Thank you for the response to the Treasury Committee’s inquiry on Solvency II dated 27 February 2018 and your letters dated 3 January 2018, 27 March 2018 and 4 June 2018. The Committee welcomes the PRA’s constructive approach to the matters raised by the Committee’s inquiry.

The Committee agrees that Solvency II is over specified and understands that currently you have limited scope to make improvements due to the Directive’s rules-based nature. The Committee welcomes the fact that the PRA understands the scope for improvements, especially in relation to the inflexibility of the Matching Adjustment and the proportionality of the reporting requirements. We look forward to receiving further updates on these issues as the PRA continues to make progress.

**Risk Margin**

In relation to your most recent letter regarding the Risk Margin dated 4 June 2018, you stated that you have considered revisiting how the PRA calculates the risk margin, and that a recalculation “has some merit as a solution to the problems being caused”. However, you noted that you do not see a durable way to recalculate the Risk Margin due to current uncertainty regarding the UK’s future relationship with the EU in relation to financial services. The Committee understands the difficulties in negotiating a recalculation of the risk margin, and would not wish to prejudice any further negotiations. Nevertheless, given the significance of this issue and its impact on the annuities market, the Committee will keep developments on this area under review and asks that you keep the Committee informed on any developments.

While the Committee understands that the PRA is constrained in how it adapts Solvency II for the purposes of the UK market without breaching the rules of the Directive, there are a number of wider areas where there are no such restrictions, which are set out below:
Competition and competitiveness
The Committee welcomes the various measures that you are taking to improve competition and competitiveness. However, we note that firms continue to exit the long-term savings market with Solvency II being one of the major contributing factors. We therefore welcome your comment that the PRA will not only enhance its engagement with the industry but will also focus on the strategic challenges facing the Life and Non-Life sectors. This will be particularly important post-Brexit to ensure that firms can be innovative in responding to changing customer needs, and are able to compete in the long-term savings market by developing products that allow customers to benefit from returns available from an appropriately wider range of asset classes.

Matching Adjustment
The Committee agrees with your comments that the Matching Adjustment is over specified, and this is a cause for concern for regulators and firms alike. We ask you to continue working with European Insurance and Occupational Pensions Authority (EIOPA) to achieve a more flexible approach.

Again, we would be interested in the precise changes that would need to be made to the existing framework which do not contravene the spirit and aims of Solvency II, but that achieve a better fit for the UK insurance market. Going forward, we encourage you to consider the following challenges remaining for insurers running Matching Adjustment asset portfolios:

- the ability to add new assets and liabilities to Matching Adjustment portfolios in a timely fashion;
- the process by which changes can be made to existing Matching Adjustment approvals; and
- the likelihood that firms will continue to need artificial structures to restructure certain asset classes in order to include them in their Matching Adjustment portfolios, and in particular how the Matching Adjustment impacts on Equity Release Mortgages assets, which are ineligible for a Matching Adjustment without artificial re-structuring.

Dynamic volatility adjustment (DVA)
The Committee looks forward to the results of your policy review in the light of EIOPA’s recently published opinion on the need to reinforce greater supervisory convergence in the use of DVA. We understand the PRA has also issued a consultation regarding the DVA since its Treasury Committee response. As the consultation draws to a close, we would be grateful for an update on the PRA’s position.
Internal Models
The Committee understands that regulators’ review and approval of internal models is necessary.

We welcome your efforts to streamline the internal model change process. We emphasise the importance of the PRA’s consideration of the following challenges arising from the current model change process:

- potential delay in putting through (and obtaining regulatory approval for) internal model changes during a financial or other crisis;
- an onerous model change process is likely to constrain internal model firms from investing in new asset classes; and
- firms are likely to face difficulties where there is a potential change to their risk profile, such as offering products covering new risks, or acquisition of a new subsidiary. Insurers will not be able to finalise their business cases until future model change applications are approved, which could damage innovation and competition with insurance markets and could constrain competition where new firms seek to join existing markets.

Reporting requirements
The Committee welcomes your initiatives to reduce the burden of Solvency II reporting. We understand the current constraints on any reductions in EIOPA-specified reporting; again, we hope that you will look for medium term opportunities to evolve and improve the arrangements. Industry feels strongly that the balance between the cost of reporting and associated benefits is sub-optimal. Industry has argued that the current reporting requirements are excessive and the data collected is not useful to assessing the financial strength of an insurer.

The Committee understands that while the UK remains a member of the European Union, these issues will continue to be governed by the Solvency II framework. After our exit, it may be sensible to remain as closely aligned as possible with other EU countries. At the same time, we believe it is important to identify where there is a lack of fit with the needs of UK consumers and industry, and the options for achieving better outcomes. The Committee would like the PRA to be proactive in this regard and to work with the industry in developing future policy. As the picture relating to the alignment of regulation becomes clearer, we will ask you to come back again to discuss your progress.

Many thanks again for your positive approach to this matter. The Committee will be placing this letter in the public domain.

The Rt Hon Nicky Morgan
Chair of the Treasury Committee