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SOLVENCY UK DRAFT REGULATIONS PUBLISHED

On 22 June 2023, HM Treasury (HMT) released information about its proposed legislative strategy for its Solvency UK reforms. The strategy includes two draft statutory instruments (SIs) that HMT will make using powers under the Financial Services and Markets Bill 2022-23 (FSM Bill). The SIs are the Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023 and the Insurance and Reinsurance Undertakings (Prudential Requirements) (No. 2) Regulations 2023.

The draft SIs have been made available for early engagement, which is a rare opportunity for insurers to provide feedback to HMT on legislative changes. This is a chance to ensure that views are considered before the requirements are finalised, so firms should engage as soon as possible.

The final regulations will be laid in Parliament after the FSM Bill receives Royal Assent and which is expected tomorrow (29 June 2023). The government is aiming to have the reforms relating to the risk margin enacted into law by the end of this year. They are also considering enabling the matching adjustment reforms to take effect by the end of June 2024, ahead of the remaining reforms of Solvency UK taking effect by the end of 2024.

OVERVIEW

The FSM Bill will give the government new powers to reform the Solvency II regime. The government intends to use these powers to:

- Repeal Solvency II legislation and introduce Solvency UK.
- Make commencement regulations for the FSM Bill that will revoke the Commission Delegated Regulation (EU) 2015/35 and the Solvency 2 Regulations 2015 (SI 2015/575).
- Make regulations under new section 138BA of the Financial Services and Markets Act 2000 (FSMA) that will give the PRA flexibility to disapply or modify the application of any of its rules.

The reforms will bring Solvency UK in line with the FSMA model of regulation, which keeps the overarching framework for regulation set by the government in legislation but removes the most detailed regulation from the statute book. The parts of Solvency II that are not restated or saved in the SIs will be replaced with new PRA rules.

Firms will be able to apply to the PRA for permission to use measures that require PRA rules to be disapplied or modified after the Solvency 2 Regulations 2015 are revoked. HMT confirms that this includes the use of internal models and that firms' existing approvals concerning measures covered by Part 4 of the 2015 Regulations will continue to be valid.

The PRA currently has the authority to waive or modify rules under Section 138A of FSMA. However, a new section 138BA FSMA power that is being proposed would give the PRA even more flexibility to disapply or modify rules. This is due to the approach being taken to implement Solvency UK, which will result in significantly more PRA rules being applied to insurers. As a result, the PRA will have considerably more discretion in deciding which rules are appropriate for the specific circumstances of each firm.

The Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023 (The 2023 Regulations)

The risk margin

The 2023 Regulations will modify the current risk margin calculation as specified in Commission Delegated Regulation (EU) 2015/35. The reforms include:

- A risk tapering factor of 0.9 for life insurers and 1.0 for non-life insurers.
- A floor of 0.25 for both life and non-life insurers.
- A lower cost of capital rate of 4%.

The 2023 Regulations are expected to make it easier for insurers to meet their risk margin requirements. This is because the new regulations will make the risk margin more risk-sensitive and reflect the duration of the contract. The changes will be particularly beneficial to life insurers, who typically hold longer-term liabilities. The impact of these reforms is positive, with HMT and the PRA expecting the reforms to reduce the risk margin by around 65% for life insurers and 30% for general insurers, freeing up capital for investment.

The government's proposals are still subject to engagement with firms, so they may be further modified before they are implemented. Impacted firms are encouraged to engage in the consultation as the government has made clear that it is committed to making the Solvency II regime more proportionate and risk-sensitive, and the reforms to the risk margin calculation are an important part of this effort.

The 2023 Regulations also amend Commission Delegated Regulation (EU) 2015/35 to remove the PRA's power to revoke an approval concerning transitional measures on technical provisions (TMTP) in specific circumstances, to ensure that firms' TMTP approvals will be unaffected by the reduction in Solvency II financial resource requirements arising from the risk margin reforms.

The Insurance and Reinsurance Undertakings (Prudential Requirements) (No. 2) Regulations 2023 (the 2023 No.2 Regulations)

The 2023 No.2 Regulations contain provisions relating to the PRA's duty to publish technical information, the calculation of risk margin (to align PRA rules with the modifications introduced by the 2023 Regulations), the application and calculation of the matching adjustment and the calculation of the fundamental spread. It also contains savings provisions concerning Gibraltar groups and undertakings and makes amendments to FSMA and secondary legislation under FSMA to update for the fact that the UK has left the EU and certain other definitional amendments.

Key observations on the reforms are as follows:

The matching adjustment

The matching adjustment is a key part of the Solvency II regime. It allows insurers to benefit from holding long-term assets which "match" the cashflows of their long-term insurance liabilities. As matching cashflows reduces an insurer's liquidity risk, the matching adjustment permits insurers to discount the valuation of the relevant matched liabilities at a higher rate than the basic risk-free rate. The regulations propose to make several changes to the matching adjustment:

Fixity of cashflows: Consistent with HMT's November 2022 response to its Solvency II Consultation, Regulation 5 introduces an exception to the requirement that all assets used for the matching adjustment must have fixed cash flows, permitting the use of assets with non-fixed cashflows where:

- the risks to the quality of matching are not material. Whether a risk is "material" is to be determined in accordance with PRA rules; and
- only such limited proportion of the matching adjustment portfolio as the PRA may determine is affected.

Whilst the intention of these changes is to permit insurers to use a wider range of assets in their matching adjustment portfolios, it is not currently known how "material" will be defined or how the PRA will determine what constitutes a "limited proportion" of a firm's matching adjustment portfolio for these purposes.

Further clarity will be important in order for firms to understand what/the extent to which non-fixed assets can be included in their matching adjustment portfolio. Regulation 5 also refers to the new power in section 138BA of FSMA and Regulation 8, which allows the PRA to make further rules on the matching adjustment. This could allow the PRA to exercise a significant amount of discretion on what non-fixed assets, and what percentage of those assets, can be used within a firm's matching adjustment portfolio.

Liability eligibility criteria: The No.2 2023 Regulations do not carry across (or amend) the existing eligibility criteria for liabilities to be included within the matching adjustment portfolio. Notably, the regulations do not include restrictions on future premium payments, policyholder options or on the underwriting risks which may be included within a firm's matching adjustment portfolio. Nor is there a restriction on the splitting of contracts into different parts for matching adjustment purposes. Other than the inclusion of morbidity risk within the types of permitted underwriting risks, HMT's November 2022 response did not propose changes to the liability eligibility criteria so it is expected that these will be contained within the rules to be made by the PRA pursuant to Regulation 8.

Revocation of approval: The PRA has the power, but not the obligation, to vary or revoke a firm's matching adjustment approval where the firm fails to comply with the eligibility criteria set out in Regulation 5. The PRA can additionally impose a limit on the value of the matching adjustment benefit during the period of default. This addresses the cliff edge issue under the Solvency 2 Regulations 2015, where the PRA must cancel a matching adjustment approval if the firm does not meet the eligibility conditions for two months or more and which could then require the firm to apply for a new matching adjustment approval. The amendments now give the PRA the discretion to deal with matching adjustment breaches more incisively.

Calculation: Regulation 6 sets out how the matching adjustment is to be calculated. This largely follows the requirements of Commission Delegated Regulation (EU) 2015/35 but does not include the current provision for increasing the fundamental spread to ensure that the matching adjustment for sub-investment grade assets does not exceed that for investment-grade assets. This is in line with the Government's approach of allowing the PRA to exercise greater supervisory discretion over sub-investment grade assets and internally rated assets, rather than mandating that requirement on firms.

The fundamental spread

The fundamental spread is a measure of the credit risk of an asset. After consulting with firms, HMT and the PRA confirmed that a wholesale change of the fundamental spread was not suitable. Instead, smaller but significant changes will be introduced.

For example, the new Regulation 7 proposes to make a small change to the fundamental spread, requiring it to be at least 30% of the long-term average for exposures to the central government of the United Kingdom and the Bank of England, and 35% for other exposures. This development is designed to encourage investment in the UK economy by requiring insurers to hold more capital against non-UK exposures.

Regulation 7(6) also essentially introduces a methodology for a new credit risk premium (CRP) to the fundamental spread. The CRP is the premium a willing arm's length third party would demand for taking on expected loss due to a default and is based on the average spread over the risk-free interest rate of assets of the same duration, credit quality and asset class, as observed in financial markets. This is a welcome addition, as it will help to make the fundamental spread more accurate and reflect the actual credit risk of assets.

Overall, the changes to the fundamental spread are positive. However, some clarifications of the high-level terminology proposed in relation to the matching adjustment are needed. These clarifications would help to improve the resilience of the UK insurance sector and allow insurers to invest in a wider range of assets for the matching adjustment, which could lead to more investment in the UK economy.

CONTACTS

Imogen Ainsworth
Partner

T +44 207006 2184
E imogen.ainsworth@cliffordchance.com

Amera Dooley
Knowledge Director

T +44 207006 6402
E amera.dooley@cliffordchance.com

Hilary Evenett
Senior Director FIG

T +44 207006 1424
E hilary.evenett@cliffordchance.com

Cheng Li Yow
Partner

T +44 207006 8940
E chengli.yow@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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