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Treasury Committee

The Solvency II Directive and its impact on the UK Insurance Industry

Third Report of Session 2017–19

Report, together with formal minutes relating to the report

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The Treasury Committee

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Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk.

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Summary

1. The development and implementation of Solvency II has been a major event for firms and regulators across the European Union. During the last Parliament, the Treasury Committee received over 50 pieces of written evidence on EU insurance regulation, and held three oral evidence sessions, from a diverse range of stakeholders including insurance firms, financial regulators, consultants, trade bodies, expert associations, and individuals. This report draws on that evidence and concludes an inquiry for which much of the groundwork was done by the previous Treasury Committee.

2. With such a large piece of legislation, it should not be a surprise that there are a number of areas that need to be refined. Specific areas explored in this Report include:

- the risk of procyclicality and market distortion;
- the potential impact on long term savings and investment, and the function of the Matching Adjustment;
- the calibration of the Risk Margin;
- the approval of Internal Models and subsequent model change;
- the volume and complexity of data required from firms;
- the usability of the Volatility Adjustment;
- the working of the Transitional Measure on Technical Provisions; and
- the rigidity of Solvency II's approach to Contract Boundaries.

3. The evidence submitted to the previous Committee highlighted problems both with the legislation as drafted and with the way it has been implemented in the UK by the Prudential Regulation Authority (PRA). While some differences of opinion are to be expected, the current Committee is as concerned as its predecessor at the extent of disagreement between the PRA and industry on matters that should be relatively factual–for example, around the availability of investment grade long-term assets. Such disagreements do not foster good policymaking.

4. The Committee understands that the PRA can act on its own initiative in a number of policy areas, whereas in others it currently has to act within the EU legal framework. However, the PRA and industry differ as to precisely where this line is drawn. The Committee strongly encourage the insurance industry and the PRA to come to an understanding on what aspects of Solvency II can be changed unilaterally while the UK remains an EU member state.

5. There will be some areas where it is clear that the PRA cannot act on its own initiative and where it may look to discuss changes as part of the ongoing review of Solvency II initiated by the European Insurance and Occupational Pensions Authority (EIOPA). Clearly it will be helpful and constructive if EU member states can agree changes together because, regardless of Brexit, there is a value to harmonisation of the industry's regulation.

6. However, the overriding priority is to develop a system of regulation which is right for the UK insurance industry, and which meets all the current and future needs of consumers, providing a prudent regulatory structure without stifling competition and innovation. We would expect the UK regulators—with close input from the industry and HM Treasury—to work on this task. It will be desirable to keep in step with the EU and other international initiatives as far as this is possible.

7. The Committee notes the views of many of those who gave evidence to the previous Committee that the PRA's approach is overly focused on solvency—to the detriment of its secondary competition objective, and to the ability of the industry to meet the savings and protection needs of consumers. Many respondents had advocated a clear competition objective for the PRA—to act as a counter balance to the solvency objective. The Committee advocates a review of this alleged conflict by HM Treasury.

8. Given the complexity of the task and the importance of the industry, both domestically and internationally, the Committee would like to see the development of a clear agreed strategy designed to provide a roadmap for:

- what changes to insurance regulation can be implemented by the UK authorities now, unilaterally, without the need for a change in the Solvency II Directive (to include consideration of what steps would be required to allow regulatory forbearance to limit systemic risks in the event of market turbulence);
- what steps the UK regulator would like to see taken to refine the Directive or its applicability to the UK post-Brexit, as a contribution to the Brexit negotiations;
- what action can be taken post-Brexit to foster innovation, competition and competitiveness for the benefit of UK consumers and the standing of the UK's place in the international insurance industry; and
- how UK insurance regulation will harmonise with international capital standards and emerging accounting standards.

1 Introduction

Background to the insurance industry

9. The UK insurance industry managed investments of over £1.9 trillion[1] in 2016 and paid nearly £12 billion in taxes to the Government.[2] It has a Gross Value Added (a measure of the contribution a sector makes to the UK economy) of £35 billion per annum.[3] It employs around 305,000 individuals, of which around a third are employed directly by providers with the remainder in auxiliary services such as broking.[4] Furthermore, the insurance and pensions sector is a significant exporter of services to the EU.[5]

10. Insurance provides a useful social purpose in that it pools risk to provide protection against losses from risks that an individual or company would be unable to bear. Of the 26.7 million households in the UK in 2014, over 20 million had home contents insurance and/or motor insurance.[6] It also facilitates long term saving by providing a vehicle for individuals to take advantage of investment in long term assets that would not ordinarily be available to them. Writing about the insurance industry as a whole, the Chief Executive of Axa UK said in 2015 that:

> "Last year as protectors we paid £14.5 billion—that's £40 million each day—in motor and property claims, £370 million was paid in claims to travellers who needed help, and £3.6 billion to provide access to private healthcare. For savers, we invested £1.9 trillion (equivalent to 25% of the UK's total net worth)—providing enormous fuel to the economy, and crucial funding for its necessary infrastructure."[7]

11. The UK insurance industry also includes the London Market—both companies and Lloyd's of London, which insures global risks through 84 syndicates. In 2015 the aggregate gross written premiums of the Lloyd's market totalled £26.7 billion,[8] out of a total of £260 billion for all firms supervised by the PRA.[9]

12. There have been only two significant failures of UK insurers in the last 40 years, which have been summarised by the Institute and Faculty of Actuaries:[10]

- *Equitable Life*, which sold products with guaranteed annuity rates (GARs) for many years. These guarantees became increasingly onerous as interest rates fell in the 1990s. Falling equity markets caused further losses, and revealed material underestimates in reserves, causing the company to close to new business in 2000.[11] Although the firm did not collapse, the Government was required to pay out compensation (amounting to more than £200m) to policyholders who had been adversely affected. The failure of Equitable was partly due to a degree

1 Association of British Insurers, UK Insurance & Long Terms Savings Key Facts, 2016
2 Ibid
3 Office for National Statistics, United Kingdom National Accounts, The Blue Book: 2015 Edition
4 SOL032
5 The United Kingdom's exit from and new partnership with the European Union, 2 February 2017
6 Association of British Insurers, UK Insurance & Long Terms Savings Key Facts, 2016
7 Association of British Insurers, A Brave New World, 2015
8 SOL028
9 'Insurance supervision at the PRA' - Speech by Sam Woods, 20 March 2017
10 Institute and Faculty of Actuaries, Reasons for Insurance Companies Failures, 2011
11 Equitable Life: Timeline of key events, BBC 2010

of blindness to the risks, which no regulatory regime can completely guard against, but also to weaknesses in the solvency requirements. In response, the FSA made fundamental changes to the rules, introducing a new solvency regime (Individual Capital Adequacy Standards, ICAS). This continued in place until the introduction of Solvency II in 2016.

- *The Independent Insurance Company Limited*, which went bankrupt in 2001, following fraudulent activity by the firm's senior management.[12] In particular, there were irregularities in relation to accounting and the use of reinsurance. The failure of the insurer had a number of varied adverse impacts. For example, many parties found themselves without vital insurance cover, and had to make emergency purchases;[13] over a thousand staff were made redundant when the company collapsed; the Financial Services Compensation Scheme paid out £366 million in compensation;[14] the taxpayer had to pay for the complex trial involving the Serious Fraud Office, and IICL shareholders suffered, amounting to a secondary impact on society where such shareholdings were held by pension schemes.

13. There have been several well-known incidents outside of the UK market. These include the failure of around a third of Japanese insurers in 2000,[15] and the collapse and near-failing of American International Group (AIG) in 2008.[16] In the latter case, AIG's UK Insurance subsidiary failed—but this was a result of the Group's non-insurance activities, rather than any intrinsic failing of the insurer. None of the various overseas failures has had a significant impact on the UK market or the UK financial system.

14. **The UK insurance industry is a major contributor to both personal and national economic development; a major employer and tax payer; and a major investor and source of market liquidity. The scale of its contribution to the UK economy is often not recognised and it has historically produced few risks to UK Government finances, and far less of a solvency risk than the banking system.**

Background to Solvency II and this Report

15. This Report contains the conclusions and recommendations of the inquiry into the effect on the UK insurance industry of the introduction of Solvency II, the new EU-wide solvency regime for insurers.

16. Solvency II is a European Union Directive[17] that entered into force on 1 January 2016, after a long period of development from 2001.[18] While reflecting much of the UK's ICAS regime that it replaced,[19] the Solvency II regime takes a more rules-based, rather than

12 Insurance bosses jailed for fraud, BBC, 2007

13 While retail policyholders had recourse to the former Policyholder Protection Board (PPB) if their insurance was compulsory (e.g. motor insurance), voluntary policies were not covered, and neither were commercial consumers. As the PPB was funded by the insurance industry costs were spread across the industry.

14 Independent insurance chiefs face jail, The Guardian, 2007

15 Learning from Japan's 'lost decades', Insurance ERM, 2013

16 What went wrong at AIG? Kellogg Insight, 2015

17 Solvency II is a Directive as opposed to a Regulation. While Regulations are legal acts of the European Union that become immediately enforceable as law in all member states simultaneously, Directives need to be transposed into national law.

18 Solvency II timeline, Insurance ERM, 2015

19 SOL043

principles-based, approach to regulation. Solvency II is seen by some as a 'gold standard' of international insurance regulation, with many countries "moving towards regimes that are more aligned to Solvency II," reflecting the "clear direction of travel for insurance regulation."[20]

17. The Solvency II Directive is an example of 'maximum harmonisation', a term used in European law for legislation that puts in place a single regulatory framework aimed at creating a level playing field[21] across the 28 EU member states and the three European Economic Area countries. Signatories of Solvency II cannot go beyond the legislation (preventing so-called 'gold-plating'). In contrast, a 'minimum harmonisation' regime allows signatories to go beyond the prescribed minimum standards. The Solvency II regime allows firms to write business in other EU Member States under the supervision of their home state regulator, without any further approval.

18. In order to achieve maximum harmonisation, the legislation is grounded in rules rather than principles, curtailing the degree of regulatory discretion at a national level.[22] This in theory prevents regulatory arbitrage, obviating any competitive disadvantage caused by prudential regulation at a national level. However, this loss of control by national regulators caused Andrew Bailey, the then Chief Executive of the PRA, to list it as one of three "major concerns" in 2013, commenting that it "will be a battleground of the future as the judgement approach of the PRA comes up against narrow interpretations of EU law".[23] Solvency II also constrains the ability of insurers to apply discretion of the rules: "there is a requirement for departures from standard protocols to be justified".[24]

19. However, there is a degree of optionality in the implementation of Solvency II. Examples include how a member state implements the Transitional Measure on Technical Provisions (see Chapter 8); whether the national regulator needs to approve a firm's use of the Volatility Adjustment (see Chapter 8), and whether the national regulator allows the use of Dynamic Volatility (see Chapter 8).

20. The long gestation period, punctuated by the 2008 financial crisis, has not gone unnoticed by the industry or financial regulators. In 2013 Andrew Bailey stated that he found "the history of the EU process on SII shocking", while also noting the "staggering" costs.[25] In total, HM Treasury has estimated a one-off cost to UK business of "£2.6 billion…and ongoing costs at approximately £196 million each year".[26] These costs have been generated by the legislation, but also the implementation of Solvency II,[27] although there have been benefits in terms of improved risk management and a level playing field across Europe (see paragraphs 57 to 59)

20 SOL018
21 Ibid
22 Letter from Andrew Bailey to Rt Hon Andrew Tyrie MP, 14 February 2013
23 Ibid
24 SOL0026
25 Letter from Andrew Bailey to Rt Hon Andrew Tyrie MP, 14 February 2013
26 SOL0043
27 SOL019

21. Opinion of the legislation and implementation of Solvency II ranged from "absolutely dreadful"[28] to a view that, while there are "bits of it that don't work well",[29] the "fundamental regime is pretty sensible".[30] For these reasons the Committee decided to undertake an inquiry into the introduction and operation of Solvency II, launching this inquiry on 13 September 2016 to:

> "Consider the options for the UK insurance industry that are created by the decision to leave the EU;
>
> Assess any impact of Solvency II on the competitiveness of the UK insurance industry;
>
> Examine the impact of Solvency II on the role of insurance in meeting the needs of UK customers and the wider UK business economy; and
>
> Assess any learning for both regulators and industry from the introduction of this major piece of insurance harmonising legislation."[31]

22. While Brexit[32] has created both complications and opportunities, to be explored in Chapter 9, the primary focus of this Report has been on the effect of the legislation and implementation of Solvency II. The effects on competition, the PRA's objectives and its implementation of the Directive are explored in Chapters 2 and 3. Macroeconomic issues are examined in Chapter 4, while specific technical elements are assessed in Chapters 5 to 8 as follows:

- The Matching Adjustment—Chapter 5
- The Risk Margin—Chapter 6
- Capital Models—Chapter 7
- Data Reporting—Chapter 7
- Volatility Adjustment—Chapter 8
- Transitional Measure on Technical Provisions—Chapter 8
- Contract Boundaries—Chapter 8
- One Year Value at Risk—Chapter 8

23. It is the purpose of this report to review Solvency II. However, in parallel with the development of EU insurance regulation, there have been developments in international solvency[33] and accounting standards[34] which may turn out to be almost as burdensome

28 Lord Turnbull giving oral evidence to the Committee on the UK's Future Economic Relationship with the European Union, 28 June 2016, HC483, Q21

29 Sam Woods giving oral evidence to the Committee on his appointment as Deputy Governor for Prudential Regulation and Chief Executive of the PRA, 19 July 2016, HC567, Q69

30 Q167

31 EU Insurance Regulation inquiry Terms of Reference, 2016

32 This term is used throughout this Report to refer to a UK exit or withdrawal from the EU

33 ICS—International Capital Standards for insurance—a detailed, risk-based capital requirement controlling the level of capital a firm must hold as a percentage of its risk-based assets, which will be applied to Internationally Active Insurance Groups (IAIGs) and Globally Systemically Important Insurers (G-SIIs) from 2019

34 IFRS 17—a new International Financial Reporting Standard, which was released in May 2017 to replace IFRS4 on accounting for insurance contracts from 1 January 2021

and costly as Solvency II, particularly coming so soon after the implementation of Solvency II. Solvency and financial reporting will normally differ, but there are significant differences between Solvency II and the recently agreed IFRS17[35] and there is a risk that the sheer number of initiatives could lead to a level of complexity which will be a barrier to understanding of an insurer's business by its Board, investors and regulators. The ability of the PRA to address this problem may be limited but, where possible, opportunities to do so should be taken.

Evidence

24. The previous Committee received, and published, 50 pieces of written evidence through the course of the inquiry. In addition, it took oral evidence on the EU Insurance Regulation from 3 panels of witnesses during three meetings as follows:

- Evidence given by Jane Portas (Partner, Insurance Regulation, PricewaterhouseCoopers), Andrew Chamberlain (Chairman of the Life Board, Institute and Faculty of Actuaries), Phil Smart (Partner, Head of Insurance and Investment Management, KPMG) on 17 January 2017.
- Evidence given by Nigel Wilson (Chief Executive Officer, Legal & General), Huw Evans (Director General, ABI), John Parry (Head of Finance, Lloyd's of London), Julian Adams, (Group Regulatory Director, Prudential) on 25 January 2017.
- Evidence given by Sam Woods (Deputy Governor for Prudential Regulation, Bank of England and Chief Executive, Prudential Regulation Authority), Victoria Saporta, Executive Director, Prudential Policy, Bank of England), David Belsham (External Member, Prudential Regulation Authority Board) on 22 February 2017.

25. The current Committee has not taken any further evidence, but it has published one further piece of correspondence received by Committee staff during the last Parliament, one further letter from the PRA and a round of correspondence with the Chancellor.

35 IFRS 17 and Solvency II - Insurance regulation meets insurance accounting standards, by Thorsten Hein, Global Insurance Industry Consultant, SAS

2 The remit, objectives, and skills of the PRA

The PRA's remit from the Chancellor

26. The Chancellor issued remit letters to various bodies, including the Prudential Regulation Committee of the Bank of England, at the March Budget 2017. In them he asked the organisations, where relevant and practical, to:

> "take the following considerations into account in their assessment of the costs, burdens and benefits of potential rules or policies:
>
> i. Competition—The government is keen to see more competition in all sectors of the industry, particularly retail banking. This includes minimising barriers to entry and ensuring a diversity of business models within the industry.
>
> […]
>
> iii. Competitiveness—The government wishes to ensure that the UK remains an attractive domicile for internationally active financial institutions, and that London retains its position as the leading international financial centre. The government considers that achieving this aim in a manner that is consistent with robust institutions and a resilient system will support its aims for sustainable economic growth."[36]

27. This theme was anticipated by many of those who gave evidence to the previous Treasury Committee in its inquiry. They considered that it would be beneficial to reconsider the PRA's remit, and specifically how it carries out its prudential oversight responsibilities in the light of the Government's wishes for an internationally competitive insurance sector that offers good value for money to its customers. There was widespread concern that the PRA's focus was weighted too heavily towards prudential matters, and that this was inhibiting competition.

Industry recognition of the PRA's strengths

28. While previous regulators had to learn important lessons from Equitable Life and Independent Insurance, history indicates that prudential oversight of the UK insurance industry has generally been effective. The industry's responses to the inquiry recognised the importance of maintaining a robust approach to prudential supervision, in order to protect the industry's customers and its worldwide reputation. Alongside their various concerns, witnesses were not short of praise for the regulator, both in oral and written evidence to the previous Committee. For example, Jane Portas stated:

> "The PRA, as I have said previously, is one of the most—if not the most—highly regarded regulators in the world. It is highly respected by other regulators."[37]

36 Letter from the Chancellor to the Governor of the Bank of England, 8 March 2017
37 Q53

These sentiments were supported by Lloyd's of London who noted that the PRA was "respected internationally",[38] and the ABI stated:

> "the PRA are, as I think we would all agree, hardworking public servants who introduced Solvency II in an ordered and measured way into the UK environment, and work phenomenally hard to clear a lot of Internal Models"[39]

29. **The PRA is highly respected internationally as an insurance regulator, both by the industry that it regulates and by other regulators.**

30. Finally, the ABI noted that there are a range of factors contributing to the standing of the UK Insurance industry, and as such Solvency II should not be considered in isolation:

> "level of trust in the UK legal system, tax regime, time zone, talent and skills base are also significant factors that contribute to the UK's leading global standing in the insurance market".[40]

The objectives of the Prudential Regulation Authority

31. The predecessor regulatory body to the PRA, the Financial Services Authority (FSA), was required to have regard to both competition and competitiveness when advancing its objectives. Specifically, the FSA were required under section 2 (3) of the Financial Service and Markets Act 2000, to "have regard to …(e) the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom; (f) the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions; (g) the desirability of facilitating competition between those who are subject to any form of regulation by the Authority."

32. When the FSA was abolished, the FCA was given an objective to promote "effective competition in the interests of consumers".[41] But the requirement to have regard to competitiveness when discharging its general functions fell away.

33. In a similar development, the Bank of England lost its third core purpose—to seek to ensure the effectiveness of the UK's financial system[42]—in 2004, following its fundamental review of its Strategy and Objectives, which had concluded that "the third core purpose is essentially a part of the first two; and while the Bank may from time to time wish to support particular initiatives in the financial sector, we have concluded that the possibility of doing so should not in itself be a core purpose".

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38 Q151

39 Q136

40 SOL032

41 Section 1E of the Financial Services and Markets Act 2000 (as amended)

42 In its description of the third core purpose, the Bank's 2003 Annual Report said that "the Bank wants a financial system that offers opportunities for firms of all sizes to have access to capital on terms that give adequate protection to investors, and which enhances the international competitive position of the City of London and other UK financial centres."

34. The Prudential Regulation Authority's objectives are set out in the Financial Services and Markets Act (2000). These are:[43]

i) a general objective to promote the safety and soundness of the firms it regulates;

ii) an objective specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders; and

iii) a secondary objective to facilitate effective competition.

35. Evidence provided to the previous Committee gave strong support for the PRA's secondary objective to be promoted to a primary objective, and for it to reflect competitiveness as well as effective competition. This would bring it closer to the objectives of its predecessor organisations. The ABI believe that the PRA's objectives "should be about maintaining a safe, vibrant market that firms are interested in entering, in addition to recovery and safe resolution".[44] For these reasons they argue that the PRA should have a responsibility to "consider the implications for UK competitiveness when developing and supervising the UK prudential regime for insurers, to ensure that the regulatory framework and its implementation is supportive of a strong, dynamic and growing UK economy".[45] In oral evidence, Huw Evans asserted that the ABI's members are "overwhelmingly in favour of it being an equal objective".[46] Agreeing with the former Committee Chairman's comments at an earlier session that secondary objectives never really get taken into account at all, he said that competition should be a primary objective:

> "That would be good for the market. This is a market, not least because of the wider public policy landscape, freedom of choice in the life side, the challenges of meeting new risks in the GI side, such as cyber and different types of flood risk, that needs innovation in the market to thrive and to continue to make sure it is a market that works for consumers, and internationally that it continues to be one of the leading markets in the world, as it always has been.
>
> "That cannot just happen by accident in a more challenging environment. We think that having a regulator that was attuned to that, and one full of highly intelligent people who are perfectly capable of striking a decent balance in operational, daytoday practicalities, is not just doable but desirable."[47]

36. Prudential were also in support of turning the secondary competition objective into a primary objective, with Julian Adams referring to the issue of conflicts of interest:

> "We feel very strongly it should because if you do not, the incentive structure of regulators is always to encourage greater and greater caution. I understand that you asked the same question of the first session, and one of the objections was, "Does that not introduce a conflict of interest?" I would

43 PRA objectives as per the Bank of England website
44 SOL032
45 Ibid
46 Q87
47 Q88

> argue that conflict of interest exists at present. There is always a tension between microprudential regulation and its impact on competitiveness. At the moment, that conflict is neither recognised nor managed.
>
> "I would encourage competition from two perspectives. I would encourage competition in the sense of low barriers to entry, to encourage domestic competition, with the socalled challenger bank issue, but, in particular postBrexit, we would encourage them to have regard for the international competitiveness of the UK relative to other financial centres. It is a difficult balance, but there are regulators around the world who in my view recognise and manage that more effectively than in the UK."[48]

37. Finally, both KPMG and the IFoA expressed support for the elevation of the secondary objective. Phil Smart commented:

> "I think there is a danger that, if you don't hold them to account—not doing it as a primary objective may not achieve that—the regulator is just encouraged to layer further prudence on top of the capital requirements. To a certain extent, that is what we have seen in Solvency II, and that has a detrimental impact on competition."[49]

38. This can have the effect of the consumer paying more than he or she needs to in premiums. Andrew Chamberlain added that:

> "I think the fact that it is a secondary objective has led to its being left behind. I don't think it is seen as important in the PRA.
>
> "We have to remember what this is primarily about: in the case of insurance, it is much more about the protection of the consumer than it is about the stability of the system, which is more applicable in banking. The price that the consumer is paying now for the level of protection of Solvency II, together with PRA's interpretations on top, is very high, particularly in some business lines such as annuities. It makes the product so expensive. The balance between security and value for money has got out of kilter."[50]

39. However, not all witnesses and submissions advocated a primary competition objective. Jane Portas of PwC stated that:

> "[I]t is really important that the PRA is held to account for competition, but actually that the primary objective should be policy-holder protection and financial stability. I say that because it can create conflicts of interest if you have it as a primary objective. It is really important that the two—policy-holder protection and financial stability—come first."[51]

40. John Parry of Lloyd's of London was of a similar view, stating:

> "We would say that the primary focus of a prudential regulatory authority should be prudence. It should be on the prudential side. There is no doubt that

48 Q86
49 Q6
50 Q8
51 Q6

> competitiveness is a mixture. Both capital efficiency and capital sufficiency are necessary for us to be competitive. We have seen other regulators being able to embrace that dual focus, so having a secondary objective, or having mind to competitiveness of the UK when we are competing on a global scale for capital and talent, yes. However, we would say that their primary focus should be prudential."[52]

41. The regulator was against the idea of elevating its secondary objective on the ground of financial stability, and also detailed its efforts at promoting competition. On the subject of financial stability, Sam Woods explained that, as insurers do not present as much stability risk as banks it would be "thoroughly confusing"[53] to elevate the competition objective for insurers only.

42. The PRA's first Annual Competition Report 2016[54] outlines its efforts at embedding the secondary competition objective. These include "applying the principle of proportionality to domestic regulations"; undertaking research work that assisted the Competition and Markets Authority regarding retail banking; appointing a senior advisor on competition; updating internal guidance to ensure competition issues are identified at the earliest opportunity during policy making; and undertaking research projects on the relationship between prudential regulation, financial stability and effective competition.[55] The PRA also authorised 17 new insurers during the first three years of the PRA's existence.[56]

43. This evidence led Sam Woods to conclude that the secondary status of the competition objective is "correct and adequate", but in evidence to the previous Committee, he added that "if people think we are not taking that competition objective seriously because of its secondary nature, then that would be a source of great concern".[57]

44. The Committee notes the views of many of those who gave evidence to the previous Committee that the PRA's approach is overly focused on solvency, to the detriment of competition and the ability of the industry to meet the savings and protection needs of consumers.

45. **While the PRA and a minority of industry voices argued in favour of the status quo, many respondents advocated a primary competition objective for the PRA to carry as much weight as its solvency objective. The Committee agrees.**

46. **The insurance function has implications for solvency in a number of areas, notably market, credit and operational risk, for which they are required to hold capital against under Solvency II.[58] Even taken together, these risks are lower than in the banking sector. For example, AIG was brought down by risks on its balance sheet that were of a banking nature. If so, then insurance solvency issues are less disruptive. Competition was rightly subordinated to systemic risk in banking, but these circumstances do not apply in insurance.**

52 Q87
53 Q160
54 The PRA's Annual Competition Report, 2016
55 Ibid
56 Q153
57 Q158
58 http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/faq_en.pdf

47. **The Treasury should immediately review the PRA's approach to its competition objective, at least for insurers, and consider giving the secondary competition objective equal primacy with the PRA's other statutory objectives, introducing primary legislation if necessary.**

48. In his evidence, Sam Woods said that it would be a concern if the industry felt the PRA was not taking the competition objective seriously. But that is exactly what industry is saying. Regulation in the USA involves a legalistic stand-off approach, whereas in the UK the PRA's approach to insurance supervision "relies significantly on the judgment of the supervisors"[59] to determine whether a firm will continue to meet its Threshold Conditions.[60] As such, the PRA needs a high level of organic engagement with the industry that it regulates.

49. **The industry and the PRA should review their approach to working together (including the conduct of consultations) in order that there can in future be a better and more productive dialogue on issues like Solvency II. Each side may have a different perspective, but there should be more common ground, and greater confidence in each other than the Committee detected during this inquiry. The PRA should set out how it intends to achieve this, as part of the work described in paragraph 88.**

50. Insurance regulation was transferred to the Bank of England in 2013. Prior to that, the Bank had little to do with insurance and when it was bolted on, the regulation of the insurance industry appeared to be a relatively poor fit with the rest of the Bank's activities.

51. **The Bank of England can rely on an immense depth of experience in banking regulation. The PRA needs to assess whether it has the skills necessary for effective insurance regulation, particularly at the most senior supervisory and policy levels. The Committee encourages the PRA, in carrying out this review, to consider the skills and experience of its Insurance Directorate to ensure there is a genuine 'feel' for the insurance industry. The Committee also suggests that the PRA and industry develop a higher level of staff exchanges so that each can appreciate the objectives of the other.**

52. While this could give rise to potential conflicts, the potential benefits are greater than the risks—provided any conflicts are managed correctly.

59 http://www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1603.pdf
60 For definition of Threshold Conditions please see p.14 & 15 http://www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1603.pdf

3 Solvency II and the way it has been implemented in the UK

The Strengths of Solvency II

53. Evidence gathered by the previous Treasury Committee suggested that Solvency II is a fundamentally sound regime, but that the legislation has been developed within a legalistic and rules-based framework which at times is interpreted as rigid truth instead of on the merits of the case. Furthermore, the implementation in the UK has, arguably, lacked proportionality. More work therefore needs to be done to develop a sound prudent regime, but one which promotes diversity and innovation in order to meet the long term needs of UK consumers.

54. **Evidence gathered by the previous Treasury Committee suggested that, while the PRA is held in high regard by the insurance industry, there is a disconcerting level of disconnect between its views and those of the industry, which might be indicative of a breakdown in effective communication. It also identified several areas where Solvency II is believed to be inhibiting competition and/or competitiveness. The Committee recommends that the PRA and industry should review how they can communicate more closely with each in addition to the more formal consultation procedures.** Earlier, more frequent and possibly more informal communication might have resolved the current difficulties at an earlier stage. A widely quoted example was the annuity market, where difficulties relating to the Risk Margin and the Matching Adjustment have led some firms to exit the market, and others to reinsure significant amounts of business overseas. Specific areas of concern such as these are discussed in later sections of this Report. This section considers respondents' higher level view of Solvency II's effectiveness overall.

55. The overwhelming view of those who provided evidence to the previous Committee was that a huge amount of time, effort and cost has been put into implementing Solvency II, and the industry does not want to throw it away and start again. Cooley LLP, representing several large insurers, commented that it would be "a shameful waste of money" and "utter madness"[61] to try to change now, pointing out that further fundamental change will create significant risk: "Brexit will bring enough change. It would be reckless to ask for more".[62]

56. There was also general consensus that Solvency II is a sound regime; this is not surprising as much of it builds on the ICAS regime, which was well regarded.

57. Many respondents commented that Solvency II has had a positive impact on raising the standard of risk management and governance in the industry. The Association of British Insurers (ABI) stated that: "Concepts such as the Own Risk and Solvency Assessment (ORSA) and improved management information…have increased the level and frequency of Board engagement and understanding of the firm's risk profile".[63] They also praised "the

61 SOL003
62 Ibid
63 SOL032

rigour with which [Solvency II] requires firms to identify, model, manage and mitigate the risks that it faces, recognising that holding capital is not the only and indeed often not even the best way to mitigate risk”.[64]

58. Several responses referred to the benefits of having a common regime across many countries. PwC for example stated that: “creating a regime that diverged from [the general direction of the International Association of Insurance Supervisors in Common Framework and Insurance Capital Standards,] would seem unwise. It has created a more level playing field across the EU, and it is recognised across the world as a robust regime.”[65]

59. Separately, PwC noted that all UK insurers should benefit from Solvency II’s global recognition as a strong regime: “There are also advantages in a regime that is known to be more robust and rigorous in terms of reputation and policyholder protection”.[66] This echoes Andrew Bailey’s comment, made in 2013: “Not all local regimes are in our view appropriately prudent, and insurers compete on the security of their promise as well as on price”.[67]

Significant improvements can be made

60. While there is no appetite to start again, there was a unanimous view there are significant weaknesses that could be improved. People giving evidence to the previous Committee argued that these problems arise both from the legalistic and rules-based nature of the directive and the manner in which it was implemented in the UK. A typical response was Aviva’s comment that: “there are problems with some of the technical aspects of Solvency II, and the way that it is implemented in the UK, that create unnecessary costs, reduce the competitiveness of UK insurers, and hamper the UK insurance industry’s role in providing stable long-term investment”.[68]

61. The ABI suggested that now is an opportune time to work towards improving the regime for UK insurers, as set out in the ABI’s response: “The regime has now been implemented, the PRA is more familiar with it and the UK industry is facing the added pressures and uncertainties associated with UK exit from the EU. Given the greater understanding of Solvency II by all parties, and the changed circumstances as a result of Brexit, we suggest it would now be timely to reassess the UK implementation of Solvency II, to ensure it is sufficiently proportionate and flexible enough to be appropriate for the UK market”, and does not put the UK at a competitive disadvantage in respect of other countries.[69]

62. The Committee believes that this will be best achieved by a joint effort from industry representatives and the regulator. While the parties may come from different starting points, there appears to be considerable common ground. For example: “The ABI supports the objectives of the PRA in maintaining financial stability and protecting consumers in

64 Ibid
65 SOL018
66 Ibid
67 Letter from Andrew Bailey to Rt Hon Andrew Tyrie MP, 19 April 2013
68 SOL023
69 SOL032

the UK market. We recognise the importance of robust supervision and are not calling for a watering down of the PRA's objectives. The disruption caused by Brexit puts these objectives at a premium".[70]

63. As noted above, witnesses identified two main drivers that may be eroding competition and competitiveness: the legalistic and rules-based nature of Solvency II legislation, and the implementation of Solvency II legislation by the PRA.

64. The IFoA commented: "SII has encouraged a rules-based and bureaucratic implementation, partly because of the Lamfalussy process followed: with the Directive set in stone early on, and Level 2 text (providing detail) following much later. This has meant, at times, that decisions have been made in terms of interpreting the Directive text as a rigid truth rather than on the merits of the case."[71]

65. **Concern was expressed that the legislation is "hampering firms' ability to innovate and provide customers with a broad range of products"[72] while higher capital requirements are "driving some areas of activity off shore (outside the EU)",**[73] such as "the reinsurance of risks to territories"[74] with less "rigid rules"[75] than Solvency II.

66. This led Lord Turnbull to speculate that London would become "more attractive to some insurance companies if it was outside the EU"[76] because a "European-based and regulated insurance company is at a disadvantage relative to a Canadian or American insurance company".[77] However, the overwhelming majority of evidence did not call for wholesale change or the repealing of Solvency II, particularly given the cost of its implementation. Nevertheless, as described in later sections, respondents had serious concerns.

67. Respondents also argued that the PRA has not been proportional in its implementation of the Directive. The role of the UK regulator, and its supervisory approach in particular are "as important as the actual rules in terms of impact on the insurance industry".[78]

68. Some felt that the PRA could adopt a more pragmatic approach without contravening the existing rules. KPMG noted that "it is also clear that other countries, when updating their regimes to one which follows similar lines to Solvency II, are not adopting all aspects of Solvency II. In particular, they are implementing less prescriptive measures and disclosure requirements, and/or allowing the requirements to factor in sensibly the specifics of the local market".[79]

70 Ibid
71 SOL026
72 SOL042
73 Ibid
74 SOL008
75 SOL026
76 Brexit will allow insurers to escape 'absolutely dreadful' EU regulation, claims former civil service chief, The Telegraph, 2016
77 Lord Turnbull giving oral evidence to the Committee on the UK's Future Economic Relationship with the European Union, HC483, 28 June 2016, Q23
78 SOL018
79 SOL008

69. The industry recognises that the nature of the Directive makes the PRA's job difficult. "In practice the regime and its requirements are overly complex and detailed…The volume of text alone is indicative of this: approximately 300 pages of level 1 text, approximately 2000 pages of level 2 text, with approximately 975 more pages of EIOPA guidelines—totalling over 3,200 pages".[80]

70. Although in theory the Solvency II legislation allows for 'proportionality', in practice it encourages a detailed rules-based approach to implementation, which a cautious and professional regulator such as the PRA found it difficult to avoid. Some evidence to the Committee suggests that the PRA's approach to the implementation of Solvency II in the UK has meant that "the level of policyholder protection […] is probably significantly above that of most EU insurers" and that the higher cost of capital that follows from it "may make the UK a less attractive place to carry out insurance business".[81]

71. While it is difficult to compare the implementation of Solvency II in different EU states, the impact of a complex rules-based regime has probably been far greater in the UK than other EU states because of the mix of business in UK firms and also the number of firms that have needed to adopt internal models.

72. **The UK's detailed approach to the implementation of the rules-based Solvency II Directive may have erred on the side of caution, enhancing policyholder protection at the expense of increasing the cost of capital for UK insurers. In any event, the PRA should give greater consideration to how it can maximise its application of proportionality.**

73. In oral evidence to the previous Committee, the PRA recognised that the level of its prudential supervision is "proportionately high",[82] but noted that firms with a balance sheet below €25 million and less than €5 million income are exempt from complying with Solvency II legislation in its entirety. This amounts to 188 firms, or 40% of the 469 insurance companies supervised by the PRA.[83] However, as it covers the smallest firms, it is unlikely to have a material impact on the market. It should also be noted that this exemption is borne from the Solvency II legislation, rather than the PRA's implementation.

74. The PRA also noted the concern expressed by Lloyd's of London that Solvency II was "not well fitted for some of the funkier things that go on in that Market" and said that it was working with the industry, Treasury and HMRC on a proposal to improve the working of the market for catastrophe bonds.[84]

75. The PRA mounted a defence both of the Solvency II regime and the way it had been implemented in the UK. On the specific point of capital requirements, Sam Woods asserted that the difference in capital requirements between the old ICAS regime and Solvency II was only £1 billion out of £126 billion—less than 1%.[85] Meanwhile, on the regime as a whole, Mr Woods argued throughout the oral evidence session that the problem did not lie with the framework in its entirety, but rather on specific (albeit numerous) elements, such as the Risk Margin, Matching Adjustment and proportionality of data requirements.[86]

80 SOL032
81 SOL018
82 Q154
83 Q153
84 Ibid
85 Q183
86 Qq152–226

76. When questioned by the previous Committee on future fundamental reform, Sam Woods made the following statement:

> "Basically, Solvency II is a sensible regime and it is a good regime. Why do I say that? It is because it is a regime in which we try to look at the values of assets and liabilities, as they are today and consistent with the market. That is basically the learning from the Equitable. If you do not do that, if you have some other way of valuing liabilities and assets, you may well be caught short if the firm gets into trouble. It is a very UK idea. Then there is this thing of the matching adjustment to encourage longterm investment. That is all good, but there are things about Solvency II that are bugs that need to be fixed and design features that are not good. The biggest and most obvious bug is the risk margin, but there are also design features that I would like to change if I had a free hand."[87]

Specific suggestions for improvement

77. **Solvency II has been very costly to implement, and there are areas which are defective, partly due to the underlying rules-based directive and partly due to a lack of proportionality in implementing it. London is known for its ability to provide finance and insurance for more esoteric products and the PRA needs to accommodate this. However, most of those costs are sunk costs and it is possible to improve the Directive's implementation without abandoning it altogether. A well-argued case has been made in evidence to the previous Committee, by individual insurers as well as the ABI and the Institute and Faculty of Actuaries, for a remedy to some of the defects that have been identified. Their views have been supported by industry experts.**

78. The ABI presented the PRA with a list of 23 areas where they believe the regulator has the power to act to amend their implementation of the Solvency II regulation for the benefit of the insurance industry, and ultimately, the consumer.[88] In oral evidence Sam Woods stated that:

> "I disagree with eight. I personally agree with five and see some merit in them. I would have to have views from the rest of the PRA board on that. The rest, the other 10, are in the middle."

79. He expanded on this comment in a subsequent letter to the previous Committee.[89] The five that he agreed with covered *model approval processes,* the recalculation of the *Transitional Measure on Technical Provisions,* the costs and benefits of external audit of firms' *Solvency Financial Condition Reports,* the amount of information required in notifications to the PRA of *longevity risk transfer and hedge arrangements*, and the requirement for *"Legal Entity Identifier codes"* for all entities within a group, including holding and dormant companies. While the PRA was able to agree on only 5 out of 23 suggestions, there appears to be common ground on some of the others.

87 Q187
88 SOL050
89 SOL051

80. Sam Woods' subsequent letter[90] provided an update on discussions with the ABI and is a helpful summary of developments as far as these items are concerned, although in most cases it showed that discussions are continuing. Nevertheless, **the PRA needs to explain its thinking on the industry's suggestions in more detail than hitherto, and it needs to consider its reactions with more of a post-Brexit mentality.**

81. **The Committee is concerned by the PRA's dismissal of many of these suggestions, and by its apparent reluctance quickly to address some of the problems of the Risk Margin. This might suggest that an excessively strict interpretation of the requirements of Solvency II, and of its own obligations, has limited its thinking in a way which could be detrimental to UK plc.**

82. The overriding priority is to develop a system of regulation which is right for the UK insurance industry, and which meets all the current and future needs of consumers, providing a prudent regulatory structure without stifling competition and innovation. We would expect the UK regulators, with close input from the industry and HM Treasury, continually to work on this task. It will be desirable to keep in step with the EU and other international initiatives as far as this is possible.

83. The Committee notes that the PRA consults with industry when designing policy in order to ascertain the views of interested stakeholders.[91] In 2016 examples of topics covered by consultations relating to Solvency II included group supervision (CP38/16),[92] reporting templates (CP40/16),[93] the matching adjustment (CP48/16)[94] and maintenance of the 'transitional measure of technical provisions' (CP47/16).[95] The Committee welcomes these efforts and encourages continued consultation, but it wishes to see a more constructive and open dialogue.

84. The insurance industry is in intense negotiations with the PRA on a number of crucial issues. Points of disagreement include the Risk Margin, the Dynamic Volatility Adjustment, the treatment of equity release mortgages and other illiquid assets. These issues are discussed more fully in Chapters 5, 6 and 8.

85. **The Committee notes that the PRA said it agrees with only five of the 23 suggestions made by the ABI, and it urges the PRA to make substantive progress on those it does agree with and to take a fresh look at the other eighteen suggestions in the context of the potential greater freedom of regulation that Brexit might bring. It is the Committee's view, from the evidence presented to its predecessor, that there are many opportunities to improve the Solvency II rules and their oversight by the PRA, and it is to be hoped that the five areas of agreement are just the start.**

86. **The Committee agrees with PwC's conclusion that the role of the UK regulator, and its supervisory approach in particular are "as important as the actual rules in terms of impact on the insurance industry".[96] The PRA's implementation of "rules" has a disproportionate impact on costs, competitiveness of the industry globally,**

90 SLV002
91 PRA insurance policy publications, Bank of England website
92 Solvency II: group supervision - CP38/16
93 Solvency II: Reporting format of National Specific Templates and reporting clarifications - CP40/16
94 Solvency II: Matching adjustment - illiquid unrated assets and equity release mortgages - CP48/16
95 Maintenance of the 'transitional measure on technical provisions' under Solvency II - CP47/16
96 SOL018

competition with the UK, the ability of the industry to provide long-term investment. The PRA needs to ensure that its supervisory approach reflects a balance between its prudential and competition objectives.

87. In the following chapters, we cover a number aspects of Solvency II and its implementation that appear to have caused problems, and make recommendations on the way forward.

88. **By way of a summary of its recommendations which are expanded in subsequent sections, the Committee considers that the PRA, working in close collaboration with the industry, should:**

- **provide a solution for the risk margin to improve its calibration;**
- **develop proposals for the introduction of forbearance at the national level to deal with procyclicality;**
- **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;**
- **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;**
- **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;**
- **develop rules for contract boundaries which reflect their economic substance rather than their legal form;**
- **develop proposals for simplifying the calculation of, and approval process for, the Transitional Measure on Technical Provisions provided for in the Directive;**
- **provide a view of where it might be possible better to align UK regulation post Brexit with IFRS17, weighing the disadvantages of change against the benefits of harmonisation;**
- **develop proposals which remove limitations in the standard formula for both existing and new entrants to the insurance market;**
- **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; and**
- **develop a solution for firms who will lose the legal validity of their contracts after Brexit.**

89. Working in close consultation with the insurance industry, the PRA needs to set out clearly what its time constraints are for delivering each of these items over the coming years, including whether it can act unilaterally or needs to wait for EIOPA. In doing so it should consider the end goal, including areas which can be developed after Brexit, rather than confining its thinking to what can be accomplished within the parameters of Solvency II. The goal is a system of regulation which is right for the UK insurance industry and which meets the current and future needs of consumers, providing a prudent regulatory structure without stifling competition and innovation.

90. **The Committee expects a progress report, including commentary on the extent to which there has been change or substantive progress and where the industry has agreed the approaches taken, by 31 March 2018. This report should set out clearly how the PRA's implementation of the directive ensures proportionality and meets its secondary competition objective.**

4 Financial stability and market distortions

Procyclicality and Regulatory Forbearance

91. It is generally accepted that the insurance industry poses much less systemic risk to the UK financial system than the banking industry, and historic evidence supports this view, (see, for example, the analysis of insurance company failures in Chapter One). However, it is important to note one risk, which arises because insurers must hold additional capital against higher risk assets such as equities and property which can fall in value. If their solvency is threatened insurers may choose, or be required, to sell these assets and buy lower risk assets such as gilts, thereby releasing most or all of the capital charge. Because a typical cause of reduced solvency is falling markets, there is a danger of a vicious circle: markets fall, insurers are forced to sell, which causes markets to fall further, in a process known as "procyclicality". As insurers are such big market players, this effect could exacerbate an emerging economic storm. It would also cause insurers to sell at the bottom of the market, crystallising losses for policyholders.

92. Solvency II incentivises insurers to act in the way described above when their solvency is threatened. This was a feature of the previous ICAS regime too; however, under ICAS the UK regulator had the ability to take overall market conditions into account when reviewing solvency. This included the ability to override normal capital requirements for the benefit of market stability. In particular, the requirement to test for a 1-in-200 year fall in equity markets (say 45%), could be relaxed if a significant fall had already occurred.

93. The regulator used this freedom in the recent financial crisis, and it is widely believed to have helped market stability. This facility, often referred to as "regulatory forbearance", has been removed in Solvency II.

94. The consequence of applying Solvency II's standardised framework across the entire EU insurance industry's €10 trillion of assets is that insurers across the EU are "likely to react to market events in tandem…reducing the natural offsets that have historically existed between national systems".[97] This increases macro-economic risks, as noted by the International Monetary Fund in their Financial Stability Report:

> "Pension funds and insurance companies are less able to play a countercyclical role in financial markets because of tighter requirements to minimise asset-liability mismatches".[98]

95. The Basel Committee on the Global Financial System also notes that:

> "Ongoing accounting and regulatory changes…limit the scope for taking long-term or illiquid assets on balance sheet, particularly during times of elevated market volatility".[99]

97 SOL026
98 IMF, April 2015, cited in SOL026
99 Cited in SOL026

96. The desire for regulatory forbearance "or temporary rule amendments in the event of a severe financial crisis"[100] was expressed by a number of respondents[101] including Unum, who noted that "it is not currently envisaged under Solvency II".[102] Regulatory Forbearance would "help avoid the unnecessary resolution of an insurer during a period of short-term distress, instead allowing it to recover".[103] This in turn would deliver a "better outcome for customers and higher market confidence in the insurance sector".[104]

97. The IFoA noted that a key political compromise in agreeing Solvency II was the Long-Term Guarantees Package containing various measures to support long-term investment and combat procyclicality. "It will be important that similar mechanisms are maintained (with enhancements) in any successor UK regime."[105] However, the key element of this, the Matching Adjustment, is over-engineered and restrictive as to what assets it covers, meaning that regulatory forbearance is still sought after. The IFoA also noted that "[I]n the event that the UK leaves the EU this presumably results in EIOPA having no UK-specific role which may then be an opportunity for the PRA to apply discretion."

98. **In developing a post-Brexit regulatory model, it is recommended that efforts are made to accommodate regulatory forbearance, where it can be shown to improve macroeconomic stability and improve consumer outcomes. The Committee would expect to see some work on how this is being progressed. In parallel with this, the PRA should develop contingency plans that it can adopt if and when necessary in emergency circumstances, as soon as it is no longer constrained by EU law.**

100 SOL008
101 SOL008, SOL009, SOL019, SOL023, SOL032, SOL026
102 SOL019
103 SOL032
104 Ibid
105 SOL026

5 Effect on long term savings and investment

Industry Concerns

99. Insurance is a long term business, particularly for many life products—"insurers could have customer relationships for 50+ years".[106] And insurance works on an aggregate basis as "a large number of uncorrelated idiosyncratic risks…diversify to reduce the overall level of risk".[107]

100. UK insurers have sold large volumes of annuity products, which provide a guaranteed stream of income to the customer until death. They also provide pension products with guaranteed returns and equity release products, where the insurer takes whole or part-ownership of a homeowner's property in exchange for providing a regular income, and allowing the homeowner to remain in residence.

101. Life companies have been able to offer these products as the cashflow profile of a large portfolio of pooled liabilities is highly predictable. They have been able closely to match the liability cashflows by investing in long term, relatively illiquid assets where the return includes an illiquidity premium to the investor (e.g. corporate bonds, equity release mortgages or infrastructure projects). After allowing for default risk, these assets provide higher returns than other more liquid assets, enabling more competitive rates to be offered to consumers.

102. While some European countries have similar product lines, they are not on the same scale as the UK, making it unique in providing long term savings of this type. This was problematic because the original Solvency II proposals did not allow credit for the illiquidity premium. Both "HMT and the PRA played a key role in winning an important concession for the UK insurance industry",[108] namely the Matching Adjustment (MA), which allowed such credit to be taken, by adjusting the discount rate used to calculate the present value of future liabilities so that when an insurer invests in assets using a "buy and hold" strategy, it is less exposed to short term market volatility, with the risk that the market value of its bond assets may fall and can only be sold for less than expected. However the design of this Adjustment "incorporated stringent restrictions and constraints required by a sceptical non-UK audience designed to prevent it being 'misused'".[109] Its particular configuration has led respondents to argue that it is too restrictive and "over-engineered"[110]—reflected in the fact that "with the exception of Spain, the UK is the only country to use the Matching Adjustment".[111]

103. The IFoA quoted several problems with the design of the Matching Adjustment, and these were repeated in other submissions. Most notably, some asset classes are ruled to be ineligible, "such as Equity Release Mortgages (which are considered to be appropriate assets to back annuity liabilities), or commercial property". These are either "excluded

106 SOL042
107 Ibid
108 SOL026
109 Ibid
110 Ibid
111 SOL047

from investment mandates which leads to lower levels of funding in the wider economy (e.g. for some infrastructure assets)," or firms have to put in place artificial constructs to convert them to eligible assets.[112]

104. Even where the Matching Adjustment is allowed, the rules (and the PRA's interpretation of them) has added cost and complexity. For example, there is an "unnecessarily onerous approval process for using the MA…inappropriately harsh consequences of breaches in the Matching Adjustment (no matter how minor)…and a requirement to use allowances for default and downgrade risk set by EIOPA (the 'fundamental spreads'). These can differ from a firm's underlying view of the risk for the assets held." The IFoA concluded that this has "increased the complexity and cost of maintaining annuity portfolios. Some of this cost is likely to be reflected in annuity pricing, to the detriment of consumers."

105. It is unsatisfactory that significant monetary and time costs are being incurred as insurers create artificial structures to "get round" the rules—for example in restructuring (reasonable) assets so that their cashflows meet the exhaustive qualifying criteria set out in the rules. This causes consumer detriment to the extent that the costs might be passed (indirectly) to consumers.

106. **In developing the future regulatory model, specific efforts should be made to avoid creating situations where artificial structures are encouraged to achieve an appropriate regulatory treatment for any class of assets or liabilities.**

107. Although the PRA has correctly attempted to reflect the long term nature of assets matching long term liabilities via the Matching Adjustment (see below) the difficulty of achieving eligibility, and the additional problems caused by the penal Risk Margin (see Chapter 6) have caused several insurers to curtail writing long-term savings products. In addition to reducing choice and value for consumers, this transfers risk to the State if and when individuals run out of money in old age.

108. **Reduced competition in the annuity and equity release markets, the extra costs in complying with the rules, and loss of access to some asset types, are leading to poorer value for customers.**

109. In oral evidence to the previous Committee, Julian Adams of Prudential took up this general theme, noting that Solvency II is not working in the way envisaged:

> "…because of the excessively rigorous implementation of rules around cash flow matching. For instance, equity release mortgages, residential or commercial mortgage-backed securities and commercial mortgage lending all have uncertain payback periods. Yet we would argue that, as an asset class, each of those would be appropriate in aggregate to match the liabilities that we would be looking to hold. As a result, it has restricted our investment in those assets, and you could make similar arguments for infrastructure lending as well."[113]

112 SOL026
113 Q93

110. The oral evidence sessions held by the previous Committee also noted that if an insurer's base currency is sterling, then they cannot hold and get the full benefit from matching their liabilities with and dollar assets because of the standard formula.[114] This means that an insurer is "penalised for being a sensible and appropriate risk manager",[115] as they still lose out, even though they may have a perfect match of assets and liabilities. Innovation is also discouraged as the regulator does not keep up with the creation of new asset classes as fast as the industry creates them.[116]

111. The "cumbersome nature and rigidity of the framework" has caused a "real global phenomenon"[117] as insurers are forced into the selection of similar assets for the benefit of "limited additional policyholder protection",[118] at the cost of reducing long term investments by insurers. Legal & General argued that this has resulted in insurers losing out to non-insurers with lower capital costs:

> "The table below compares the capital requirements for a 1 year and 10 year duration A-rated corporate bond:
>
> | | 1 year | 10 year |
> |---|---|---|
> | Solvency II standard formula credit risk capital requirement | c.1% | c.10% |
> | Basel credit risk capital requirement | c.5% | c.5% |
>
> Furthermore, for pension schemes there is a clear advantage for non-insurers to hold those liabilities relative to insurers. Insurers have to provide capital under the assumption that scheme members rank alongside policyholders, whereas non-insurance companies do not have the same constraint".[119]

112. Absent Solvency II, there are a "number of areas of socially useful investment" where insurers would be the "natural investors", such as infrastructure projects, student loans and retirement funding.[120] However, Solvency II appears to be hampering both investment from outside the EU, alongside investment within the EU. For example, Nigel Wilson of Legal & General stated that:

> "There is billions of capital available outside of the UK that would come into the UK that could be invested with a better regulatory set up."[121]

Meanwhile Aviva noted that "EU insurers may have more capital tied up as regulatory capital than an equivalent insurer operating in or from a different country outside the EU".[122]

114 Q123
115 Ibid
116 Q133
117 Q42
118 SOL008
119 SOL009
120 Ibid
121 Q75
122 SOL023

The Regulator's View

113. In oral evidence to the previous Committee, Sam Woods noted that "insurers are natural holders of long-term assets" and the PRA "want to encourage that", asserting that the Matching Adjustment provides this mechanism.[123] Accordingly, the regulator has "handed out…£59 billion of Matching Adjustment and £1 billion of Volatility Adjustment"[124] (to be discussed in Chapter 8). Furthermore, the regulator argued that the industry had "put their case much too strongly"[125] because there are other factors to be considered besides the rules when assessing the lack of investment in infrastructure by insurers, including the availability of such assets. Elaborating on this point, Sam Woods noted that the "rough average of the intentions of those firms across the next four years is to raise" the share of illiquid assets backing annuity business "from 25% to 40%".[126] When asked whether insurers would have invested more in infrastructure under the old rules than they will under the new rules, Mr Belsham responded:

> "the availability of the assets is the problem. It is very difficult to find a pipeline of attractive longterm illiquid investmentgrade fixedinterest assets".[127]

114. Legal & General responded on this specific point, noting the possibility of securitising some assets, but pointed out that this was a costly process, and that there was no certainty that the PRA would be comfortable with the structures that firms put in place.[128]

115. In terms of taking steps to address the problem, David Belsham noted that "the Solvency II rules are very clear that the Matching Adjustment is only allowed on assets with fixed cash flows" which "cannot be changed".[129] However, he added that "the PRA is allowing the firms to carry out a restructuring to get a senior tranche of that asset, which could be 8090% of the cash flows, to be eligible", so while they are "stuck with the rules as they are written", they are "trying to operate them in as flexible a way as possible".[130] Sam Woods also commented that:

> "There are some bugs that need to be ironed out and there are some design features that I would like. On the Matching Adjustment specifically, if I had complete control of it, I would probably do something slightly different. I would want to take account of unexpected defaults and I would probably be a tiny bit more flexible around this notion of "fixed". That is how I see it."[131]

116. Despite insurers facing a "more complicated process"[132] compared to the old ICAS regime, David Belsham felt that the level of investment in infrastructure assets is "very similar".[133] Furthermore, Sam Woods argued that the Solvency II regime had not had an impact on annuity rates, with these instead being driven by risk-free rates and corporate bond spreads.[134]

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123 Q162
124 Ibid
125 Q165
126 Q163
127 Q169
128 SLV001
129 Q166
130 Ibid
131 Q167
132 Q166
133 Q170
134 Q174

117. **UK firms believe that Solvency II makes it harder for them to invest in longer-term illiquid assets, such as infrastructure and equity release mortgages. This is a concern as the disincentive could have negative economic consequences and act as a restraint on UK plc.**

118. **To the extent that the rules also discourage insurers from offering annuities, there will be a transfer of risk to Government, and poorer value for consumers.**

119. **The Matching Adjustment has given some relief to the industry in that it attempts to reflect the long term nature of assets matching long term liabilities. Nevertheless, the Adjustment is a "workaround" solution, bolted on to the core Solvency II rules, which is cumbersome, and unnecessarily constraining. For these reasons, the PRA needs to conduct a fundamental review of the Matching Adjustment and its eligibility criteria, in order to achieve a more principles-based approach to the Matching Adjustment.**

120. **The regulator and industry should work together to ensure that opportunities are taken to develop a more effective long-term approach to the treatment of insurers holding long-term assets to match long-term liabilities.**

121. Infrastructure is one such asset. Others may include equity release products. It is concerning that, when asked by the previous Committee, the PRA appeared to be of the view that the problem is down to a simple lack of availability of such assets, whereas the industry suggest that it is the PRA's interpretation of the term "fixed cashflows" which limit the number of appropriate long-term illiquid investment grade assets.[135]

122. **A robust process will still be needed for approving and maintaining any approach that gives credit to an illiquidity premium. Evidence suggests that there is scope for more pragmatic rules to be agreed, with more flexibility alongside strict criteria to avoid the need for artificial restructuring of firms' cashflows for purely regulatory purposes. The Committee would expect the PRA's progress report (requested at paragraph 90) to address the extent to which this is the case, and set out what action it proposes to take.**

135 SLV001

6 Risk Margin

Industry Concerns

123. In Solvency II, the basic capital requirement is that insurers hold enough capital to be 99.5% confident of surviving extreme events over a 12 month period. The Risk Margin is an additional margin which purports to represent the additional capital that a third party would need in order to run off the insurance firm in the case of such an event. The overall intention is to arrive at a market consistent valuation of liabilities (though in practice this is artificial as there is not a liquid market of this type). However the method of calculation of the Risk Margin is prescriptive and was determined when economic circumstances were very different. The Risk Margin is "very sensitive to long term interest rates",[136] meaning that, in certain economic circumstances, such as the unprecedented period of record low interest rates, it is 'ballooning' and can cause insurers to hold a high a level of capital. Consequently the Risk Margin is "demonstrably out of line with the market price for transferring risk",[137] and particularly hits insurers who are writing longer term annuities or savings products with any form of guarantee.

124. The Risk Margin is specifically referred to within the Chancellor's remit letter for the Prudential Regulation Committee. In context of the Government's commitment to effective regulation, the Chancellor noted that:[138]

> "The PRC supports this vision by working to lower barriers to entry to create a regulatory environment where new entrants and smaller firms can more easily enter, expand and compete with incumbents in a way that acknowledges the impact of their growth on systemic risk."

The Chancellor went on to note that:

> "The government also welcomes the work being undertaken to examine the design of the Risk Margin feature in the insurance regulation to limit the sensitivity to changes in the risk-free interest rates, which will have beneficial macroprudential and financial stability impacts".[139]

125. KPMG picked out two areas of specific weakness that should be addressed in the Risk Margin calculation in order to "remove the excessive prudence which it now represents".[140] They suggest that the "fixed 6% per annum cost of capital rate on which the Risk Margin is based could be replaced with a margin (of say 2%pa to 3%pa) over the current risk free rate".[141] This sort of calibration would prevent the over-sensitivity to low interest rates described above. In common with other respondents they also suggested that: "Where there is clear evidence that the risk in question is in practice hedgeable, no Risk Margin component should be needed. Longevity risk is a particular case in point where many actual hedging transactions have taken place. The requirement for a 'deep and liquid market' is in our view an unnecessary barrier".[142]

136 SOL026
137 SOL009
138 Letter from the Chancellor to the Governor of the Bank of England, 8 March 2017
139 Ibid
140 SOL008
141 Ibid
142 Ibid

126. A specific example of the effect of the Risk Margin was provided by Legal & General:

> "To provide a numerical example, we set out below the example of a customer giving us a lump sum of £100 to purchase an annuity. In this example, the firm retains the longevity risk and invests in Matching Adjustment eligible assets. The table below sets out the total amount of capital resources we have to hold which is made up of policy reserves, Risk Margin and capital requirements. The table shows that, under current market conditions, an insurer would have to fund £27 of capital resources in addition to the £100 of premium received, compared to a third of this amount under the "reasonable" requirements, i.e. £8. […]
>
> "In addition to the Solvency I requirements, the UK operated the Individual Capital Assessment ('ICAS') regime; the capital requirements under ICAS, including the PRA's capital guidance, were much more closely aligned to those shown under the "Reasonable View."[143]

127. Legal and General went on to illustrate how Solvency II and Solvency I compared with what their own Economic Capital Model considers to be a more appropriate calibration of longevity risk:

	Solvency II	Solvency I (Pillar 1)	Reasonable View
Premium (customers £100)	100	100	100
Policy Reserve	92	100	90
Risk Margin	15	n/a	5
Capital Requirement	20	4	13
Total	127	104	108
Capital funded by insurer	27	4	8

128. The Risk Margin is causing UK firms to transfer risk to other jurisdictions:

> "The size of the Risk Margin means that it is uneconomic to retain longevity risk in the UK causing business to be transferred to, amongst others, the United States, Canada and Switzerland. In the short term, without reform to SII, we expect over 90% of the UK's longevity reinsurance will be undertaken by non UK insurance companies, whilst in the longer term we expect the whole business activity to be transferred out of the UK".[144]

129. This trend, alongside other factors, has ramifications for the macroeconomy. In oral evidence Andrew Chamberlain noted the following:

> "I think everybody is aware that people are finding it more and more difficult to retire. It is expensive to get the income from the sums they have managed to accumulate. The implications of that are quite widespread. I am not decrying people who wish to work longer, but a lot of people are having to work longer, because they have no choice. The implications that

143 SOL047
144 Ibid

> has around the economy on the availability of jobs for young people, for the behaviours of those people who are working later, are quite widespread. So it has a significant impact."[145]

The Regulator's View

130. The regulator noted in oral evidence that the Risk Margin is "considered as part of a best estimate or fair value of insurance, because it is now being included in the IFRS framework that is due to be discussed later this year".[146] It should be noted however, that while the concept of a 'risk margin' is included, its conceptual basis is different, because IFRS is not prescriptive as to how it should be calculated.

131. As with the Matching Adjustment, the regulator accepted that flaws exist in this part of the Solvency II legislation. Sam Woods told the previous Committee that the PRA disagreed with the figures presented by Legal & General (noting a figure of £13 would be more appropriate than their £27 because the figures for the risk margin and the capital requirement were less than the £15 and £20 quoted in L&G's table), but he agreed that the Risk Margin is "overcooked"[147] and "may be dangerously procyclical".[148] Consequently, the regulator took action to dampen the effect of the Risk Margin by encouraging firms to apply for transitional measures to smooth the impact.[149] This is clearly sub-optimal as it would be better to get the Risk Margin right than to rely on transitional measures. Consequently, it led Sam Woods to label the Risk Margin as the "biggest and most obvious bug"[150], which has "soaked up a lot of capital"[151] as it ballooned to £44 billion at the end of Q3 last year for the life industry.[152]

132. However, where the industry and regulator do diverge is on the course of action to address the Risk Margin. The industry advocates taking action now, arguing that the PRA does not need to wait for Europe to change the enabling legislation. This argument was outlined in supplementary evidence provided by the ABI to the previous Committee:

> "2.2.1 In November 2016, the ABI wrote to the PRA to outline industry thinking on steps the PRA could take to address the challenges associated with the Risk Margin, without the need to make amendments at the EU-level to the level 1 (Directive) or level 2 (Delegated Regulation and Implementing Technical Standards) text.
>
> 2.2.2 These were to consider:
>
> – Review of PRA approach to longevity risk stresses and their quantitative indicator framework
>
> – Inclusion of the Matching Adjustment in the calculation of the Risk Margin

145 Q14
146 Q218
147 Q184
148 "The revolution is over. Long live the revolution!" Speech by Sam Woods, 28 October 2016
149 Ibid
150 Q187
151 Q188
152 Q209

– Allowance for longevity reinsurance arrangements in calculating the Solvency Capital Requirements of the reference undertaking”[153]

133. Legal & General also prepared a paper in parallel to the ABI, outlining two options to address the Risk Margin:

> “the first being amendment to European legislation and the second (and preferred) being the adoption by a firm of a management action (the Management Action Solution).”[154]

134. The PRA had considered the idea of a management action, but concluded that “with some reluctance because we are sympathetic to the argument, we decided that it would not be wise to do that and that was for two reasons”.[155] Sam Woods went on to explain these reasons:

> “One was that we cannot get any castiron reassurance that, if we allow the genie out of the bottle in that way, in relation to the Risk Margin, that same genie cannot be let out of the bottle in all sorts of other parts of the framework, for instance in relation to capital requirements and technical provisions. The collective view of the PRA board was that that would be a very dangerous thing to let loose.
>
> “The second argument was that, if we break glass locally, I am sure it will undercut us in Europe. That seems to be highly likely, and we would therefore be unlikely to be able to fix the thing at source. We would have this imperfect local fix and we might be stuck with it for a while, with something different in Europe. In the meantime, it is very important that we say that transitionals (the Transitional Measure on Technical Provisions—see Chapter 8) get the full benefit for capital purposes here in the UK, because that gives us a bit of time here. That is where the matter rests for now.”[156]

135. It appears that the PRA is concerned that if we make changes unilaterally, EIOPA will say that we cannot do so and our case for Europe-wide change will be weakened. Instead, the PRA would rather follow the EIOPA process of changing the legislation at source. Victoria Saporta explained that this would be agreed at the end of 2017 and implemented by the end of 2018.[157] Sam Woods asserted that the PRA’s ability to negotiate was not “impaired”[158] by the UK’s decision to leave the European Union, insisting that “we seem to be making good progress”.[159]

136. **A Risk Margin—that is an additional margin which purports to represent the additional capital that a third party would need in order to run off the insurance firm in the case of an extreme event—makes conceptual sense. It is included in other solvency and accounting frameworks, for example under the International Financial Reporting Standards. It should continue to form part of the UK’s solvency regime. However, the previous Committee heard widespread criticism of the Solvency II**

153 SOL050
154 Ibid
155 Q210
156 Ibid
157 Q214
158 Q209
159 Ibid

Risk Margin as it is currently formulated. The regulator has acknowledged these criticisms. There is widespread grasp of the problem among regulators and the issue is being reviewed by EIOPA and the European Commission. But in the meantime UK business is being reinsured overseas. The pressure for this trend will continue as the Transitional Measure on Technical Provisions expires (see paragraph 169). For these reasons, many respondents and technical experts are advocating that the PRA take action now, irrespective of the Commission review process. The Committee concurs and asks the PRA for an update on the best approach for improving the risk margin calibration.

7 Proportionality

137. Both written and oral evidence to the previous Treasury Committee highlighted the lack of proportionality both within the PRA's application of Solvency II, but also the rules-based approach of the underlying legislation. For example, regarding the genesis of Solvency II, the Institute and Faculty of Actuaries stated that:

> "The early simplicity of concept was distorted in the process of negotiation, both of the original Directive, the amendments under the 'Omnibus II' Directive and in the Commission's Delegated Regulation.
>
> "Solvency II has encouraged a rules-based and bureaucratic implementation, partly because of the Lamfalussy process followed: with the Directive set in stone early on, and Level 2 text (providing detail) following much later. This has meant, at times, that decisions have been made in terms of interpreting the Directive text as a rigid truth rather than on the merits of the case."[160]

138. The ABI supported this evidence, noting the volume of regulation that firms are expected to follow:

> "[I]n practice the regime and its requirements are overly complex and detailed[161]. This needs to be addressed to allow for a more proportionate, effective and sustainable prudential regulatory regime. The volume of text alone is indicative of this: approximately 300 pages of level 1 text, approximately 2000 pages of level 2 text, with approximately 975 more pages of EIOPA guidelines—totalling over 3,200 pages."[162]

139. Although in theory the legislation allows for 'proportionality', in practice it encourages a detailed rule based approach to implementation which a cautious and professional regulator such as the PRA found it difficult to avoid. KPMG compared the UK approach with other European Union countries:

> "Based on our discussions with KPMG colleagues in other EU countries, and with pan-European clients, the implementation of Solvency II in the UK was a more difficult and onerous process than in other EU countries. In particular, the approach to obtaining Internal Model approval was more onerous than we understand was the case in other EU countries."[163]

140. Two specific examples of proportionality highlighted by the majority of submissions are in relation to capital models and data requirements.

160 SOL026
161 Two thirds of respondents to Grant Thornton's market survey Solvency II - In the brave new world (October 2016) thought that Solvency II is too complicated and two thirds also agreed that the costs of Solvency II were disproportionate to the size of the business
162 SOL032
163 SOL008

The Standard Formula and the Process for Approving Internal Models

Shortcomings of the Solvency II regime

141. The rules-based approach taken by the Solvency II legislation has led to an excessively rigid approach to capital models, particularly Internal Models. Capital requirements under Solvency II can be calculated using the Standard Model or, subject to regulatory approval, an Internal Model. Whereas most firms by number use a Standard Model, almost all the larger or more sophisticated insurers use (or will have a preference for developing) their own Internal Model,[164] which can be more complex and tailored to the circumstances and risks of the individual firm.

142. The use of Internal Models was encouraged by the PRA. To prevent misuse, an Internal Model's structure and assumptions have to be agreed by the regulator before use. The nature and sophistication of the UK insurance industry, combined with the PRA's approach, meant that the PRA had to approve more Internal Models than any other national regulator,[165] and necessarily had to develop a structured process. The development and approval of Internal Models in the UK has come under significant criticism from many respondents because of the work and cost that approval it entails, but also because of the resulting lack of flexibility. The Institute of Actuaries summarised the weaknesses of taking an approach that builds everything around one central, but complex, model often with thousands of assumptions:

> "The development of Solvency II has been more model dependent than it should have been. Belief in the benefits of capital models reached a high water mark in 2007–8 when Solvency II was being cast and although there have been more considered views recently, development has encouraged an excessively rigorous testing of models. There is then an expectation of complete reliance on such models, rather than less exacting testing of models and more flexibility in their use, which may be a better approach."[166]

143. Even the most sophisticated or complex models can only ever provide an approximation of reality. Models are also far more likely to be used if they produce sensible results in which the insurer has faith. Different models have different uses and may be appropriate for varying purposes. For example, a far more granular model would be necessary for looking at one aspect of the business, compared to a model assessing the overall firm. The current approach fails to recognise this because it emphasises the importance of using the (single) capital model for a whole range of purposes.

Model validation and approval

144. The PRA requires approval for the use of Internal Models to calculate capital requirements, and further approval of any subsequent amendments to those models. The focus on a large complex Internal Model has been accompanied by a detailed and expensive validation process. The sentiments of the IFoA submission were echoed by many other submissions to the previous Committee:

164 PRA's Solvency II Internal Model approvals, 5 December 2015
165 Q54
166 SOL026

> "In our view the process developed by the PRA to review and approve Internal Models is too onerous and time-consuming, and in turn, this has led to excessive levels of Internal Model validation within firms. Whilst some validation and review is clearly necessary, we believe the level of validation and documentation required has been excessive and, at the margin, of limited value. This approach does not seem to be sustainable and is driving unnecessary cost into insurers, which may ultimately be to the detriment of consumers."[167]

The IFoA noted the effect that this process has had on the regulator:

> "Internal Models have also left the regulator very careful and cautious about what it is agreeing to. The PRA is having to sign-off on an ongoing model as opposed to a 'point in time' capital figure, which then results in them being—understandably—risk averse".[168]

145. Of particular concern for those insurers whose models are now approved is that the process for gaining approval of changes to their models is also onerous and is expected to take several months, constraining their commercial flexibility, and meaning that they will be required to use either inappropriate or unapproved models in the interim.

146. Finally, some witnesses argued that if the Standard Model were refined, it would be applicable to more insurers, reducing the need for complex, and costly, Internal Models. When questioned by the previous Treasury Committee on this point, Andrew Chamberlain of the IFoA suggested that it "would certainly be a laudable thing to achieve", adding " a number of rigidities" make it "impossible for many" to operate, particularly in the UK.[169] These views were echoed by Jane Portas of PwC, who noted there were "opportunities" to refine the approach.[170] This may be of limited significance to currently authorised insurers who have made their decisions and are unlikely to change in the short term, but it does have an impact on the attractiveness of the UK regime for new entrants.

147. Written evidence to the previous Committee presented suggestions for changes to the standard model. For example, Steve Dixon of Steven Dixon Associates LLP advocated:

> "More research on the standard formula on two key aspects: the operational risk module and the morbidity risk module for health insurance. The former arrives at amounts of capital requirements that appears too low for the majority of smaller firms and too high for large firms. The latter generates a capital requirement to cover 2 or 3 times the expected sickness by the additive effect of the combination of a stress on incidence of periods of sickness and a stress on the speed at which people recover from sickness."[171]

While KPMG asserted that:

> "The Standard Formula [Solvency Capital Requirement] does not cope well with the following risks, often due to a simple lack of clarity: Pension scheme risk…Operational risk…Sovereign debt risk…Currency risk…

167 Ibid
168 Ibid
169 Q9
170 Q10
171 SOL006

> Deferred tax…The Standard Formula has no volatility stresses in it. This is in our view an omission, particularly in respect of equity volatility which is material for many life insurers."[172]

148. In their supplementary evidence following their oral evidence session, the PRA identified the Internal Model change process as an area where they are open to reform, and will explore options with the ABI:

> "The PRA will continue to review the ongoing appropriateness of model approval processes and ensure they do not impose an excessive burden, whilst respecting the constraints of the Solvency II regime. We are currently reviewing a large number of Internal Model and other approvals and acknowledge the resource-intensive nature of the regime. We are actively looking at ways to reduce the burden on supervisors, firms and boards. It should be noted that although, under the relevant Solvency II provisions, the PRA has six months from the date of application to provide a decision on major model changes, our experience so far has shown we have taken considerably less than six months to provide decisions."[173]

149. **The Committee notes the widespread and consistent concerns expressed by firms over the proportionality of the PRA's approach, particularly with regard to the review and approval of internal Models and amendments to those models. The PRA is urgently asked to review its practices and report to the Committee on proposed changes.**

150. **The current EU legislation allows for proportionality in national regulators' approach to capital models. There should be no reason to wait until the UK has left the EU to take advantage of these provisions. The Committee requires the PRA to note this stipulation and report on intended actions.**

151. Evidence suggests that the Standard Formula does not adequately reflect the risk profile of many firms,[174] so they will need to develop their own internal models to run their business, even if those models that are not PRA-approved. Examples of areas where the Standard Formula is insufficiently sophisticated include interest rate risk and longevity risk, particularly where a firm has products which contain financial guarantees which require a more sophisticated evaluation. Firms can also be exposed to market risks—such as inflation risk and gilt spread risk—where liabilities are hedged using gilts but the discount rate which must be used for valuing liabilities must be swap based. These are not covered by the Standard Formula. Its allowance for operational risk is formulaic and does also not reflect the true risk profile of any individual firm. It is likely to understate the risk for a sophisticated firm, although the impact of this can be offset by the fact that it does not allow for the benefits of diversification.

152. **The PRA should also assess whether the Standard Formula could be enhanced for the benefit of existing users, especially if an improved version could save some firms from needing, or choosing to upgrade to, an Internal Model. The Committee suggests that the PRA consider the specific ideas for improvement put forward by witnesses in evidence to this inquiry.**

172 SOL008

173 SOL051

174 For example: SOL026 paragraph 83; SOL008 paragraph 4d; SOL006 paragraph 4d.

The approach to data requirements

Shortcomings of the Solvency II regime

153. Regular reporting is of a different order of magnitude from that under the previous regulatory regime. Annual and quarterly returns requiring immense detail are obligatory. To these the PRA has added UK requirements[175] which the ABI said were "over and above the EU requirements",[176] which many respondents claimed had imposed a "very significant UK-specific burden".[177]

154. It is unclear what value much of the reporting adds. KPMG stated that some of the Quantitative Reporting Templates "are in our view of limited benefit",[178] while Legal & General states that "the disclosure requirements…are excessive and of limited use to regulators, investors, intermediaries and policyholders.[179]

155. The industry is concerned with the "significant ongoing cost",[180] but there is also the danger that the "sheer volume of the rules and guidance acts to limit understanding and effectiveness of Solvency II".[181] Lloyd's of London make the following remarks in their submission:

> "Solvency II's requirements are very detailed and it is not clear what use supervisors can make of all the information they receive. The reporting should enable supervisors to get maximum benefit which would be better achieved by reducing the volume and frequency of template collection, which would also reduce the administrative burden on insurers."[182]

156. One consequence of the additional data requirements is an impact on competition. For example, the ABI noted the disproportionate impact on small firms, because, although they may "apply for an exemption to some, but not all, quarterly reporting requirements… the PRA has also set out an expectation that such firms should be able to respond to ad hoc requests from the PRA for any of these exempt templates".[183] This sentiment also has traction outside the UK, with the Insurance Europe's Reinsurance Advisory Board concluding that a "'one size fits all' approach is unworkable, as it results in an approach whose complexity is inappropriate for companies with smaller and simpler risks and leads to results that are misleading or wrong for undertakings with larger and more complex ones".[184]

157. Following their oral evidence the ABI, Legal & General and Lloyd's of London submitted further evidence to the previous Committee on the level of burden. The ABI stated that in comparison to the previous regime volume had increased by 4–8 times, frequency had increased from annually to quarterly and deadlines are reducing over

175 PRA Policy Statement PS2/15 Solvency II: A New Regime for Insurers; 12 Reporting - National Specific Templates
176 SOL032
177 SOL028
178 SOL008
179 SOL009
180 Ibid
181 SOL008
182 SOL028
183 SOL050
184 SOL028

the 3-year implementation period.[185] Meanwhile Lloyd's of London explained that it must collect information from each of its 111 syndicates on a quarterly and annual basis,[186] meaning that the "reporting burden is huge".[187] For this reason Lloyd's of London advocates several changes, including discontinuing the quarterly reporting in favour of half yearly reporting, which would be consistent with the frequently of insurers' financial statements. The ABI has recommended four specific changes in this area.[188]

Regulatory view

158. The regulator made several arguments concerning the volume of regulatory reporting. In oral evidence to the previous Treasury Committee, Sam Woods argued that the data "is useful" as during times of a stress supervisors can tell him "very rapidly" whether or not a firm is exposed to a particular risk. He said "that is really going to matter when, hopefully far in the future, we come to bail in a bank".[189] Victoria Saporta added that, while firms should know their counterparties and be able to produce this data as soon as possible, in her experience "that is not always the case", notably during the recent crisis.[190] Sam Woods later noted that "the law is pretty clear that we just have to collect some of this stuff,"[191] although the then Chairman of the Committee retorted this was "up to a point, Lord Copper".[192]

159. However, the regulator did acknowledge that this issue was "probably the most consistent theme across the shop",[193] noting that quarterly reporting does "feel rather onerous"[194] given the limited turnover of assets, while total costs were estimated at between £200 million and £250 million industry-wide.[195]

160. For these reasons the regulator has already taken some action, notably a waiver for small firms which "takes them out of about 70% of the quarterly reporting burden".[196] They also stated that they are keeping an "open mind" on the current requirements.[197] Thus, while the numbers inform the "basics of supervision"[198], and indeed they cannot "drop [requirements] entirely",[199] Sam Woods and David Belsham acknowledged that they should undertake a review[200] to "see whether [further] waivers can be given"[201] and whether some of the data could be collected by exception.[202] He subsequently wrote to the

185 SOL050
186 SOL048
187 Q103
188 Q139 and SOL050
189 Q192
190 Q197
191 Q203
192 Q204
193 Q192
194 Q194
195 Q199
196 Q153
197 Q192
198 Q205
199 Q193
200 Q205
201 Q194
202 Qq203, 205

Committee to confirm that he would review the PRA's implementation of the Solvency II reporting requirements, with specific reference to the usefulness, or otherwise, to the PRA of the data collected, and the impact on firms of the reporting requirements.[203]

161. **There is evidence that the regular reporting requirements are costly and overly detailed. The Committee believes that they could be streamlined, reducing the burden and cost on firms, and reducing the risk that the PRA could miss something. The PRA should review the information collected—both in the EIOPA and national templates—and assess it in the context of both usefulness and cost effectiveness, notably the quarterly data. The merits of exception reporting and/or focusing more on changes to previous information should also be considered.**

203 SOL051

8 Other technical matters

162. This Chapter describes a number of technical matters that were raised in the written and/or oral evidence:

a) Volatility Adjustment

b) Transitional Measure on Technical Provisions (TMTP)

c) Contract Boundaries

d) One Year Value at Risk

163. The first two are relativity crude adjustments to help counter some of the limitations of Solvency II and received a great deal of comment, particularly from Life firms. The last two challenge the conceptual framework of Solvency II.

Volatility Adjustment

Shortcomings of the Solvency II regime

164. The Volatility Adjustment is similar to the Matching Adjustment, and can be applied to insurance products which are not eligible for the Matching Adjustment. It is a mechanism "albeit only of limited effect and artificial in application, that allows liabilities to be reduced on a prudent basis when asset values are particularly low".[204]

165. The Volatility Adjustment is only available in certain currencies (US Dollars and European currencies),[205] limiting its usability for international insurers. A further limiting factor is that HM Treasury decided that firms must seek regulatory approval in order to use the Volatility Adjustment, unlike some other EU member states[206] on the ground that it may encourage pro-cyclical behaviour. However, the IFoA point out that requiring approval "could also lead to pro-cyclical behaviour, in which insurers would become forced sellers in an economic downturn".[207] For this reason the regulator's approach has been labelled "unnecessarily rigid".[208]

166. Most of those who gave evidence on the subject to the previous Treasury Committee noted that the rules could be changed without needing EU permission as "different countries in Europe have done different things",[209] setting a precedent for change. They made several suggestions on how the Volatility Adjustment could be improved. For example, the IFoA argued that "it would be appropriate for the 'emergency' VA approval to be granted were necessary", and the Volatility Adjustment "should be permitted to vary in assumed stressed conditions i.e. it should be treated as dynamic rather than fixed".[210] This

204 SOL026
205 Q74
206 SOL026
207 Ibid
208 Q21
209 Sam Woods giving oral evidence to the Committee on his appointment as Deputy Governor for Prudential Regulation and Chief Executive of the PRA 19 July 2016, HC567, Q71
210 SOL26

would align the UK approach with some other European jurisdictions where the Volatility Adjustment is recalculated in a stress.[211] In oral evidence to the previous Committee, Andrew Chamberlain noted that:

> "It is well documented in the public arena that the Dutch regulator has already taken a more liberal view than the PRA. As far as we are aware, no action has been taken against the Dutch regulator in regard to that, so there must be some scope".[212]

Regulatory view

167. The Volatility Adjustment was briefly touched upon in oral evidence given to the previous Committee by the regulator, who noted that £1 billion of Volatility Adjustment had been "handed out"[213] to the insurance industry. It was not explored in the PRA's written submission.

168. **The Committee agrees with the oral evidence that its predecessor heard from Andrew Chamberlain that the Volatility Adjustment is "fairly crude". From the oral and written evidence it would appear that there are two main problems with the Volatility Adjustment. First, whether it should require approval from the regulator, and second, whether firms should be allowed to use a 'dynamic' Volatility Adjustment. Given the problems of procyclicality examined in Chapter 4, it would seem prudent for the Volatility Adjustment to vary in certain prescribed circumstances, without regulatory approval. Given the actions of other regulators, notably the Dutch, this action seems uncontroversial, and the Committee sees no reason why it should not be undertaken without delay. An update should be included in the PRA's progress report requested at paragraph 90.**

The Transitional Measure on Technical Provisions

Shortcomings of the Solvency II regime

169. In the absence of any transitional relief, the introduction of Solvency II resulted in a significant increase in the level of capital required to be held for regulatory reporting purposes compared to the previous UK regime. This was a bigger issue for the UK industry than most others because of the nature of UK products, and a particular problem for the life industry due to the impact of the Risk Margin. This could have resulted in reported solvency problems for many companies, despite their unchanged assets, liability and risks from levels previously accepted by the PRA. Insurers may therefore, with supervisory approval, apply for transitional relief[214] (the Transitional Measure on Technical Provisions or "TMTP"), which allows the initial increase to be phased in over a period of 16 years by means of a deduction from technical provisions as calculated under Solvency II.

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211 SOL10
212 Q22
213 Q162
214 For clarity, this terminology does not relate to the concept of 'transitional measures' for the implementation of Brexit.

170. In 2016, the first year of Solvency II, the availability of TMTP was considered to be "beneficial and generally effective".[215] However, in order to gain PRA approval for any re-measurement that may be required in future, there is a risk that insurers will in effect need to maintain their old models running alongside Solvency II models and calibrations. The ABI asserted this will be "costly and not practical",[216] while the calculation itself has been labelled "highly complex".[217] For example, concerns have been expressed on the drafting of the rules, particularly "the so-called 'double run-off' issue in relation to in force technical provisions, which superimposes the 16 year run-off of the initial impact of Solvency II onto the natural run-off of the business existing at 1 January 2016…and the degree of onerousness in the recalculation for the transitional provisions, particularly in the light of falling interest rates".[218]

171. The transitional benefit only applies to provisions for business written prior to 1 January 2016, not to new business. As the TMTP is reduced (on a linear basis) the potentially higher capital requirements can be expected to re-emerge as an issue in absence of further action. These concerns have led the ABI to conclude that that "we do not believe the PRA's approach to the implementation of TMTP is practical or flexible enough".[219]

Regulatory view

172. The Transitional Measure on Technical Provisions was discussed briefly by the regulator in oral evidence to the previous Committee; Sam Woods noted that the PRA have allowed it to be dynamic so it can be recalculated as risk-free rates move. Sam Woods also acknowledged the ABI's request for simplification, stating "I am absolutely in the market for simplification ideas; if they can bring something forward, that would be great".[220]

173. The Bank of England published an exposure draft in October 2016 (CP 47/16) on the calculation of TMTP and replies were due in by 25 March 2017. This focused mainly on how firms should take account of changing circumstances and assumptions in recalculating the TMTP as time progresses. The conclusions were published in a supervisory statement in April which was then updated in May, reflecting the complexity of the subject.

174. **The PRA's consultation on the calculation of the Transitional Measure on Technical Provisions was welcome, but was limited in scope. Broader issues remain to be addressed including: (i) whether and how the transitional benefit should be allowed to run-off over time; (ii) whether the principal causes of the increase in reserves that accompanied the introduction of Solvency II can be "corrected" when determining the future UK solvency regime issue; (iii) reducing the cost, particularly over the potential need to maintain dual models for sixteen years in case a re-measurement is required; and (iv) developing an approach which is practical to implement.**

215 SOL008
216 SOL032
217 SOL009
218 SOL008
219 SOL032
220 Q215

Contract Boundaries

175. In Solvency II, the rules for contract boundaries (to identify where one contract ends and another begins in cases where an insurance contract includes options for extending it, for a separate premium) follow a legalistic rather than economic approach. Solvency II therefore ignores the conventional economic and accounting convention of matching income to costs. This is a key issue because it differs both from insurers' current practice and the recently published international accounting standard, IFRS 17.

176. KPMG told the previous Treasury Committee that:

> "In our view, the Solvency II rules on contract boundaries are artificial and are not economically based. The latest drafting for the forthcoming IFRS 4 Phase 2 (now known as IFRS 17) financial reporting standard is much more economic in this area"—ie it allows for future premiums to be projected, subject to a best estimate of future cessation rates, and then subjecting this best estimate to stress testing in the capital requirements. We believe that the solvency approach should be similarly economically based."[221]

177. They cited reinsurance as an example of the distortion it creates.

> "Currently, a consistency issue arises where reinsurance protection is purchased to cover a class of business over a period of time—typically one year from the date of reinsurance purchase or renewal. The full cost of purchasing the reinsurance is taken into account, but the benefit of the reinsurance can only be recognised in respect of the business in force at the valuation date in question (as opposed to the full expected amount of business). Given that most reinsurance programmes are renewed on an annual basis, this is causing an artificial strain."[222]

178. One consequence of this distortion is that firms may need to maintain an alternative model in order to show the true economic picture. As the Investment and Life Assurance Group said in its evidence to the previous Committee:

> ''A number of areas of the Solvency II calculation are not considered to be truly economic, for example the implementation of contract boundaries. This means that even insurers that are using an internal model may need to maintain an additional model to allow for what they would consider the true economic impact to be''[223]

One year value at risk

179. In Solvency II, the basic capital requirement is that firms hold enough capital to be 99.5% confident of surviving extreme events over a 12 month period. The risk margin is an additional margin which increases the amount of the provision to a level that is supposed to represent its market value, although clearly there is little or no market for insurance liabilities

221 SOL008
222 Ibid
223 SOL005

180. Most firms did not challenge this concept but preferred to advocate remedies to a rigid interpretation of the one year concept. However, Prudential's evidence to the previous Treasury Committee outlined why they disagreed with the core one year at risk concept.

> "There are major problems in applying this construct to insurance. Given the length of a life insurer's liabilities, it is highly likely that the construct of 1 Year value at risk will fail to capture the path dependency of risk factors beyond the 1 Year period. This is a highly significant constraint given the number of dynamic management actions which can be taken over the lifetime of the liabilities, the effect of which would then need to be re-modelled."[224]

181. Lloyd's of London cited the IMF's suggestion that for non-life insurance, the framework's one-year horizon is potentially insufficient for some of the long-tail risks insured in the London market, and went on to say how it will compensate for the limitations of the one year approach:

> "It should be noted that Lloyd's bases member capital setting on the ultimate Solvency Capital Requirement (SCR), i.e. adverse development until all liabilities have been paid, rather than the one-year SCR, because it believes that this is more appropriate."[225]

224 SOL042
225 SOL028

9 Brexit

Background

182. Information about the Government's approach to Brexit has emerged gradually over the last year or so. Written evidence was gathered by the previous Treasury Committee between 13 September 2016 and 11 November 2016, and it held oral evidence sessions in January and February, either side of the publication of the Government's White Paper on Brexit.[226] The triggering of Article 50 on 29 March 2017 was a significant milestone, but does not materially change the relevance of the evidence of the conclusions of the Committee when considering it.

Passporting and Equivalence

183. A UK insurer can currently passport into any EU country by applying either 'freedom to provide services' or 'freedom of establishment' mechanisms. If the outcome of the UK's negotiations to leave the EU is that a UK insurer will not be able to passport into the EU directly from the UK, then it can instead use an existing subsidiary in any EU member state, or establish a new EU subsidiary, and passport across the EU from this entity. The principal regulator for the insurer's EU operations would then be the regulator in the country where it had established its EU subsidiary. The PRA would be responsible for the regulation of any entity above this subsidiary, alongside all its other non-EU operations. Given the time take to establish EU subsidiaries, many UK headquartered insurers already appear to be taking steps to do so, thus pre-empting the outcome of Brexit negotiations.

184. The Solvency II Directive "recognises the fact that the insurance industry is a global industry".[227] As such, "to avoid unnecessary duplication of regulation, the European Commission may decide about the equivalence of a third country's solvency and prudential regime".[228] The assessment of a regime to be equivalent is "mutually beneficial" to both the EEA and third countries, and they "promote open international insurance markets, while simultaneously ensuring that policy holders are adequately protected globally".[229] The subject of 'Equivalence' featured in numerous submissions and was discussed in oral evidence. A popular theme to emerge was that "equivalent does not mean identical, as Switzerland and Bermuda demonstrate".[230] For this reason, Phil Smart of KPMG noted in oral evidence that other regimes "have gained equivalence but do not have the same level of disclosure currently required by Pillar III. This is an area that could be quite safely amended".[231]

185. Some written submissions to the previous Treasury Committee and other publications put weight onto the importance of gaining and maintaining equivalence,[232] while others explained that equivalence was not a general grant, but instead is granted for specific

226 The United Kingdom's exit from and new partnership with the European Union, 2 February 2017, CM9417
227 EIOPA website, 2017
228 Ibid
229 Ibid
230 SOL013
231 Q24
232 SOL032, SOL026, SOL008, SOL023, SOL021, SOL017, SOL035, LMG - A Brexit Roadmap for the UK speciality commercial insurance sector

areas such as group supervision or reinsurance.[233] PwC stated that equivalence should be sought "at least" for group supervision under Article 260.[234] This led PwC to conclude that any change to UK insurance legislation post-Brexit "should be weighed against the risk of the UK losing equivalent status with the EU."[235] However, in oral evidence the Committee heard that:

> "equivalence as a notion has had a bit too much put on its back in terms of what it can bear. [...] As you know, equivalence does not guarantee market access anyway. It is a framework by which regulators can work with each other in order to enable trade across borders, but it does not guarantee that trade itself. You still have to have some sort of agreement around the trading relationship."[236]

186. Huw Evans of the ABI went on to note the politicisation of equivalence:

> "Equivalence is currently a political process, which can be withdrawn very quickly. [...] It is not something that can, under its current form or its accepted usage, bear the weight of expectation that is being placed on it".[237]

187. Julian Adams of Prudential supported this view stating that equivalence "allows too much discretion to Europe" and can be "unwound very quickly".[238] For this reason, the ABI advocated a "bespoke treaty" between the UK and European Union to "ensure the full range of access and regulatory co-operation [...] to make that relationship a success".[239] Huw Evans suggested that, given the high degree of convergence of the regulatory frameworks, it "should not be beyond the wit of humanity to devise a route that ensures ongoing market access while ensuring the best of the regulatory regimes" for both the UK and the EU 27.[240]

188. Sam Woods noted in oral evidence to the previous Committee in July 2016, that even were the UK to seek equivalence, "it does not necessarily follow that to have equivalence, you have to have the same thing", citing the equivalence granted to the US regime, which is "quite different" from Solvency II.[241] While it might be logical that the UK regulatory regime is comparable with that of the EU, it is more important, for the sake of the industry and policyholders, that UK insurers "have unimpeded access to the EU market"[242] and vice versa.

Complications

189. Several complications were highlighted by oral and written evidence to the previous Committee. In the absence of a more comprehensive agreement, Brexit will require business re-structuring as insurers seek to set up their preferred structure for a post-

233 SOL018
234 Ibid
235 Ibid
236 Q150
237 Ibid
238 Q151
239 Q150
240 Q151
241 Sam Woods giving oral evidence to the Committee on his appointment as Deputy Governor for Prudential Regulation and Chief Executive of the PRA, 19 July 2016, HC567 Q37
242 LMG - A Brexit Roadmap for the UK speciality commercial insurance sector

Brexit world. These actions will have an impact on UK regulators (PRA and FCA) and European regulators in terms of assessing and scrutinising business model restructuring, which may include the creation of new subsidiaries, and redomestication (both in the UK and Europe).[243] Numerous suggestions have been made to alleviate the pressure on both regulators and the insurance industry. As noted by PwC, these include grandfathering agreements, which have been employed at several times previously to avoid relicensing queues as regulatory regimes change.[244]

190. Clearly the ideal solution would be some form of reciprocal agreement between the UK and EU whereby neither UK or EU firms had to restructure their operations and the current status quo was effectively maintained. As a contingency, the PRA has asked firms to prepare plans for a full range of outcomes, including that there is no reciprocal arrangement.[245] Firms are going ahead on this basis and many are already working with EU regulators to set up subsidiaries from which they can branch throughout Europe. Other firms may open third country branches in the EU but this is much more restrictive and cannot be opened while the UK is a member of the EU.[246] EU firms are in a comparable position in that they need to decide how to operate in the UK.

191. However even if UK firms do establish EU subsidiaries, there is another technical issue relating to pre-Brexit contracts. Insurance contracts which are written pre-Brexit either in EU branches of UK firms or written directly into the EU will be outwith the firm's authorisation unless further action is taken. It may therefore be difficult to pay claims or receive premiums, and there is a risk of a reduction in competition and a loss of jobs, as well as detriment to policyholders. One idea would be to transfer pre-Brexit business into a firm's new EU subsidiary by a 'Part VII', but in practice this would seem to be unachievable at industry level, because each firm would have to obtain its own Court approval, and there would be insufficient specialist resource (PRA, independent experts, legal expertise, etc) to support such a programme.[247]

192. **Agreement on a pragmatic approach to pre-Brexit contracts is vital. In the absence of this, or a comprehensive reciprocal arrangement which addresses the problem of the loss of passporting, there will be substantial additional work for firms and regulators in both the EU and UK, especially the PRA. Wherever possible the PRA should adopt pragmatic approaches such as granting provisional recognition to EU branches prior to Brexit.**

193. Further complications arise because, while the Solvency II Directive has equivalence provisions, two other directives relating to insurance (the Insurance Mediation Directive, and its proposed successor the Insurance Distribution Directive) do not include such provisions. This means that "business models of many insurers might become unworkable".[248] However, as PwC explained, "this can be overcome by thinking ahead about the links between the different directives insurers and brokers use to sell insurance products in the EU market".[249]

243 SOL018
244 Ibid
245 Letter from the Chancellor of the Exchequer to Nicky Morgan, 20 September 2017
246 EY - Brexit for Insurance
247 Letter from Nicky Morgan MP to the Chancellor of the Exchequer, 14 September 2017
248 SOL018
249 Ibid

194. Lloyd's of London is a unique organisation, and as such, Brexit presents it with some unique complications. Lloyd's of London was set up by Act of Parliament, and is in effect a franchise operation for its various member syndicates (as opposed to being an insurance company in its own right). It currently operates across the EU because Solvency II incorporated specific legislation to allow for its unique role.

195. When the UK leaves the EU the specific legislation would no longer apply and Lloyd's would be unable to operate in its current form across the EU. Until now, apart from a venture in China, Lloyd's has provided the framework for syndicates to write their own business, rather than write business in its own name. This issue was discussed with the previous Treasury Committee in oral evidence. John Parry explained that:

> "Our priority is to maintain mutual market access to the EU postBrexit. […] That may not happen, and certainly we are not expecting to get certainty on that any time soon. We want to be able to service our clients as seamlessly as we can, by establishing it before transition arrangements are clear.
>
> The two alternatives are to set up branches in Europe, where you would operate as a third-party country, or via a subsidiary option in the EU, owned by the corporation of Lloyd's".[250]

John Parry went on to explain the implications of such arrangements:

> "The branches carry a lot of issues. A lot of capital would need to be put up, and for insurance, putting up capital in each different place that you trade is very inefficient. If I insured everybody's house in this room, but I had to hold the capital in case your house burned down just for you, I would hold an awful lot of capital. It is not going to be very efficient. Branches are out, so setting up a subsidiary is not the preferred option but we will need to progress it to offer that certainty to clients in advance of any decision on either transition arrangements or single market access".[251]

He then explained their expectation to keep activity in London:

> "One of the considerations is how much of that could be kept in London, around the Lloyd's building and the other different businesses. The more frictional cost you add to it, the less attractive our platform will look. We are competing for capital and talent globally, so international groups could set up their own. We want to offer an attractive proposition, and obviously we need to do that at an efficient cost".[252]

He concluded that they were undertaking work to ensure they had a "realistic plan" to offer their market participants in the event that they do not secure single market access post-Brexit: "This is the price of uncertainty".[253] Subsequently, Lloyd's has announced that it will set up a new subsidiary in Brussels, from which it can passport across the EU.[254]

250 Q106
251 Ibid
252 Q108
253 Q109
254 Insurer Lloyd's of London confirms new Brussels subsidiary, BBC, March 2017

196. 93% of Lloyd's business is done without EU passports into the European Union;[255] the United States is its largest market, at 40%.[256] John Parry explained that it was about Lloyd's of London's "ability to offer a global service to clients"[257] that made EU access important.

Opportunities

197. While Brexit does bring complications, the insurance industry and the PRA must seek to exploit its opportunities.

198. One opportunity is borne from the UK's increased flexibility in its policymaking.[258] For example, the IFoA noted that "in the event that the UK leaves the EU this presumably results in EIOPA having no UK-specific role which may then be an opportunity for the PRA to apply discretion".[259] This would also increase the PRA's ability to "operate in the international space".[260]

199. Another potential opportunity was highlighted in oral evidence when the previous Committee heard about the Covered Agreement Notifications relating to reinsurance entered between the United States and European Union on 13 January 2017.[261] This lowers the legal and capital barriers to business, and may present an "opportunity for the UK to arrange something similar" with the US,[262] a point made strongly by the London Market Group in evidence to the International Trade Select Committee in March[263].

200. It should be noted that the EU/US covered agreement took many years to agree and is limited to the abolition of the requirement to post reinsurance collateral. Furthermore, the Swiss have an agreement with the EU[264] which recognises the equivalence of Swiss supervision and capital calculations, but this, too, has its limitations as it does not offer the full reciprocal rights that the UK currently has in the EU. Nevertheless these two agreements have been cited as models which could provide useful precedents for a UK/EU agreement to reduce or remove non-tariff barriers for insurance.[265]

201. **The insurance industry should be regarded as a priority sector during the Article 50 negotiations. The Government should consider bespoke reciprocal agreement with the EU, similar to, but far more comprehensive than, the agreements that the EU has with Switzerland and more recently with the United States. Such an agreement could provide a solution for other parts of the financial services sector. At the very least, if the Government wants to meet its objective of a "smooth and orderly exit" from the EU, then it needs to address the urgent issue of pre-Brexit cross border contracts, perhaps through the mutual recognition of pre-Brexit insurance insurance contracts written in UK or EU member states.**

255 Q121
256 Ibid
257 Ibid
258 SOL018
259 SOL026
260 Q151
261 US Department of the Treasury, Press Release, 13 January 2017
262 Q31
263 Evidence provided to the International Trade Select Committee, UK-US Trade Relations inquiry, HC 978, 11 March 2017 (TER0251)
264 Agreement between the European Economic Community and the Swiss Confederation on direct insurance other than life assurance, 1993
265 LMG - A Brexit Roadmap for the UK speciality commercial insurance sector

Conclusions and recommendations

1. The UK insurance industry is a major contributor to both personal and national economic development; a major employer and tax payer; and a major investor and source of market liquidity. The scale of its contribution to the UK economy is often not recognised and it has historically produced few risks to UK Government finances, and far less of a solvency risk than the banking system. (Paragraph 14)

2. The PRA is highly respected internationally as an insurance regulator, both by the industry that it regulates and by other regulators. (Paragraph 29)

3. While the PRA and a minority of industry voices argued in favour of the status quo, many respondents advocated a primary competition objective for the PRA to carry as much weight as its solvency objective. The Committee agrees.(Paragraph 45)

4. The insurance function has implications for solvency in a number of areas, notably market, credit and operational risk, for which they are required to hold capital against under Solvency II. Even taken together, these risks are lower than in the banking sector. For example, AIG was brought down by risks on its balance sheet that were of a banking nature. If so, then insurance solvency issues are less disruptive. Competition was rightly subordinated to systemic risk in banking, but these circumstances do not apply in insurance.(Paragraph 46)

5. The Treasury should immediately review the PRA's approach to its competition objective, at least for insurers, and consider giving the secondary competition objective equal primacy with the PRA's other statutory objectives, introducing primary legislation if necessary. (Paragraph 47)

6. The industry and the PRA should review their approach to working together (including the conduct of consultations) in order that there can in future be a better and more productive dialogue on issues like Solvency II. Each side may have a different perspective, but there should be more common ground, and greater confidence in each other than the Committee detected during this inquiry. The PRA should set out how it intends to achieve this, as part of the work described in paragraph 88. (Paragraph 49)

7. The Bank of England can rely on an immense depth of experience in banking regulation. The PRA needs to assess whether it has the skills necessary for effective insurance regulation, particularly at the most senior supervisory and policy levels. The Committee encourages the PRA, in carrying out this review, to consider the skills and experience of its Insurance Directorate to ensure there is a genuine 'feel' for the insurance industry. The Committee also suggests that the PRA and industry develop a higher level of staff exchanges so that each can appreciate the objectives of the other.(Paragraph 51)

8. Evidence gathered by the previous Treasury Committee suggested that, while the PRA is held in high regard by the insurance industry, there is a disconcerting level of disconnect between its views and those of the industry, which might be indicative of a breakdown in effective communication. It also identified several areas where Solvency II is believed to be inhibiting competition and/or competitiveness. The

Committee recommends that the PRA and industry should review how they can communicate more closely with each in addition to the more formal consultation procedures. Earlier, more frequent and possibly more informal communication might have resolved the current difficulties at an earlier stage. A widely quoted example was the annuity market, where difficulties relating to the Risk Margin and the Matching Adjustment have led some firms to exit the market, and others to reinsure significant amounts of business overseas. Specific areas of concern such as these are discussed in later sections of this Report. This section considers respondents' higher level view of Solvency II's effectiveness overall. (Paragraph 54)

9. Concern was expressed that the legislation is "hampering firms' ability to innovate and provide customers with a broad range of products" while higher capital requirements are "driving some areas of activity off shore (outside the EU)", such as "the reinsurance of risks to territories" with less "rigid rules" than Solvency II. (Paragraph 65)

10. The UK's detailed approach to the implementation of the rules-based Solvency II Directive may have erred on the side of caution, enhancing policyholder protection at the expense of increasing the cost of capital for UK insurers. In any event, the PRA should give greater consideration to how it can maximise its application of proportionality. (Paragraph 72)

11. Solvency II has been very costly to implement, and there are areas which are defective, partly due to the underlying rules-based directive and partly due to a lack of proportionality in implementing it. London is known for its ability to provide finance and insurance for more esoteric products and the PRA needs to accommodate this. However, most of those costs are sunk costs and it is possible to improve the Directive's implementation without abandoning it altogether. A well-argued case has been made in evidence to the previous Committee, by individual insurers as well as the ABI and the Institute and Faculty of Actuaries, for a remedy to some of the defects that have been identified. Their views have been supported by industry experts.(Paragraph 77)

12. Sam Woods' subsequent letter provided an update on discussions with the ABI and is a helpful summary of developments as far as these items are concerned, although in most cases it showed that discussions are continuing. Nevertheless, the PRA needs to explain its thinking on the industry's suggestions in more detail than hitherto, and it needs to consider its reactions with more of a post-Brexit mentality. (Paragraph 80)

13. The Committee is concerned by the PRA's dismissal of many of these suggestions, and by its apparent reluctance quickly to address some of the problems of the Risk Margin. This might suggest that an excessively strict interpretation of the requirements of Solvency II, and of its own obligations, has limited its thinking in a way which could be detrimental to UK plc.(Paragraph 81)

14. The Committee notes that the PRA said it agrees with only five of the 23 suggestions made by the ABI, and it urges the PRA to make substantive progress on those it does agree with and to take a fresh look at the other eighteen suggestions in the context of the potential greater freedom of regulation that Brexit might bring. It is

the Committee's view, from the evidence presented to its predecessor, that there are many opportunities to improve the Solvency II rules and their oversight by the PRA, and it is to be hoped that the five areas of agreement are just the start.(Paragraph 85)

15. The Committee agrees with PwC's conclusion that the role of the UK regulator, and its supervisory approach in particular are "as important as the actual rules in terms of impact on the insurance industry". The PRA's implementation of "rules" has a disproportionate impact on costs, competitiveness of the industry globally, competition with the UK, the ability of the industry to provide long-term investment. The PRA needs to ensure that its supervisory approach reflects a balance between its prudential and competition objectives.(Paragraph 86)

16. By way of a summary of its recommendations which are expanded in subsequent sections, the Committee considers that the PRA, working in close collaboration with the industry, should:

- provide a solution for the risk margin to improve its calibration;
- develop proposals for the introduction of forbearance at the national level to deal with procyclicality;
- 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;
- 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;
- 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;
- develop rules for contract boundaries which reflect their economic substance rather than their legal form;
- develop proposals for simplifying the calculation of, and approval process for, the Transitional Measure on Technical Provisions provided for in the Directive;
- provide a view of where it might be possible better to align UK regulation post Brexit with IFRS17, weighing the disadvantages of change against the benefits of harmonisation;
- develop proposals which remove limitations in the standard formula for both existing and new entrants to the insurance market;
- 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; and

- develop a solution for firms who will lose the legal validity of their contracts after Brexit. (Paragraph 88)

17. The Committee expects a progress report, including commentary on the extent to which there has been change or substantive progress and where the industry has agreed the approaches taken, by 31 March 2018. This report should set out clearly how the PRA's implementation of the directive ensures proportionality and meets its secondary competition objective. (Paragraph 90)

18. In developing a post-Brexit regulatory model, it is recommended that efforts are made to accommodate regulatory forbearance, where it can be shown to improve macroeconomic stability and improve consumer outcomes. The Committee would expect to see some work on how this is being progressed. In parallel with this, the PRA should develop contingency plans that it can adopt if and when necessary in emergency circumstances, as soon as it is no longer constrained by EU law. (Paragraph 98)

19. In developing the future regulatory model, specific efforts should be made to avoid creating situations where artificial structures are encouraged to achieve an appropriate regulatory treatment for any class of assets or liabilities.(Paragraph 106)

20. Reduced competition in the annuity and equity release markets, the extra costs in complying with the rules, and loss of access to some asset types, are leading to poorer value for customers.(Paragraph 108)

21. UK firms believe that Solvency II makes it harder for them to invest in longer-term illiquid assets, such as infrastructure and equity release mortgages. This is a concern as the disincentive could have negative economic consequences and act as a restraint on UK plc.(Paragraph 117)

22. To the extent that the rules also discourage insurers from offering annuities, there will be a transfer of risk to Government, and poorer value for consumers. (Paragraph 118)

23. The Matching Adjustment has given some relief to the industry in that it attempts to reflect the long term nature of assets matching long term liabilities. Nevertheless, the Adjustment is a "workaround" solution, bolted on to the core Solvency II rules, which is cumbersome, and unnecessarily constraining. For these reasons, the PRA needs to conduct a fundamental review of the Matching Adjustment and its eligibility criteria, in order to achieve a more principles-based approach to the Matching Adjustment.(Paragraph 119)

24. The regulator and industry should work together to ensure that opportunities are taken to develop a more effective long-term approach to the treatment of insurers holding long-term assets to match long-term liabilities.(Paragraph 120)

25. A robust process will still be needed for approving and maintaining any approach that gives credit to an illiquidity premium. Evidence suggests that there is scope for more pragmatic rules to be agreed, with more flexibility alongside strict criteria to avoid the need for artificial restructuring of firms' cashflows for purely regulatory

purposes. The Committee would expect the PRA's progress report (requested at paragraph 90) to address the extent to which this is the case, and set out what action it proposes to take. (Paragraph 122)

26. A Risk Margin—that is an additional margin which purports to represent the additional capital that a third party would need in order to run off the insurance firm in the case of an extreme event—makes conceptual sense. It is included in other solvency and accounting frameworks, for example under the International Financial Reporting Standards. It should continue to form part of the UK's solvency regime. However, the previous Committee heard widespread criticism of the Solvency II Risk Margin as it is currently formulated. The regulator has acknowledged these criticisms. There is widespread grasp of the problem among regulators and the issue is being reviewed by EIOPA and the European Commission. But in the meantime UK business is being reinsured overseas. The pressure for this trend will continue as the Transitional Measure on Technical Provisions expires (see paragraph 169). For these reasons, many respondents and technical experts are advocating that the PRA take action now, irrespective of the Commission review process. The Committee concurs and asks the PRA for an update on the best approach for improving the risk margin calibration. (Paragraph 136)

27. The Committee notes the widespread and consistent concerns expressed by firms over the proportionality of the PRA's approach, particularly with regard to the review and approval of internal Models and amendments to those models. The PRA is urgently asked to review its practices and report to the Committee on proposed changes.(Paragraph 149)

28. The current EU legislation allows for proportionality in national regulators' approach to capital models. There should be no reason to wait until the UK has left the EU to take advantage of these provisions. The Committee requires the PRA to note this stipulation and report on intended actions. (Paragraph 150)

29. The PRA should also assess whether the Standard Formula could be enhanced for the benefit of existing users, especially if an improved version could save some firms from needing, or choosing to upgrade to, an Internal Model. The Committee suggests that the PRA consider the specific ideas for improvement put forward by witnesses in evidence to this inquiry. (Paragraph 152)

30. There is evidence that the regular reporting requirements are costly and overly detailed. The Committee believes that they could be streamlined, reducing the burden and cost on firms, and reducing the risk that the PRA could miss something. The PRA should review the information collected—both in the EIOPA and national templates—and assess it in the context of both usefulness and cost effectiveness, notably the quarterly data. The merits of exception reporting and/or focusing more on changes to previous information should also be considered. (Paragraph 161)

31. The Committee agrees with the oral evidence that its predecessor heard from Andrew Chamberlain that the Volatility Adjustment is "fairly crude". From the oral and written evidence it would appear that there are two main problems with the Volatility Adjustment. First, whether it should require approval from the regulator, and second, whether firms should be allowed to use a 'dynamic' Volatility Adjustment.

Given the problems of procyclicality examined in Chapter 4, it would seem prudent for the Volatility Adjustment to vary in certain prescribed circumstances, without regulatory approval. Given the actions of other regulators, notably the Dutch, this action seems uncontroversial, and the Committee sees no reason why it should not be undertaken without delay. An update should be included in the PRA's progress report requested at paragraph 90. (Paragraph 168)

32. The PRA's consultation on the calculation of the Transitional Measure on Technical Provisions was welcome, but was limited in scope. Broader issues remain to be addressed including: (i) whether and how the transitional benefit should be allowed to run-off over time; (ii) whether the principal causes of the increase in reserves that accompanied the introduction of Solvency II can be "corrected" when determining the future UK solvency regime issue; (iii) reducing the cost, particularly over the potential need to maintain dual models for sixteen years in case a re-measurement is required; and (iv) developing an approach which is practical to implement. (Paragraph 174)

33. Agreement on a pragmatic approach to pre-Brexit contracts is vital. In the absence of this, or a comprehensive reciprocal arrangement which addresses the problem of the loss of passporting, there will be substantial additional work for firms and regulators in both the EU and UK, especially the PRA. Wherever possible the PRA should adopt pragmatic approaches such as granting provisional recognition to EU branches prior to Brexit. (Paragraph 192)

34. The insurance industry should be regarded as a priority sector during the Article 50 negotiations. The Government should consider bespoke reciprocal agreement with the EU, similar to, but far more comprehensive than, the agreements that the EU has with Switzerland and more recently with the United States. Such an agreement could provide a solution for other parts of the financial services sector. At the very least, if the Government wants to meet its objective of a "smooth and orderly exit" from the EU, then it needs to address the urgent issue of pre-Brexit cross border contracts, perhaps through the mutual recognition of pre-Brexit insurance insurance contracts written in UK or EU member states.(Paragraph 201)

Formal Minutes

Wednesday 25 October 2017

Members present:

The Rt Hon Nicky Morgan, in the Chair

Rushanara Ali	Kit Malthouse
Charlie Elphicke	John Mann
Stephen Hammond	Alison McGovern
Stewart Hosie	Catherine McKinnell
Mr Alister Jack	Wes Streeting

The following declarations of interest relating to the inquiry were made:

Mr Alister Jack declared the following interest

Shareholdings: over 15% of issued share capital

Cantco Ltd (100% owned Nameco); Lloyds insurance underwriting. (Registered 29 June 2017)

Draft Report (*The Solvency II Directive and its impact on the UK Insurance Industry*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 201 read and agreed to.

Resolved, That the Report be the Third Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 31 October at 10.00am

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Tuesday 17 January 2017

Question number

Jane Portas, Partner, Insurance Regulation, PricewaterhouseCoopers, **Andrew Chamberlain**, Chairman of the Life Board, Institute and Faculty of Actuaries, and **Phil Smart**, Partner, Head of Insurance and Investment Management, KPMG — Q1–73

Wednesday 25 January 2017

Nigel Wilson, Chief Executive Officer, Legal & General, **Huw Evans**, Director General, ABI, **John Parry**, Head of Finance, Lloyd's of London, and **Julian Adams**, Group Regulatory Director, Prudential — Q74–151

Wednesday 22 February 2017

Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority, **Victoria Saporta**, Executive Director, Prudential Policy, Bank of England, and **David Belsham**, External Member, Prudential Regulation Authority Board — Q152–226

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

SLV numbers are generated by the evidence processing system and so may not be complete

1 Legal & General (SLV0001)

2 Prudential Regulation Authority (SLV0002)

The following written evidence was received by the Committee in the previous Parliament and can be viewed on the inquiry publications page.

SOL numbers are generated by the evidence processing system and so may not be complete.

1 Association of British Insurers (SOL0032)

2 Association of British Insurers (SOL0034)

3 Association of British Insurers (SOL0050)

4 Association of Financial Mutuals (SOL0014)

5 Aviva Plc (SOL0023)

6 AXA UK (SOL0037)

7 Bupa (SOL0025)

8 Cooley (UK) LLP (SOL0003)

9 Equity Release Council (SOL0024)

10 Financial Conduct Authority (SOL0015)

11 ICAEW (SOL0030)

12 Institute and Faculty of Actuaries (SOL0026)

13 Institute and Faculty of Actuaries (SOL0046)

14 International Underwriting Association (SOL0027)

15 Investment and Life Assurance Group (SOL0005)

16 JRP Group (SOL0016)

17 KPMG LLP (SOL0008)

18 KPMG LLP (SOL0049)

19 Lane Clark & Peacock LLP (SOL0035)

20 Legal & General Group Plc (SOL0047)

21 Legal & General Group Plc (SOL0009)

22 Lloyd's (SOL0028)

23 Lloyds of London (SOL0048)

24 London Market Group (SOL0022)

25 LV= (SOL0010)

26 Moody's Analytics (SOL0007)

27 Mr Mahesh Patel (SOL0020)

28 Mr Samuel Achord (SOL0036)

29 Noleen John (SOL0041)

30 Pension Insurance Corporation (SOL0044)

31 Prudential Plc (SOL0042)

32 Prudential Regulation Authority (SOL0043)

33 Prudential Regulation Authority (SOL0051)

34 PwC LLP (SOL0045)

35 PwC LLP (SOL0018)

36 Royal London (SOL0039)

37 RSA Insurance Group (SOL0013)

38 S&P Global Ratings (SOL0011)

39 Steve Dixon Associates LLP (SOL0006)

40 Talbot Underwriting Ltd (SOL0017)

41 TradeRisks Ltd (SOL0031)

42 Unum (SOL0019)

43 Willis Towers Watson (SOL0040)

44 Xiaohan Fang (SOL0004)

45 XL Catlin (SOL0029)

46 Zurich Insurance Plc (SOL0021)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website.

Session 2017–19

First Report	Appointment of Sir Dave Ramsden as Deputy Governor for Markets and Banking at the Bank of England	HC 472
Second Report	Appointment of Professor Silvana Tenreyro to the Bank of England Monetary Policy Committee	HC 471