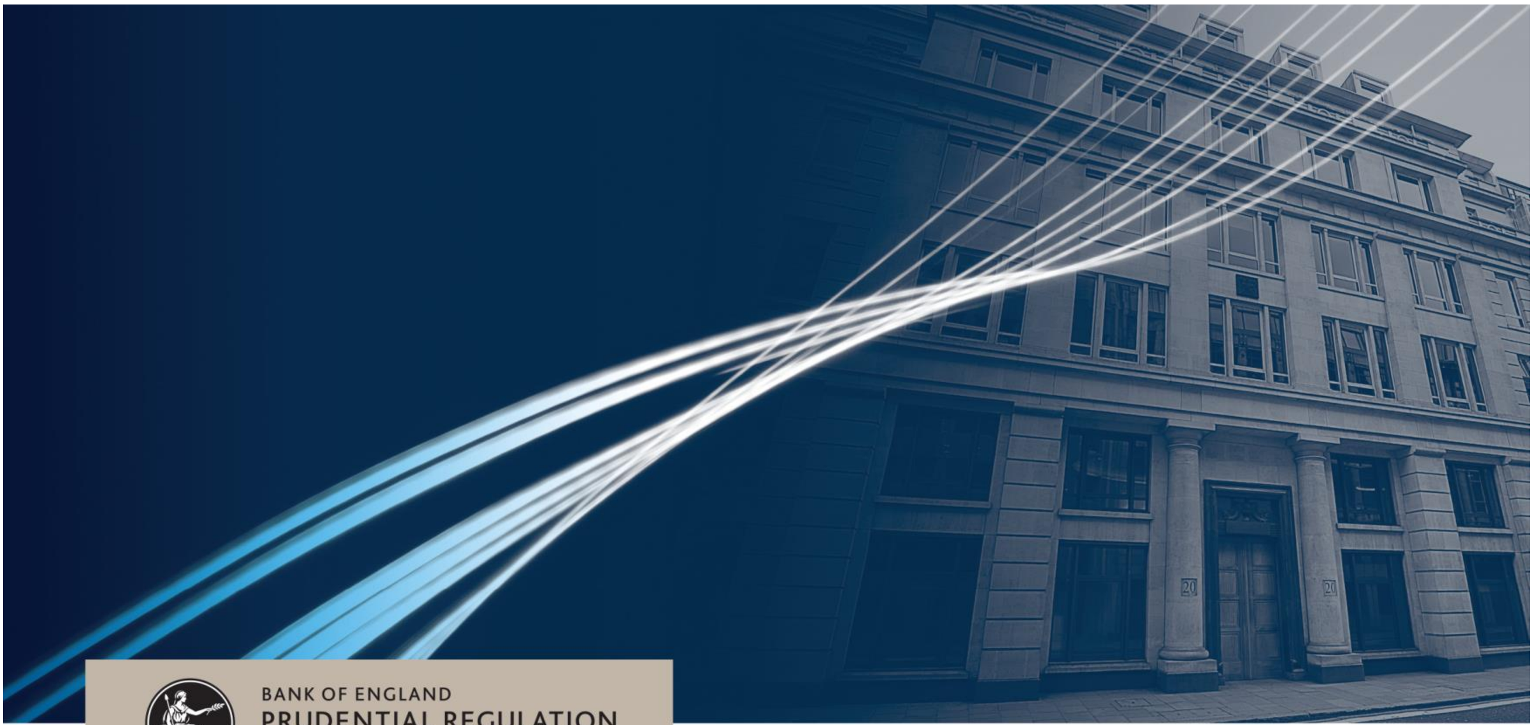

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

PRA response to the Treasury Committee’s inquiry into Solvency II

February 2018

Contents

Executive Summary

The Prudential Regulation Authority (PRA) thanks the Treasury Committee (herein 'the Committee') for its report 'The Solvency II Directive and its Impact on the UK Insurance Industry'.[1] On 3 January 2018, Sam Woods, Deputy Governor for Prudential Regulation, set out his initial thoughts[2] on the report's recommendations. In this response, as requested by the Committee, we provide further detail on the areas discussed in that letter.

Prudential regulation of insurers addresses important market failures. Without it, imprudent insurers could drive sound insurers out of the market and more insurers would fail, leaving policyholders with financial losses and without protection at times of their greatest need. Ultimately, a loss of confidence in insurers could threaten the broader financial system. The development over time of the prudential regime for insurers (and an accompanying compensation scheme) has been designed to address these failures.

The Solvency II Directive is based, in many respects, on the principles underlying the previous UK Individual Capital Adequacy Standards (ICAS) regime. UK insurers were therefore relatively well positioned for the switch to Solvency II on 1 January 2016. Since its introduction, UK life and general insurers have continued to perform well, despite various business challenges they face, including reduced demand for individual annuities, persistently low interest rates and a larger number of insured catastrophe events. That said, there are a number of differences between Solvency II and ICAS, and as our experience of operating under the Solvency II Directive increases we are committed to making improvements where the regime is not working as intended, including in the areas highlighted by the Committee, while delivering our statutory objectives and remaining within the constraints of the law.

Parliament has given the PRA two primary objectives: a general objective relating to the safety and soundness of firms, and an objective specific to insurers, to contribute to securing an appropriate degree of protection for policyholders. Since 2014, the PRA has also had a secondary competition objective (SCO) to facilitate effective competition in financial services markets, including the insurance market. The SCO has a strong, practical influence on our policy and supervisory approach for insurance. We have taken a number of steps to achieve a better fit between regulation and firms' particular business models, fostering a UK market which comprises a very wide range of businesses, by size and line of business. Moreover, prudential regulation underpins the principle of effective competition in supporting the resilience of the insurance sector. This in turn drives innovation and ultimately the productivity and competitiveness of the sector. We have, however, examined areas where we could do more in support of our SCO, particularly on the insurance side. For example, we are exploring how we might improve our current authorisations approach to facilitate the entry into the market of new insurers.

The PRA agrees with the Committee on the importance of fostering and maintaining a strong, effective and open dialogue between regulator and industry. In the past 18 months,

[1] Available at: https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/324/324.pdf.
[2] See PRA interim response to the Treasury Committee's report on Solvency II. Available at: www.parliament.uk/documents/commons-committees/treasury/Correspondence/2017-19/PRA-Interim-Response-Solvency-II.PDF.

the PRA has participated in over 70 industry speaking events and held over 200 engagement meetings in addition to the normal run of supervisory engagement with individual firms. But inevitably over the past few years the implementation challenge posed by Solvency II has dominated many of these discussions. We are exploring ways to enhance our engagement with industry and re-orient it towards the strategic challenges facing life and non-life sectors. As part of this we intend to set up a new, insurance-focused sub-committee of our Practitioner Panel.[3]

The PRA has limited scope to change Solvency II due its detailed, rules-based nature. But we are committed to making improvements to our implementation of it where appropriate and where we have discretion to do so, and there is a lot of common ground between the Committee, the industry and the PRA about aspects of Solvency II which do not work well. We have considered the Committee's recommendations on specific policy issues and set out in this report our responses and the actions we are taking to address the points raised.

This report is split into four parts.

Part 1 gives an overview of the UK insurance industry and sets out the rationale for the prudential regulation of insurers.

Part 2 discusses the design of Solvency II, how it differs from the previous prudential regime for insurers in the UK (ICAS), and the impact Solvency II has had on insurers since it came into force on 1 January 2016.

Part 3 discusses the Committee's recommendation in respect of the SCO, and the points raised by the Committee about the PRA's engagement with industry and its skills and experience in insurance.

In Part 4, we respond to the specific policy recommendations made in the Committee's report and provide an update on further developments on other policy issues raised by the Association of British Insurers (ABI) during the Committee's inquiry. We will provide a further update in due course on any outstanding issues, including the risk margin.

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[3] Further information on the PRA's Practitioner Panel is available at: https://www.bankofengland.co.uk/prudential-regulation/pra-practitioner-panel.

Part 1: Overview of the UK insurance industry

The UK insurance sector is the largest in Europe by total premiums, and insurance companies play an important role in the financial system and the real economy. As the Committee has highlighted, UK insurers manage investments in excess of £1.9 trillion and their contribution to the UK economy is £35 billion per annum.[4] They enable policyholders to pool and transfer risk, providing protection against the financial consequences of uncertain future events. Some policies enable the accumulation of long-term savings, and insurers offering such policies are in turn able to make long-term investments, which support the growth of the real economy.

A stable insurance sector matters for the protection of policyholders and the stability of the wider financial system. The failure of an insurer should generally[5] pose less systemic risk to the financial system than failure of a bank because insurers are less exposed to runs and contagion from the failure of other insurers. But the case for prudential regulation, and the ability of firms to meet their liabilities with a high degree of confidence, is still strong. Insurer failure can expose policyholders to life-changing losses, particularly where they rely on insurance for future income (e.g. annuities or bodily injury compensation). Failures can also spread stress through the financial system, for example where insurers are part of wider financial services groups including banks, or where a failure reduces policyholder confidence in other insurers.[6]

Confidence in insurance markets depends on the promises insurers make to policyholders being met in full and on time. Yet many policyholders lack the capacity to make informed judgements about the financial soundness and longer-term viability of their insurers. The shorter-term interests of shareholders and management can also conflict with the longer-term interests of policyholders. And insurers which cannot absorb the costs of their own failure can distort the market and prevent fair competition.

The rationale for the prudential regulation of insurers

The purpose of regulation is to correct market failure. Insurance markets have many characteristics which, unregulated, could lead to poor outcomes for society.

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[4] United Kingdom National Accounts, The Blue Book: 2015 Edition (insurance corporations and pensions funds). Available at: www.ons.gov.uk/economy/grossdomesticproductgdp/compendium/unitedkingdomnationalaccountsthebluebook/2015-10-30/chapter04financialcorporations.

[5] An obvious exception is AIG, which became heavily interconnected with the banking system through some of its activities, and the US insurance monolines.

[6] Insurers in stress might also be incentivised to act in ways that generate or amplify price movements in asset markets, potentially contributing to 'fire sales' or asset price bubbles. The impacts insurers can have on the financial system are discussed more fully in: 'The rationale for the prudential regulation and supervision of insurers', Bank of England Quarterly Bulletin 2013 Q3. Available at www.bankofengland.co.uk/quarterly-bulletin/2013/q3/the-rationale-for-the-prudential-regulation-and-supervision-of-insurers; 'Insurance and financial stability', Bank of England Quarterly Bulletin 2015 Q3. Available at https://www.bankofengland.co.uk/quarterly-bulletin/2015/q3/insurance-and-financial-stability; and 'Macroprudential Policy for Insurers', speech given by Vicky Saporta, Chair of the Executive Committee of the International Association of Insurance Supervisors, 2016. Available at: www.bankofengland.co.uk/paper/2016/macroprudential-policy-for-insurers.

Problems arise, in part, because of the inherent nature of insurance contracts. In a typical contract, an insurer receives premiums upfront and invests in assets. But it can take a long time – sometimes decades – before any payment to policyholders becomes due. This might give rise to the potential for poorly managed insurers to undertake excessively risky investment strategies, to price aggressively for new business or to under-reserve against future claims. The complexity of insurance businesses limits the effectiveness of market discipline. Moreover, insurance contracts are often difficult or costly for policyholders to cancel.

Prudential regulation has developed in response to the crystallisation of these risks. For example, in 2002, policyholders of Equitable Life accepted a write-down in the value of their policies following its near collapse, caused by a failure to value and manage guaranteed benefits properly. The Government agreed to pay compensation amounting to £1.5 billion to policyholders in 2010. Amongst these compensated policyholders were 37,000 annuitants, the majority aged 75 and over, who on average had suffered losses of around £16,500 each. Improved prudential regulation, with risk-based capital and a market-based valuation of assets and liabilities, could have helped to prevent this loss to policyholders.

A different example of policyholder detriment occurred in the early 2000s when the investment freedom of some with-profits funds became constrained due to inadequate capital. The Bank of England's *Financial Stability Review* in June 2003 highlighted that financial strains for UK life firms had been felt by policyholders.[7] Insurers reined in investment risks in order to be more assured of meeting existing liabilities, but this reduced the scope to achieve higher returns for policyholders in future. In particular, life firms were large sellers of equities, purchasing government and corporate bonds instead. Equity option strategies were used to limit losses, but in many cases these were funded by selling options that reduced upside exposure. Firms also lowered annual and final bonuses to with-profits policyholders, and increased the cost of surrendering policies before maturity (so-called 'market value adjustments'). Again, improved prudential regulation could have helped to contribute to a greater degree of protection for the affected policyholders.

Another rationale for regulation is that policyholders may select insurance based on price where they are buying cover against harm they may do to third parties. This is particularly true if such insurance cover is compulsory, e.g. motor insurance and employers' liability in the UK. Market discipline is even less likely to work where policyholders are protecting innocent third parties rather than themselves. Many will simply choose the cheapest product. In the absence of minimum prudential regulation, poorly managed firms offering under-priced insurance may win a large share of the market, distorting competition.

Even the most informed policyholder is unlikely to have sufficient information to be able to assess the balance sheet and behaviour of an insurance company. And if the right amount of information is available, policyholders may not be able to make sufficiently informed judgements about the type of risks firms are running. It is this asymmetry of information between the policyholder and insurer that leads to moral hazard, where a firm could take excessive risks knowing that others would bear the costs.

[7] See Bank of England Financial Stability Review, June 2003, page 62. Available at: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2003/june-2003.

Policyholders can be harmed not only when their claims are not paid, but also when their insurance cover is unexpectedly withdrawn following failure. This can occur at scale. For instance, in the UK, many motorists found themselves uninsured following the failure of Fire, Auto and Marine in 1966 (400,000 policyholders) and Vehicle & General in 1971 (1.2 million policyholders). Another prime example is from Australia, where the failure of HIH Insurance in 2001 marked the biggest collapse in the country's corporate history. HIH provided insurance ranging from personal insurance products to workers' compensation and builders' warranty insurance. In Queensland, car accident victims insured with HIH were left waiting for operations and other medical procedures worth AUD$190 million. Professional services firms were left without indemnity cover and community events were cancelled due to loss of public liability insurance. Almost AUD$2 billion of construction activity was put on hold while replacement builders' warranty insurance cover was sought.

Ultimately, excessive risk-taking by insurers could mean that policyholders do not receive a pay-out when they need it most, perhaps to pay a pension or following a serious accident. Such policyholder losses can result in significant costs for more prudent, surviving firms who have to fund the Financial Services Compensation Scheme (FSCS). For example, the FSCS has paid out £405 million over a thirteen-year period to meet claims on a single firm, Independent Insurance, since its failure in 2001. This included claims for victims of workplace injuries. While Independent Insurance was the most high-profile failure of a general insurance company in recent years, 21 other general insurers failed in the decade prior to 2001.

Internationally, surviving insurers have experienced losses when insurers fail. For instance, seven mid-size life insurers in Japan failed during the period 1997-2001. These failures did not lead to the need for taxpayer support. But other firms contributed $7 billion to a policyholder protection fund, with the costs passed on to policyholders through higher premiums. Policyholders in five of the failed firms also experienced cuts to the value of their own policies. Taxpayer assistance was needed following the 2010 and 2011 earthquakes in New Zealand, and the government assumed the liabilities of AMI Insurance Limited.

Market failures provide a clear basis for why the insurance industry should be subject to some form of prudential regulation. However, there is also a judgement to be made on how prudential regulation should be undertaken.

A major element of insurance regulation since its inception, particularly in the United Kingdom, has been the disclosure of information about an insurance company's financial health to policyholders and the wider financial market. This principle lies behind the reporting and disclosure requirements in Solvency II. It seeks to address in part the problem of asymmetric information by enabling the market to monitor, assess and, where necessary, impose discipline on insurance firms. However, for the reasons set out above, disclosure is a useful but not sufficient regulatory response.

The other key element of regulation has been prudential (or solvency) regulation, and, under Solvency II, the central part of the regulatory framework is the requirement for an insurer to hold sufficient own funds to act as a buffer against losses not covered by technical reserves. This solvency buffer is calibrated to a 1-in-200-year confidence level over one year, based on the risks that are actually being run by the firm. Such a capital stake ensures that firms are dis-incentivised from taking excessive risks, as funds are costly to raise and will be first in line to be lost should the firm fail. It addresses the moral hazard problem, but it does not require a firm to capitalise against all eventualities. In setting capital requirements, a balance needs to be made between the level of policyholder protection provided, and the consequent cost of insurance to consumers, and in this respect, a 1-in-200-year standard may appear high; it is however only equivalent (in terms of probability of default) to a BBB-rated corporate bond. It is likely that, as part of their business models, firms will aim to hold more capital than required for a BBB rating in order to provide higher levels of confidence to both their policyholders and their investors.

Finally, even a reasonable amount of capital may be insufficient protection against the failure of a poorly run firm, and therefore firms are also held to robust qualitative standards in relation to risk management and governance through the PRA's regulation and supervision.

In implementing and running this regime, we pursue the two primary objectives given to us by Parliament: a general objective to promote the safety and soundness of the firms we regulate, and an objective specific to insurance firms, to contribute to securing an appropriate degree of protection for current and future policyholders. The insurance-specific objective ensures that policyholders receive an appropriate degree of protection even if their insurer does not pose systemic risk to the stability of the wider financial system.

The Bank of England's Independent Evaluation Office (IEO) recently examined our pursuit of our policyholder protection objective,[8] and made four high-level recommendations. These were to:

- articulate more fully the PRA's strategy and approach with respect to its policyholder protection responsibilities;
- communicate the PRA's preferred strategy and approach, both internally and externally;
- implement the PRA's preferred strategy and approach effectively, including through a clear and consistent approach to firm categorisation; and
- enhance the PRA's framework for co-ordination with the Financial Conduct Authority (FCA) in respect of policyholder protection.

The PRA welcomed the IEO's evaluation and committed to take forward a set of actions in response.[9] These included a discussion by the Prudential Regulation Committee in September 2017 on the legal interpretation of the insurance objective, the interaction of the insurance objective with the general objective, and the definition of firm failure. The PRA will do further work during the course of 2018 on: whether and how to vary the appropriate degree of protection across different types of policyholders; the extent to which supervision should take the FSCS into account; and co-ordination arrangements with the FCA. The

[8] See IEO report 'Evaluation of the Prudential Regulation Authority's approach to its Insurance Objective', March 2017. Available at: www.bankofengland.co.uk/-/media/boe/files/independent-evaluation-office/2017/evaluation-of-the-pras-approach-to-its-insurance-objective.pdf.

[9] See PRA response to the IEO's evaluation of the PRA's approach to its insurance objective, March 2017. Available at: www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/praresponsetoieofpraapproachtoitsinsuranceobjectivemarch2017.pdf.

PRA was reassured that the IEO's assessment found clear evidence of supervisors advancing policyholder protection and no evidence of supervisors stepping beyond their responsibilities.

Part 2: Solvency II and the UK insurance sector

The development of Solvency II

Solvency II came into effect across the European Economic Area (EEA) on 1 January 2016. It introduced a harmonised, risk-based, forward-looking and transparent prudential regime which in many respects brought the rest of the EEA into line with the principles underlying the UK's previous ICAS regime.

The Solvency II framework is built on three pillars:

- Pillar 1 quantitative requirements: the amount and quality of capital insurers are required to hold after their assets and liabilities are valued to reflect current market conditions is known as the Solvency Capital Requirement (SCR). The SCR is calibrated to ensure firms are sufficiently capitalised to withstand a 1-in-200-year shock over a one-year horizon;

- Pillar 2 qualitative requirements: firms must meet governance and risk management requirements, including the conduct of an Own Risk and Solvency Assessment (ORSA), which must consider the risk profile of the business, compliance with capital requirements and any deviations from the assumptions underlying the SCR; and

- Pillar 3 reporting and disclosure requirements: reporting requirements cover both Pillar 1 and Pillar 2 information, including disclosure reports to the market and regulatory reporting.

Solvency II has many similarities with the UK's previous ICAS regime. These include:

- valuation of assets, financial guarantees and options embedded in a firm's liabilities by reference to market data. This ensures that the values included in a firm's balance sheet reflect prevailing market conditions and fully recognise the market cost of the guarantees and options in the firm's liabilities, on a basis that is consistent with the asset valuations;

- valuation of insurance liabilities (including eg mortality, longevity, persistency, expenses) using best estimate cash flows, discounted generally using a risk-free yield curve. This ensures that the best estimate liability values included in the balance sheet also reflect prevailing market conditions, and that the liabilities are expected to be met if the firm closes to new business;

- allowance for an illiquidity premium in the discount rate used to value long-dated illiquid insurance liabilities, such as annuities. This is known as the Matching Adjustment (MA) under Solvency II. This recognises the nature of such insurance liabilities, and incentivises firms to invest in matching long-dated assets;

- allowance for management actions and risk transfer arrangements in the calculation of solvency requirements. This, in conjunction with the market-based valuation of assets and liabilities, incentivises good risk management by firms;

- risk-based capital requirements reflecting all of a firm's risks, and for life insurers, calibrated to a 1-in-200-year level over one year, after allowing for diversification between risks (recognising that not all risks occur simultaneously);

- capital requirements may be calculated using internal models in order to capture a firm's specific risk profile; and

- good governance practices and strong risk management are recognised as fundamental requirements.

As a result, UK insurers were relatively well positioned for the shift to Solvency II both in terms of their risk management and modelling capabilities and their balance sheet strength.

Solvency II also introduced some new features to the UK. These include:

- the introduction of a 'risk margin' into the valuation of insurance liabilities. The risk margin is intended to capture the cost of transferring a firm's commitments to another insurer on arms-length terms should it close to new business;

- the extension of an illiquidity premium to the valuation of other (not necessarily illiquid) liabilities through the Volatility Adjustment (VA), which can be approved for use on specific conditions;

- the introduction of the standard formula for firms with a 'standard' risk profile, a Minimum Capital Requirement, and the requirement for firms to conduct an ORSA;

- increased public disclosure (the risk-based capital requirements under ICAS were confidential between the firm and the regulator); and

- transitional measures to help ensure a smooth transition from Solvency I to Solvency II. For UK insurers, the main use of transitionals is to phase in the risk margin on existing business at the point Solvency II was introduced.

More generally, Solvency II is a more detailed and rules-based regime than ICAS, which reduces the scope for domestic regulatory discretion. Examples of this include:

- formalisation of the quantification of the illiquidity premium that can be assumed in the valuation of long-dated illiquid liabilities, through the MA, with strict rules on the eligibility of the backing assets;

- introduction of supervisory approval of internal models, including specific and rigorous criteria; and

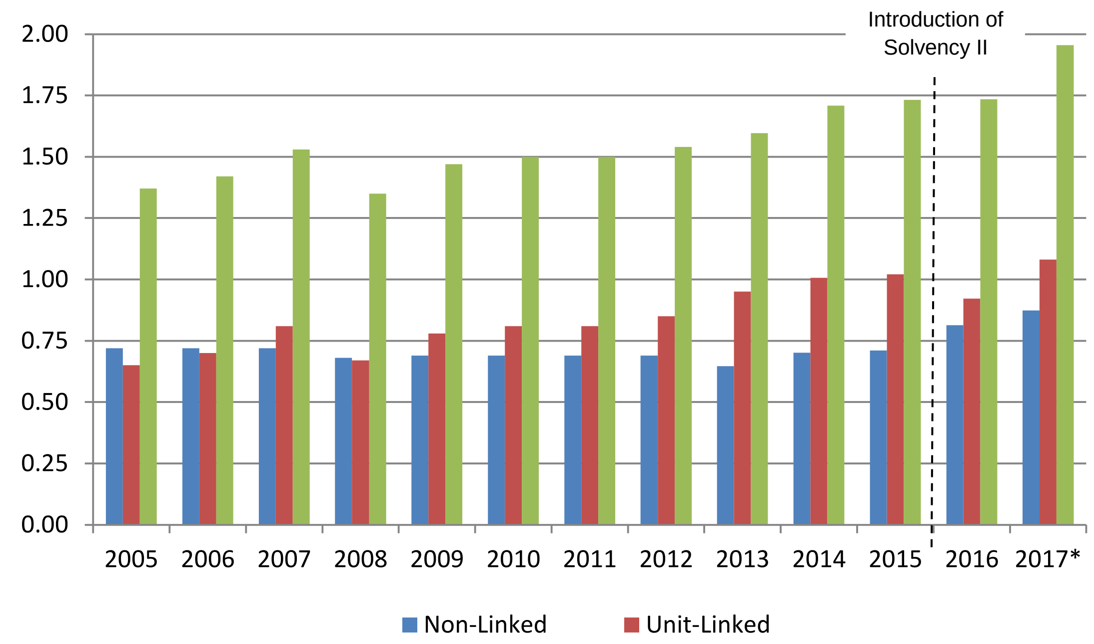
- reduction of the flexibility that existed under ICAS for the supervisory application of capital add-ons.

The PRA has where possible made adjustments to its implementation of Solvency II in order to account for differences in the UK insurance market. These are discussed further in Parts 3 and 4 of this response.

The impact of Solvency II on insurers and policyholders

Since Solvency II came into force, insurance firms have continued to perform strongly and sector balance sheets have continued to grow **(Chart 1)**.

Chart 1: UK insurance sector assets 2005–2017 (£tn)



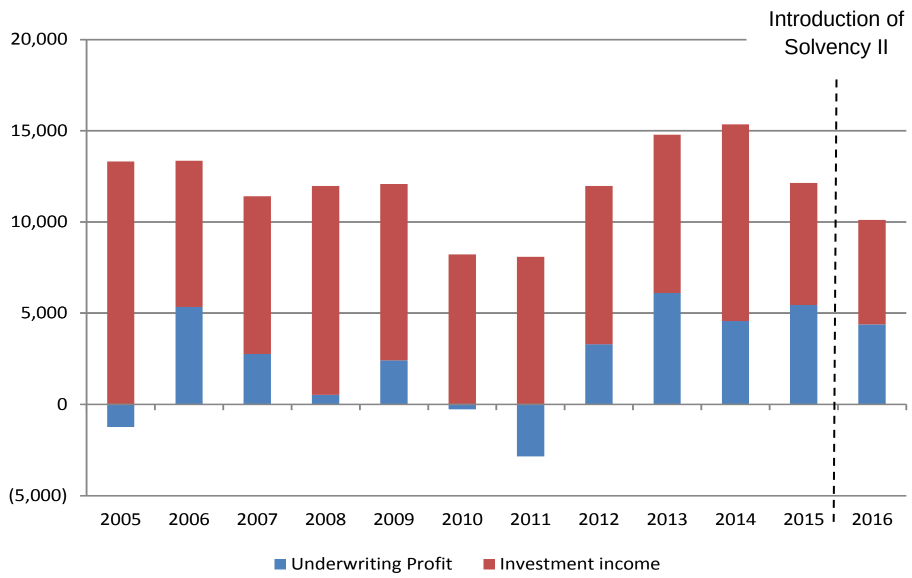
* Data as at 2017 Q3

Sources: Solvency I and Solvency II returns, Bank calculations

Life firms have reported strong profits and healthy aggregate solvency ratios (c.159% in 2017 Q3), despite the challenges of reduced demand for individual annuities, reduced investment income under persistently low market interest rates and the introduction of the risk margin.

General insurers' overall profits fell in the first year of Solvency II in 2016 due to market competition, the impact of the 'Ogden rate'[10] change, and a larger number of insured catastrophe events **(Chart 2)**. But profitability remains around its average level over the past decade, as lower underwriting profits have been offset by claim reserve releases.

Chart 2: General insurers' pre-tax profit split between underwriting and investment income (£m)



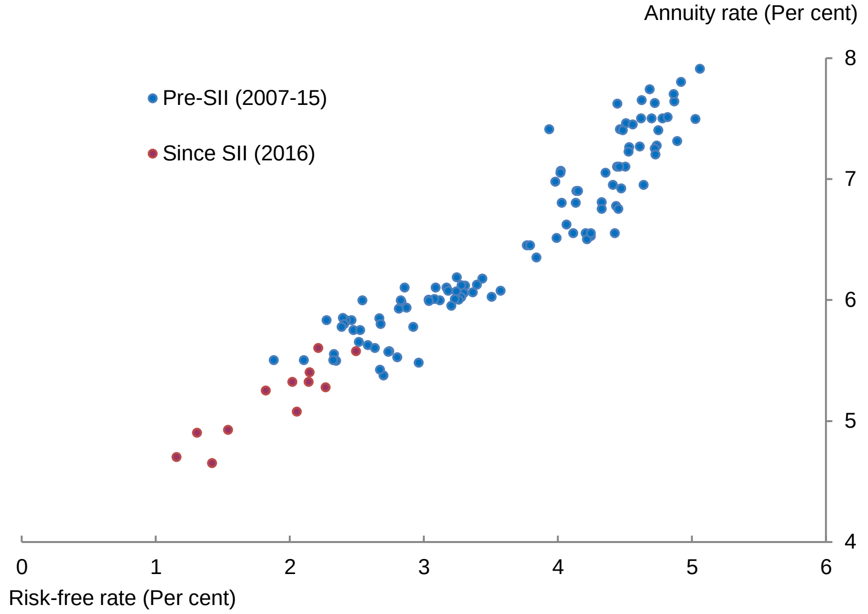
Sources: Bloomberg, sharingpensions.co.uk and Bank calculations

Returns on equity for larger UK insurance groups have remained steady at above 9%, close to the levels seen on average since 2010. And credit market perception remains positive, with larger UK insurers' average credit default swap premium having fallen since the introduction of Solvency II: from 70 basis points (1 January 2016) to 47 basis points (6 February 2018).

We have also examined whether Solvency II is having a detrimental impact on policyholders as firms pass on increased costs of regulation, looking first at annuities. We conclude that risk-free market interest rates and corporate bond spreads continue to be the dominant driver of annuity prices, and the relationship does not appear to have changed since Solvency II came into effect (**Charts 3 and 4**).

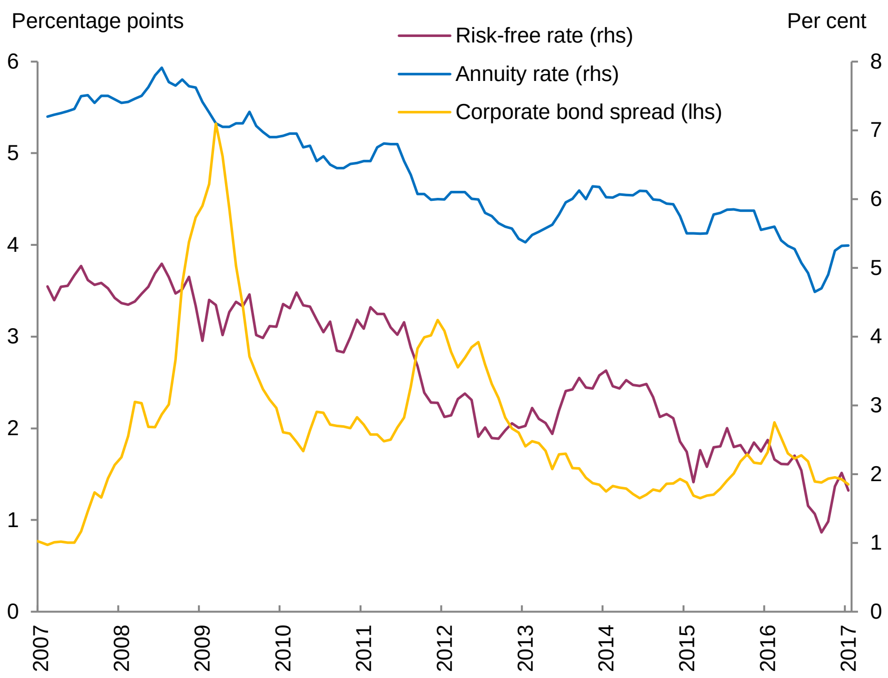
[10] The 'Ogden rate' is used to discount future liabilities for personal injury and fatality claims.

Chart 3: Relationship between annuity rates and risk-free market interest rates



Sources: Bloomberg, sharingpensions.co.uk and Bank calculations

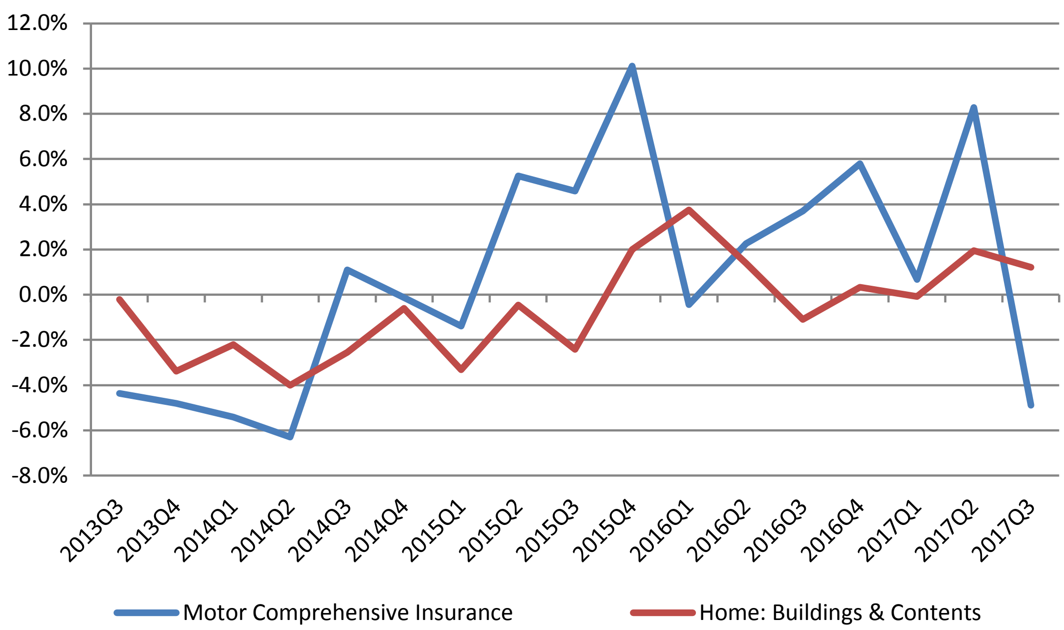
Chart 4: Time series of market annuity rates, risk-free market interest rates and corporate bond spreads



Sources: Bloomberg, sharingpensions.co.uk and Bank calculations

Turning to general insurance, average motor and household premiums and changes in premiums were not in our assessment affected by the introduction of Solvency II. In both motor and household, rates hardened in 2015 due to greater loss experience, and UK motor insurers were particularly affected by market factors[11](**Chart 5**).

Chart 5: Quarterly change in average Motor and Household rates (%)



Sources: AA British Insurance Premium Index, 2017 Q3

We recognise that the implementation of Solvency II was costly. The final impact assessment by HM Treasury estimated a one-off cost to the insurance sector of £2.6 billion (other industry estimates are in the order of £3 billion) and ongoing costs at approximately £200 million each year. While implementation represents costs already spent, the ongoing cost of compliance represents just 0.07% of the total gross written premiums[12] of the insurance industry (or 35p on an average motor policy of £493).

Worldwide, a trend of convergence towards a Solvency II-type framework is emerging. A number of jurisdictions are changing their domestic regimes to incorporate the key Solvency II features of market-valuation and risk-sensitive stresses. Solvency II allows for third country insurance solvency regimes to be found 'equivalent' provided that they offer a similar level of policyholder protection as under Solvency II. There are three different types of equivalence for third countries, from which several countries benefit.[13]

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[11] Market factors include: competition, alternative capital, claim reserve release and 'Ogden rate' changes in year-end 2016 accounts.

[12] Based on 2016 Solvency II data.

[13] The different types of equivalence are reinsurance equivalence, solo equivalence for group purposes and group equivalence. Switzerland and Bermuda have full equivalence under all three types. Japan has temporary reinsurance equivalence. Australia, Brazil, Canada, Japan, Mexico and the United States have provisional solo equivalence for group purposes.

Part 3: Response to recommendations – PRA issues

Competition

Parliament has given the PRA two primary objectives: a general objective to promote the safety and soundness of the firms it regulates, and an objective specific to insurance firms, to contribute to securing an appropriate degree of protection for current and future policyholders. In 2014 the PRA was given a secondary objective. This states that when discharging its general functions in a way that advances its primary objectives, the PRA must act, so far as is 'reasonably possible', in a way that facilitates effective competition in the markets for services provided by PRA-authorised firms. This secondary competition objective (SCO) is itself unique to the UK system; it does not appear in this way in the objectives of any other prudential regulators.

The PRA must also 'have regard' to statutory regulatory principles and a number of considerations set out in the Chancellor's letter on recommendations to the Prudential Regulation Committee.[14] These considerations include competition, growth, competitiveness, innovation, trade, and better outcomes for consumers.

The terms 'competitiveness' and 'competition' are sometimes used interchangeably. They are, however, different. The PRA's SCO relates to facilitating effective competition in the markets for services provided by PRA-regulated firms. In this context, effective competition can be said to exist where: suppliers offer a choice of products or services on the most attractive and sustainable terms to customers; where customers have the confidence to make informed decisions; and where firms can enter, expand and exit from the market. Competitiveness, on the other hand, is concerned with the extent to which one group of agents has a competitive edge against another group.

The two concepts are however linked: effective competition, underpinned by robust prudential regulation, will in turn drive innovation and ultimately create the conditions needed for the UK insurance sector to be internationally competitive. On the other hand, measures designed primarily to make one part of the market more competitive than another, through measures that favour one group of firms over another, reduce incentives for innovation and productivity. This is damaging in the long run.

Facilitating effective competition is given a high priority in the PRA. The SCO has a strong, practical influence on our policy and supervisory approach for insurance. However, the 'reasonably possible' condition recognises that domestic or European law may restrict the PRA's policy choices. And this is the case under Solvency II, where the detailed rules-based nature of the regime limits our discretion. That said, there are a number of areas where we have advanced our SCO through our policymaking for and supervision of insurers. Some specific examples include:

- Solvency II includes 'default' approaches to calculating both technical provisions and setting capital requirements. It also includes a number of alternative approaches that require regulatory approval – for example, using an internal model to calculate capital

[14] See letter from the Chancellor to the Governor on recommendations for the Prudential Regulation Committee, 2017. Available at: www.bankofengland.co.uk/letter/2017/remit-for-the-prc-2017.

requirements or the MA to calculate technical provisions. The PRA has issued over 700 such approvals and other waivers under Solvency II. This has helped achieve a better fit between regulation and firms' particular business models, fostering a UK market which comprises a very wide range of businesses, by size and line of business. For example, we have approved many more internal models than any other EEA jurisdiction – small as well as large firms are able to use internal models, and of the 23 internal models approved to date, 8 were for smaller firms.

- The PRA regulates and supervises smaller firms in a proportionate manner. We have used waivers to exempt them from some Solvency II requirements and are currently consulting[15] on making even greater use of our waiver powers under the Directive, for example with regard to quarterly reporting. We have also implemented a streamlined and tailored regime for firms (including very small firms) that fall outside the scope of Solvency II, which represent 35% of the firms we supervise.[16]

- A key principle underlying the PRA's supervisory approach is that we do not operate a zero-failure regime.[17] Currently, the PRA is supervising the orderly run-off of approximately 120 insurers. And the FSCS protects retail policyholders from loss if an insurer does fail. Allowing insurers to fail, so long as failure is orderly, reflects the view that insurers should be subject to the disciplines of the market.

- The PRA is responsible for oversight of, and rules relating to, the FSCS in respect of deposit and insurance policy protection. The FSCS enables effective competition as it provides confidence to policyholders and allows customers to choose more freely between firms on the basis of price and quality of the product. We have chosen to include effectively all direct life insurance as well as the classes of direct general insurance that are compulsory (motor and employers' liability) within the FSCS, going beyond the protection in almost all other EU countries. But in the event of an insurer failing, we recognise that ultimately the costs are borne by the remaining firms (and their policyholders) which would have to fund the FSCS *ex-post* to cover any losses.

- We continue to support new firm authorisations, having authorised 26 new insurance firms since 2013. When assessing applications for authorisation of an insurer, we seek to ensure that our requirements are applied in a proportionate manner. This includes the use of waivers and modifications to PRA rules where appropriate. Furthermore, the PRA and FCA have agreed to explore how we could adapt our existing approach to authorising and supervising new firms to simplify the process, provide additional support through the process, and potentially to allow for a mobilisation phase as available for new banks.

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[15] See PRA CP 2/18 'Changes in insurance reporting requirements', January 2018. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2018/changes-in-insurance-reporting-requirements.

[16] As at February 2018.

[17] See the PRA's approach to insurance supervision. Available at: www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/the-pras-approach-to-insurance-supervision-march-2016.pdf.

- The design and implementation of the Senior Insurance Managers Regime (SIMR) was shaped by the PRA's application of the SCO and the principle of proportionality. This is evident in some of the features of the SIMR including:
  - fewer responsibilities that must be allocated to a senior manager approved by the PRA for incoming non-EEA branches, insurance special purpose vehicles (ISPVs), and small firms which are not in scope of the Solvency II Directive;
  - a requirement on each firm to produce a 'responsibilities map' whose length, content and level of detail should reflect its size and complexity;
  - the ability of individual directors and senior managers moving between regulated firms to submit a shortened form to the regulators, where there has been no change to the basic information already provided about the individual's fitness and propriety; and
  - a simplified and streamlined SIMR for smaller firms outside the scope of Solvency II,[18] and new rules for the optimisation of the SIMR[19] which will come into effect on 10 December 2018. The application of a number of these proposed new rules will help to ensure that larger insurance firms and groups operate under comparable governance standards to one another, which, together with a more streamlined approach for smaller firms, should ensure a proportionate approach is adopted.

A recent example of how we have had regard to competitiveness, as required in the Chancellor's letter to the PRC, is our work which recognises the growth of the insurance linked securities market. We have worked closely with HM Treasury, the FCA and industry to design a new, commercially viable framework for Insurance Special Purpose Vehicles[20] in the United Kingdom. That framework launched in December 2017 and very shortly after the PRA authorised its first ISPV. This is an example of the PRA having regard to the competitiveness of the United Kingdom in what is a global market.

We remain committed to ensuring the application of the Solvency II regime in the United Kingdom continues to be clear and proportionate. On 25 October 2017, we launched a series of consultations proposing to make targeted improvements to the PRA's implementation of Solvency II. These improvements support the PRA's commitments set out in Sam Woods' letter[21] to the previous Committee in March 2017. The PRA has explored

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[18] See PRA PS26/15 'The prudential regime, and implementation of the Senior Insurance Managers Regime, for non-Solvency II firms', November 2015. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2015/prudential-regime-and-implementation-of-the-senior-insurance-managers-regime-for-non-solvency-2.

[19] See PRA CP8/17 'Strengthening accountability in banking and insurance: optimisations to the SIMR, and changes to SMR forms', February 2018. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2017/strengthening-accountability-in-banking-and-insurance.

[20] ISPVs are the vehicles central to the structure of 'insurance linked securities' which provide (re)insurers a capital markets-based form of risk transfer as an alternative to traditional reinsurance and is a growing, innovative market.

[21] See http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/eu-insurance-regulation/written/49691.pdf.

reform of the areas of our implementation of Solvency II set out in the letter and we have developed these closely with the ABI through a number of working groups.

The three consultation papers published so far include:

- proposals to provide greater clarity on the PRA's expectations of firms in relation to the MA;
- proposals to update guidance to firms on the internal model change process, model change policies and minor model change reporting; and
- proposals to reduce the reporting burden on insurers, particularly smaller firms.

The contents of these consultations are discussed in greater detail in response to some of the Committee's recommendations in Part 4.

In parallel, we are continuing to work on a number of other areas for potential improvements which the ABI recommended for reform. They include assessing the feasibility of further simplification to the maintenance of the Transitional Measure on Technical Provisions (TMTP) and reviewing the proportionality of the requirement for external audit of the Solvency and Financial Condition Report (SFCR).[22]

Prudential regulation and competition

Prudential regulation is a pre-requisite for effective competition in insurance markets. Robust minimum prudential standards are essential to underpin the sustainability of the insurance sector and this in itself is beneficial to effective competition. Without minimum standards, imprudent firms could drive prudent firms out of the market by cutting prices. This is especially true in many insurance markets where annual renewals mean that there are low barriers to switching and so insurers' market shares can change quickly.

A recent Bank of England staff working paper[23] (Fisher and Grout (2017)) includes an analysis of the relationship between financial stability and competition. Their results show that a conflict between the two can arise where there is poor or no prudential regulation (i.e. that increased competition weakens financial stability), but suggests that if prudential regulation is made while there is a competition objective, any potential conflict between stability and competition tends to disappear.

Consistent with the 'twin peaks' model for regulation, the PRA's objective to facilitate effective competition is distinct from, but complementary to, the powers of the FCA. This avoids overlap and also makes it distinct from other competition regulators of the financial services sector such as the Competition and Markets Authority (CMA). The CMA has a UK economy-wide competition remit including financial markets, whereas the FCA exercises competition law powers concurrently with the CMA, albeit only in relation to financial services. These bodies are responsible for promoting competition and have wide-ranging toolkits and specific powers that enable them to enforce competition law, conduct market

[22] Discussed further in Part 4.
[23] Fisher, P and Grout, P (2017), 'Competition and prudential regulation', Bank of England Staff Working Paper No 675. Available at: www.bankofengland.co.uk/-/media/boe/files/working-paper/2017/competition-and-prudential-regulation.pdf.

studies or make relevant market investigation references (summaries of some of the recent competition assessments conducted by the FCA and CMA on the insurance sector are set out below). In addition, the FCA can refer a market to the CMA to conduct a market investigation. In contrast, the PRA does not have powers specifically relating to competition; instead, its legal powers relate to the advancement of its primary objectives.

Giving the PRA a primary competition objective would require it to pursue competition as an objective in its own right and enable it to use its powers for that purpose alone. This would dilute focus in the PRA, undoing a key reform put in place by Parliament following the financial crisis[24] and would likely create significant overlaps with the activities of the existing competition regulators. For example, with a primary competition objective, the PRA could be required to undertake market studies with the option of introducing new rules or guidance to firms with the specific aim of promoting competition. It would be difficult to define a distinct role for the PRA here, and would require a large degree of coordination with the existing competition regulators.

Observations on the state of competition in the insurance sector

To provide further context, an overview of previous competition assessments on the insurance sector by the FCA and CMA is set out below.

- In November 2017, the FCA launched a market study[25] on wholesale insurance brokers to assess how effective competition is and how brokers influence competition in the underwriting sector. Concerns have been raised by the FCA's stakeholders that competition may not be working effectively in this market. Specifically, a prolonged soft market, with declining premium rates, has put pressure on brokers' earnings from commission set as a percentage of premiums. Stakeholders have raised concerns about how this could give rise to a range of competition issues. For example, larger brokers may be using their market power to oblige insurers to sign up to their facilities or pay for wider services.

- The CMA has carried out a number of projects involving price comparison websites. In September 2017, it launched an investigation[26] against a price comparison website with respect to the use of a most-favoured-nation clause in home insurance. The CMA

[24] See HM Treasury, 'A new approach to financial regulation: judgement, focus and stability', July 2010. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/81389/consult_financial_regulation_condoc.pdf and HM Treasury, 'A new approach to financial regulation: building a stronger system', February 2011. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/81411/consult_newfinancial_regulation170211.pdf.
[25] See FCA, 'Wholesale Insurance Broker Market Study – Terms of Reference', November 2017. Available at: www.fca.org.uk/publication/market-studies/ms17-2-1.pdf.
[26] See CMA, 'Price comparison website: use of most favoured nation clauses', September 2017. Available at: www.gov.uk/cma-cases/price-comparison-website-use-of-most-favoured-nation-clauses.

has also argued[27] that insurance firms may have to pass on higher commission fees to consumers through higher premiums if price comparison websites are not competing effectively.

- The FCA undertook a market study[28] on the provision of retirement income services. In its interim report published in December 2014, the FCA found that the annuities sector has seen limited new entry in recent years. The most significant factor contributing to the lack of new entry appears to be gaining access to the customers of incumbent pension providers. The FCA considered the impact of regulatory barriers (specifically, capital requirements) but concluded that these had minimal impact.

- In its Annual Competition Report 2016/17,[29] the FCA remarked that since the conclusion of its market study on retirement incomes, there had been consolidation in the retirement income sector as a result of a number of mergers. Those mergers were cleared by the CMA,[30] suggesting that none of the mergers raised anti-competition concerns.

- The FCA undertook a market study[31] on the provision of general insurance add-ons. In its interim report published in March 2014, the FCA found that: there was no evidence of significant barriers to entry in either underwriting or distribution of the add-on product; insurers did not generate high profits from the underwriting of the sampled products for either add-on or stand-alone sales; commercial terms between insurers and distributors appeared weighted in favour of distributors; and that its findings were consistent with previous analyses of competition in such markets.

Industry engagement and staff skills

We aim to maintain strong, effective and open dialogue with the industry on matters of shared interest. PRA senior management hold regular bilateral meetings both with key individuals at firms and external stakeholders including trade bodies, in order to keep abreast of issues affecting both the life and non-life sectors. In the past 18 months alone, the PRA participated in over 70 insurance industry speaking events and held over 200 engagement meetings, aside from the much more numerous regular run of supervisory meetings with individual firms.

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[27] See CMA, 'Private motor insurance market investigation – Final report', September 2014, paragraphs 8.6 and 8.7, available at: https://assets.publishing.service.gov.uk/media/5421c2ade5274a1314000001/Final_report.pdf. See, also, See CMA, 'Digital comparison tools market study – Final report', September 2017, paragraphs 4.76-4.78, available at: https://assets.publishing.service.gov.uk/media/59c93546e5274a77468120d6/digital-comparison-tools-market-study-final-report.pdf.
[28] See FCA, 'Retirement income market study: Interim Report', December 2014, page 51, available at: www.fca.org.uk/publication/market-studies/ms14-03-2.pdf.
[29] See FCA, Annual Competition Report 2016/17, available at: www.fca.org.uk/publication/annual-reports/annual-competition-report-2016-17.pdf.
[30] In the United Kingdom, although the FCA is a 'concurrent competition regulator', the CMA has exclusive competence for merger control.
[31] See, FCA, 'General insurance add-ons: Provisional findings of market study and proposed remedies', March 2014, Chapter 5, available at: www.fca.org.uk/publication/market-studies/ms14-01.pdf.

Industry-wide communication, through speeches at conferences and regular ‘Dear CEO’ letters, has also proved to be effective in providing clear and consistent messaging to the industry on important issues. The PRA has issued fifteen industry-wide letters in the past two and a half years.

However, we acknowledge that the challenge of Solvency II implementation and our constrained resources may have crowded out space to engage with the industry and other stakeholders on other strategic issues.

We are therefore planning to enhance our engagement with industry, including on challenges outlined in the Committee’s report, while remaining alert to any risk of regulatory capture. These plans include increasing the PRA’s presence at industry conferences and finding ways to provide feedback on the results of our thematic work to wider audiences. We will also launch an insurance sub-committee to the current Practitioner Panel to obtain a wider insurance perspective and stronger focus on the sector. This will complement the existing cross-sectoral panel we operate, of which three members out of thirteen are from the insurance sector.

There are also several other initiatives either in train or being considered to strengthen the PRA’s actuarial engagement. These include greater engagement with Chief Actuaries, establishing actuarial working groups, and enhancing our engagement in existing industry forums.

The PRA aims to have a broad mix of skills and experience within the Insurance Directorate to enable effective supervision. Based on our own assessment of need, our recruitment strategy targets a mix of individuals from within the insurance industry and from other sectors where we consider relevant skills and experience can be transferred to prudential regulation. Currently around half of the staff within the Insurance Directorate have prior industry experience, including the majority of our eighty actuaries. We believe this is currently appropriate, but will continue to review the balance of skills and experience within the Insurance Directorate and take action to redress any gaps identified.

Staff exchanges are a key part of the PRA’s engagement with industry. We have conducted over forty inward and outward secondments with the insurance industry and ancillary firms since 2013 and have processes in place to manage conflicts of interest. We will continue to consider ways to improve our forward programme of staff secondments, and have recently asked the CEOs of large and medium-sized firms to consider what scope they have to increase levels of secondments.

Part 4: Response to recommendations – policy issues

Overview

There is a lot of common ground between the Committee, the industry and the PRA about aspects of Solvency II which do not work well. One of these is the risk margin, on which we are actively looking at further steps we might take and will provide a fuller update in due course. We have previously highlighted in our response to the European Commission's call for evidence on the EU regulatory framework for financial services[32] that there are a number of specific areas (including the risk margin) where Solvency II is not working as intended, and where we support improvements. Such improvements include:

- considering the inclusion of macro-prudential tools in Solvency II, where we have identified concerns with how regulators could respond to a period of substantial market stress. We discuss this later on in our response to the Committee's specific recommendations;
- welcoming the European Commission's proposal to amend the standard formula to introduce a more tailored treatment for qualifying infrastructure investment assets to support insurers' investment in long-term assets;
- supporting the European Commission's review of the appropriate level of capital charges for Simple, Transparent and Standardised (STS) securitisations. Current charges on STS securitisations could be lowered without jeopardising protection for policyholders;
- finding a common basis to derive and apply discount curves under different currencies and different national markets to improve comparability between different jurisdictions;
- reviewing the treatment of sovereign exposures under Solvency II with a view to adding spread risk and concentration risk charges for EU government bonds; and
- reviewing the definition of 'financial institutions' under Solvency II. Currently Solvency II requires that entities which would be 'financial institutions' according to the Capital Requirements Regulation (CRR) should be treated according to CRR valuation in the group solvency calculation. This could pose a significant administrative burden for groups which do not have any entities regulated under the CRR, but which still include entities that fall under the definition of 'financial institutions'.

However, while we remain a member of the European Union (EU) however, these issues will continue to be governed by the Solvency II framework. We consider it best not to speculate at this stage on where and how a future UK regime should depart from Solvency II, given that this will depend on the wider terms agreed by governments in the ongoing EU

[32] See the Bank of England's response to the European Commission's call for evidence on the EU regulatory framework for financial services, February 2016. Available at: www.bankofengland.co.uk/paper/2016/boe-response-to-european-commission-call-for-evidence-on-eu-regulatory-framework-for-financial.

withdrawal negotiations. But there are many areas highlighted by the Committee which can be considered and acted on now (see below).

International developments

We agree with the Committee on the importance of having regard to the broader international context of insurance regulation when considering any changes to domestic rules. The PRA will continue to consider the consistency of UK insurance regulation with international capital standards and emerging accounting standards.

We are actively involved in the work of the International Association of Insurance Supervisors (IAIS) and the PRA's Executive Director of Prudential Policy, Vicky Saporta, currently chairs the IAIS Executive Committee. The IAIS leads the development of the insurance capital standard for internationally active insurance groups. And the IAIS Insurance Core Principles apply to insurance supervision in all jurisdictions and set out a globally accepted framework for the supervision of the insurance sector.

We also recognise that there are advantages in regulatory and accounting regimes being aligned where it is sensible to do so. We are continuing to analyse IFRS 17 to understand what, if any, impact it is likely to have in the context of our remit and statutory objectives. We are engaged with other regulators at the international and European levels who are considering IFRS 17 and will feed in any significant conclusions from our analysis. The PRA will also continue to evaluate the differences between the regimes in the context of the future development of Solvency II and the work of the IAIS.

Response to specific recommendations

'Develop proposals for the Matching Adjustment and 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'

Matching Adjustment

The MA confers a significant benefit (equivalent to £66 billion[33] of additional capital) on UK insurers. UK insurers that apply the MA receive a reduction in their technical provisions, and the reduction that is available under Solvency II is greater than the reduction that was achieved by applying an 'illiquidity premium' to the valuation of technical provisions under the previous ICAS regime. The availability of the MA has had the effect of increasing the average SCR ratios[34] of UK insurers that use it from 65% to 155% after transitional measures have been applied.

The MA requirements set out in Solvency II are prescriptive and the PRA has little scope for flexibility over the eligibility criteria. For example, the Solvency II Directive requires assets to have fixed cash flows in order to meet the MA eligibility requirement and the regulatory approval process is governed by an implementing EU Regulation. Under Solvency II, the

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[33] As at end 2016.
[34] The SCR ratio is the ratio of eligible own funds and the Solvency Capital Requirement (SCR). Firms are required to hold an SCR ratio that is 100% or higher so as not to be subject to certain types of regulatory action.

PRA does not have the power unilaterally to change the criteria upon which the MA is assessed in line with more principles-based requirements. Likewise, the deduction from bond spreads which firms are required to apply in order to calculate the amount of MA benefit when calculating technical provisions is set out in technical information published by the European Insurance and Occupational Pensions Authority (EIOPA) using a methodology prescribed in Solvency II and adopted in implementing EU Regulations.

On 25 October 2017, the PRA published a consultation paper which sets out proposals that aim to give further clarity on interpretation of the MA requirements.[35] The consultation includes additional proposals on how firms can demonstrate that assets can be considered eligible, including loans with a 'construction phase' and assets which include early repayment options for the borrower. We have also included additional guidance on re-structuring asset cash flows, processes for managing an MA portfolio and approval applications. The consultation also gives updated guidance in two areas where MA requirements might previously have been considered burdensome for firms: the consequences of detecting breaches of MA requirements; and determining when MA approvals need to be updated. The consultation paper was developed as part of the PRA's work on adjustments to the insurance prudential framework in the light of experience following the UK introduction of Solvency II, including in areas recommended for reform by the ABI.

The PRA would prefer a regime that avoids the incentive for firms to re-structure assets in order to secure the benefit of the MA, given the additional complexity this inevitably brings. Even under the current regime, we do not encourage re-structuring in order to meet the regulatory requirements.

Illiquid assets

The MA provides strong financial incentives for UK life firms to invest in long-term illiquid assets, such as commercial property, equity release mortgages and infrastructure financing. The MA is intended to provide a reduction in technical provisions broadly corresponding to the compensation for illiquidity risk on the assets, a risk to which the insurer is not exposed if it holds the assets to maturity.

The present value of the MA is, in principle, available for distribution upfront to shareholders even though it is only earned over the lifetime of the assets. Additionally, illiquid assets typically have no quoted market value or external credit rating, which can make assessment of the appropriate amount of MA benefit uncertain. It is therefore vital that the amount of MA benefit is calculated correctly, recognising in full all of the risks to which the insurer is exposed. The PRA has recently issued guidance[36] in this area. We plan to monitor the level of MA benefit claimed by firms investing in illiquid and unrated assets in order to gain assurance that the level of MA benefit remains appropriate.

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[35] See PRA CP21/17 'Solvency II: Matching adjustment', October 2017. Available at: www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2017/cp2117.pdf.

[36] See PRA SS3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages', July 2017. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.

Volatility Adjustment

The UK is one of a number of EU countries that have exercised an option in the Solvency II Directive to require prior supervisory approval for the Volatility Adjustment (VA). The VA enables insurers to neutralise some of the effect of movements in asset values by allowing them to make a partially offsetting change to the value of their liabilities. The VA takes the form of a variable addition to the risk-free rate used to value insurance liabilities, and is calculated as 65% of the 'risk-corrected' spread on a representative portfolio of bonds, where the risk-correction removes a part of the spread representing compensation for credit risk.

The MA and VA are alternative adjustments to the calculation of technical provisions for life products with long-term guarantees. Broadly speaking, the MA is more generous than the VA but has much stricter eligibility requirements. This is because the MA requires assets and liabilities to be cash-flow matched, and is generally only applicable to annuity liabilities, whereas the VA is in principle available on any type of business. The MA is also calculated by reference to the assets actually held by a firm whereas the VA is calculated by reference to a hypothetical representative portfolio. Because some UK life insurers have large annuity books, the UK life industry makes more extensive use of the MA than the VA. The VA, by contrast, is widely used by life insurers in many other EU countries that write different types of products.[37]

If applied without appropriate control, use of the VA could create additional risks. This is especially true for insurers with highly unpredictable liabilities, in particular those that contain options for policyholders to surrender their policies at short notice. If such liabilities are valued with the VA, there is a risk that the VA will not actually be earned and, as a result, not enough sufficiently liquid resources will be available to meet a large volume of surrenders when asset prices are depressed. It is to protect against this risk that the PRA requires prior supervisory approval for use of the VA.

The UK's transposition of the option specifies the three statutory approval conditions for the VA. These are that:

- the VA is applied correctly to the relevant risk-free interest rate term structure in order to calculate the best estimate;
- the undertaking does not breach a relevant requirement as a result or consequence of applying the VA; and
- the application of the VA does not create an incentive for the undertaking to engage in pro-cyclical investment behaviour.

Supervisory approval for the VA ensures that the risks that arise from use of the VA are unlikely to be detrimental to policyholders. The VA is not subject to strict eligibility criteria and the PRA's principles-based approach has meant that it has been able to be flexible when assessing firms' applications and has approved applications from firms to use the VA for various types of business (eg with-profits business and shorter-tailed non-life business).

[37] Firms have received an aggregate benefit of £66 billion from the MA and over £1 billion from the VA as at end 2016.

'Dynamic' Volatility Adjustment

The PRA's view is that the VA is intended to provide relief from 'artificial' short-term volatility in the Solvency II balance sheet, particularly in times when asset prices are temporarily but sharply depressed. This reduction in volatility is achieved by allowing the VA to be used in the calculation of the best estimate liabilities. Use of a 'dynamic' VA (DVA) would, in addition, allow firms to anticipate future increases in the VA when modelling, for example, future bond price falls. This would primarily have the effect, not of reducing volatility, but simply of reducing the capital that firms hold against credit spread risk.

Under Solvency II, standard formula firms are not permitted to use a DVA and historically, the PRA has taken the view that the same approach should be applied to internal model firms. We recognise, however, that this interpretation is not taken by all Member States, which has led to differences in approach.

The EIOPA Board of Supervisors recently published an opinion[38] on the supervisory assessment of internal models including a DVA. The opinion is intended to reinforce greater supervisory convergence in this area and covers modelling, risk management and public disclosure. In particular, the opinion notes that deviations between EIOPA's and firms' VA modelling methodologies should be addressed to ensure that the firm's internal model produces an SCR that ensures a level of policyholder protection that is at least as high as if the EIOPA methodology[39] were to be replicated. The opinion also encourages national supervisors to balance the internal model requirements with actions that do not give rise to undesirable risk management incentives. And finally, the opinion reminds firms who use the VA to include the impact of setting the VA to zero and to provide an explanation of their DVA methodology within their SFCR.

The EIOPA opinion is clearly a material policy development. The PRA is reviewing its approach in the light of this and we will provide a fuller update to the Committee in due course.

<u>'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'</u>

The PRA has reviewed the reporting burden on firms, and on 11 January 2018 we published a consultation paper setting out proposed reforms.[40]

The reporting package under Solvency II is extensive. It gives the PRA the opportunity to develop much richer management information and metrics that speak to firm-specific and thematic risks. For example, we were able quickly to identify insurers with exposures to

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[38] See EIOPA 'Opinion on the supervisory assessment of internal models including a dynamic volatility adjustment', November 2017. Available at: https://eiopa.europa.eu/Publications/Opinions/2017-12-20%20EIOPA-BoS-17-366_Internal_model_DVA_Opinion.pdf.
[39] EIOPA has published technical documentation where all the assumptions and methodologies of risk-free interest rates including the VA are documented, June 2017. Available at: https://eiopa.europa.eu/Publications/Standards/Technical Documentation (27 June 2017).pdf.
[40] See PRA CP 2/18 'Changes in insurance reporting requirements', January 2018. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2018/changes-in-insurance-reporting-requirements.

Carillion ahead of its recent insolvency. But it is important that the reporting burden on firms is proportionate to the risks it enables the PRA to detect, monitor and mitigate.

There are two overarching parts of the financial reporting regime under Solvency II: a harmonised part that was developed by EIOPA to deliver consistent reporting requirements across the EU; and a part that can be determined by individual regulators to reflect the particular features of their domestic markets.

The harmonised part is wide-ranging and is delivered primarily through so-called Quantitative Reporting Templates. But it is not perfectly tailored to the PRA's supervisory needs for the specifics of the UK insurance market. Where the PRA has identified gaps reflecting particular features of the UK industry, it collects additional information about firms' balance sheets via National Specific Templates. We also collect information on firms' Internal Model Outputs to ensure their ongoing suitability, and operate a handful of further data collections to monitor and understand the effects of possible capital drift for internal model firms against a variety of external benchmarks. The information collected includes: solvency using the standard formula; the sensitivities of insurers' capital coverage ratios to market risk factors such as interest rates and financial asset prices; longevity risk transfer transactions; and the effects of selected stress events on non-life and (in due course) life insurers' business models.

The majority (80–90%) of reporting to the PRA under Solvency II relates to the EIOPA harmonised package. Of the remainder, the PRA has worked with the ABI to design an extensive package of reforms to reduce insurers' reporting burdens as much as possible while allowing the PRA to meet its statutory objectives.

The specific items in scope of the PRA's review therefore included:

- the PRA's implementation of quarterly reporting exemptions,[41] the PRA's interpretation of look-through to underlying assets held via funds, and the PRA's guidance in SS40/15, 'Solvency II: reporting and public disclosure – options provided to supervisory authorities';[42] and

- all aspects of reporting that are fully owned by the PRA – with a particular emphasis on National Specific Templates, and to a lesser extent Internal Model Outputs, given industry feedback about where the burden is highest.[43]

The PRA's reporting reform proposals outlined in its consultation paper would reduce the reporting within the PRA's gift by up to a half. The proposals would reduce the number of

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[41] While complying with the limitation that reporting waivers shall be granted only to undertakings that do not represent more than 20% of a Member State's life and non-life insurance and reinsurance market respectively.

[42] July 2016. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-reporting-and-public-disclosure-options-provided-to-supervisory-authorities-ss.

[43] Industry has also flagged the PRA's requirement for standard formula SCR reporting for firms operating PRA-approved internal models as being comparatively a high burden. But the PRA continues to view as important its ability to monitor the risk that capital requirements drift down over time (so-called 'model drift'). Moreover, the Solvency II Directive requires that firms retain the capability to produce standard formula SCR numbers.

data lines we collect in a number of the remaining templates. And fewer firms would be required to submit some others. We are also proposing to maximise our use of quarterly reporting waivers by effectively granting them automatically for smaller firms.

'Develop proposals for simplifying the calculation of, and approval process for, the Transitional Measure on Technical Provisions provided for in the Directive'

Solvency II includes transitional measures to allow a gradual phasing in of the impact of any higher capital requirements on old books of contracts that were underwritten and priced in a different regulatory environment. This includes a TMTP that allows a firm to make a deduction to its technical provisions. For UK insurers, the main new element of Solvency II that gives rise to a transitional deduction to technical provisions is the risk margin. The transitional measures reduce steadily over 16 years. UK insurers receive a benefit from these transitionals of approximately £30 billion.[44] The inclusion of transitional measures results, on average, in an increase in UK insurers' SCR ratios from 107% to 154%.[45]

Transitionals are an integral part of the Solvency II regime and, given their materiality, it is important that they reflect the economic position of firms to a reasonable degree of accuracy.

Solvency II requires firms to obtain prior approval to recalculate transitionals every 24 months, or more frequently where the risk profile of a firm has materially changed. The PRA has set out some examples of the circumstances which may give rise to a material change in risk profile.[46] These include: changes in operating conditions, including in interest rates; a change in a firm's use of either the MA or VA; or the acquisition or disposal of business priced and written before Solvency II came into force.

We recognise however, that it is burdensome for firms to have to maintain multiple systems and processes for 16 years in order to be able to calculate the technical provisions and financial resource requirements. We are continuing to assess the feasibility of simplifying the recalculation of transitionals. We are discussing our proposals with industry and expect to consult on any proposed changes in 2018.

'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'

To date, the PRA has approved 23 internal models.[47] This is more than any other European regulator and there are a number of other firms currently in the application process. The PRA has also approved 26 major model change applications. All complete applications were assessed within the specified time limit of six months, with the PRA taking an average of just under four months to reach each decision.

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[44] As at end 2016.
[45] See EIOPA 'Report on long-term guarantees measures and measures on equity risk' (page 127). Available at: https://eiopa.europa.eu/Publications/Reports/2017-12-20 LTG Report 2017.pdf.
[46] See PRA SS6/16 'Maintenance of the 'transitional measure on technical provisions under Solvency II', December 2017. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2016/maintenance-of-the-transitional-measure-on-technical-provisions-under-solvency2-ss.
[47] Of which, one firm has now reverted to the standard formula.

The requirements for internal model approval are set out in detail in the Solvency II Directive. They are rigorous because an approved internal model determines an insurer's capital requirements. We keep our model approval processes under review in order to ensure they do not impose an excessive burden, while respecting the constraints of the Solvency II regime.

The PRA uses judgement to decide which risk areas of an internal model require in-depth review. This depends on the drivers of risk capital and the materiality of assumptions. Similarly, proportionality is applied when assessing the model against the Solvency II requirements. It is the model as a whole that is assessed against the requirements and not the various risk areas in isolation.

The PRA is currently consulting on proposals on the model change process.[48] Firms divide model changes into major changes, which affect their capital position materially, and minor changes. Major changes require PRA approval. The PRA is proposing to remove the current requirement for firms to apply for a 'major' model change when accumulated 'minor' model changes reach a defined threshold (unless the threshold is reached within a twelve-month period). Subject to not reaching this threshold within a twelve-month period, firms would be able to reset accumulated model changes to zero annually. The consultation also proposes more timely submission of quarterly model change reports and clarifies the PRA's expectations on the scope of model change policies.

The proposals will reduce the likelihood that an accumulation of minor model changes will result in a major model change. This in turn will reduce the burden on firms and make better use of the PRA's supervisory resources. The proposals introduce a slight increase in prudential risk as they will reduce the frequency with which firms have to seek PRA approval for changes to their internal models. However, we consider that this risk is effectively mitigated by the PRA's monitoring of any 'model drift'.[49]

Develop a solution for firms in relation to contractual continuity after Brexit

The Bank's Financial Policy Committee (FPC) continues to assess the risks of disruption to UK financial services arising from Brexit so that preparations can be made and action taken to mitigate them. Consistent with its remit, the FPC is focused on scenarios that, even if the least likely to occur, could have the most impact on UK financial stability. This includes scenarios in which there is no agreement in place at exit. It published its most recent assessment of the risks to financial stability arising from EU withdrawal in the November 2017 *Financial Stability Report*.[50] In particular, it set out that a significant number of policyholders could be affected in both the United Kingdom and EEA and the most effective mitigant of these risks would be a bilateral agreement between the UK and EU authorities.

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[48] See PRA CP27/17 'Solvency II: Internal models update', available at: www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-ii-internal-models-update.
[49] See PRA SS15/16 'Solvency II: Monitoring model drift and standard formula SCR reporting for firms with an approved internal model', October 2016. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-monitoring-model-drift-and-standard-formula-scr-reporting-ss.
[50] 'Risks to the provision of financial services from Brexit', Bank of England Financial Stability Report, November 2017. Available at: www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2017/november-2017.pdf.

To ensure continuity of contracts with their EEA customers, some UK insurance companies are planning to transfer insurance contracts to legal entities located in the EEA that have the required authorisations. Such transfers can be done in bulk using the procedure in Part VII of the Financial Services and Markets Act 2000. This is expected to result in a significant increase in the volume of such transfers.

Similarly, insurers located in the EEA would need to ensure any activities in respect of existing UK business that require authorisation in the UK are performed by entities with the correct permissions in the UK. The UK Government announced[51] on 20 December 2017 that it will, if necessary bring forward legislation which will ensure that contractual obligations, such as insurance contracts, which are not covered by the regime, can continue to be met. We continue to discuss this with EU colleagues, with the aim of gathering support for a bilateral agreement to solve the problem.

On 20 December 2017, we published a consultation paper[52] which sets out our proposed approach to authorising and supervising the insurance branches of third country insurers. The consultation was released together with a draft supervisory statement which also sets out new factors to be considered alongside the PRA's current requirements for third country branch authorisation. In particular, we also propose to consider the scale of UK branch activity covered by the FSCS and the impact of the failure of a firm with a UK branch on the wider insurance market and financial system.

Areas where we are constrained under Solvency II

As noted in our letter to the Committee of 3 January 2018, there are some areas raised by the Committee where the PRA is more constrained under Solvency II. These are areas which are therefore better considered once there is greater clarity about the UK's future relationship with the EU. We expand on the nature of these constraints in this section.

Procyclicality and regulatory forbearance

There are several features in Solvency II which are intended to lean against procyclicality. For example, the MA ensures that the market valuations of cash-flow matching long-term assets and liabilities are not unduly affected by volatility in market prices that does not reflect changes in underlying fundamentals. Similarly the VA is intended to provide relief from volatility in the Solvency II balance sheet, particularly when asset prices are temporarily but sharply depressed. The PRA has also taken action to deal with the immediate risk of procyclicality from changes in long term interest rates feeding through into volatility in the risk margin through issuing guidance[53] to insurers on recalculating their TMTP. And the

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[51] See written statement on financial services by the Chancellor of the Exchequer, December 2017, available at: www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2017-12-20/HCWS382/.

[52] See PRA CP 30/17 'International insurers: the PRA's approach to branch authorisation and supervision', December 2017. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2017/international-insurers-pras-approach-to-branch-authorisation-and-supervision.

[53] See PRA SS6/16, 'Maintenance of the 'transitional measure on technical provisions' under Solvency II', April 2017. Available at: www.bankofengland.co.uk/prudential-regulation/publication/2016/maintenance-of-the-transitional-measure-on-technical-provisions-under-solvency2-ss.

equity risk sub-module under the standard formula includes a symmetric adjustment which allows an equity shock to move within a band of 10% on either side of the underlying standard equity stress. This symmetric adjustment is included to avoid the risk of firms being unduly forced to raise additional capital or sell their investments as a result of adverse movements in financial markets.

During the European Commission's call for evidence on the EU regulatory framework for financial services, the Bank also raised the issue of whether macro-prudential tools should be available as part of Solvency II, noting concerns about how regulators could respond to a period of substantial market stress.

Under the so-called 'ladder of intervention' in Solvency II, where a firm breaches its SCR, it must submit a realistic recovery plan for approval by the PRA. The PRA will then require the firm to remedy that breach within six months. If appropriate, that period can be extended by three months. In the event of an 'exceptional adverse situation', which must be declared by EIOPA, the PRA may further extend the recovery period by a maximum period of seven years.

We are keen to ensure that the process for 'exceptional adverse situations' works as well as possible. The PRA is participating in workstreams at EIOPA and the European Systemic Risk Board (ESRB) which are aiming to develop guidance and internal processes on:

- EIOPA declaring exceptional adverse situations; and
- how regulators can assess the risks of firms engaging in pro-cyclical behaviour when breaching their SCR and act quickly in response.

The ESRB and EIOPA are also considering whether further tools are needed to reduce procyclicality within Solvency II, which could include tools to decrease capital requirements in times of stress. The PRA is also participating in these workstreams, which are intended to provide information to the Commission for its 2021 review of Solvency II.

Contract boundaries

The PRA recognises that the scope of the boundary of a contract, which defines the point at which future cash flows are no longer included in the valuation of an insurance liability, differs slightly between IFRS 17 and Solvency II. However, under Solvency II the definition of the contract boundary is prescribed in an EU Regulation. There is therefore no scope for the PRA to change that definition.

Standard formula

The PRA recognises that there are certain limitations in the standard formula. The European Commission is currently undertaking a review of the standard formula, at the end of which some of its inadequacies may be addressed. There are, however, a number of risks including inflation risk, gilt spread risk and operational risk, referred to in the Committee's report that are not within the scope of this review. We are engaging in the review and will consider our position further once it has concluded. It may be noted that firms can develop a partial or full internal model if they consider it will reflect their risk profile more appropriately.

Further developments on issues raised during the Committee's inquiry

We have made progress on the other recommendations we agreed to take forward with the ABI (in addition to the internal model change process and recalculation of the TMTP discussed previously).

External audit of the Solvency and Financial Condition Report

We have met with trade bodies, audit firms, and other stakeholders and users of the SFCR, in order to gather evidence to support a review of whether our policy of requiring external audit of the SFCR remains proportionate, particularly for smaller firms. In addition we have collected data on the cost of audit for the first SFCRs. We are now reviewing this evidence in order to determine whether the policy continues to remain proportionate for smaller firms. If we determine that a change to the policy is appropriate, we expect to consult on any proposals in the first half of 2018.

Longevity transfer and hedge arrangements

As noted in our letter of 22 September 2017, the PRA has clarified with the ABI that there is no PRA approval process for longevity transfer and hedge arrangements. These arrangements can, however, represent significant changes to firms' risk profiles, and we do therefore currently expect to be notified of new transactions.

Reporting also enables us to identify any build-up of market-wide risk concentrations. We are open to considering whether some of the information provided by firms could be omitted so as to reduce any undue burden, and intend to take stock of the current notification arrangements once we have completed a series of reviews of firms' counterparty risk management.

Legal entity identifiers

We have determined that approximately 80% of all dormant undertakings fall within five insurance groups, and that the cost to the vast majority of firms of maintaining Legal Entity Identifier codes (LEIs) for dormant firms is insignificant (well below £5000). Therefore, we have decided to maintain the current expectation that all firms obtain LEIs. We will however consider the specific circumstances of firms where this is disproportionate.

Remaining ABI recommendations

We have reviewed our previous positions on the ABI's remaining recommendations. There are several areas where there have been updates:

- Quantitative Indicators: the PRA uses its quantitative framework (which includes the use of specific Quantitative Indicators) as: a diagnostic tool to help assess model rigour and capital adequacy; a prioritisation tool to help inform where review teams should direct their attention when reviewing firms' models; and as one contributor to our review of whether insurers' models meet Solvency II tests and standards. Last year we communicated to industry in a speech[54] by David Rule, Executive Director of

[54] See 'Changing risks and the search for yield on Solvency II capital', July 2017. Available at: www.bankofengland.co.uk/speech/2017/changing-risk-and-the-search-for-yield-on-solvency-2-capital.

Insurance Supervision, that we are undertaking a review of our Quantitative Indicators for longevity risk in the light of recent longevity experience.

- US securitisations: Solvency II securitisation requirements will be replaced following the coming into force of the Simple, Transparent and Standardised (STS) securitisation regulation. This regulation was agreed by the European Parliament, the Council and the Commission on 30 May 2017 with further technical talks to finalise the text to follow.

- Availability of own funds at group level: following EIOPA's response to a Q&A on the availability of group own funds (i.e. that the solo SCR should, in principle, not be regarded as a barrier to availability), we are currently reviewing our approach.

- Surplus funds: we are currently evaluating the surplus fund rules and accompanying supervisory statement. We are actively reviewing firms' reporting submissions and SFCRs to investigate implementation of the rules across the UK insurance industry and we expect to further our review in 2018.

- Senior Insurance Managers Regime (SIMR): the SIMR has now been in place for over a year, and though it is early days, we consider that it is promoting better governance through a clearer allocation of individual responsibilities to key decision-makers. PRA supervisors are also proactively using many tools provided by the policies to support reviews of firms' governance, which is likely to lead to better supervisory outcomes over time. In July and December 2017, the PRA consulted on proposals for the extension to all insurers of the Senior Managers & Certification Regime. This will be introduced by amendments to the Financial Services and Markets Act made by the Bank of England Act 2016. The PRA plans to publish final policy during 2018, and the regime will come into effect from 10 December 2018.