculate technical provisions and financial resources. We are assessing the feasibility of simplifying the recalculation of the Transitional Measure on Technical Provisions (TMTP) and will consider the issues raised by the Committee. The PRA expects to consult on any proposed changes in 2018.

***Develop proposals for improving the sophistication and usefulness of internal models by (a) maximising the proportionality allowed in the Directive for the approval of internal models and (b) simplifying the approval process for changes to models***

On 12 December 2017 the PRA published CP 27/17 on the model change process, the second in a short series of consultation papers on reform to the implementation of Solvency II. The proposals reduce the likelihood that insurers will need to apply to the PRA to approve a "major" model change as a result of an accumulation of "minor" changes. This should reduce work for both firms and PRA supervisors. The CP also proposes more timely submission of quarterly model change reports and clarifies the PRA's expectations on the scope of firms' model change policies.

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<sup>9</sup> While complying with the limitation that reporting waivers shall be granted only to undertakings that collectively do not represent more than 20% of a Member State's market share.

<sup>10</sup> Industry has also flagged the PRA's requirement for Standard Formula SCR reporting for firms operating PRA-approved internal models as being comparatively high burden. But the PRA continues to view as important its ability to monitor the risk that capital requirements drift down over time (so-called 'model drift'). Moreover, the Solvency II Directive requires that firms retain the capability to produce Standard Formula SCR numbers.

### ***Develop a solution for firms in relation to contractual continuity after Brexit***

The Bank published an assessment of the risks to financial stability arising from EU withdrawal in its November 2017 Financial Stability Report. In particular, it set out that a significant number of policyholders could be affected in both the United Kingdom and European Economic Area<sup>11</sup>.

More broadly, insurers located in the EEA will need to ensure their activities in respect of existing UK business are performed by entities with the correct permissions in the United Kingdom. In that regard, on 20 December 2017, the PRA published CP 30/17 which set out its proposed approach to authorising and supervising the insurance branches of third country insurers. The CP was released together with a draft supervisory statement which also sets out new factors to be considered alongside the PRA's current requirements for third-country branch authorisation. In particular, the PRA proposes that it also considers the scale of UK branch activity covered by the FSCS and the impact of the failure of a firm with a UK branch on the wider insurance market and financial system.

### ***Further areas where we are constrained under Solvency II***

In some areas raised by the Committee we are more constrained under Solvency II; these are areas which are therefore better considered once there is greater clarity about the UK's future relationship with the EU. These areas are relevant in particular to the Committee's recommendations relating to the introduction of regulatory forbearance, contract boundaries, IFRS 17, and proposals on the standard formula. We will expand on the nature of these constraints more fully in our update by March.

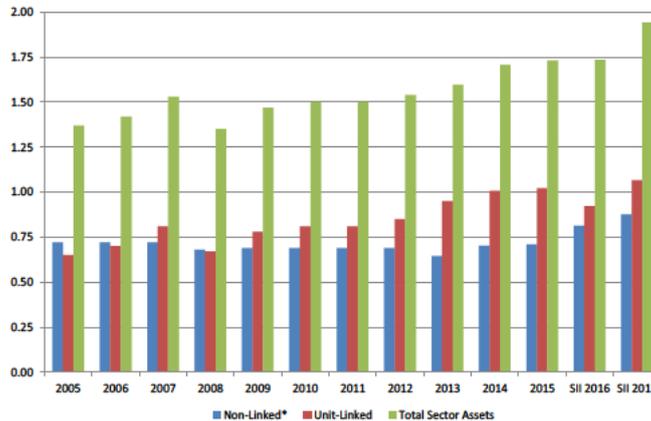
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<sup>11</sup> Initial estimates suggest around £20 billion of insurance liabilities and six million UK policyholders could be affected because their contract is with an insurer based in the EEA. £40 billion of insurance liabilities and 30 million EEA policyholders could also be affected.

## Annex 2: Prudential regulation and the insurance sector

Insurance firms have continued to perform strongly since Solvency II came into force and sector balance sheets have continued to grow (**Chart 1**). Life firms have reported net profits and healthy aggregate solvency ratios (c153%: Q3 2017), despite the challenges of much reduced demand for individual annuities, reduced investment income under persistently low market interest rates and the risk margin. Returns on equity for larger European insurers have remained steady at around 9%, close to the levels seen on average since 2010.

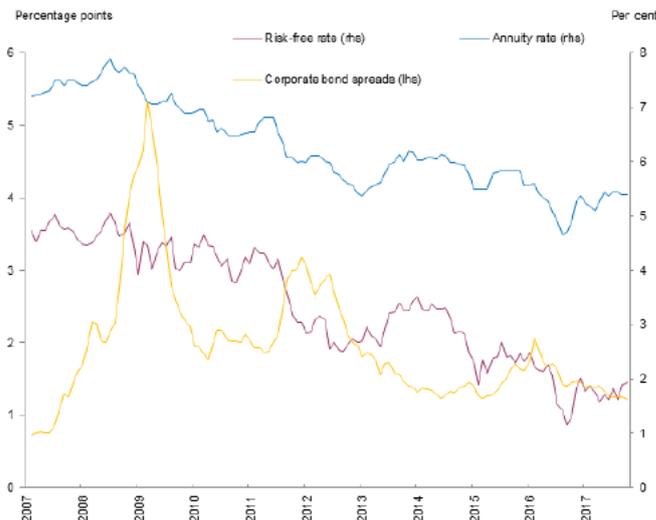
**Chart 1: Sector asset growth (2005-Q2 2017) (£tn)**



UK life insurers' average credit default swap premium has fallen since the introduction of Solvency II: from 70 basis points (01/01/2016) to 54 basis points (04/12/2017).

Although life insurers sometimes contend that Solvency II is having a detrimental impact on policyholders as firms pass on increased costs of regulation, risk-free market interest rates and corporate bond spreads continue to be the dominant driver of annuity prices. And the relationship does not appear to have changed since Solvency II came into effect (**Chart 2**).

**Chart 2: Time series of market annuity rates, risk-free market interest rates and corporate bond spreads**



Sources: Bloomberg, sharingpensions.co.uk and Bank calculations

## ***The case for prudential regulation of insurers***

This section provides a brief overview of the case for prudential regulation of insurers. We intend to elaborate further on this in our full report to the Committee.

The failure of an insurer should generally<sup>12</sup> pose less of a systemic risk to the financial system than the failure of a bank, since insurers are less exposed to runs and to contagion from the failure of other insurers. But there is still a strong case for prudential regulation and policyholder protection, particularly where policyholders rely on their insurance products for future income (e.g. annuities or bodily injury compensation).

The regulatory regimes for banks and insurers are both based on requiring firms to hold sufficient capital to cover shocks. However, there are important differences between banks and insurers too. The value of banks' liabilities (e.g. deposits) is typically fixed and the main risks are to the value of their assets. Insurers, by contrast, have risky assets and liabilities. Insurance regulation is about both establishing a 'best estimate' of liabilities (reserves) and assessing the risks to the value of those liabilities in a stress.

Problems in insurance arise, in part, because of the nature of the insurance contract. In a typical insurance contract, an insurer receives premiums upfront and invests them in assets. But it can take a long time – sometimes decades with life policies – before any payment to policyholders becomes due. Policyholders' money sits on company balance sheets for a long time before it needs to be paid out. This means that the company can undertake excessively risky investment strategies, or it can engage in aggressive pricing based on under-reserving. In practice, the market has been unable to exert much influence over behaviour like this as valuation of insurance contracts is complex in part because losses take a long time to emerge. Moreover, these insurance contracts are often difficult or costly to cancel.

For example, in 2002, policyholders of Equitable Life accepted a write-down in the value of their policies following its near collapse, caused by a failure to value and manage guaranteed benefits properly. The Government agreed to pay compensation amounting to £1.5 billion to policyholders in 2010. Amongst these policyholders were 37,000 annuitants, the majority aged 75 and over, who each suffered around £16,500 of losses on average.

Ultimately, excessive risk-taking by insurers could mean that policyholders do not receive a pay-out when they need it most, perhaps to pay a pension or following a serious accident. This can result in significant costs for more prudent, surviving firms who have to fund the Financial Services Compensation Scheme (FSCS). For example, the FSCS has paid out £405 million over a 13-year period to meet claims on Independent Insurance since its failure in 2001. This included claims for victims of workplace injuries. Whilst Independent Insurance was the most high-profile failure, 21 other general insurers failed in the decade prior to 2001.

Internationally, surviving insurers have experienced losses when insurers fail. For instance, seven mid-size life insurers in Japan failed during the period 1997-2001. These failures did not lead to the need for taxpayer support, since other firms contributed \$7 billion to a policyholder protection fund. But policyholders for five of the failed firms experienced cuts to the value of their own policies. Taxpayer assistance was needed following the 2010 and 2011 earthquakes in New Zealand, where the Government assumed the liabilities of AMI Insurance Limited.

Policyholders can be harmed not only when their claims are not paid, but also when their insurance cover is unexpectedly withdrawn following failure. In the UK, many motorists found themselves uninsured following the failure of Fire, Auto and Marine in 1966 (400,000 policyholders) and Vehicle & General in 1971 (1.2 million policyholders).<sup>13</sup> This is a classic case of moral hazard, where somebody takes excessive risks, because somebody else bears the costs.

Another problem for policyholders is asymmetric information. It is unlikely that the policyholder will have sufficient information to be able to assess the balance sheet and behaviour of an insurance company.

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<sup>12</sup> An obvious exception is AIG, which became heavily interconnected with the banking system through its Financial Products business.

<sup>13</sup> In Australia, the failure of HIH Insurance marked the biggest collapse in its corporate history. HIH provided insurance ranging from personal insurance products to workers' compensation and builders' warranty insurance. In Queensland car accident victims insured with HIH were left waiting for operations and other medical procedures worth AUS\$190 million. Professional services were left without indemnity cover and community events were cancelled due to loss of public liability insurance. Almost AUD\$2 billion of construction activity was put on hold whilst replacement builders' warranty insurance cover was sought.

Even if policyholders do have the right amount of information, it is unlikely that they would be able to make sufficiently informed judgements about the type of risks firms are running.

Under Solvency II, the central part of the PRA's regulatory framework is the requirement for an insurance firm to have the prescribed minimum amount of own funds to act as a buffer against unexpected losses. Such a capital stake ensures that firms are dis-incentivised from taking excessive risks, as funds are costly to raise and will be first in line to be lost should the firm fail. However, even a reasonable amount of capital may be insufficient protection against the failure of a poorly run firm, and therefore firms are also held to robust standards for risk management and governance. Reporting and disclosure is another major element of insurance regulation, which seeks to address the problem of asymmetric information by enabling the wider market better to monitor, assess, and where necessary impose discipline on insurance firms.