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Response to UK’s HM Treasury review of Solvency II: call for evidence

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Introduction

The Insurance Europe Reinsurance Advisory Board (RAB) welcomes the opportunity to contribute to the call for evidence on the review of Solvency II by the UK’s HM Treasury (HMT).

The RAB generally believes that Solvency II works as intended and supports its market-consistent and risk-based approach. A number of areas of the framework have proven to work well and are essential for reinsurers. HMT's review nevertheless provides an important opportunity to improve the framework in some areas, including those specifically related to reinsurance (eg, by better recognising non-proportional reinsurance), and to adapt the framework to the UK market.

The RAB strongly supports HMT’s objective of protecting policyholders through the safety and soundness of firms. As global reinsurers, the RAB members also welcome HMT’s objective of supporting the UK’s ability to be a vibrant, innovative and competitive (re)insurance hub. This response outlines the areas of improvement that would allow (re)insurers to play their role as long-term investors and key participants in the UK’s growth and climate-change goals.

The RAB would also like to take this opportunity to stress that open reinsurance markets are vital to enable insurance markets to operate efficiently, to diversify risk globally and to promote continued growth and the recovery of global and national economies. Any barriers to trade in reinsurance undermine the efficiency of (re)insurance markets and lead to higher reinsurance costs and less capacity in the long term.

The outcome of HMT’s review of Solvency II must continue to recognise the specific treatment of reinsurance in regulation as a cross-border business-to-business activity and build on the elements of the existing Solvency II and UK frameworks that recognise this. In particular, a pure reinsurance branch of an undertaking situated in a country that has been deemed equivalent should be subject to very limited — if any — additional UK regulation with respect to the local UK branch activities (please refer to the responses on Chapter 8).

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Chapter 4 — Calculation of the SCR

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

Internal models are crucial for the proper assessment of capital requirements.

- This is particularly the case for firms, such as reinsurers, whose risk profiles frequently differ from the assumptions of the standard formula, as highlighted in the RAB's paper on Internal Models.
- The RAB also believes that internal models play an important role in avoiding a systematically wrong estimation of risk, which is an inherent drawback of a standard-formula approach.

The RAB supports internal models undergoing a thorough and well-defined approval process, while avoiding unnecessarily burdensome approval steps that would discourage their use.

- The RAB would encourage the Prudential Regulation Authority (PRA) to coordinate with the regulators based in the European Economic Area (EEA) on supervisory approval processes for internal models and changes to these processes, even in the absence of any formal equivalence decision between the future UK and EEA prudential regimes. Situations where changes are approved in one jurisdiction but not in another significantly increase firms' operational complexity.
- For internal models to perform well, they must be adapted relatively quickly to reflect changes in risk profile or new insights. A close collaboration between companies and the PRA and the relevant EEA regulators is important.

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

The RAB advocates a UK risk-based prudential regime that appropriately recognises risk-mitigation techniques (see further details in the response to Chapter 12 — Other areas for review).

- The RAB regularly sees non-life insurers that would like to cede risk through a reinsurance structure (such as non-proportional reinsurance) that cannot be fully recognised under the standard formula, although it provides clear risk transfer and its recognition under internal models is commonplace. This is because the current design of Solvency II provides for fixed adjustment factors for premium and reserve risk that are not sensitive to the existence (or absence) of non-proportional reinsurance arrangements.
- Non-proportional reinsurance is an important tool for non-life insurers to keep their risk levels in accordance with internal tolerances. This is particularly crucial for smaller and medium-sized companies to manage peak risk.
- In particular, the standard formula should provide for better recognition of non-life non-proportional reinsurance in the premium and reserve risk sub-module (see the response to Chapter 12 — Other areas for review). On reserve risk, a useful starting point would be the incorporation of a methodology for the recognition of adverse development covers.
- The treatment of basis risk should be adapted to allow for a risk-based treatment of situations in which material basis risk arises, where the standard formula typically provides for an "all-or-nothing" recognition dynamic.

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

Please refer to the answer to Question 13 (4.15).

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

The RAB believes that it is important to maintain the technical integrity of the framework and cautions against changing prudential requirements for political reasons without technical evidence. Nevertheless, the RAB is aware that the treatment of certain asset classes under Solvency II is sub-optimal. It would support a more risk-sensitive treatment. In particular, the treatment of individual asset classes under Solvency II should, as much as possible, reflect economic reality by taking asset class risk/return characteristics (eg historical volatility, credit quality, loss/default rates, etc.) into account. For instance, the lower volatility of a particular asset class should be recognised and lead to a corresponding treatment in the capital charge: eg, infrastructure loans vs corporate credit bonds.

Chapter 7 — Reporting requirements

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

While the RAB would encourage HMT to consider the removal of branch capital requirements (see the response to questions in Chapter 8), which would by extension largely remove branch reporting requirements, and to recognise the use of internal models (see the response to questions in Chapter 4), it would nevertheless like to express views on the current Solvency II reporting requirements.

- **Recognition of internal models**: The RAB particularly opposes standard formula reporting requirements for internal model firms. Insurers using internal models do so with the recognition from their supervisor that the standard formula is not appropriate for their risk profile. Internal models undergo an extensive approval and ongoing supervision process. A comparison between the internal model and standard formula results for a particular insurer is not meaningful and is likely to lead to misleading conclusions. Producing internal model, as well as standard formula results, comes with significant cost and little benefit. The cost will ultimately have to be borne by the policyholder. As set out in response to the questions in Chapter 8, the RAB also believes that branches of foreign (re)insurers with an approved internal model by the home supervisor should receive recognition of the internal model.
- **Leaner reporting requirements:** The RAB would welcome either the removal or the simplification of templates with a particularly high complexity and reporting burden. The following examples are among the ones found to be the most burdensome to produce in the context of Solvency II and represent potential areas to significantly improve the reporting process:

  - The list of assets is very detailed, with several validation checks. This leads reporting entities and regulators to focus overly on details. The RAB believes a template such as a summary of assets would represent an appropriate level of detail.
  - The look-through approach raises challenges with getting look-through details of the funds for unit-linked investments, although the risk is borne by policyholders.
  - Structured products
  - Income gain and losses in the period
  - Life obligation analysis
  - Most of the non-life templates
  - The reinsurance template on prospective reinsurance programme is a complex template, which is not straightforward to interpret, and hence populating it represents a challenge.
  - The variance analysis templates consist of several parts and include very complex internal reconciliation rules, making it very challenging to populate and reconcile.

  However, the RAB would like to stress that even minor changes in the reporting templates may entail considerable costs to adapt reporting and financial systems. Therefore, removing templates or significantly simplifying them would be preferred over minor simplifications. In a prudential regime with branch capital requirements — which the RAB would not favour — this would help avoid costly duplication for foreign firms.

- **Risk-based thresholds**: Alternatively, the RAB would welcome the introduction of risk-based thresholds, in line with the proportionality principle, to determine the reporting scope and to exclude certain non-core reporting templates from the scope based on proportionality. This could be implemented similarly to the application of the proportionality principle to third-country branch reporting, where the reporting categories are defined based on the size of the firm/branch. An illustration of a risk-based approach would be in the context of the current look-through approach (in particular for unit-linked investments). In this example, the risk is borne by the policyholder and there is therefore no impact on the balance sheet of firms.

- **16-week reporting timeline:** The RAB would welcome an increase of the annual reporting timeline from 14 to 16 weeks. For the quarterly reporting, it would encourage HMT to either drop the Q4 submission or replace the quarterly submissions with one mid-year submission. The current Solvency II reporting in Q4 creates redundancy and operational complexity with the standard reporting process of solvency figures and conflicts with the annual reporting process, while not bringing a significant added value in terms of updating the risk profile of the company. An alignment with the EU's reporting timeline would again avoid costly duplication of efforts and unnecessary operational complexity.

- **Third-country branch reporting requirements:** For third-country branches, the opportunity to report in the reporting currency of the firm and according to the local Generally Accepted Accounting Principles (GAAP) in its home state would be of a considerable benefit from an operational perspective, as it would leverage considerably from existing processes and systems. The RAB takes the view that the frequency of the regular supervisory report for third-country branches should be minimal (currently every three years as a standard case).

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

The RAB recommends keeping national specific templates and ad hoc requests to a minimum, as these require significant additional resources and operational capabilities. While it understands that a changing environment may require spontaneous reporting requests, it believes that key considerations for such requests are timing and the allowance of time for planning. Structuring ad hoc requests around a pre-determined timeline/window in a regular reporting timeline during a year would allow for better planning of resources for ad hoc requests. Moreover, it is important that those requests avoid being too strongly focused on legal entities and reflect the specificities of a branch set-up.

Chapter 8 — Branch capital requirements

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

An appropriate regime governing the activity of branches of foreign (re)insurers is key to maintaining and promoting the UK as an internationally competitive (re)insurance hub. The recent equivalence decisions in respect to EEA jurisdictions granted by HMT were welcomed by the RAB. The propositions below would support HMT's efforts made in this direction while ensuring a solid and sensible approach to the supervision of branches of foreign (re)insurers.

The RAB is in favour of the removal of branch capital requirements. The RAB also agrees with the statement of this call for evidence that a branch cannot fail independently of the firm and that branch capital requirements provide limited prudential benefit while imposing a burden on a branch of a foreign (re)insurer. The RAB believes capital requirements for foreign reinsurance branches serve no purpose.

The RAB explains in its Open reinsurance markets paper why barriers should not be placed in the way of professionally managed and well-capitalised reinsurance companies accessing markets on a cross-border or branch basis. Non-admitted EEA reinsurers (as well as reinsurers from other equivalent jurisdictions) can currently reinsure UK ceding companies without being subject to additional regulatory requirements. Therefore, UK reinsurer branch requirements create a disproportionate level of supervisory scrutiny, whereas equivalence appropriately provides the same regulatory treatment and recognition of reinsurance contracts provided by cross-border reinsurers subject to equivalent home state supervision only.

The specifics of a reinsurance branch in facilitating cross-border business-to-business reinsurance activity is already recognised in the UK regulatory framework, which does not require the localisation of assets for pure reinsurance branches. This supports the management of the pure reinsurer’s assets at firm level and obviates the case for local branch capital requirements.

In this context, branch reporting requirements for pure reinsurers in particular provide limited benefit, while entailing high implementation and process costs in order to segregate data at branch level, which otherwise may not necessarily exist, be meaningful or be managed on a stand-alone branch basis. The RAB believes that all the current reporting requirements for branches of foreign (re)insurers, both quantitative and narrative, should be removed for pure reinsurers in particular in the UK framework. It also strongly opposes any public disclosure of stand-alone branch information.

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The RAB takes the view that branch capital requirements provide an inflated view of risk and solvency. Branch capital requirements are determined in relation to the branch balance sheet. These Solvency II branch requirements do not apply to pure reinsurers. Branch capital requirements also lack a diversification benefit compared to the overall SCR/minimum capital requirement of the firm. Furthermore, a stand-alone balance sheet of a branch may not necessarily be meaningful, when balance sheet and assets are managed at legal entity level. This potentially leads to an incomplete, misleading and probably artificial representation of the branch's solvency, and would not achieve the purpose of regulatory oversight of ensuring adequate policyholder protection. The meaningfulness of an own risk and solvency assessment (ORSA) at branch level is also doubtful since, similarly to capital requirements, it considers the overall risk profile including risk diversification, as well as the overall risk and business strategy of the firm.

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

The RAB believes that the prudential supervision of branches should have a high degree of recognition of the home-state legal entity supervision already in place, where deemed equivalent to the UK's objectives and standards. With the UK's withdrawal from the EU, there will be a new population of UK branches of firms domiciled in EEA states, which are regulated under Solvency II. These firms are already subject to regulatory oversight, capital and reporting requirements with a key underlying objective of policyholder protection and financial stability. Adopting such an approach also allows for increased proportionality in the supervision of these branches. The case is even stronger for pure reinsurers, given the cross-border nature of the business, which is already recognised in Solvency II, and the fact that pure reinsurer's branch assets are not required to be localised under the current UK regulatory framework.

In light of this, lighter reporting requirements for reinsurance branches would be a concrete and pragmatic step forward in terms of proportionality in the regulation. As UK branches of EEA reinsurance firms are fully subject to Solvency II in respect of their total entity business, the need for additional reporting for those branches should be proportionate to the benefit expected from the second layer of supervision performed by UK supervisors.

Supervisory objectives could be addressed through closer supervisory coordination with the home supervisor and via an emphasis on the right of the UK supervisors to require the foreign (re)insurance firm to communicate on a regular basis any other information prepared under the responsibility of, or at the request of, the senior management of the firm in relation to branch operations.

Chapter 12 — Other areas for review

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

The RAB advocates improved recognition of risk mitigation techniques. It would like to draw HMT's attention to the topic of **risk mitigation** — an important topic not otherwise directly covered in the call for evidence. It would like to encourage HMT to further examine the issue of **recognition of risk transfer mechanisms**, where it believes that improvements to the framework are justified on technical grounds.

- **Further recognition of non-life non-proportional reinsurance in the premium and reserve risk sub-module in the standard formula**. This would be an important aspect to consider in the review,

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as the current rules do not assess the risks in an economic risk-based fashion. Additionally, this is the predominant risk-mitigation instrument for the non-life sector and a crucial tool for smaller and medium-sized companies to manage peak risk. An improvement to the framework would better recognise effective risk transfer and lead to better incentives for good risk management without leading to excess complexity.

While the standard formula recognises the impact of non-proportional reinsurance in the catastrophe sub-module of the non-life underwriting risk module of the SCR, it fails to do so in the premium and reserve risk sub-module. This is a technical inconsistency of the standard formula that needs to be addressed. Moreover, allowing the recognition of non-proportional reinsurance would enable a more proportionate application of the standard formula by small- and medium-sized companies, particularly for reserve risk, and help them to manage their volatility by transferring risks to reinsurers.

- **Adverse development covers (ADCs)**: EIOPA has addressed the issue in the Solvency II regime by introducing, as part of the 2020 review, a proposal for improved recognition of ADCs under the reserve risk sub-module in the standard formula. While that is a positive development, the EIOPA final proposal lacks ambition, given its limitations, and therefore fails to completely address the issue. The formula proposed by EIOPA should also apply to multiple lines of business and should not have any limitation to the attachment point, as the economic effects of the attachment point are already recognised by the formula. The RAB would encourage HMT to address this issue. Improved recognition of ADCs would reduce the volatility of small- and medium-sized insurance companies, while protecting their back book of historical risks from distortions.
- **Basis risk:** In addition, a clarification and improvement of the current rules on basis risk in the context of risk-mitigation techniques in the standard formula would be welcome. Indeed, the approach in force takes an “all or nothing” view of material basis risk, which creates significant uncertainty for both insurers and reinsurers and is not consistent with a risk-based approach. The RAB considers the current rules under Solvency II for basis risk in the standard formula to be unclear in two respects: (i) how to interpret the existing guidelines on basis risk in the reinsurance context; (ii) how an identified basis risk can/should be quantified. Inconsistencies in these aspects impact the recognition of reinsurance treaties under Solvency II for standard formula users.

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