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By email: SolvencyIIReview@hmtreasury.gov.uk

8 February 2021

Dear Sir

HM Treasury | Review of Solvency II: Call for Evidence

Thank you for giving us an opportunity to respond to your Review of Solvency II: Call for Evidence (the **Call for Evidence**).

Fox Williams is a single office City of London law firm. We are regularly asked to advise national and international insurers and reinsurers on Solvency II issues, and other matters.

We have discussed the Call for Evidence with insurers and reinsurers, and our aggregated answers to your questions are below. Although the answers use the terms "we" and "our", they reflect the views of the majority, rather than our views or the views of every insurer and reinsurer we discussed the Call for Evidence with. We are very grateful to the insurers and reinsurers that were kind enough to discuss the Call for Evidence with us and help us to prepare this response. We are unable to share their identities in this letter, however, the group comprised major global insurers and reinsurers of both long term and general insurance, Lloyd's market participants, as well as retail-focussed and commercial insurers. Some of our correspondents are more focussed on the US and Asia because of their parent or group interests, while others are mostly subject to Solvency II in their home states. We believe that this gives a broad overview and assisted our response.

Risk Margin

Question 1: *What is the impact of the current design of the risk margin?*

Question 2: *What changes, if any, should be made to the methodology to improve the operation of the risk margin?*

Question 3: *What are the benefits, and costs, of any proposed changes to the methodology to calculate the risk margin?*

Like the Government and the PRA, we also "*support the objective underpinning the risk margin and the protection that it provides to policyholders*", and agree that "*the design* *of the risk margin … can be improved to better meet its objectives, without reducing policyholder protection*"

We are concerned about three issues: (a) the size of the risk margin; (b) its volatility; and (c) the indirect pressure it creates.

In October 2017, the Treasury Select Committee (the **TSC**) noted (for example) that:

"*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*".

Our experience, and the anecdotal evidence available to us, suggests that these transfers are continuing. That is to be regretted for at least three reasons: (a) the cost of insurance in the UK is higher than it needs to be; (b) assets and liabilities that could be usefully retained in the UK have been and are being transferred to other jurisdictions; and (c) that transfer means the number of highly skilled jobs available in the UK is gradually falling. If this continues, it means that the UK will eventually (and unnecessarily) lose a complex and valuable skill-set to other countries. We should note that one of our correspondents sees longevity risk transfer as important in allowing the industry to pool and diversify risk and does not see this loss as a long term problem.

In his oral evidence to the TSC, Andrew Chamberlain[1], noted that the risk margin increases the cost of annuities, making them more expensive than they need to be – something he described as an "*own goal*", an assessment with which we agree. Huw Evans, Director General of the ABI, speaking at the Insurance ERM conference on 3 December 2020 noted that with reform of the risk margin, "*insurers will be able to offer more affordable products and there will be greater availability of long-term savings products*".

At the moment, and in the ordinary case:

- "*the risk margin [is] calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement necessary to support the insurance and reinsurance obligations over the lifetime thereof*" (article 77(5) of the Solvency II Directive (the **Directive**)) (see Rule 4.1 in the Technical Provisions part of PRA Rulebook for SII Firms);

- "*The rate used in the determination of the cost of providing that amount of eligible own funds (Cost-of-Capital rate) shall be the same for all insurance and reinsurance undertakings and shall be reviewed periodically*" (article 77(5) of the Directive) (see Glossary to the PRA Rulebook); and

- The Cost-of-Capital rate is fixed at 6% (article 39 of the Solvency II Delegated Regulation, the **Regulation**)– which is the rate that the European Union policymakers considered appropriate for the typical EEA insurer;

[1] Chair of the Actuarial Standards Committee of the International Actuarial Association; a member of the Fairness and With-Profits Committee Reassure UK, and a member of the IFRS Advisory Council.

- At the moment of Brexit, the Cost-of-Capital rate was transferred into and fixed by UK law, something only Parliament can now change (unless and until the relevant requirements are transferred into the PRA's Rulebook, as proposed in and by the Government's Regulatory Framework Review).

It seems to us that the Government and/or the PRA (as the case may be) might therefore usefully:

(a) Transfer the Cost-of-Capital rate to the PRA Rulebook, and reduce it from 6% to (say) 2% (this might be done gradually, if thought appropriate);

(b) (If the PRA's view is that it would be better to keep fixing the rate for the industry as a whole), review the rate annually (and more often, if the industry or economy are stressed), before deciding whether to increase, maintain, or reduce it. As one of our actuarial correspondents suggested, "*a fixed Cost-of-Capital rate in a standard isn't particularly the right thing and I agree with your proposals to have an annual review of that rate*";

(c) (In our view, it would be better to fix the rate on a case by case basis, so that it properly reflects the Cost-of-Capital for individual firms and their groups), require every insurer to assess its own Cost-of-Capital in accordance with rules and guidance to be made by the PRA – assessments that would be periodically reviewed by the PRA, before it gives individual guidance about rates.

Setting the Cost-of-Capital rate on a firm by firm basis, using a methodology of this kind would be familiar to the industry and PRA. In the pre-Solvency II period, insurers, reinsurers and the PRA used a similar methodology (ICAS and ICG), and the PRA and FCA are still using an ICAS / ICG-style methodology when they determine (for example) bank-specific counter-cyclical capital buffers, and the capital requirements for investment and other firms. Only one of our correspondents did not support a reduction in the Cost-of-Capital rate.

Reducing the risk margin will allow insurers and reinsurers to release capital, and/or to invest it more freely than they can today. "*The insurance and long-term savings industry can play a greater role in the real economy*", commented Huw Evans of the ABI at the Insurance ERM conference.

This comes with two caveats:

(a) It seems to us that the current Cost-of-Capital rate (6%) is too high; and that an appropriate and immediate downwards adjustment is highly desirable. After that, it seems to us that it would be better if the rate was gradually increased or decreased, so that firms have time to adjust and policyholder protection is not undermined; and

(b) care will need to be taken, in case a reduction jeopardises the equivalence we hope and anticipate the Commission will give the UK later in 2020 or in early 2021. However, this point should also be turned on its head, cautioning the UK regulators from taking "narrow views on any incoming firms" from regimes that do not mirror any UK-centric tailored requirements.

Matching adjustment

Question 4: *What changes if any, should be made to the eligibility of assets for the matching adjustment?*

Question 5 *What changes if any, should be made to the calculation of the matching adjustment?*

Question 6 *What changes, if any, should be made to the matching adjustment approval process?*

Question 7 *What changes, if any to the matching adjustment could be made to support insurance firm's provision of long-term capital to support growth, including investment in appropriate infrastructure or other long-term productive assets?*

Question 8 *What changes, if any, to the matching adjustment could be made to better reflect climate change-related risks arising from investments and contribute to sustainable investment?*

Question 9 *What are the costs and benefits of any changes proposed in response to the above questions? How should any risks to the safely and soundness of insurers and/or to policyholder protection be mitigated?*

Question 10 *What changes if any, should be made to the PRA's powers to manage risks to the safety and soundness of firms, and policyholder protection, arising from the use of matching adjustment?*

As the Government appears consistent in its desire to have the insurance industry fund infrastructure investment, the use of long-term investment providing steady returns to meet risk margins seems an obvious match. We note that the industry has previously suggested that the matching adjustment should be included in the calculation of risk margin.

We suggest that this inclusion should be considered. One of the key refrains from the industry has been the request for a reduction in complexity and that proportionality should be applied to the requirements. Similarly, the Regulatory Framework review suggests that the need to indulge in extra complex capital calculations has provided a disincentive for firms to undertake long term business.

The PRA now has the Solvency II data from the last few years to determine whether use of certain assets is acceptable. Note that the PRA's Equity Release Mortgage (ERM) consultation paper of July 2017 (CP48/16) suggested that illiquid unrated assets with the characteristics of ERMs were unlikely to be deemed suitable for the matching adjustment to which we would have asked what then would be and why? We should now have the data to make such determinations. While the PRA wishes to be flexible in determining which assets should be appropriate, to some extent, the matching adjustment has meant the PRA making detailed legal interpretations, where the industry wanted to use a principle-based approach. Any changes to the eligibility of assets might well be seen in light of former admissible asset and permitted links requirements, when the regime for insurers provided a clear set of rules and proportions for each type of asset. While these did not do much for the flexibility of investment, they were at least easy to operate. This approach might if usefully applied, encourage greater use of infrastructure investment.

Overly restrictive categories of asset eligible for the matching adjustment will usually lead to poorer investment performance and poorer pensioners with annuities. Given the potential upside to having a vibrant and growing life assurance market, we should be examining the need for a matching adjustment and the underlying issues which lead to its creation. Do the same issues which led to its creation still exist and is so, what solutions are available?

Solvency II has a relatively short-term risk focus which is a fundamental contradiction where we are dealing with life assurance. Further to this point, we should ask whether the matching adjustment is the only way to manage what is essentially a credit default risk and whether a different approach would be better? There is a risk in becoming wedded to the matching adjustment as such and this should be recognised. The real way in which you would normally assess credit default risk, is to analyse the actual risks themselves. That said, some long-term risks may be more difficult to quantify, by their nature.

However, assuming that removal of the matching adjustment from the prudential regime is not on the cards, we need to simplify and streamline the calculation and as it is a calculation based on the assurer's own assets and liabilities, apply a more principles-based approach. We note that the requirement for a complex calculation has acted as a deterrent for life assurance (see the TSC Report from 2017). We also note that the existence of the matching adjustment has provided certain benefits (see paragraphs 3.4 and 3.5 of the Call for Evidence) which need to be taken into account. There appears to be some reluctance on the part of the insurance market to comment for fear of losing these benefits.

Even more importantly, we have understood that the insurance industry is not keen to throw out Solvency II completely. Instead, they seek "*improvement at the edges [of the matching adjustment] rather than a fundamental re-examination*". We note that this is not just confined to thoughts on the matching adjustment. A constant refrain has been the wish to see no root and branch amendments to the Solvency II regime, largely because of the time, cost and effort it has taken to implement and operate the regime so far, with systems specifically running to produce the data required for Solvency II reporting. We understand and sympathise with this, and would also note, more worryingly that Solvency II does not seem to reflect the actual running of an insurance company. Almost every company we spoke to commented that the Solvency II data is not what they use for the day to day running of the company. A few said that the ORSA was useful. However, a larger number commented that Solvency II data was produced for the returns, but the company relied either upon the data produced by systems which pre-dated Solvency II or used other data, which conformed better with the group reporting. The data which they used might then be updated for Solvency II purposes, but was rarely important for running the company. This surely makes Solvency II an expensive and cumbersome burden, rather than producing a useful set of data for the companies and the regulators in making the market safer. Regulators should concentrate on reducing the data required, but making it more useful and pertinent.

A common point made by our correspondents was that Solvency II had created a small separate industry of its own, costing at least 3% of an insurers income to produce the required data and returns. One insurer commented that the whole quarter is needed to produce the return, it is not just something that happens in the background. We refer to reporting later on, but these costs (both in terms of time and value) are too great. "*We never see a full cost benefit analysis of the whole, only a constant drip drip of cost benefit analysis of each small addition. It is not helpful.*"

Additionally, the Government's desire to increase infrastructure investment should not come at the cost of policyholders' returns; while infrastructure assets could be a positive investment for the purposes of the matching adjustment, they should not be prioritised if they are poorly performing. Equally, we need to recognise that concentrating investment in a limited pool of assets carries its own risks. We have some concerns that the PRA could consider the matching adjustment and the assets it represents as an opportunity to intervene in investment strategies. Essentially as the matching adjustment is a capital fiction (because of the way in which Solvency II assesses risk, the matching adjustment created may have little to do with the actual underlying risks inherent in the related assets), arguments have more widely been made that the creation of a matching adjustment is essentially a way of adding artificially created capital to the insurer's balance sheet (see for example, Dr Buckner's objections in the Part VII transfer hearing for Equitable Life v. Utmost Life & Pensions). At best, the regulator should be using every opportunity to create a prudential regime where an adjustment is not needed, because the underlying risks are being better dealt with.

The practical steps that we believe can and should be taken now in respect of matching adjustments, include:

1. obviate any need for restructuring of assets;

2. identify and rate assets across the board, the EMIR has created a uniform way of doing so and the Solvency II data which the PRA has received to date will assist this;

3. keep the capital allocation against such risks low.

4. create tax incentives for insurers and reinsurers that make infrastructure investments, especially if they do so consistently over time.

We have discussed time horizon and asset valuation questions with several insurers. One insurer, reflecting a commonly held view, noted that, "*if you [look at] the real value of assets … if you are looking at the asset over a long term period … you should [also look] at climate risk, transition risk and holding that asset for a long period of time, not just the current value … if you argue for taking the genuine risk of an asset into account and matching that against the liabilities, you naturally end up in this kind of space*". However, "*building climate change into [the valuation] is difficult*".

In our view, it would therefore be better if the matching adjustment was ***not*** used as a pro-active tool for tackling climate change, and climate change risks. If an insurer invests in investment-appropriate infrastructure, and the infrastructure will have a positive impact from a climate change perspective, we clearly have a very positive result. Using the matching adjustment to encourage or facilitate infrastructure investments that are not (or are not necessarily) investment-appropriate, simply because they will (or might) help the environment, makes no sense and should be strongly resisted. This is because:

1. It is extremely difficult to balance policyholders' reasonable expectations, their financial needs, and their financial objectives (on the one hand), with the clear need to protect the environment (on the other). We are especially concerned that if the balance shifts, perhaps only slightly towards the environment, too many policyholders will suffer, financially, and mis-selling and other claims will follow;

2. There are so many variables to consider, from both a policyholder perspective and an environmental or climate change perspective, that the law of unanticipated and

unintended consequences is almost certain to apply, especially over the medium and longer term, to the detriment of policyholders *and the environment*.[2]

The caveat to this is what our correspondents have pointed out, that "*larger firms probably have more of an appetite [for such investments] than smaller firms. Indeed, it is no secret that the likes of Aviva have been supportive of infrastructure and climate change investment*". Insurers could therefore work with the Government on infrastructure projects which actively assist with the impact of climate change, such as flooding defences and coastal erosion. This might be more appropriate, as such infrastructure projects balance needs with the impacts. While we do not consider the insurance industry should meet the Government's responsibilities in general, if the insurers in question have received considerable tax breaks and capital benefits from making the initial investments, the logical approach means that they should be meeting some of the costs associated with the investment.

The regulatory approval process for the matching adjustment can be complex, time consuming and off-putting to some life assurers who may not have the capacity to undertake what is necessary. Given that there are some advantages to applying the matching adjustment, there is an incentive to go through the process and the certainty which the approval process gives is beneficial. It makes sense to have the PRA set out what it will find acceptable in terms of the implementation and assets applied to the matching adjustment. Only if the firm is going to deviate materially from the PRA's outline, should a formal approval process go ahead.

SCR

Question 11: *What other tools should be available to supervisors to assess and ensure the overall level of capital held by firms is appropriate?*

Question 12: *What changes if any, should be made to the current approval process for new internal models and changes to models? What type of supervisory tool would be an appropriate alternative to the rejection of an insufficient model application?*

Question 13: *What changes, if any should be made to the standard formula to better reflect the risk profile of the UK insurance industry? What are the costs and benefits of such changes?*

Question 14: *In circumstances in which there is insufficient justification for a full or partial internal model, how might the SCR be calculated for insurance firms or business for which the standard formula is deemed inappropriate?*

Question 15: *What changes, if any, could be made to the methodologies that insurance firms can use to calculate the SCR, including by removal of potential barriers, to enable them to provide long-term capital to support growth, including to invest in infrastructure, venture capital and growth equity and other long term productive assets, consistent with the Government's objectives?*

[2] One particular risk is that science will strongly suggest that certain infrastructure makes sense; insurers and their policyholders will invest; the science will change, and the insurance / policyholder investments will make it difficult or impossible for the infrastructure to be changed and/or fresh infrastructure to be built. All to the immediate detriment of policyholders; *and the environment.* In addition, the risks of the Government focusing on climate change mean that an element of infrastructure will need to be built to meet those aims, e.g. the necessary charging infrastructure for electric cars by 2030 and this leads to industry concern as to achievability.

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Question 16: *What changes, if any, should be made to the SCR calculation to promote better measurement and capitalisation of climate changes-related risks?*

Policyholders are undoubtedly better protected when supervisors have better knowledge of the firms they supervise. Accordingly, rather than focussing on the modelling and SCR, could there be more investment in and focus upon the supervision itself? While in the past, there has been concern that supervisors could get too close to the object of their supervision (regulatory capture), there is disquiet that staff turnover and insufficient time, knowledge, experience and resource devoted to insurance firms leads to poor supervision. In our discussions, we have heard that "*sometimes [the PRA] focus on the things that may not matter rather than those that might*" which may be attributed to the PRA consisting of "*two categories of people: people that have been there 6 months and people that have been there their whole life*", thereby creating a lack of experience and an inconsistency in approach. Improvement in understanding and continuity of supervision would have benefits for both firms and the regulators.

More, more experienced, and more highly trained, supervisors, who spend longer supervising their particular firms before they are rotated, would help policyholders, firms, the regulators, and the wider economy. Moving to a supervisory model of this kind would clearly be expensive. Many insurers would be willing to contribute towards these costs, because of the policyholder, firm specific, and wider economic benefits that would bring. Nonetheless, one of our correspondents confessed to being scared by the idea of more highly trained supervisors, because of the likely associated increase in costs. "*Our fees feel very high for what we get out of it. We haven't seen a return on the information we give, for seven years."*

The Call for Evidence imagines more flexibility in the application of any model, with partial internal models and thus selected changes to standard formulae. Such flexibility will be welcomed by the market, as currently "*supervisors are pushing [firms] to evaluate with the standard model, but if it is inappropriate for your firm the stretch to get internal model approval is a big stretch*". Temporary adjustments and waivers should also be considered as well as greater use of management actions. These have in the past been rejected by the PRA, but they may well assist the PRA in its supervision, both of new lines of business and where there is little or no appetite for development of a full internal model. If firms use SCRs that properly reflect the nature of their businesses, and the nature of the risks inherent in them, this would be of immediate benefit to both policyholders and the wider economy because (for example) it would be easier to ensure that every insurer and reinsurer had an appropriate SCR, and an appropriate level of own funds over above the SCR, *and no more*. At that point, policyholders would have the protection they deserve; and, in many cases, capital could be released into the wider economy, while the cost of insurance and reinsurance would fall (because the cost of capital being carried by firms, would fall too). The same changes would also make it easier for insurers to develop new lines of business, of equal benefit to policyholders and firms alike.

With the internal model process, more support and detailed explanation would go a long way to assisting firms in making a better application and indeed firms would expect their supervisors to be clear as to their expectations. An application should not be made in a vacuum. Providing an environment with a constructive and supportive regulatory system would undoubtedly increase the UK's attractiveness as an insurance centre.

As we have already said, using the Solvency II data which has been collected by the PRA over the last 5 years will assist the industry if it is made more available and the regulator demonstrates that it has learnt from the data which has been submitted in the returns made. For example, we expect that data should indicate where the firms have encountered strains – it would help to know that the regulators have considered this and ways in which this might have been alleviated. It is all very well for the industry to be expected to find solutions to these issues, but where they have, the benefits should be identified and publicised as there is little or no point in re-inventing the wheel. Equally, more details could be given to the industry on the reporting made to date and what could be reduced. Perhaps this should be the topic of future consultation?

Where changes have been introduced to the standard formula for certain insurers, the regulators must analyse these and determine whether or not they should alter the standard formula where there is sufficient deviation across the board. We have seen little evidence that this has been done to date. One solution might be to use a general business UK firm and a long-term business UK firm to establish UK-specific standard models to which the industry can map their own businesses and identify changes both to the Solvency II standard formula. In addition, firms might use any template so established to make changes in future. This would allow "*the specifics of the UK industry that may not apply to the EU*" to be better captured in the UK legal and regulatory system. This approach (using standard models) after all was the starting point for Solvency II.

It would help to simplify the internal model process. Deviation from the standard formula should also be less of an issue. The regulator must acknowledge that deviation usually reflects the precise nature of the business they supervise, rather than some renegade or otherwise risky approach to its management. Allowing firms to make greater use of management actions to address the parts of the standard model that are inappropriate for them would help. Management actions are often useful and reliable tools, not something that lets "*the genie out of the bottle*" (Sam Woods), as the PRA seems to think. These actions, with a better and deeper understanding of insurance, insurers and individual firms, should be at the heart of regulatory oversight – not kept at the margins, because supervisors do not have the knowledge, skills and experience required to properly understand and act appropriately on them.

We have already considered the ways in which insurance can assist with the Government's aims to invest in infrastructure and manage climate change risks. As we have already said, the easiest and most consistently attractive way to drive these changes is through reductions in tax, reductions in regulatory hoops to jump through and a more amenable risk capital rate.

Using the tests which are applied to the current infrastructure investments, there is a consistent complaint that it is difficult to find investment grade quality investment in infrastructure. Some of this is down to the tests which are applied to such investments, such as ratings, types of infrastructure etc. Making the initial adjustments to the underlying investments to ensure that they can be treated as suitable for an insurer to apply to its SCR prior to their being marketed would undoubtedly assist insurers in making those investments. Concern was expressed that "*a number of artificial constructs are being used to re-package assets into an asset which insurance firms can invest in that can comply with the rules but doesn't seem to add more protection legally or economically*". We have seen investment managers determinedly building funds which insurers can invest in and treat, thanks to "look through", as an infrastructure investment. Rather than relying upon the work of a third party, if the insurance industry sees there is merit in direct investment and that may or may not be the case, then ensuring that the investment can be made to take advantage of the capital related requirements would be a useful step to take.

Group

Question 17: *Which issues should be considered in relation to the powers for the PRA to allow for temporary calculation of the consolidated group SCR using multiple group internal models following an acquisition or merger?*

We do not propose to respond to these questions

Transitional measure of technical provisions

Question 18: *What changes, if any, should be made to the current process for recalculating TMTP deductions? What are the costs and benefits of such changes?*

Question 19: *Should the TMTP be integrated into any broader transitional arrangements resulting from the Government's review of Solvency II?*

We do not propose to respond to these questions

Reporting requirements

Question 20: *What changes, if any, should be made to insurance firms' reporting requirements? What are the costs and benefits of such changes?*

Question 21: *Insurance reporting comprises several layers. Solvency II templates, National Specific Templates, reporting expectations in supervisory statements and ad hoc requests. What changes, if any, should be made to bring together the various layers to create a more coherent reporting framework?*

It is, we believe, both important and useful to work with the IAIS and the US insurance industry to ensure that while the proposed introduction of the Insurance Capital Standard (ICS) is taking time, it does not add to the reporting requirements laid upon the UK insurance industry.

Taking this approach is something that those responsible for the implementation of Solvency II would appear to have ignored, thus adding to the reporting burden. We understand that with the insurance supervisors worldwide preferring to follow the US approach (which makes sense in terms of numbers to whom it applies), those subject to Solvency II have increased reporting burdens. Surely an effort to streamline the reporting so that the same figures can be applied across the board would be a laudable aim. One of the global insurers we spoke to commented that this was "*a very genuine concern and we do double up a lot on reporting. There is no central repository for information. I would rather have expected the PRA to be driving towards that. The PRA regulation of the Lloyds market seems to work like that…if we can report in one direction then data is fed out at a higher reporting level that would be very helpful*". We believe the PRA now has an opportunity to strip out that duplication and make the process more efficient.

The reporting which Solvency II still engenders (i.e. when the excess and duplication has been removed) should then be used for the benefit of the industry, not least because the data which is reported to the PRA undoubtedly contains the seeds of the next financial crisis, but there would appear to be little or no effort applied to analyse this. The benefits of doing this analysis should be unquestioned and incentivise the industry to continue giving the information required. We are sure that the costs associated for insurers with their reporting are constantly under review, so enabling them to see a benefit from output of the industry and better data management would be welcomed. As our discussions reflected across the board for the industry "*there is a lot more value to be gained and there would be less criticism of reporting requirements if some of that was played back to firms*".

Timing and proportionality are key to the whole of this review and their applicability to reporting requirements cannot be overstated. A general spirit of reduction should be applied, with supervisors asking themselves, "*What do we really need, when and why? If we must ask for data, how can we use it in a way that will give the industry a return?*" Given the number, depth and breadth of the routine quarterly and annual reports required to be prepared and made, ad hoc requests for additional data should be minimised and limited. One common criticism was that it is a "*bad habit of regulators to request a bucket full of data to a very tight deadline and then not obviously do anything with that data, which is inefficient for all concerned*". Too often, firms are unexpectedly asked (or required) to provide large amounts of data, and then left for weeks or months without firm-specific or industry feedback, if any feedback is received at all.

As we have mentioned above, firms spend a disproportionate amount of time gathering data for Solvency II reporting, but all of them, even those in Solvency II-parented groups commented that very little of that data is useful. "*Some parts of the SFCR have value, but the RSR is only repackaging information from elsewhere which has already been submitted. A lot of the content is waffly boilerplate.*" There is also an impression given to firms that the extra reporting is required because of regulatory personnel changing and needing to be brought up to speed on history and context. But one cannot avoid the feeling that if regulatory reporting aligned better with the actual use of the data, it would be easier to collate and share and be the subject of far less grumbling. *"Solvency II is a subset of the data we look at and we don't examine it."* The habit of outsourcing reporting requirements to external service providers means a potential concentration of expertise outside the firm itself which is dangerous and reinforces the impression that the Solvency II reporting requirements are not pertinent to the firm's business. We observe that there is much duplication of effort, with Lloyd's reporting, as well as other layers created by local templates and information gathering through "Dear CEO" letters. The costs are "*fantastic, quite monumental and all too frequently [data is] provided in a vacuum.*"

It would be more impressive if the regulators explained why they wanted the data; and how it would be used; and if the regulators gave a commitment to provide firm-specific and industry wide feedback, within a reasonable and useful period, so that everyone can learn every time the requests are made. All too often, the regulators give the impression that they would like some data, but they have not fully thought through what they really need; or what they will do to get the best value from the data they receive. Sometimes, one has the impression that the data is collected, but the regulators do not have the resources needed to analyse it, so it gathers dust on a shelf, for no purpose at all. .

Branch capital requirement

Question 22: *What are the costs and benefits of the removal of capital requirements for foreign branches and consequential changes?*

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Question 23: In what other ways could the branch regime be reformed in order to increase the attractiveness of the UK as a destination for foreign branches, while preserving appropriate protections for policyholders?

This seems to be relatively straightforward. As the Call for Evidence notes, branches are not separate undertakings. It is therefore rather artificial to ask firms and their branches to (a) calculate branch-specific capital requirements; and (b) retain an amount of own funds to meet them. It also adds a layer of cost that could easily be saved by recognising the legal and economic reality – *viz* that the branch and the head office are one and the same. One of the insurers we spoke to described "*separate solvency tests [as] a fiction [when] a more holistic view [needs] to be taken*". That said, those firms which have essentially been forced to convert branches to subsidiaries are not keen to see others escape the burden of doing so and we perceive some bitterness might arise, if changes are made. One insurer commented that such a fuss was made to require branches to subsidiarise that the market would not expect to see change to this requirement any time soon. They noted what they saw as the protectionist nature of Solvency II and speculated that the idea behind it was that it might make it harder for third country insurers.

Encouraging international firms with reputable regulatory credentials to open and maintain at least one UK branch, would broaden and deepen the market at little obvious cost. Making it simpler to operate in the UK would also help us to demonstrate that the UK remains open for business. It is also likely to help from a UK financial stability point of view, if UK risks can be insured in a way that spreads them thinly around the world, rather than unnecessarily concentrating them in the UK.

In the same way as under Solvency II, a branch should continue to meet the common good requirements and demonstrate how it does so. This is more a matter for the FCA than the PRA, so retaining the remit for review of capital requirements should be required of the PRA, operating at a higher level and leveraging its relationships with overseas regulators (some of which are currently subject to unhelpful "frictions"). As insurance regulation and prudential supervision has increasing appeal to the global organisations, the PRA should concentrate on ensuring its presence at all levels on international supervisory bodies and translate that into active and market focussed regulation. Focus on policyholder satisfaction to the exclusion of all else, will ultimately lead to no-one including policyholders being satisfied.

From our perspective, the "*piece around international competitiveness should be on [the PRA's] agenda. We lost quite a lot of business to the EU as a result of Brexit and we need to re-establish ourselves as a place that's great to do business. The regulators' reputation, the transparency of their processes and how easy it is to get approved to do business here is part of that*" (Huw Evans, ABI, Insure ERM conference, 3 December 2020). As the PRA and FCA should be aware, one of the best ways of ensuring that insurers and reinsurers want to come to, and stay in, the UK is to create a transparent, stable, and proportionate regulatory environment. An environment where it is easy to do business with other businesses *and with the regulators*. A regulatory objective that used to be in vogue, and seems to have slipped in recent years.

Thresholds for regulation by the PRA

Question 24: What changes, if any, should be made to the current regulations on the scope of the applications of Solvency II? What are the costs and benefits of such changes?

Question 25: What should be the key features of a regulatory regime for insurance firms not covered by Solvency II (non-directive firms)?

Mobilisation of new insurance firms

Question 26: What changes, if any, should be made to the requirement that new insurance firms expected to exceed thresholds for size in Solvency II within five years of authorisation are subject to Solvency II from the point that they begin operations?

Question 27: What are the key features that should be considered in developing a regime for new insurance firms if the full Solvency II regime is not applied from the point of authorisation?

On both these points, we consider that the supervisory remit should be to provide a regime which is the same across the board, but takes into account the scale and proportionality appropriate. It is important for the UK to ensure that firms are appropriately supervised whatever their size, but it does not mean that the UK supervisory system needs to adopt the heavy handed approach which Solvency II has led to. The approach taken to firms in the regulatory sandbox should be rolled out, so that we start from the light touch approach and only add to that where size and exposure demands it.

We would very much like to see a new insurer mobilisation unit, akin to the bank mobilisation unit the PRA has maintained over several years.

Success depends on:

- The skills, knowledge and experience of those who staff the PRA's insurer mobilisation unit. In particular, they must properly understand insurance, the insurance market and insurers; and they must be easy to do business with;

- The willingness of the PRA (in particular) to enter into a well-informed dialogue with new insurers – a dialogue that aims to solve problems, rather than leaving firms to identify and solve every problem for themselves. It is unrealistic to expect new firms to be resourced in a way that allows them to do this for themselves, at first;

- Proportionality - the regulatory sandbox approach could be usefully applied here, so that small, simple, early stage firms start in a light touch (but not a soft touch) environment, where they are only expected to comply with the rules in a way that gives policyholders an appropriate degree of protection, and still matches the nature, scale and complexity of the relevant business. For example, "*there are now many arrangements with InsurTechs or distributors", where "every link in the chain is [regulated, which is] unnecessary and ultimately does no favours to the consumer*".

- Consistency – being able to rely upon the regulatory environment and a fair and practical approach from the regulator to come forward with the same approach and requirements every time is important for market certainty.

Comments were put forward about the peculiar benefits of the Lloyd's market and the need to regain its entrepreneurial approach which has to some extent been lost with the heavy duplication of regulatory effort. "*It is an expensive way to do business and unsurprisingly start-ups choose to operate outside the market".*

LIBOR

Question 28: *What factors should be considered as port of the proposed transition of insurance firm discount curves from LIBOR to OIS rates? When should the transition be introduced?*

We do not propose to answer this question

Other areas for review?

Question 29: *What if any, areas of Solvency II not covered elsewhere should be considered for review?*

In its report of October 2017, the TSC:

(a) noted that the PRA only agreed with five of the 23 suggestions made by the ABI; and

(b) urged the PRA to take a fresh look at the other eighteen, in the context of the greater freedom that Brexit would 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*".

The PRA's reluctance to consider, and either act on or answer the ABI's suggestions seems strongly to imply that the PRA is out of touch, and out of step, with the industry it regulates.

Although it is entirely right and proper for the PRA to seek to deliver an appropriate degree of protection for policyholders, since the financial crisis, the UK's regulators have become so risk averse, and so laser-focussed on absolute policyholder protection, that excess prudence is now required, to the detriment of competitiveness between UK insurers, between UK and international insurers, and between the UK and other jurisdictions.

The Call for Evidence gives us a good opportunity to consider the role of the UK's regulators, acknowledging that "*smart regulators are capable of making judgments with reference to a number of different touchpoints. It is not the case that having a competitiveness agenda neuters the effectiveness of the regulator or makes it unable to preside over a financially stable system*" (Huw Evans, ABI).

We have noted that, "*a lot of regulators have objectives to maintain competitiveness*", thereby creating a constructive "*conflict between the competitive angle and the regulation angle*".

The broadly positive approach made by the Call for Evidence, suggests (we hope) that the PRA and FCA recognise that a different tack is now required.

For the benefit of the UK, UK firms, and UK policyholders, we would like the UK to have regulators:

- that are easier to do business with than they are today;

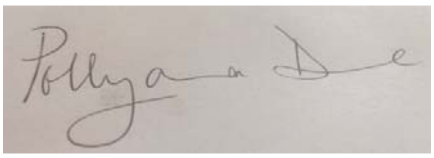
- that have the knowledge, skills, experience and resources required to have and to maintain an open dialogue, at a reasonable pace, with the firms they supervise; and

- that are more easily and appropriately accountable for their actions (and their failure to act) if they are too slow, too uncertain, or too vague, in their supervisory activities and that causes detriment (as it does) to authorised firms, and their policyholders.

One of one our key concerns is that HM Treasury should facilitate access to, and provide analysis of, all the data that the regulators have collected to date from Solvency II. If it can be done in an appropriate way, this data could be monetised. Either way, it must be analysed, and the anonymised results must be shared with the industry, in a way that enables everyone to learn from the aggregated industry's experience over time. A systematic review and use of the data can only give the industry more certainty and detailed information in the future, which surely will assist the insurance market in its planning and strategy.

We would also welcome detailed feedback on more effective and uniform valuation of assets and how well the "look through" approach to assets has been working over time. If EMIR can drive a uniform approach to the valuation of assets, it is likely to be to the good if the same system (or something similar) can be used to make it easier for insurers to identify and value assets too. If the regulator wants to ensure that the firms operate in a level playing field, detailed analysis of, and feedback on the regulators' data sets, are bound to help.

Yours faithfully

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