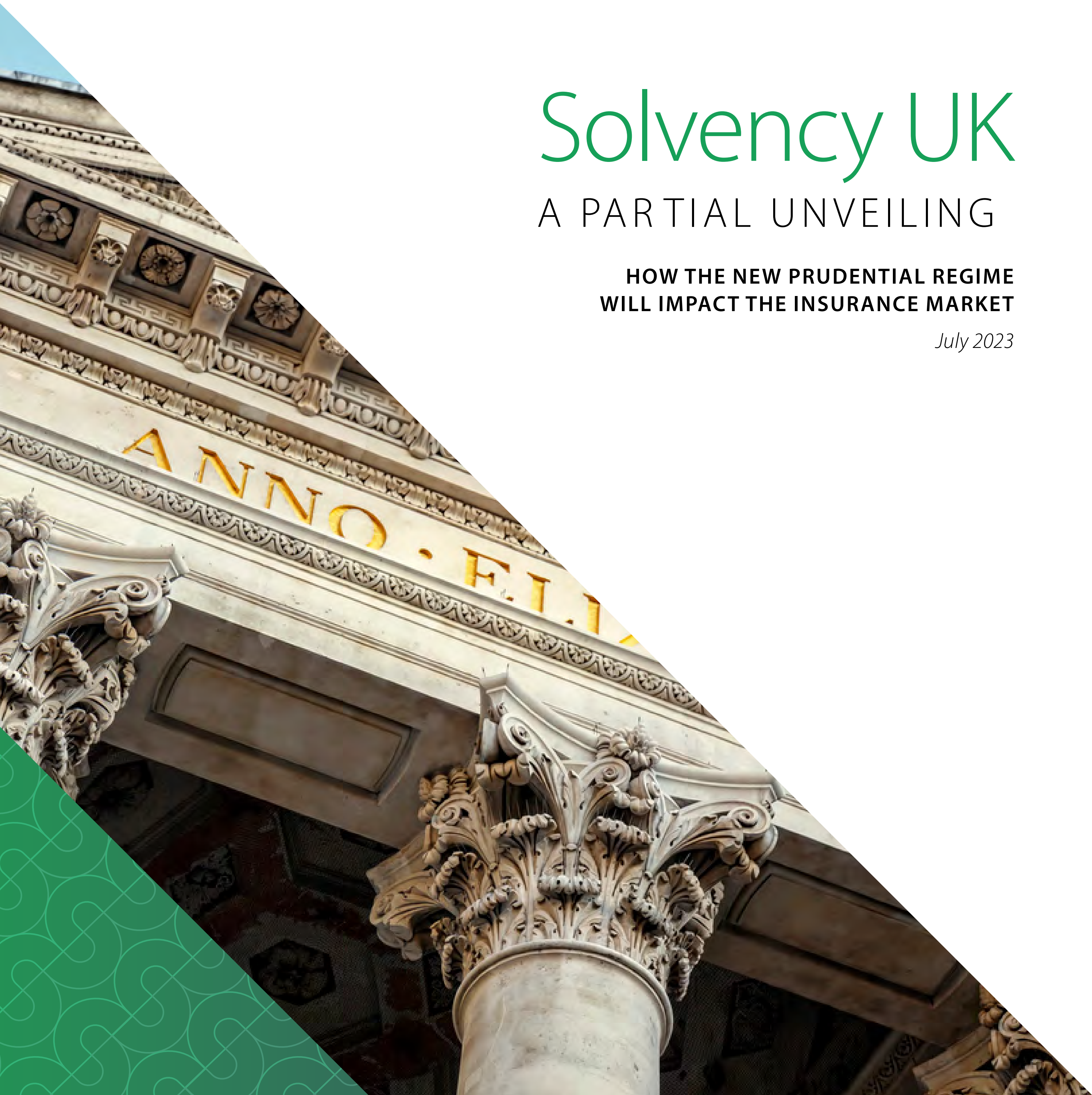
SICSIC ADVISORY
FINANCIAL SERVICES
RISK & REGULATION

Solvency UK

A PARTIAL UNVEILING

HOW THE NEW PRUDENTIAL REGIME WILL IMPACT THE INSURANCE MARKET

July 2023



INTRODUCTION

The Prudential Regulation Authority's (PRA) late June consultation, Review of Solvency II: adapting to the UK insurance market needs to be read alongside the Financial Services and Markets Bill, and the two Statutory Instruments published by the Treasury. We have not seen the full package yet. There will be two further consultations, in September and in early 2024, and Solvency UK should come into force at the end of 2024.

Solvency UK clearly belongs to the Solvency II family. The first point to note is that those expecting big changes will be disappointed. The UK's Review of Solvency II focused on a limited number of issues – principally the Risk Margin and the Matching Adjustment. All the key features of Solvency II have proven their worth over the past ten years, and will not change in Solvency UK.

Solvency II came into force across the EEA in 2016, after a long development journey. It still influences the prudential regulation of insurance firms in the UK.

In June 2020, the UK Government announced a review of Solvency II to ensure the prudential regime properly reflects the unique structural features of the UK insurance sector.

The move to Solvency UK gained further clarity in June 2023 with the publication of:

- A couple of draft statutory instruments called "Draft Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations" contain the proposals to reform the calculation of the Risk Margin (RM) and Matching Adjustment (MA)
- The first of the PRA 's long-awaited consultation papers (CP12/23) on adapting the Solvency II framework for the UK market.

Two further consultations are expected:

- The first one in September on proposals relating to investment flexibility and the Matching Adjustment; and
- The second one in early 2024 on how the remainder of Solvency II will be transferred to the PRA rulebook.

Solvency UK should come into force at the end of 2024 and all the indications are that the proposals will align with the direction of travel outlined in HM Treasury's 2022 "Review of Solvency II: Consultation – Response". It will therefore be very similar to Solvency II with a lower Risk Margin, some increased investment freedom, various simplifications and some reduced reporting. In addition, the authorisation route for insurers will include a new optional mobilisation stage that may help the journey to the market.

Simplification
There are a number of simplifications for firms around Transitional Measures for Technical Provisions (TMTP) and the internal model application process. In addition, the reduction in reporting will be welcomed by most firms.

Impact
The reduction in the risk margin is the most significant element of the June proposals. It will see a reduction of 30% for general insurers and around 65% for life insurers. The other changes, for existing insurers, will either result in slightly different conversations with the PRA, e.g. internal model reviews and analysis of change, or reduced workloads, like reporting. For new insurers, the proposed mobilisation approach offers an interim step to authorisation which may give greater flexibility.

Flexibility
The PRA is keen to stress the move to a more principles-based regime. This will, in theory, give firms and the PRA greater flexibility in their approach to the supervisory process and one that is appropriate for the risks each firm runs.

Mobilisation
A new concept has been introduced that will enable firms seeking authorisation to move from no authorisation to a partial state assisting firms in demonstrating their readiness for subsequent authorisation.

Competitiveness
The PRA, due to the Financial Services and Market Act, has an additional secondary objective relating to facilitating the international competitiveness of the UK's economy. The measures within these proposals are in alignment with this objective and help reduce unnecessary burdens, including for instance the removal of the need for branch capital within overseas branches.

WHAT DOES IT MEAN FOR FIRMS?

The answer will vary by firm and depends on a number of factors.

For a number of firms that do not use MA, TMTP, or an internal model, the impact will be restricted to the change in the risk margin and some reduced reporting. For other firms, the amount of preparation may be significant as they need to assess the impact of the various options and whether or not they need to put additional processes and controls in place.

One unknown at this stage is the impact of the proposals in the September consultation paper involving the changes in investment flexibility for the Matching adjustment and any associated reporting.

There will be some smaller firms that may no longer be subject to Solvency UK, but they will want to assess whether or not their growth plans may lead to being back in scope in a few years' time.

TIMELINE

	06/2023	Q3 2023	Q4 2023	H1 2024	H2 2024
HM Treasury statutory instruments (SI)	Drafts published →		Risk margin (RM) reforms in force →	MA reforms in force	
PRA June consultation paper (CP)	CP published →	CP closes →		Final policy published →	In force
PRA September consultation paper: Matching Adjustment (MA) reforms		CP published →	CP closes →	Policy published and implemented	
PRA Q1 2024 consultation paper: All other areas				CP published/ closes in Q2 →	Policy published with changes implemented in Rulebook

This is a simplification package, just as described by the PRA

Sam Woods, Deputy Governor for Prudential Regulation and CEO of the PRA, described this consultation package as follows: "These measures will reduce bureaucracy, facilitate competition, and support UK economic growth and competitiveness without lowering prudential standards or weakening policyholder protection."

There are a few areas where the PRA has introduced new requirements, but overall this is a perfectly accurate description of the package.

OVERVIEW OF THE MAJOR AREAS OF THE CONSULTATION

Major area	*Details*
Transitional Measures for Technical Provisions (TMTP)	• The PRA proposes to simplify the methodology for calculating the TMTP to reduce the burden on firms of maintaining multiple calculation routines. The FRR test will be scrapped at implementation and there will be a requirement to model and monitor the run-off of the TMTP to avoid any solvency risks. • There is the possibility of maintaining a legacy approach to the calculation of TMTP, subject to approval. • The Chief Actuary will oversee the TMTP calculations rather than the audit committee. • No new TMTP permissions will be given apart from where it involves a transfer of business already subject to TMTP and third country branches will be unable to utilise TMTP. (No branches currently use it.)
Internal models	• Moving to a principles-based framework for permission to use an internal model. This will include refining the Tests and Standards and reducing the amount of evidence required. • A new category of permission where the model has Residual Model Limitations (RML) is proposed. This would allow a model with known limitations to be granted permission. • Profit and Loss Attribution will be replaced by a requirement to perform an Analysis of Change of the SCR. • The PRA plans to update its ongoing Internal Model review process by having a 4-strand process involving 1) PRA-driven thematic reviews, 2) annual Analysis of Change exercise, 3) SMF Attestation of Ongoing Internal Model Compliance (in most cases, the CRO) and 4) monitoring of safeguards triggered by an RML.
Capital add-ons	• To support the introduction of RML, the PRA propose to introduce new approaches to the calculation of Capital Add-ons (CAO), their use, disclosure and monitoring.
UK branches of Overseas Insurers	• Removal of capital requirement for branches, with a consequent change in reporting requirements. • PRA focus will be on the overall financial strength of the overseas insurer the UK branch belongs to.
Mobilisation regime	• The PRA is looking at ways of enabling start-up firms to have an effective journey to full authorisation. One area of concern has been the entry barrier of requiring full compliance with the Minimum Capital Requirement (MCR) floor at the date of authorisation and a fully functioning organisation that can trade. • The PRA is proposing to add an optional interim stage of up to a year to the authorisation process where firms are authorised with restrictions, including on the type and volume of business they can write, and allowed to operate at an MCR floor level of £1 million. • Firms will use the mobilisation period to meet full authorisation requirements including capital, governance, IT, senior management etc. • The CP contains a number of examples of the development journey a firm may go on during mobilisation, whilst minimising the risk to policyholders and the PRA.
Reporting regime	• Removal of the requirement to produce a Regular Supervisory Report (RSR). • Other changes to individual templates as a result of proposed changes contained within the CP.
Other areas	• Ability to use different approaches to the calculation of Group Solvency when using Method 2 (Deduction and Aggregation). • The PRA proposes to increase the Solvency II compliance threshold so that firms with Gross Written Premium below £15 million and technical provisions below £50 million would not be subject to Solvency UK. • Solvency II fixed values denominated in Euros will be converted to Pounds Sterling at the rate of £1 = €1.13.

WHAT DO FIRMS NEED TO DO?

The key will be to understand which proposals impact the firm and to assess what this means.

For example:

- For a change in reporting requirements, a gap assessment should be conducted and any system or process changes should be evaluated so the changes can be made in 2024.
- If a firm currently uses TMTP, it should start to consider what the impact of the changes are and how the firm will manage them once implemented. For example, does the firm need to consider using the legacy approach?
- Internal model firms will need to work with their supervisory team to understand the Analysis of Change requirements and any further impact that may occur on the internal model change journey, including the proposed attestation requirement.

As mentioned previously, the impact on firms will vary and could be quite complex. For the majority of firms though, it will probably be quite minor and the most obvious change will be the reduction in risk margin caused by the updated calculation.

Recommendation:
Work in collaboration with the PRA

It is all too easy to think of prudential regulation as a Manichean struggle between the PRA, determined to maintain levels of regulatory capital, and the industry, keen to exploit any loophole to reduce regulatory capital. The truth is more boring. Both sides believe that a sound prudential regime is essential, and differences of view are at the margin.

The PRA has a job to do, and will surely do it. Companies should use the supervisory dialogue to explore in depth the thinking behind your supervisors' concerns, and to explain carefully what steps the company has already taken. And remember that the PRA will look carefully at the governance.

HOW CAN SICSIC ADVISORY HELP?

Our team of experts can help you navigate the regulatory regime as it applies to you. Covering both prudential and conduct matters, you can tap into our experience and insights from the wider market to help improve your regulatory risk management and control. Using our forward-looking approach, we can help identify the key issues for your business and deliver tailored, practical solutions.

As the Mobilisation Regime is a key element of the consultation, firms should take advantage of it. If you're a firm looking to expand into a regulated area for the first time or through a merger or acquisition, Sicsic Advisory has a broad range of skills and experience to support you at every stage of your authorisation journey. Learn more about our services supporting you through the authorisation process here.

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REFERENCES:

- CP12/23 - Review of Solvency II: Adapting to the UK insurance market
- Financial Services and Markets Act 2023
- Statutory Instruments
- Sam Woods quote on the consultation package

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