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UK Solvency II Reforms

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The views expressed in this presentation are those of the authors and do not necessarily reflect the views of WTW.

Some of the summarised material within this presentation has been prepared based on HM Treasury's Consultation Paper and the PRA Discussion Paper on the review of Solvency II published on 28 April 2022 as well as HM Treasury's Consultation Response and PRA Feedback Statement FS1/22 published on 17 November 2022.

Our analysis focusses on the issues relating to life insurers and annuity providers in particular.

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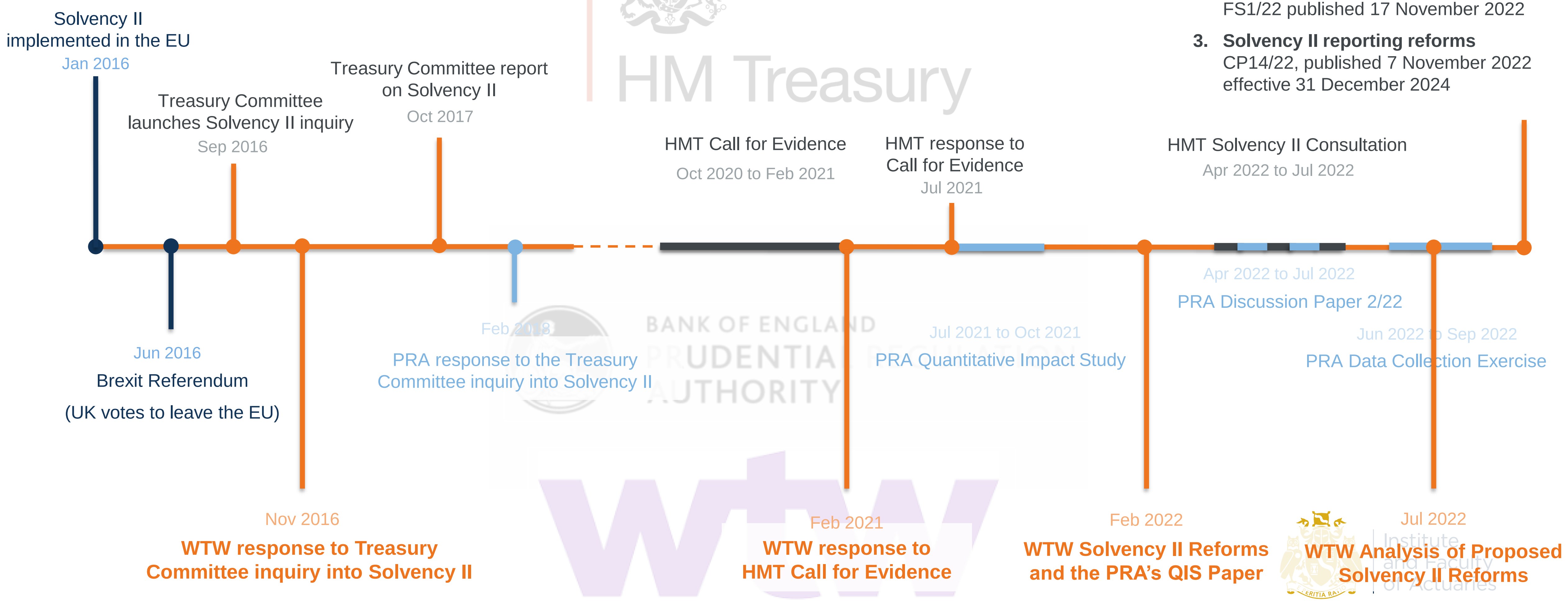
Agenda

1. Overview of reforms timeline and recent responses from HMT and PRA
2. Implications of the reform package
3. Analysis of key aspects of the reform package
4. Further reforms and review of HMT objectives
5. Where do we go from here?

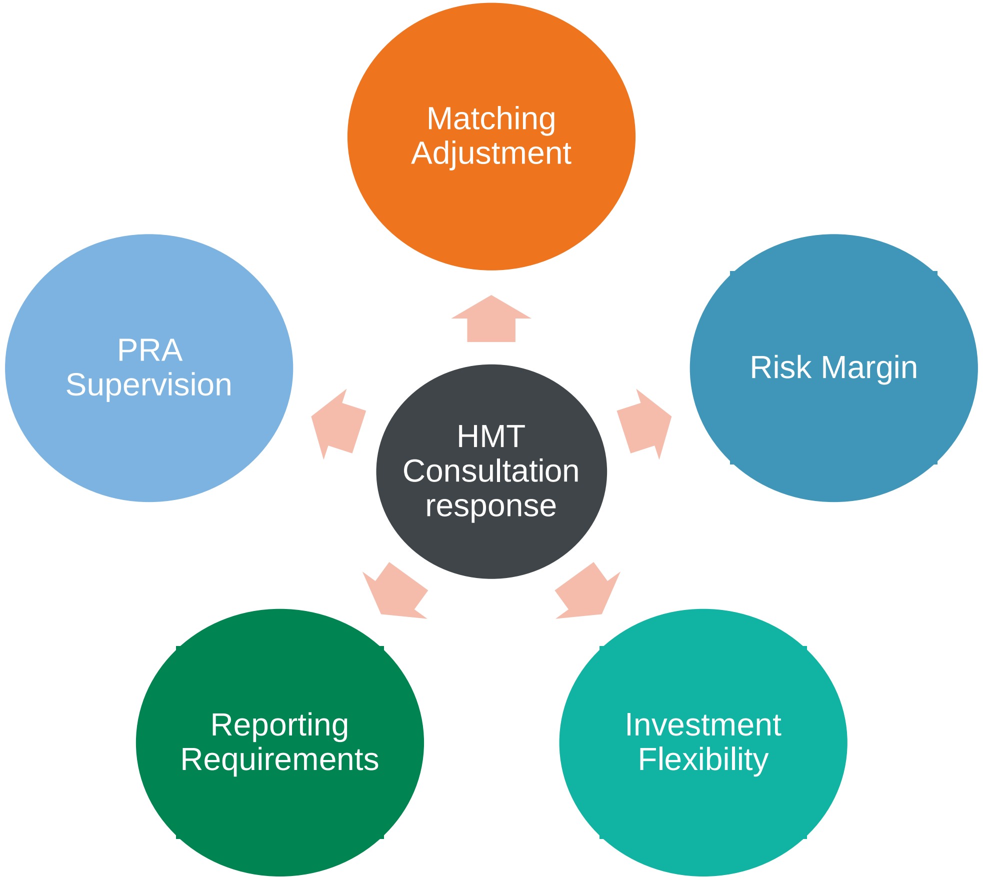
An overview of the reforms timeline

Latest updates:

1. **HMT Consultation Response** published 17 November 2022
2. **PRA Potential Reforms to Risk Margin and Matching Adjustment within Solvency II** FS1/22 published 17 November 2022
3. **Solvency II reporting reforms** CP14/22, published 7 November 2022 effective 31 December 2024



HMT Consultation response



Matching Adjustment

- Maintain existing FS methodology and calibration.
- Introduce allowance for the use of notched ratings.

Risk Margin

- Tapered cost of capital method
- Change targeting substantial reduction
  - 65% ↓ for long-term life insurers
  - 30% ↓ for general insurers

Investment Flexibility

- MA eligibility criteria to be broadened to include assets with ‘highly predictable’ cashflows subject to increased FS
- Extending range of liabilities eligible for MA
- Removal of sub-investment grade cliff-edge
- More streamlined approach to accelerate reviewing MA applications

Reporting Requirements

- Removing requirements for UK branches of foreign insurers to calculate branch capital requirements / hold local assets to cover
- Doubling threshold for size and complexity of insurers before the regime becomes required
- Reducing reporting and administrative requirements

PRA Supervision

- Requirement for insurers to participate in regular stress testing exercises
- Formal SMR attestation on sufficiency of FS to reflect all retained risks
- Ability to apply FS add-on
- Further assurance on internal credit ratings

Source: HMT Review of Solvency II: Consultation - Response, 17 November 2022

PRA Feedback Statement FS1/22

While FS1/22 only summarised responses, it highlighted aspects directly relevant to the reforms package

“The most frequently suggested solution, to help address the PRA’s concerns on the current FS design and calibration, was for the PRA to increase the graduations in ratings (notching), as well as to recognise the positive and negative ratings outlooks published by ratings agencies”

“no assurance that any capital release would be used by life insurers to increase productive investment. They argued that it might instead be used to increase insurers’ dividends or remuneration.”

“a calibration of a reformed risk margin design to the edge of what the PRA’s technical analysis could support could result in a reduction to the risk margin of around 60% for long-term life business, under economic conditions prevailing at the time of DP2/22.”

“the current FS was noted as already being materially higher than historic defaults. Many felt it contained sufficient margins for uncertainty and considered the regime as a whole was working well.”

“Responses on the likely impact of the possible design and calibration of the FS focused largely on: annuity provision and prices; investment in productive assets; and use of reinsurance.”

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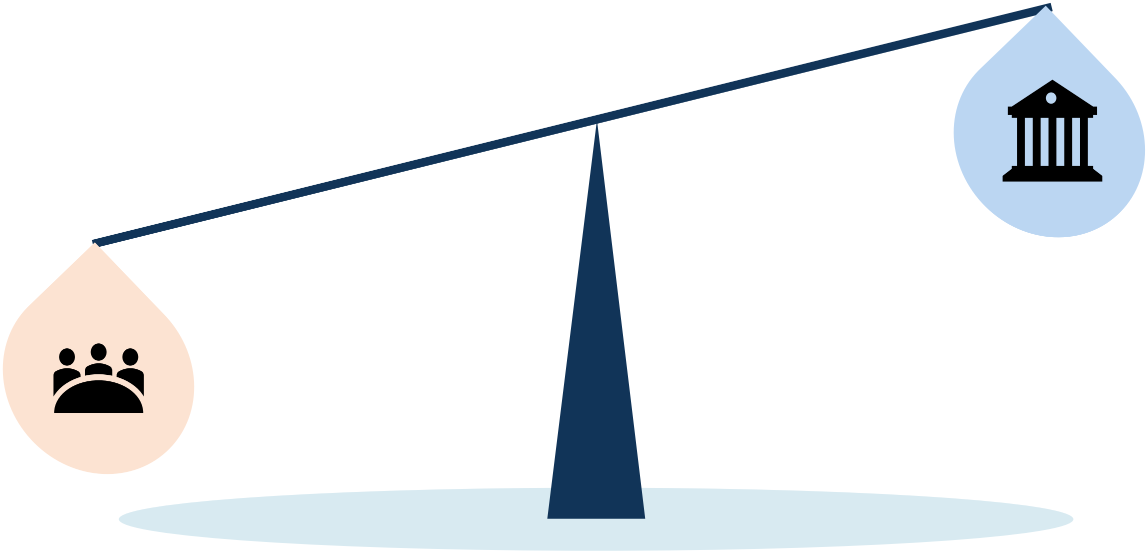
Implications of the reform package

While insurance companies have welcomed the reform package, there may also be gains for the regulator

Insurance companies

- Capital release as a result of reduction in risk margin
- Implementation of notching proposals within FS
- Removal of BBB cliff
- Ability to include further assets in the MAP
- Ability to extend MA to other liabilities
- Reduction in reporting and administrative effort



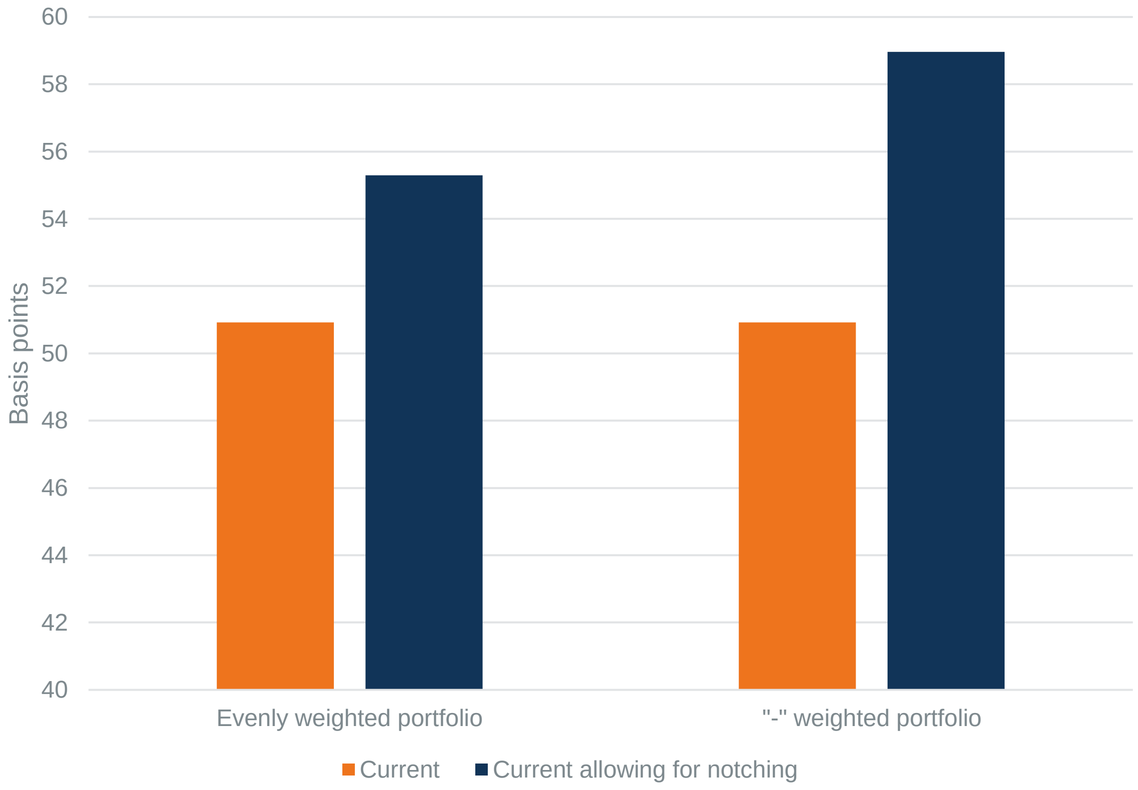
Prudential Regulation Authority

- Regular mandatory stress testing exercises and ability to publish of individual firm results from stress tests
- Formal SMR attestations on appropriateness of level of FS
    - Expectation of rigorous analysis on MA and FS of assets held in MA portfolios
    - Further scrutiny over internal ratings
- Application of firm by firm FS add-ons (at portfolio / asset class / asset level?)
- Update the FS for highly predictable cashflows

Source: HMT Review of Solvency II: Consultation - Response, 17 November 2022

Allowance for notched ratings

- The graph on the right sets out the impact on FS from applying notching. The base FS of 51 bps is calculated using an illustrative portfolio with a typical asset allocation for MA portfolios, with average term to maturity at 10 to 15 years.
- We have used a simple approach of linearly interpolating the current full-letter FS to include + and – notched assets.
- We have shown the impact of notching in two scenarios:
  1. An evenly split portfolio with 33% of asset in each notch
  2. A “-“ weighted portfolio with 50% of the assets “–“ rated, 25% of the assets “+” rated and 25% of the assets in the exact letter rating.
- As expected, the “-” weighted portfolio which is biased receives a higher increase in the FS from notching.



Source: WTW Analysis of Proposed Solvency II Reforms, 21 July 2022 (Figure 5.3)

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Risk margin impacts

	Lambda*	COC rate	Reduction in RM due to proposed changes YE20	Q322
Current approach	100.0%	6.0%	-	-
EC approach	97.5%	5.0%	33%	31%
EU Parliament approach	90.0%	4.0%	68%	65%
HMT April proposal (lower end of range)	90.0%	5.0%	60%	57%
HMT April proposal (upper end of range)	85.0%	5.0%	70%	67%
HMT November reforms	?	?		65%

** No cumulative lambda floor is applied*

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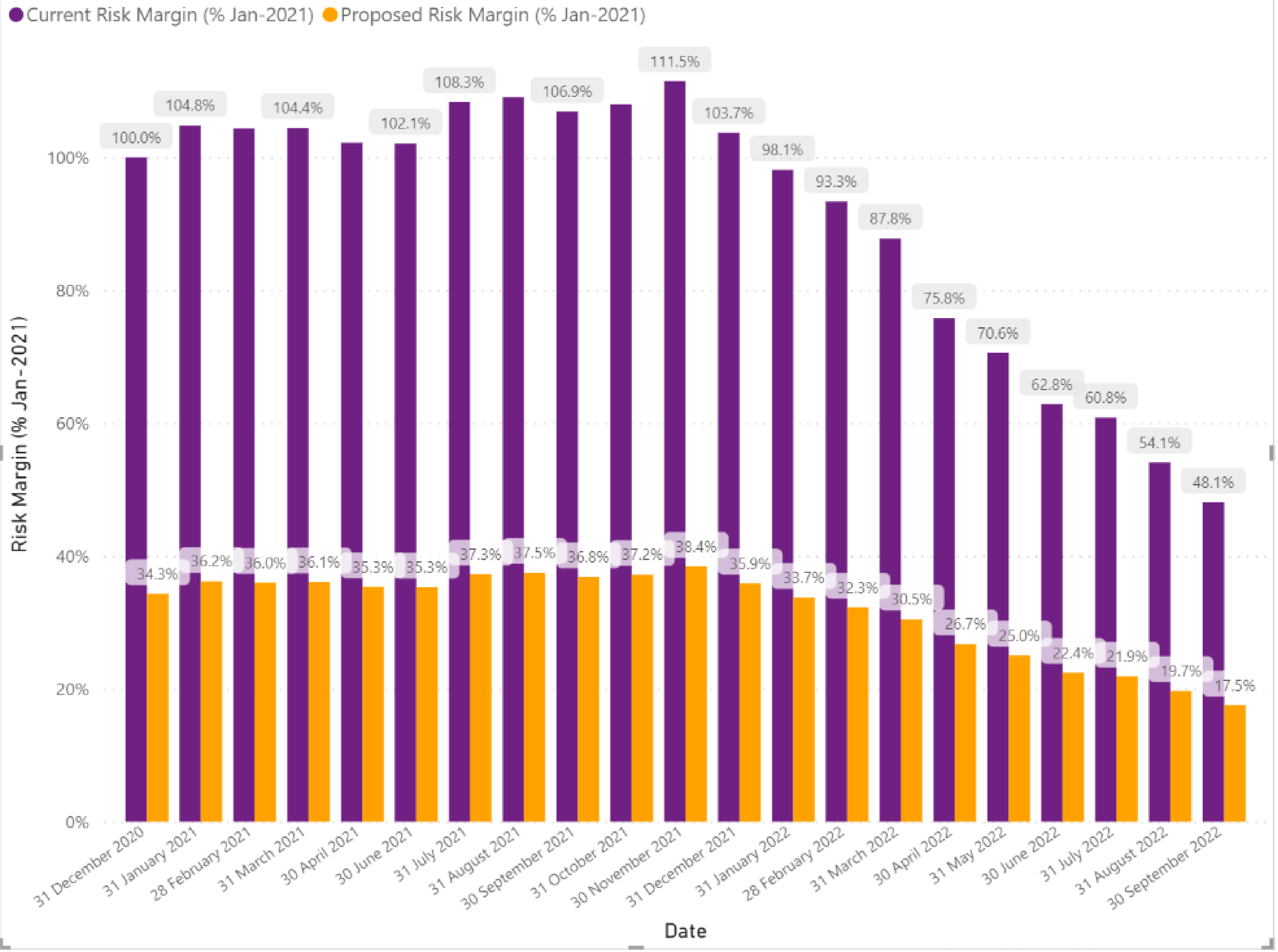
RM Impact - Time Analysis

Risk Margin Current vs Proposed



31/12/2020 30/09/2022

Annuity Type

Immediate Annuity

Identifier

All

Reinsurance

0.90

CoC Rate (%)

4

Lambda

0.90

Floor

Without Floor

Proposed Solvency II reporting reforms (Phase 2)

- This second phase builds on previous Phase 1 reporting changes
  - Phase 1 highlights were the removal of selected reporting requirements and expanded application of modification by consent to waive quarterly reporting requirements
- Phase 2 covers deletions and changes in reporting frequency of existing templates, amendments to or consolidation of existing templates and additional reporting requirements (including 4 new templates on life outwards reinsurance).
- Additional reporting on new topics (a new annual template on each):
  - Excess capital generation
  - Cyber underwriting risk
  - Non-life obligations analysis
- PRA estimates a median industry-wide cost reduction of around £23 million per annum due to the proposals
- PRA plans to consult on the other areas of reform (RM, MA, TMTP, IM, etc.) and areas of their disclosure requirements at a later date.
- PRA is also planning to review existing requirements of the SFCR and RSR with a view to consult on these.

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Objectives of the reform as set out by Treasury

1 *Spur a vibrant, innovative and internationally competitive insurance sector*

2 *Protect policyholders and ensure the safety and soundness of firms*

3 *Support firms to provide long-term capital to drive growth consistent with the Government's climate change and productive finance objectives*

HM Treasury

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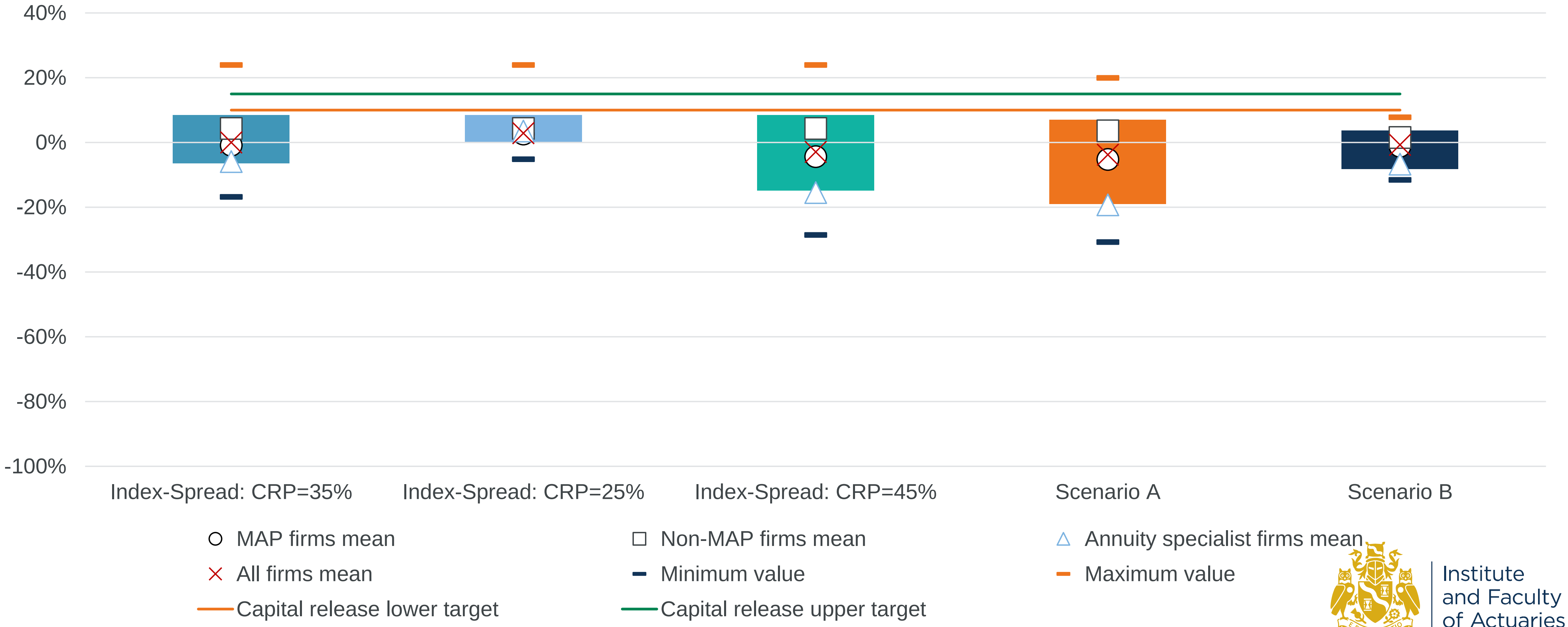
Range of potential outcomes on insurers Own Funds

Percentage change in OF at YE20 after allowing for TMTP recalculation



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Where do we go from here?

1. What is the timeline for implementation of the reforms?
2. Will there be any transition period for the reforms?
3. Will the PRA consult on the approach for notched ratings within the FS?
4. Will the PRA consult on the criteria for “highly predictable cashflows”?
5. What might the reduced reporting and administrative requirements look like?
6. How might the PRA make use of its additional supervisory powers?
7. How much effort will be required of firms to provide SMR attestations about the FS
8. Will there be further changes to the MA at the 5 year review point?

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Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

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Thank you

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