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GIRO50 Conference 2023

1–3 November, EICC Edinburgh

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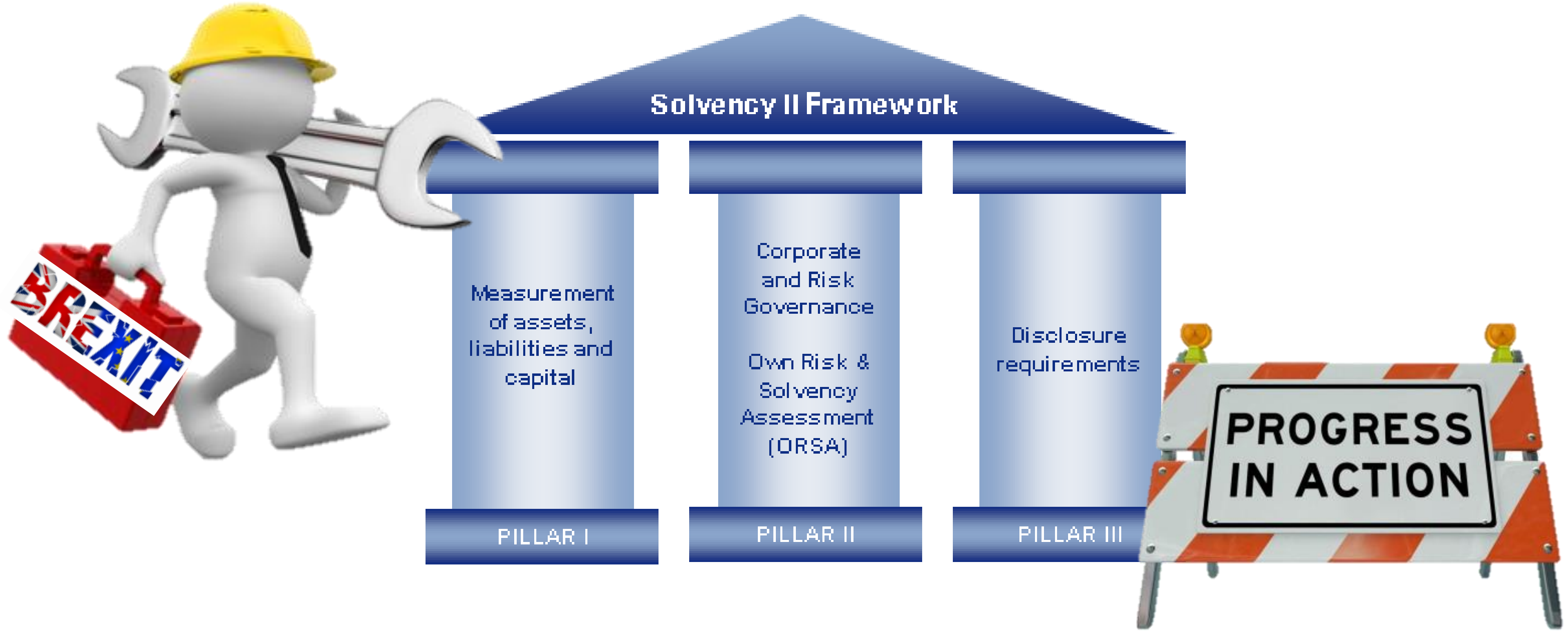
Solvency II Practical Review Working Party update

Solvency UK & its impact on the industry

1-3 November 2023
Amrita Pattni (Chair), Guy Carpenter
Jeff Courchene, Milliman

Contents

Working party background



<u>Objective</u>: Working Party set up in 2017 to identify practical issues with Solvency II

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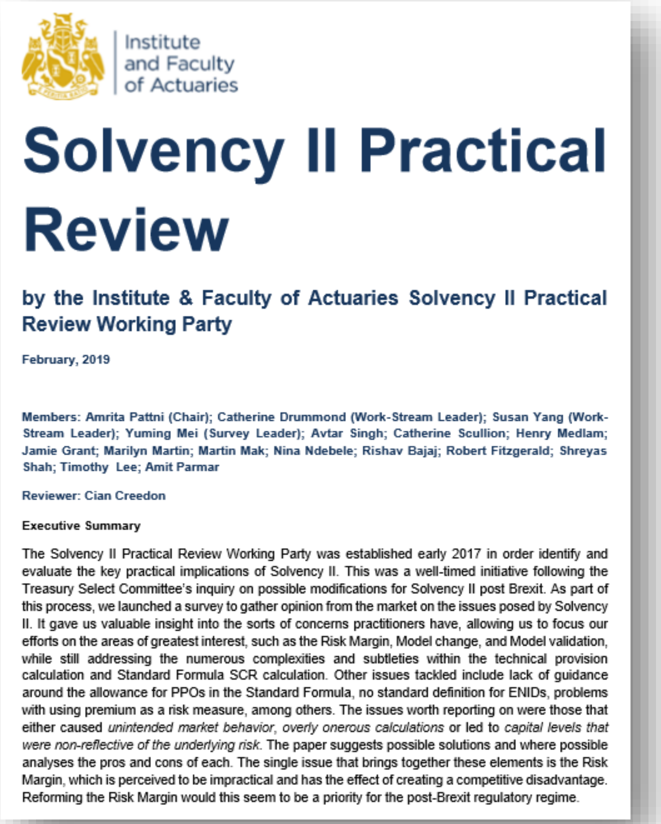
Working party milestones

Objective	• Working Party set up to identify practical issues with Solvency II
Year 1 - 2017:	• Focus on Pillar 1 – Capital & Pillar 2 – Technical Provisions
Year 2 - 2018:	• Focus on Pillar 3 – Reporting
Year 3 - 2019:	• Focus on regulatory initiatives on Pillar 1, 2 & 3 – EIOPA review
Year 4 - 2020:	• Covid 19 Impact & Solvency II resilience



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Solvency II Practical Review

by the Institute & Faculty of Actuaries Solvency II Practical Review Working Party

February, 2019

Members: Amrita Pattni (Chair); Catherine Drummond (Work-Stream Leader); Susan Yang (Work-Stream Leader); Yuming Mei (Survey Leader); Avtar Singh; Catherine Scullion; Henry Medlam; Jamie Grant; Marilyn Martin; Martin Mak; Nina Ndebele; Rishav Bajaj; Robert Fitzgerald; Shreyas Shah; Timothy Lee; Amit Parmar

Reviewer: Cian Creedon

Executive Summary

The Solvency II Practical Review Working Party was established early 2017 in order identify and evaluate the key practical implications of Solvency II. This was a well-timed initiative following the Treasury Select Committee's inquiry on possible modifications for Solvency II post Brexit. As part of this process, we launched a survey to gather opinion from the market on the issues posed by Solvency II. It gave us valuable insight into the sorts of concerns practitioners have, allowing us to focus our efforts on the areas of greatest interest, such as the Risk Margin, Model change, and Model validation, while still addressing the numerous complexities and subtleties within the technical provision calculation and Standard Formula SCR calculation. Other issues tackled include lack of guidance around the allowance for PPOs in the Standard Formula, no standard definition for ENIDs, problems with using premium as a risk measure, among others. The issues worth reporting on were those that either caused *unintended market behavior*, *overly onerous calculations* or led to *capital levels that were non-reflective of the underlying risk*. The paper suggests possible solutions and where possible analyses the pros and cons of each. The single issue that brings together these elements is the Risk Margin, which is perceived to be impractical and has the effect of creating a competitive disadvantage. Reforming the Risk Margin would this seem to be a priority for the post-Brexit regulatory regime.

2021-2022 Break; when reform consultation launched

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2023 Working Party Scope

Solvency UK: Understand the changes and impact on firms & the industry

2022 November: UK Government Announces Its Post-Brexit Solvency II Reforms - ‘Solvency UK’

2023 June: PRA published its Consultation Paper 12/23 (“CP12/23”) covering the first set of proposed reforms

2023 September: Reform of the matching adjustment & investment flexibility

	Change
Simplification	- **Risk margin** - **Reporting & disclosure** - Transitional Measure on Technical Provisions (TMTP) - Matching adjustment - Currency redenomination
Improved Flexibility	- **Internal Models & Capital add-ons** - Groups SCR - Thresholds
Encouraging Entry	- **Third-country branches** - **Mobilisation**

Survey is Live!:

Solvency II Practical Review Working Party – Market Survey

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Working party members (2023)

1. Amrita Pattni (Chair) - 2017
2. Amerjit Grewal - 2019
3. Avtar Singh - 2017
4. Francisco Sebastian - 2019
5. Jeff Courchene - 2023
6. Madhuri Kumar - 2019
7. Nina Ndebele - 2019
8. Schalk Van Tonder - 2023
9. Shanawaz Hirani - 2019
10. Valerie Teo - 2019
11. Yuming Mei - 2019

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Timeline

Solvency UK

UK Government announces its post-Brexit Reforms: "Solvency UK," in November 2022.

PRA Publishes CP 12/23 covering the first set of proposed reforms.

PRA Publishes CP 19/23 covering detailed proposed changes to the matching adjustment.

PRA Final policy to be published during 2024Q2 Including updated reporting templates

Implementation MA reforms effective 30 June 2024 while other reforms effective 31 December 2024.

Brexit

2019 | 2020 | 2021 | 2022 | 2023 | 2024+

EIOPA Review

EIOPA consultations EC sent a call for advice to EIOPA in February 2019. EIOPA issued public consultations on draft advice.

EIOPA Info Requests EIOPA carried out information requests for impact assessment.

EIOPA Final Advice EIOPA's final advice published December 2020.

European Commission Proposal EC publishes its proposals in September 2021.

European Parliament In June 2022, the European Parliament's rapporteur published his proposed amendments to the EC's proposals.

European Council In June 2022, the European Council published its agreed position.

European Parliament In August 2022, the European Parliament published (over 600) amendments to the rapporteur's proposals.

ECON Vote The European Parliament Committee on Economic and Monetary Affairs (ECON) vote on proposals 9/23

European Commission If the Directive Amendments are approved, Delegated Acts could be agreed in 2023/2024.

Implementation The Member States will be obliged to adopt relevant laws to comply with the amendments by 30 June 2025 and to apply them from 1 January 2026.

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Risk margin – Solvency UK

What is the change?

The draft SIs, published on 22 June 2023, set out proposed **transitional amendments** to the existing onshore Commissioned Delegated Regulations.

Impact on the firm

Cost of capital rate to be set at 4% (6% currently)

- Article 39 of DA
- Article 77(5) of FD

Lloyd's impact is different

Impact on the market

Depending on view:

- Reconsider growth strategy and risk appetite (deploy additional EOF)
- Neutralise impact within internal metrics (CoC rate change ≠ risk profile change).

Unintended Consequence

Recalibration of comparisons with past metrics.

Audience questions

By how many % points would the Solvency ratio increase as a result of this change in the risk margin? 0%, 5%, 10%, More

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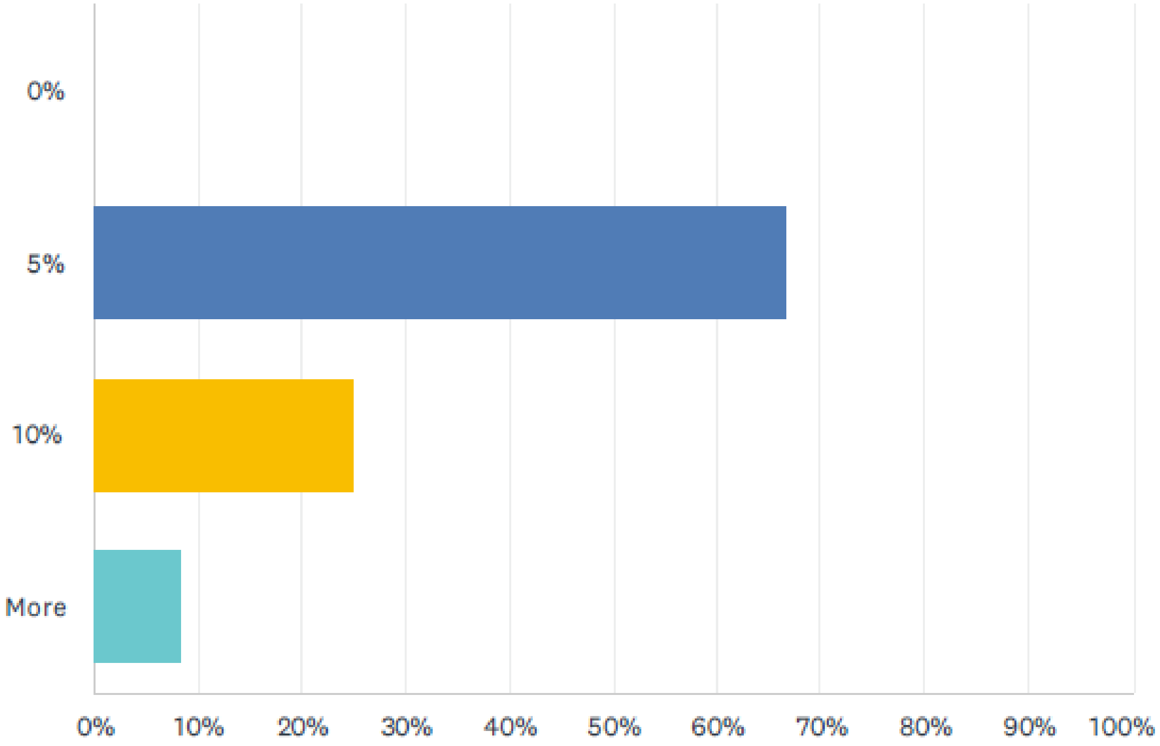
By how many % points would the Solvency ratio increase as a result of this change in the risk margin?



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Risk Margin – Lloyd’s

- Setting capital is different (UTH rather than 1YTH) at Lloyd’s, which means that the **Risk Margin can be used to offset capital requirements.**

- TPs will reduce (same as other insurers), but the **impact on the capital requirement is NOT the same**.

- The **reduced risk margin will increase the economic capital assessment** by more than the reduction in TPs (hence the Solvency Ratio will decrease)

- Lloyds’ view is that this is not the **intent of the change** and intends to “change the rules” in order to pass the benefit to its members (with an adjustment to the QCT process)

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Audience question

Do you think EIOPA should reduce the Cost of Capital to align to Solvency UK's Cost of Capital?

Risk Margin – Solvency II

- EIOPA carried out Solvency II review during 2020. The Risk Margin formed part of this review.
- Following the review, **EIOPA proposed no change to the risk margin** calculation because
  - No indication that TPs were "systematically under/over estimated," based on the transfer value analysis.
  - The sensitivity of the risk margin to changes in interest rates is generally as expected
  - On balance, the cons of making a change to include VA/MA outweigh the pros.
  - The RM was reviewed in detail as part of the Second set of Advice to the European Commission on specific items in the Solvency II Delegated Regulation during 2018.
- On 22 September 2021, the European Commission published legislative proposals for amendments to the Solvency II Directive arising out of the 2020 Solvency II Review. The ECON committee decision to **enter into interinstitutional negotiations** was confirmed by Parliament's plenary on 13 September 2023, opening the way for trialogues between the co-legislators.
- The Commission has indicated that **it will consider reducing the cost-of-capital rate** (in contrast to EIOPA's advice).

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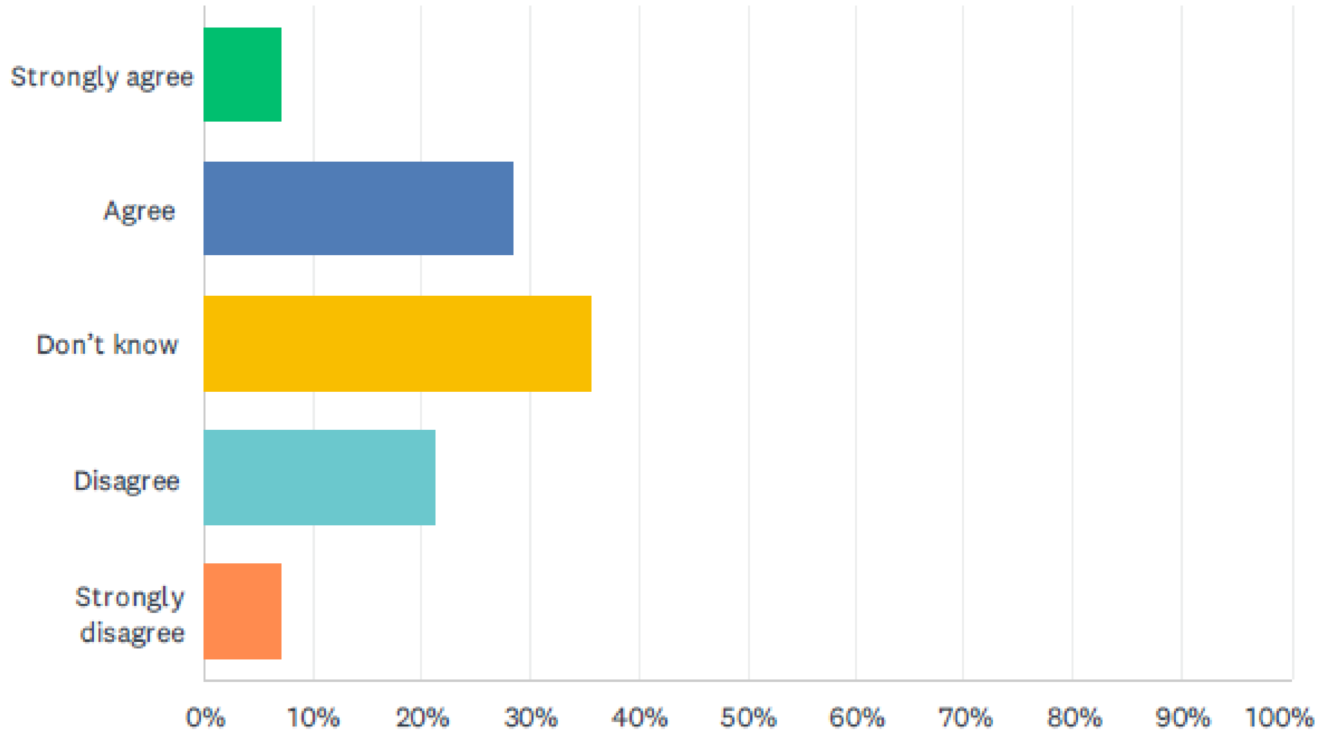
Do you think EIOPA should reduce the Cost of Capital to align to Solvency UK's Cost of Capital?



Internal Model Flexibility

What is the change?

Change from requirement to comply with all tests and standards (“T&S”) for approval:

- **PRA grants *permission* to use an IM rather than *approval* of an IM**
- Internal model ongoing review (IMOR) framework introduced, **adding safeguards (e.g. CAO)** to bring a model that is not wholly compliant into compliance

Impact on the firm

Firms will likely welcome the **increased flexibility**

Possibly **greater incentive** to apply for an internal model

Niche companies more likely to apply for an IM?

Impact on the market

Reduce **dependency** on the Standard Formula

More firms using a sophisticated Internal Model, overall ***market becomes undercapitalised***

Unintended Consequence

Does increased flexibility come at a cost?

Analysis of Change exercise
Annual Senior Management Function (SMF) attestation

Audience question

1) **A greater number of firms will be willing to apply for an Internal Model as a result of this change.**

2) **The internal model flexibility will impact the number of applications to change an EXISTING internal model.**

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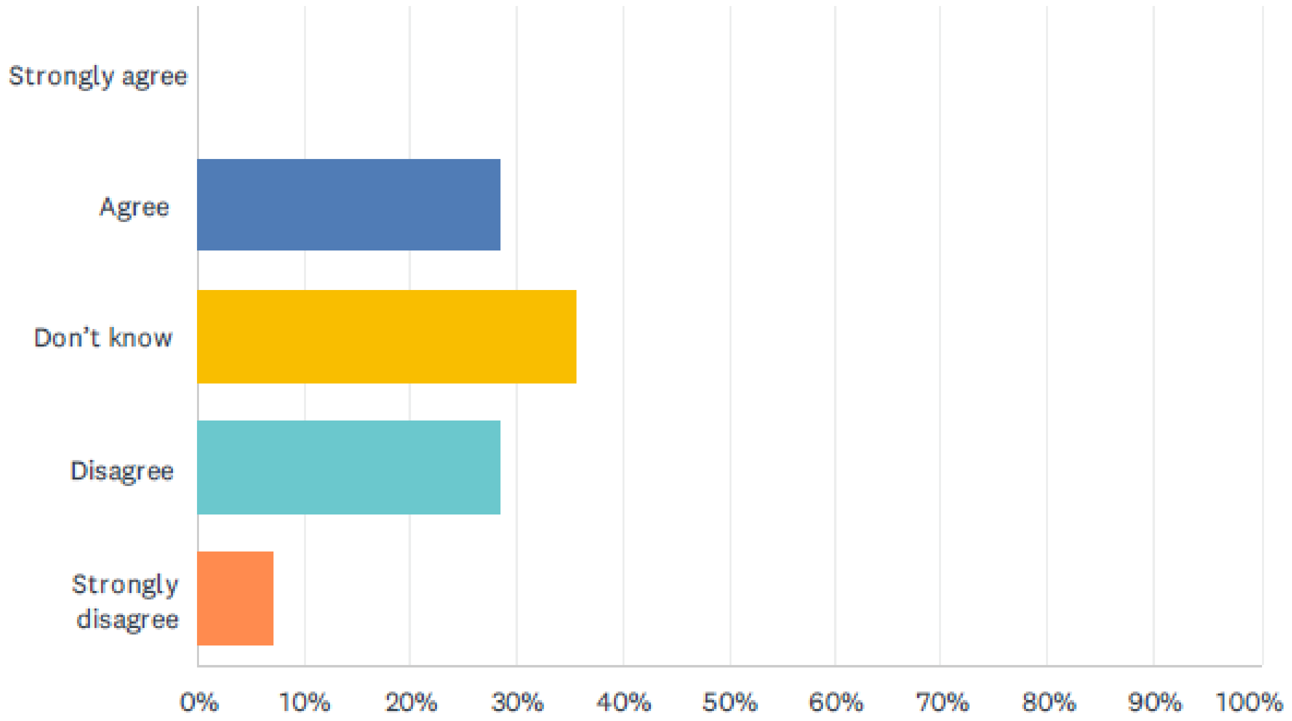
A greater number of firms will be willing to apply for an Internal Model as a result of this change.



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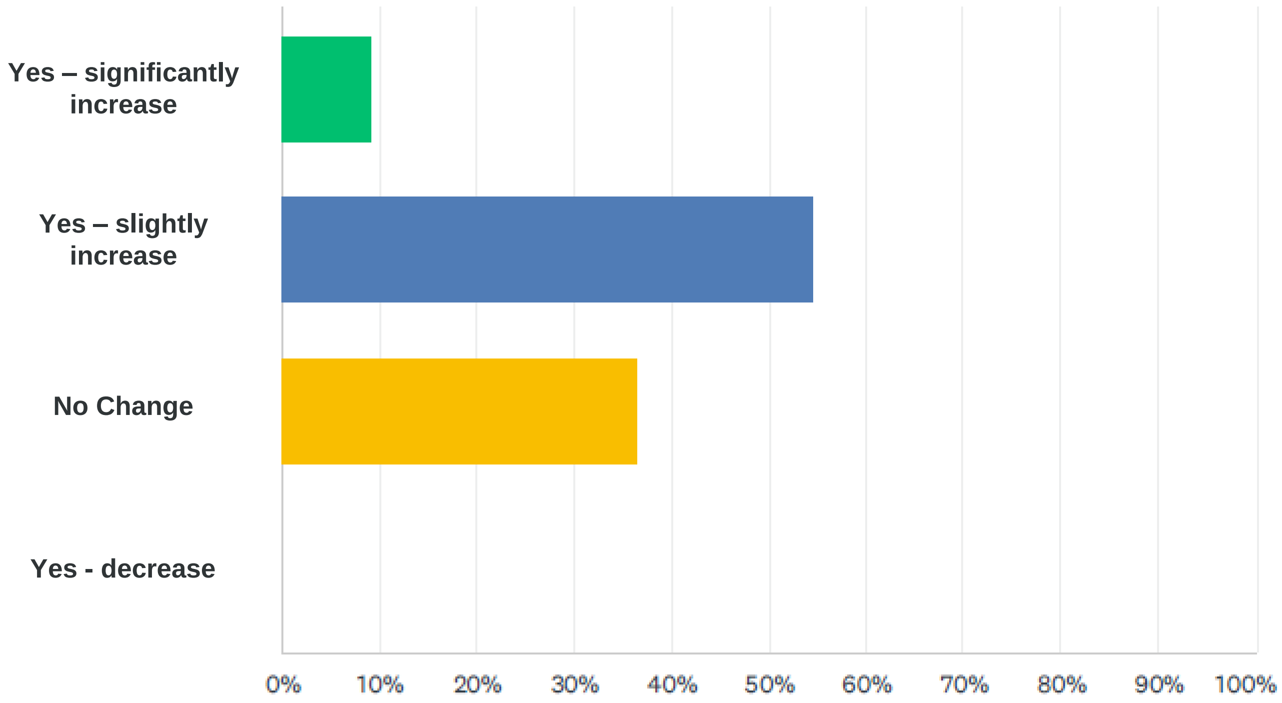
The internal model flexibility will impact the number of applications to change an EXISTING internal model.



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Residual Model Limitation: Capital Add-On

What is the change?

The RML CAO is one of the safeguards used to address **deviation in the risk profile of a firm** from the assumptions underlying the SCR

- Calculated as a proportion of the ***difference between SF and IM***
- Reviewed at least annually

Impact on the firm

Practicalities issues e.g., timing of communication, governance approval and funding:

- Disincentive, if process is not sufficiently efficient, proportionate and well timed

Poor choice of metric: Further away from risk profile?

Impact on the market

Proportion of the ***difference between SF and IM*** **< 100%**

More firms using a sophisticated Internal Model, overall ***market becomes undercapitalised***

Unintended Consequence

PRA: Application of CAO that is not reflective of the risk profile (agenda?)

Firms: Possible reduction in ownership of model and diminish effectiveness as tool?

Audience question

The enhancement to the Internal Model application process associated with the RML Capital Add-On approach will be received positively by firms.

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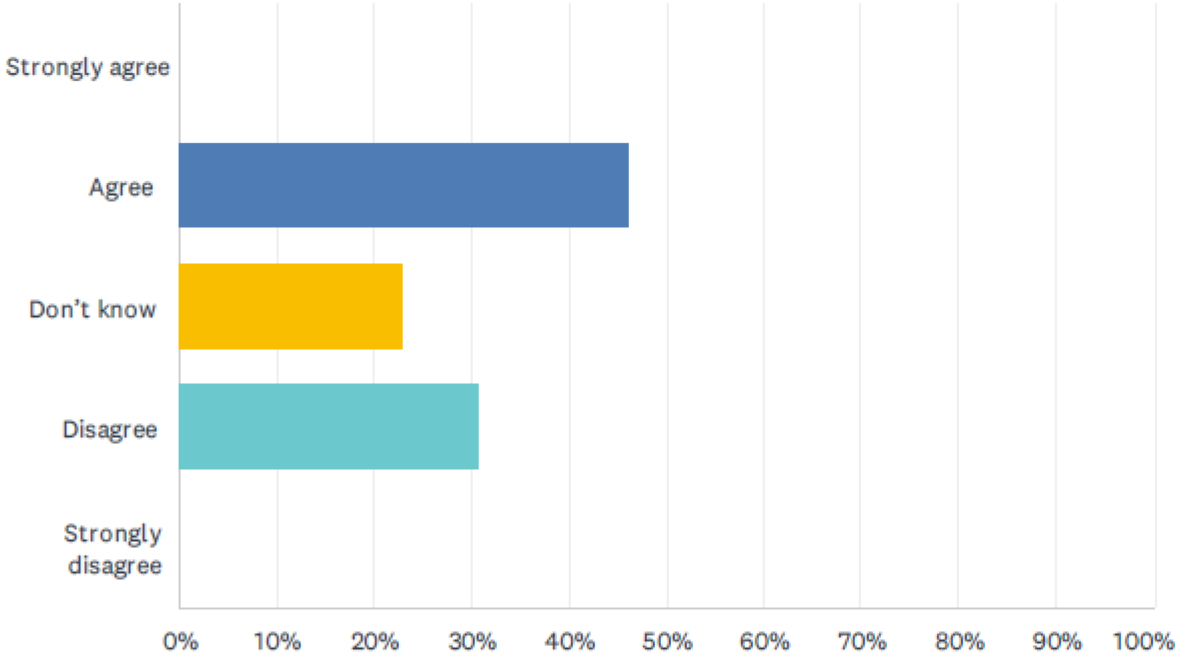

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Reporting and Disclosure

What is the change?

1.Fewer templates submitted
2.Removal of Regular Supervisory Report (“RSR”)
3.Other proposed changes:

- Change in acceptable methods for group SCR (allow SF+IM)
- Amended TCB reporting (to include branch legal entity)
- Amended Group reporting
- No longer bifurcate Heath in EBS
- New template for changes in SCR since prior year-end (AoC)
- Amended IM output reporting to include more granular data

Impact on the firm

- Short term: change in existing QRT solution
- Long term: reduction in the reporting burden

Impact on the market

Benefit TCB and Group most

Unintended Consequence

Firms who benefit the most are those who have (thus far) invested the least in automated processes.

Audience question

The changes in reporting and disclosure requirements will have a material impact on reducing the administrative burden in relation to cost/ time taken.

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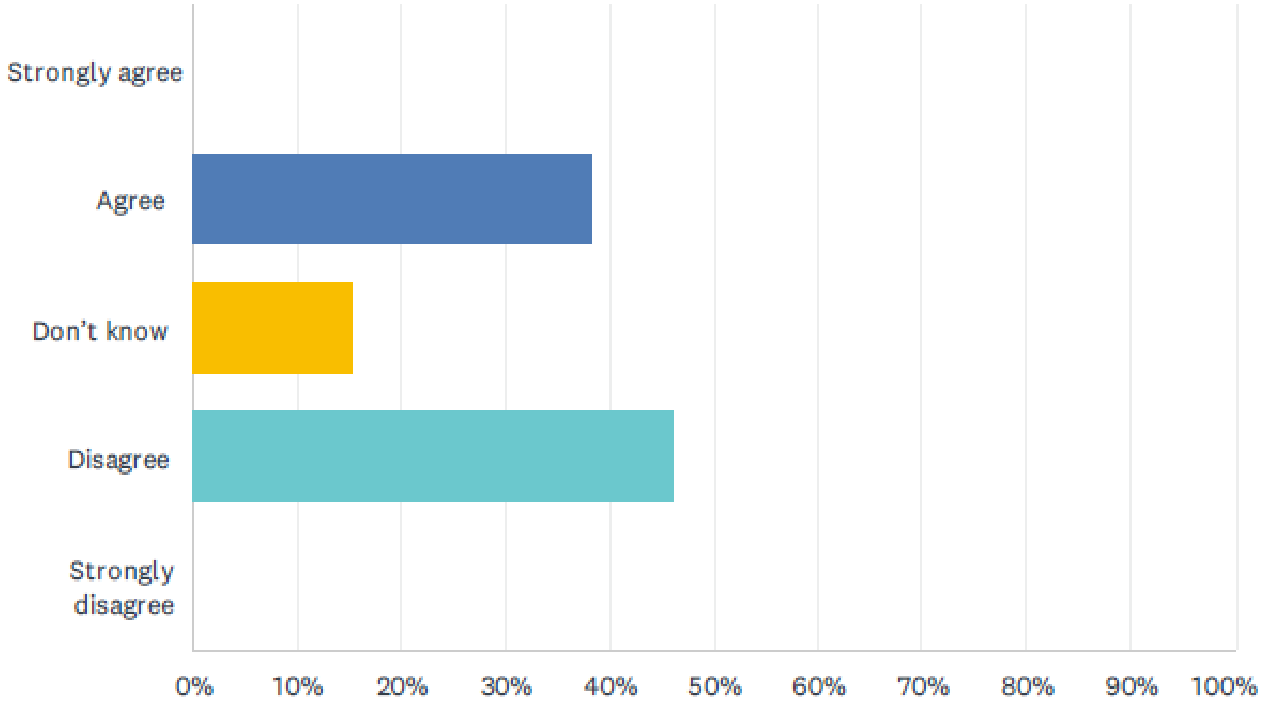

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Sources:
1. *Proposal amending the Solvency II Directive*, European Parliamentary Research Service (EPRS)
2. *Highlights of the European Parliament's draft amendments to Solvency II*, Arthur Cox

Reporting and Disclosure – Solvency II

As a result of the review, on 22 September 2021, the Commission tabled a proposal for a directive amending Solvency II (the "amending proposal"). The changes the amending proposal would include:

1. **Adapt the reporting requirements for low-risk profile undertakings**, based on meeting relevant criteria:
   - Captive (re)insurance; or
   - No significant cross-border activity,
   - Compliance with the SCR and no capital add-on being imposed, and
   - GWP of less than €100 million and inward reinsurance constituting less than 50% of GWP.
2. **Modify the structure of the SFCR** in **Article 51** Solvency II, splitting its content into parts addressing policyholders and other stakeholders; and introducing auditing requirements for the prudential balance sheet. Using (P)IM, insurance companies would have to report regularly an estimation of the solvency capital requirement.
3. **Introduce a new Article 45a on climate scenario analysis**, whereby insurers would have to identify any material exposure to climate change risks and assess the impact of long-term climate change scenarios on their business.
4. **Modify Article 212 to facilitate the identification of entities that form a group**, and more specifically defining "insurance holding companies," both empowering the supervisory authorities to force a group restructure.

Third Country Branches

What is the change?

Remove requirements:
- Calculate of SCR and RM
- Hold local assets to cover SCR

Replace with:
- Stand-alone TCB reporting
- QRTs and NSTs
- Assurance UK policyholders are given appropriate priority in the event of a wind-up

Impact on the firm

Onerous for some TCBs:
- SM&CR
- Quantification of "FSCS protected liabilities"
- Branch Legal Entity QRTs
- Nation-Specific templates
- Additional scrutiny if home jurisdiction capital regime is not "broadly equivalent."

Impact on the market

- **Less capital held in the UK**
- Less contributions to FSCS
- **Validation of PRA's opinion** that their approach for authorising and for ongoing supervision of TCBs is sufficient.

Unintended Consequence

Risk that non-UK firms compete in UK on more favourable terms than UK firms oversees.

Audience question

The change in third country branch requirements will encourage more non-UK firms to set up a UK branch.

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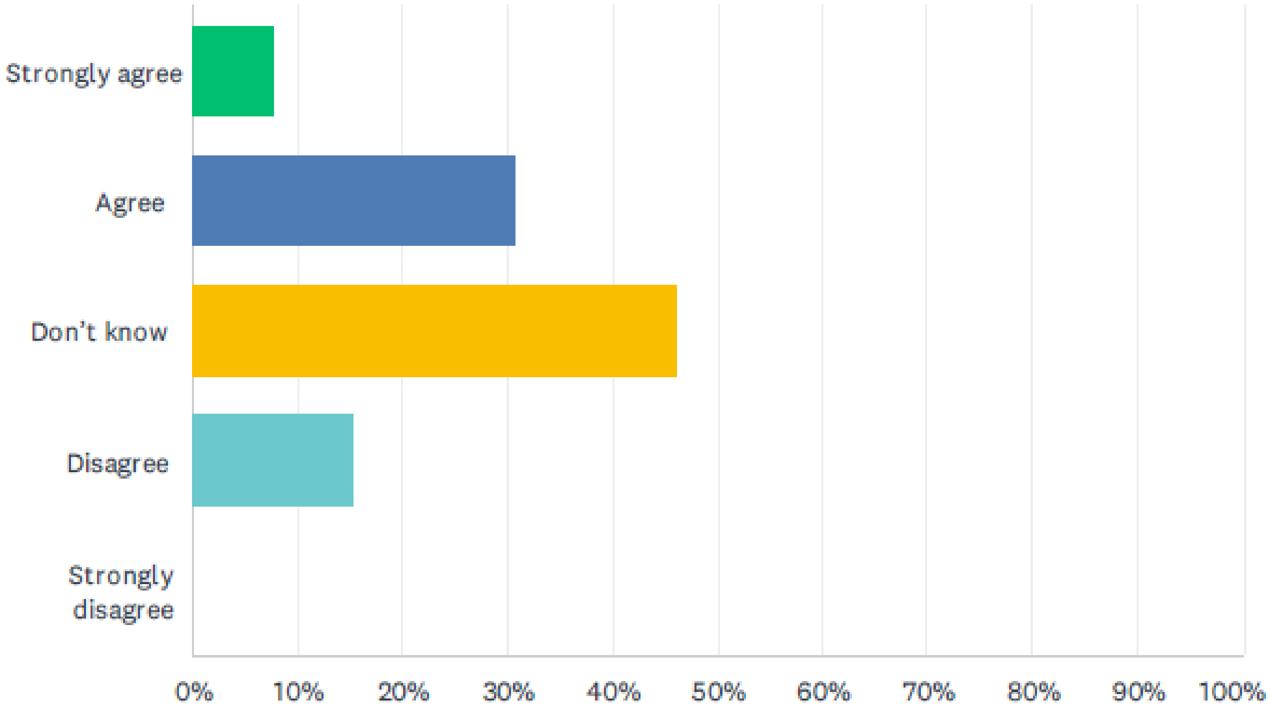
The change in third country branches requirements will encourage more non-UK firms to set up a UK branch.



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Mobilisation

What is the change?

- Support **new insurers' entry** and **expansion** in the UK.
- Provision to build up necessary systems/resources, operating under business restrictions and proportionate requirements.
- The **PRA may lower minimum capital requirements during the mobilisation phase**, benefitting firms aspiring for insurer authorisation in the UK

Impact on the firm

- Easier entry for new insurers may **heighten competition**, requiring existing firms to adapt and innovate to maintain market share
- The reforms aim to **boost the UK's appeal** as a business location, potentially attracting foreign insurers and diversifying the market landscape

Impact on the market

- **Increased innovation** due competition resulting in existing insurers accelerating their innovation efforts
- **Market diversification** through the entry of new insurance products and services into the market

Audience question

A large number of firms will take advantage of and utilise the mobilisation period.

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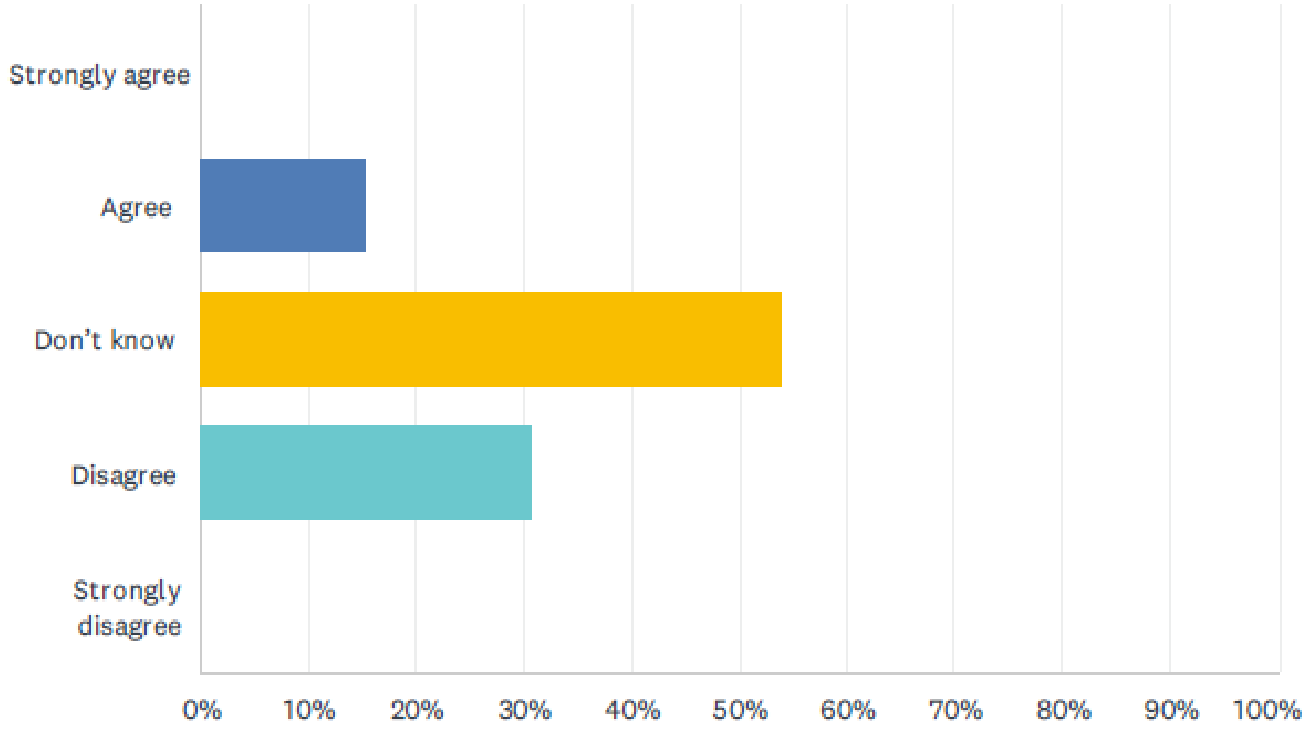
A large number of firms will take advantage of and utilise this mobilisation period.



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Case Study: Bermuda Monetary Authority Regulatory Sandbox

1. What is it?

- **BMA's insurance regulatory sandbox** (in effect 2018).
- Innovation track designed to enable companies to test new technologies or business models with a limited number of clients, in a controlled environment away from the regulated market, for a set period under the oversight of the BMA.

2. Its successes

- Thus far, **nine** companies have been registered under the regulatory sandbox, of which **four** have received insurance licensing.
- Fostered innovation within the **Insurtech** sector.
- Enabled businesses to understand and adapt to regulatory requirements before full-scale operation.
- Attracted international Insurtech players due to its forward-thinking regulatory approach.

3. Businesses benefitting

Cyber Risk Management and Insurance	Developing systems for managing, pricing, and trading cyber risks, and insurance for digital asset loss or theft.
Parametric and Catastrophe Insurance	Utilising smart contracts and ML to enhance underwriting processes.
Bitcoin-based and Digital Reinsurance Insurance	Offering Bitcoin-denominated insurance and tested digital reinsurance contract platforms.
Insurance Risk Transfer and Trade Marketplace	Testing an electronic marketplace for transferring and trading insurance risks.

4. Lessons Learned

Such solutions could benefit from being:

- Streamlined and efficient.
- More inclusive of smaller insurers and start-ups.
- Better aligned with existing regulatory framework.

Other changes

Group SCR

Allowing group SCR calculation by **adding results of entities** with different calculation approaches temporarily, subject to group being permitted by PRA

Proposes to allow **UK group's overseas sub-group SCR to be included in group SCR**, allowing diversification benefit (Method 2)

Threshold

Increase thresholds from when Solvency UK would apply

- Gross **written premium** income increased from **€5 million to £15 million**
- Group **technical provisions** are increased from **€25 million to £50 million**

CCY Redenomination

Administrative amendments and redenomination in PRA rulebook from **EUR to GBP**

Sustainability (EIOPA)

April 2021 opinion on use of **climate change scenarios in ORSA**

At least 2 scenarios: one with global temp under 2 degrees, other that is significantly higher

Solvency UK to follow?

Matching adjustment – PPO impact

HM Treasury intends to **extend the scope of MA to income protection liabilities and some other products not currently in scope e.g., Periodic Payment Orders (PPOs).**

Opportunity for capital savings and implications for product pricing.

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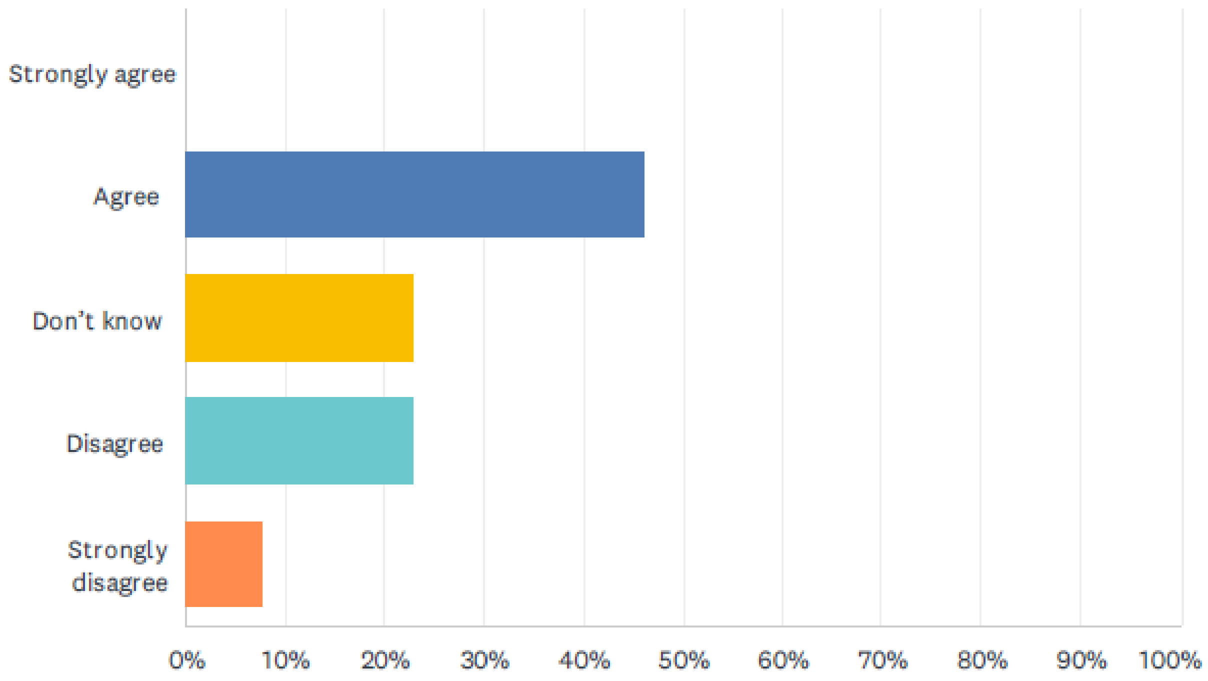
The increased thresholds for Solvency UK eligibility will have a material impact on the number of firms that will need to comply with Solvency UK requirements.



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Solvency II vs IFRS17

EIOPA has considered alignment of Technical Provisions calculation with IFRS 17 calculation.

However, EIOPA has concluded that ***the alignment is not possible*** *due to several reasons*, among others:

- The **objectives of both frameworks are different**, which creates some reasonable differences. An example could be the Contractual Service Margin, where there is no equivalent concept under Solvency II.
- **Technical provisions shall be valued at transfer value**. However, in IFRS 17 the overarching principle is the fulfilment value.
- **Granularity of the calculations have several differences**, like IFRS 17 annual cohorts. Besides, unbundling requirements may be significantly different in some cases. While Solvency II is driven by risks, requiring them to be split at least by Lines of Business, IFRS 17 is based in contracts, and unbundling of different insurance components of a contracts is not the default approach.

Source: EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

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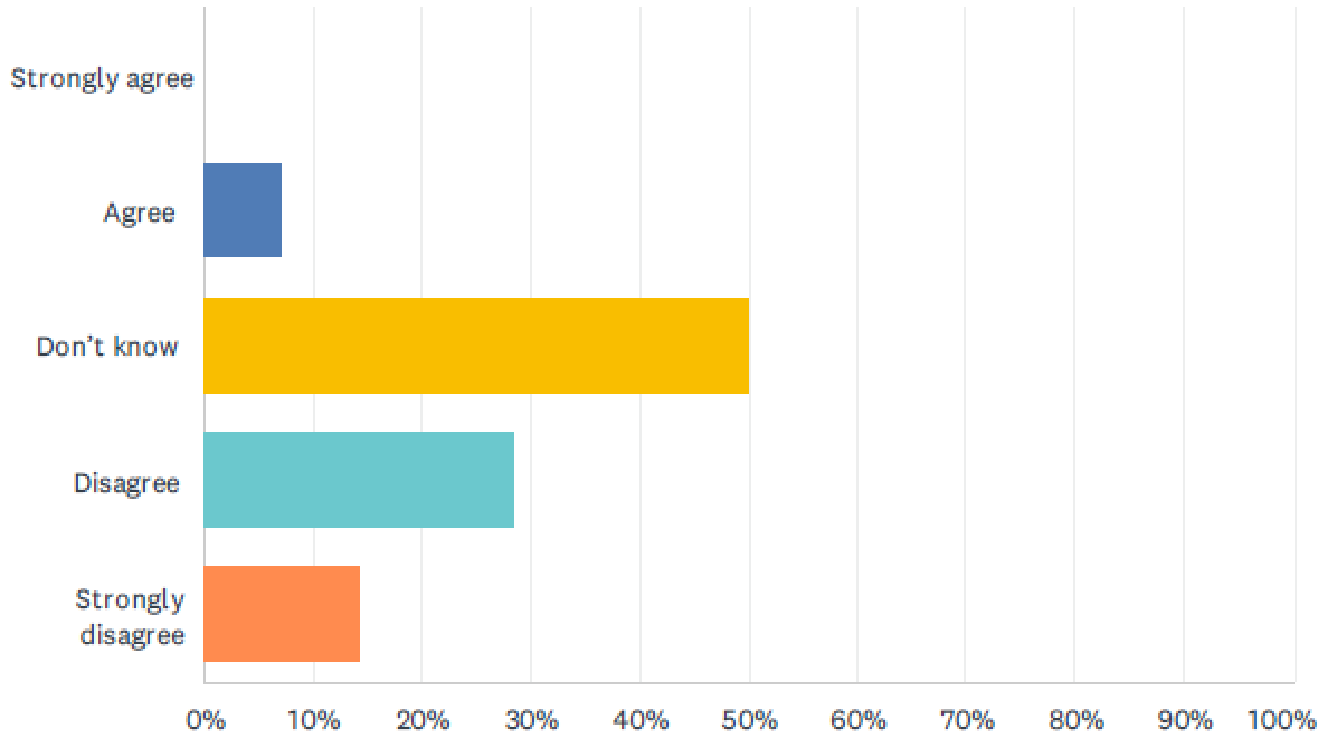
The alteration in risk margin brings the economic balance sheet further in line with IFRS17.



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Conclusion

- **Solvency UK**: Risk margin reduction, Internal Model flexibility, Mobilisation, Reporting simplification
- Despite intention to implement changes quickly (and still faster than the pace of change in Europe), the process is slow

What firms need to do:

  - Prepare for **new risk margin** calculation
  - Deploy **new found capital**, where appropriate
    - Reduced risk mitigation – retain more risk due to increased capital?
  - **Re-think internal model** and analysis of change requirements
  - **Pillar 3 reporting**: Plan for this change
  - TCB of entities **domiciled in non equivalent jurisdictions** should expect heightened scrutiny
  - New Entrants leading to **increased competition**

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Questions

Comments

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

The views expressed in this presentation are those of the presenter.

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Thank you