



HMT Review of Solvency II: Call for Evidence

IFoA Response

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

Key points

The IFoA welcomes the opportunity to respond to HMT's Call for Evidence on the review of Solvency II (SII). We agree there is scope to improve the efficiency and effectiveness of SII in the UK, but also scope to allow the regime to better-reflect the particular features of the UK insurance sector.

We have considered HMT's SII review from an independent, public interest perspective. In particular, we have focused on the impacts of SII on consumers and society as a whole.

We support HMT's underpinning objectives in this SII review, including the need for a prudential regulatory regime which fosters innovation and international competitiveness, appropriate policyholder protection/ soundness of firms, and facilitates long-term infrastructure and 'green' investment.

The current design of the SII risk margin is too interest-rate sensitive and too high, particularly in the current low-interest rate environment. We believe reform, and an overall reduction, in the risk margin is desirable and can be done whilst keeping an appropriate balance between policyholder protection and cost.

The Matching Adjustment (MA) is vitally important to UK insurers, UK pension schemes and individuals. Without it, annuity prices would increase, and it would simply not be affordable for many pension schemes to buy-out with an insurance company. The IFoA fully supports the continued inclusion of the MA; the MA has successfully helped reduced procyclical investment behaviour, such as during the stressed conditions in early 2020. However, we believe that the MA framework needs to incorporate more pragmatic flexibility, without a lowering of regulatory standards.

We favour incentivisation of 'green' investment rather than overly penal disincentives for 'brown' asset classes, noting that sectors considered 'brown' must also be part of the solution to the challenges of climate change.

The standard formula Solvency Capital Requirement was calibrated on European data, and a recalibration of the standard formula based on UK data would therefore improve its appropriateness for the UK. The internal model approval and change processes and associated documentation requirements are onerous. They should be proportionate and take a more principles-based approach.

We believe there is scope to streamline significantly SII reporting and the associated documentation requirements, to make it more UK-specific but also fit-for-purpose. We believe this can be done without compromising the safety and soundness of firms, or of policyholder protection.

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1. The Institute and Faculty of Actuaries (IFoA) very much welcomes the opportunity to respond to HMT's Call for Evidence on the review of Solvency II (SII). We agree there is scope to improve the efficiency and effectiveness of SII in the UK, but also scope to allow the regime to better-reflect the particular features of the UK insurance sector.
2. In developing our response, we have drawn upon input from a wide range of members working in both life and general insurance, together with specialists on institutional investment and sustainability issues. We have also had input from a number of technical working parties on topics including on the risk margin and matching adjustment. In addition, we conducted a survey distributed to general insurance actuaries working in London market syndicates and at other UK insurance firms.
3. It is important to note that, as for any IFoA response, we have considered HMT's SII review from an independent, public interest perspective. In particular, we have focussed on the impacts of SII on consumers and society as a whole.
4. Given the above, we believe that the IFoA has an important role to play in the debate on the future evolution of SII in the UK. We would therefore be delighted to discuss our response with HMT in due course.
5. We support HMT's underpinning objectives in this SII review, including the need for a prudential regulatory regime which fosters innovation and international competitiveness, appropriate policyholder protection/ soundness of firms, and facilitates long-term infrastructure and 'green' investment. We have borne these objectives in mind in drafting this response.
6. Without incorporating sustainability considerations and adjusting the regulatory framework to incentivise firms to invest and develop products today, the regulatory regime contributes to the risks of a disorderly or failed transition. Both of these risks have wide-ranging societal impacts. Therefore, the review of SII needs to assess more than the risk-based capital calculation in isolation.
7. The IFoA supports the fundamental principles of the SII regime, and we take a pragmatic approach to its future development. We also agree that any future review of SII should be informed by emerging international regulatory developments.
8. Given SII 'went live' in 2016, we have reflected on experience since implementation, including the relative strengths and weaknesses of the regime. In particular, our members have identified aspects of the regime could which be improved to make UK insurance sector more competitive, efficient and innovative, without impacting financial stability or policyholder security.
9. Any reform of SII in the UK should consider the potential impact on the competitiveness of the UK insurance market to institutional investors. Reform would also need to be considered in the context of equivalence to (the evolving) SII in the EU. Equivalence will be particularly relevant to UK firms which have European groups/ subsidiaries/ branches.
10. In some cases, changes to SII being sought by life and general insurance actuaries may differ in detail or substance, and where relevant we set out any differing viewpoints/ emphases below. Given this, we suggest that HMT should consider whether any changes implemented to SII should differ in detail between life and general insurance, where considered appropriate.
11. Given the nature of SII, many aspects of the review are unavoidably technical, and our responses to some of the Call for Evidence questions are quite detailed. In the light of this, our full response to the questions is given in the appendix. It is however worth highlighting below key aspects of our full

response, including two features of SII in particular need of reform, together with key points on wider aspects of the regulatory framework.

Risk Margin

12. The current design of the risk margin is too interest-rate sensitive and too high, particularly in the current low-interest rate environment. It is also out line with the current market cost of risk transfer for longevity risk.
13. This sensitivity to interest rates is quite acute on insurance business covering longevity risk, and in particular retirement-related annuities. This has various adverse effects including increasing the cost of annuities for consumers and of buy-outs for defined benefit pension schemes, adding to procyclicality in interest-rate markets, and artificially incentivising offshore risk transfer. The risk margin may also be too high for single premium multi-year general insurance contracts.
14. We believe reform, and an overall reduction, in the risk margin is desirable and can be done whilst keeping an appropriate balance between policyholder protection and cost.
15. We do not believe that the reforms proposed in EIOPA's opinion on the SII 2020 review are sufficient. In our view it is in the public interest that the UK's reform of the risk margin should go further, given that the risk margin is a more material issue for UK than typical EU insurers.
16. There are a number of potential options for reform, which we discuss in our detailed response and we would recommend an impact study on different options. We would particularly suggest consideration of the Prudential Margin over Current Estimate which is proposed in the Insurance Capital Standard (ICS) regime and gaining strong currency in Asian economic capital regimes.

Matching Adjustment

17. The Matching Adjustment (MA) is vitally important to UK insurers, UK pension schemes and individuals. Without the MA, annuity prices would increase, and it would simply not be affordable for many pension schemes to buy-out with an insurance company. The same is also true of individuals reaching retirement, where annuities are important part of the retirement toolkit.
18. The IFoA fully supports the continued inclusion of the MA. It is based on a fundamental actuarial technique (and one employed under the previous regulatory regime) that ensures the valuation of annuity-style liabilities reflects only the market risks to which the firm is exposed when adopting a buy-to-hold investment strategy. Since 2016, the MA has successfully helped reduced procyclical investment behaviour amongst UK insurers, such as during the stressed conditions in early 2020.
19. However, we believe that the MA framework needs to incorporate more pragmatic flexibility. This does not mean a lowering of regulatory standards, but means removing blockers created through a set of rules which are very black and white in nature.

MA: addressing the binary eligibility rules

20. The current interpretation of what it means for an asset cashflow to be 'fixed', and the lengthy and onerous approvals process for making changes, have meant that firms do not always have the right incentives to invest in long-term innovative assets. Much effort has been spent by the industry in avoiding relatively immaterial features in assets which may challenge a theoretical purist view of the regulation, rather than necessarily posing a material real-world risk.

21. Removing these artificial barriers, and introducing proportionality considerations, can be a key enabler of long-term investment and support for the UK government's climate change objectives.

MA: Fundamental Spread reform

22. Insurers could also be incentivised to invest in a more economically beneficial way by addressing shortcomings with the formulation of Fundamental Spreads.
23. Firstly, we believe there are a number of aspects which are not necessarily economic; capping of the MA for non-investment grade assets, flooring the Fundamental Spread at an average of long term historic spreads, and the lack of a sufficiently granular differentiation between asset classes (e.g. infrastructure versus corporate bonds).
24. Secondly, we believe that insurers' internal ratings processes should achieve better alignment between long term sustainable investing and credit quality steps used to assign Fundamental Spreads in the MA calculation. Consideration should be given to how investments would perform in different climate scenarios when formulating internal credit quality outlooks.

MA: governance and approvals

25. Given the increased accountability of those running insurance firms, through the Senior Managers and Certification Regime (SM&CR), we consider that the HMT and PRA could place much more reliance on the judgment and responsibility of such individuals who manage MA portfolios.
26. MA eligibility assessments (e.g. assessing the presence of new 'features'), internal ratings, sufficiency of independence of fund management, investment and trading practices are areas that fall within the remit of firms' senior managers. As they are held responsible and accountable through the SM&CR, it follows that they should have the ability to exercise their judgement in dispensing these responsibilities in line with the regulations, and the PRA should give them latitude to do so.
27. In adopting a more pragmatic interpretation of MA rules and placing accountability under the SM&CR on those running MA portfolios, the PRA should be able to focus on the more material and/ or systemic risks. This should also allow for a less onerous and more efficient MA approvals process, with firms able to act on opportunities in a timely manner.

MA: Periodical Payment Orders

28. Existing MA requirements do not cope well with UK Periodical Payment Order (PPO) liabilities: the indexation used to increase annual PPO payments is problematic, and there are no current investment vehicles that have been shown to match the relevant liability cashflows. This increases uncertainty around whether the assets will cover the liabilities, and also reduces an insurer's ability to apply an MA.
29. Changes to MA eligibility requirements for assets backing PPO liabilities would thus be beneficial, and could better reflect firms' actual management of PPO liabilities.

Other Key Areas for SII Reform

Supporting infrastructure investment

30. The insurance and long-term savings industry is responsible for the stewardship of circa £1.7 trillion assets and there are potential societal benefits should more of these assets be invested in long-term infrastructure development.

31. By their nature, less 'standard' assets are less likely to fit into the tick-box requirements of more established assets, and where there is a lack of data, it can be challenging for a firm to evidence to current regulatory standards their true assessment of the risk profile of such assets, and thus justify an appropriate capital requirement. Greater flexibility over determining MA eligibility of such assets is also important, as firms look to include a wider array of projects and asset variants within MA portfolios.

Incentivising green investment

32. Embedding climate change is a rapidly evolving area for insurers. Where risks are not factored in today, we expect this to happen in the near-term. We favour incentivisation of 'green' investment rather than overly penal disincentives for 'brown' asset classes, noting that sectors considered 'brown' must also be part of the solution to the challenges of climate change. As the risks for 'brown' assets are factored-in, we expect a natural shift towards greener investment.
33. A lower capital charge could be justified for 'green' assets that are likely to benefit from policy changes required to transition to net-zero emissions (e.g. subsidies and carbon pricing). Due to the lack of historical data or means to demonstrate that the 'green' assets entail lower risks than 'non-green' ones, calibrations of climate risk factors will need to be judgement-based.

Calculation of the Solvency Capital Requirement

34. The standard formula Solvency Capital Requirement (SCR) was calibrated on European data. Although the UK provided some input to the calibration, the results are naturally different from what a hypothetical standard formula calibrated on UK data would look like. A recalibration of the standard formula based on UK data would therefore improve its appropriateness for the UK.
35. The internal model approval and change processes and associated documentation requirements are onerous. They should be proportionate and take a more principles-based approach.
36. Within the UK's former ICAS regulatory regime, the possibility of a capital add-on covered situations where a firm's management disagreed with the regulator as to the appropriate methodology or assumptions to use. This supervisory tool could be used either indefinitely to reduce the overall burden of the internal model approval process, or during an interim period whilst approval is being sought to reduce the timelines. However, some care would be needed with such add-ons to avoid unintended consequences, such as situations where firms might become over-capitalised.
37. It is clearly in the wider public interest that interested commentators have a way of comparing the capital requirements of internal model firms. Whilst using the standard formula is one way of achieving this, internal model firms generally have complex structures, which are not well-captured by the standard formula. In these circumstances the standard formula may not be an appropriate benchmark, and other alternative disclosures could achieve a similar outcome at a lower cost to the industry.
38. An additional tool that would be useful for supervisors is a standard model calibrated 'to-ultimate', i.e. to the point where all liabilities are paid. Existing tools focus substantially on 1-year measures of solvency and not the ultimate time horizon. The ultimate time horizon corresponds most to the needs of policyholders. The 'to-ultimate' model would also assist supervisors in assessing situations where the liabilities stretch a long period of time into the future, and would benefit both life and general insurers and their customers. However, again care would be needed with a 'to-ultimate' approach, to avoid the risk of over-capitalisation.

Calculation of the Transitional Measure on Technical Provisions

39. The purpose of the Transition Measure on Technical Provisions (TMTP) is to smooth insurance firms' transition from the SI regime to the SII regime. In general, SII technical provisions are significantly higher, and so the TMTP has proved to be an invaluable tool in managing the transition, particularly in mitigating the impact of the risk margin.
40. The calculation and maintenance of the TMTP is highly complex, and its objective could continue to be met through simpler methods.
41. It should be noted that as the risk margin comprises the largest part of the increase between SI and SII, if the design/ calibration of the risk margin were revised, the need for reform to the TMTP may be reduced.
42. We do however see considerable benefit if firms can agree a set of pragmatic simplifications to their TMTP calculation which removes the areas of associated complexity. This has the potential to reduce balance sheet volatility making firms' capital positions easier to understand and supervise.

Reporting requirements

43. We believe there is scope to streamline significantly SII reporting and the associated documentation requirements, to make it more UK-specific but also fit-for-purpose. We believe this can be done without compromising the safety and soundness of firms, or of policyholder protection.
44. We also believe that the SII reporting requirements are disproportionate in some areas, and this adds to the cost burden for insurers. The reporting burden is particularly marked for smaller insurers. Whilst some allowance does exist for exclusions for smaller insurers in the form of waivers, we recommend an increased use of such waivers to make reporting less onerous for smaller insurance companies.
45. There is currently significant duplication within the SII reporting requirements, including between a firm's Solvency and Financial Condition Report (SFCR) their report and accounts.
46. The SFCR would also benefit from a major re-cast. It lacks useful sensitivity analysis, and the lack of analysis of change is a significant gap. Furthermore, the typical lack of disclosure of assumption values is an omission that should also be addressed: it is very difficult to compare/ judge the robustness of technical provisions without this information. The former SI reporting to the PRA was better in this regard.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk) in the first instance.

Yours Sincerely,

Tan Suee Chieh

President, Institute and Faculty of Actuaries

Appendix: Responses to Questions within Call for Evidence

Risk Margin

1. The IFoA commissioned a research working party into the risk margin, which reported its findings in September 2019. Our comments below draw on this research, as well as the wider views of the IFoA. The research paper provides further detailed evidence supporting our conclusions ¹.
2. Many of our comments focus primarily on longevity risk, with this being a key source of the overall risk margin for UK life insurers.

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

3. As noted in HMT's Call for Evidence, the current design of the risk margin is too interest-rate sensitive and too high, particularly in the current low-interest rate environment. The risk margin is also out of line with the current market cost of risk transfer for longevity risk. More generally, there is potential misalignment with the actual cost of capital. *See research paper link below* ¹.
4. This sensitivity to interest rates is particularly acute on insurance business covering longevity risk, and in particular retirement-related annuities. However, other perpetuities such as Periodical Payment Orders (impacting general insurance firms) are also impacted.
5. There is a 'double whammy' effect in that the Solvency Capital Requirement (SCR) is also higher for longer tailed life insurance risks like longevity and expenses, when interest rates are low. The risk margin calculation projects these (higher) SCRs forward in time assuming current low interest rates persist, and then also discounts these projected SCRs back at the same low interest rates.
6. The risk margin also adds to procyclical exposures to interest rate risk, as insurers can be forced to hedge the risk margin when rates fall, which, in turn, can then exacerbate market cycles and requiring larger amounts of capital at times when capital is most scarce.
7. The selection of SCR run off is also very sensitive. Some general insurance firms consider using outstanding cashflow run-off pattern, whilst others consider SCR running-off using a function of outstanding cashflow, i.e. a square-root method.
8. The risk margin artificially incentivises offshore transfer of longevity risk. The current calibration of the risk margin makes it prohibitive to retain the longevity risk even where an insurer wishes to do so.
9. We believe that a firm's decision to reinsure risk should be made on the basis of its own risk appetite, and not that the economics of retaining the risk are skewed one way or the other, as is currently the case. In order to redress this imbalance, a significant reduction in the risk margin is required. Some of our members (and industry commentators) have suggested that, in the current market conditions, a reduction in the risk margin of up to three-quarters is required. A lower reduction will not address the imbalance, and we are unlikely to see a change in firms' behaviour.
10. With the risk margin currently being too high, this also means that the SII Technical Provisions are too large, and are considerably higher than those held in equivalent global regimes e.g. in Canada, the

¹ See:

https://www.actuaries.org.uk/system/files/field/document/Risk%20Margin%20Working%20Party%20Research%20Paper%20Final%2008082019_0.pdf

US and Switzerland. We believe that the risk margin can be reduced without impacting policyholder protection in the UK below that of other international regimes.

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

11. There has been considerable industry discussion of possible solutions to improve the operation of the risk margin some of which are set out below and which could be used on their own or in combination:

Modify the cost-of-capital used

12. The cost-of-capital rate, currently 6% p.a. above risk-free, could be reviewed and a lower level chosen. There is a considerable amount of analysis that has been conducted by industry participants and bodies that suggest that a considerably lower cost-of-capital could be justified.
13. The cost-of-capital could also be made interest rate-dependent to reduce the sensitivity, and reflect the suggestion that the cost-of-capital tends to fall when rates fall. This could be quite complex for insurers to hedge however.

Dependency of risks over time

14. The December 2020 EIOPA Opinion on the 2020 review of SII ² has proposed to adjust the projected future SCRs used in the risk margin calculation to reflect the time dependency of risks. It does this by introducing a floored, exponential and time-dependent element ‘ λ ’ to the projection of future Solvency Capital Requirements.
15. The theoretical justification for the approach, but not a specific calibration, is given in a 2019 paper ³ by the Actuarial Association of Europe. The rationale behind the parameters recommended by EIOPA is not entirely clear, and indeed EIOPA note that their proposal is intended to be a simple and prudent adjustment. *Note however, that this approach was first developed in the UK, and first documented by the ABI, before being adopted by EIOPA.*
16. Inclusion of a time-dependent ‘ λ ’ element could represent a pragmatic solution to the issues created by the use of the cost-of-capital method in the risk margin, and we would suggest this merits further consideration. However, the conservative parameterisation proposed by EIOPA does not appear sufficient to fully address the issues impacting longevity risk in the UK market.

Adjustments to the cost-of-capital approach: life insurer considerations

17. The EIOPA Opinion commented that ‘there are a number of different approaches that could be used to calculate the risk margin’ but did not consider revising the cost of capital approach as within the scope of their review. We would suggest that the UK review should also consider a wider scope and take account of international developments. In particular, the UK could consider:

a) Treat longevity risk as hedgeable

18. In this approach, insurers could treat longevity risk as hedgeable and use the market cost of risk transfer in their best estimate liability, rather than hold a separate risk margin for longevity risk. This has some practical difficulties, but is arguably the most logical solution given a key aim of the risk margin is to produce a market-consistent price for non-market risk. An alternative would be to use a broad proxy for the market cost of risk transfer.

² See: (https://www.eiopa.europa.eu/content/opinion-2020-review-of-solvency-ii_en)

³ “A review of the design of the Solvency II risk margin”, Actuarial Association of Europe, December 2019 <https://actuary.eu/wp-content/uploads/2019/12/Solvency-II-Risk-Margin-FINAL.pdf>

19. A pragmatic alternative would be to recalibrate the overall cost of capital based on evidence from longevity risk transfer markets, rather than the more theoretical analysis used in SII.

b) P-MOCE approach as under ICS

20. The Call for Evidence refers to the international Insurance Capital Standard (ICS) regime under development; the ICS is gaining strong currency in Asian economic capital regimes. The proposed ICS equivalent to the risk margin is the Prudential Margin Over Current Estimate, or 'P-MOCE', which has gained support over the alternative C-MOCE, which is consistent with the SII cost-of-capital method.
21. We recommend considering this alternative to the cost-of-capital approach to the risk margin, given its presence within ICS (and to an extent the IFRS 17 accounting standard). However, we note that the chosen percentiles in the P-MOCE have been calibrated to the group of global Internationally-Active Insurance Groups (IAIGs) who have contributed to the ICS field-testing. As such, the percentile for life business may not be entirely suitable for the UK market, particularly annuities.
22. The current design of the risk margin does not allow for any diversification at group level, or between life and general insurance business within the same entity. Allowing such diversification would be appropriate in the context of group risk margin calculations.

Adjustments to the cost-of-capital approach: general insurance considerations

23. There is support from general insurers for a general overhaul of the cost of capital approach. Simplification of the requirement to make calculation of the risk margin materially reasonable, whilst removing the theoretical constraints causing computational complexity would be welcome.
24. It may be appropriate to take a different approach to the cost of capital for life and general insurers. We therefore suggest that differing solutions for life and general insurers should be explored to reflect their differing risk profiles.
25. For example, rather than having the cost of capital for general insurers fixed at 6%, it could be parameterised and updated on a regular basis (e.g. monthly or quarterly), similar to the equity symmetric adjustment.
26. A more dynamic approach would be to reflect the credit rating of the entity; where credit rating were not possible, using a rating determined by bands of SCR cover ratio could be considered. A percentile approach is used in Australia. *However, note the comments with respect to general insurers in response to question 3.*
27. More generally, and not specific to life or general insurance, it would be helpful for HMT to consider how any change made to the risk margin methodology would potentially impact insurers reporting under IFRS 17. It is likely that insurers reporting under both regimes would want alignment to minimise operational costs. This could help promote UK firm competitiveness (and relates not only to the risk margin, but SII more widely).

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

28. We believe a redesign of the risk margin would be beneficial from a public interest perspective due to:

- a reduction in procyclicality;
- the retention of premiums in the UK to fund investment, growth, jobs and UK tax revenue;
- greater alignment with firms' risk appetites;
- the risk margin could be reduced without impacting policyholder protection in the UK, below that of other international regimes.

29. Any risk margin methodology, including the current approach, should be considered against a number of criteria. In practice, some of these will conflict and trade-offs are inevitable:

- **policyholder protection** - an overriding concern is to ensure that technical provisions are sufficient. However, as the IFoA noted in its submissions to the Treasury Committee in 2016/2017, there is a trade-off between policyholder security and policyholder value for money, and the current risk margin calibration may provide excessive security. We note that there was no equivalent of the risk margin under the previous ICAS regime which was considered to provide an adequate level of policyholder security;
- **market-consistency** - the stated purpose of the risk margin in SII was to make technical provisions compatible with the amount required to transfer liabilities to a third party. However, for longevity risk, the risk margin significantly exceeds the cost of external reinsurance;
- **objectivity** - technical provisions should be calculated in an objective and consistent manner;
- **applicability to different risks** - although our comments have focused on longevity risk, any approach should ideally work as well for short-tailed general insurance contracts. The P-MOCE under ICS may represent an ideal solution here since this has been designed to work for all insurance contracts;
- **avoiding procyclicality** - as noted above, the current operation of the risk margin may be exacerbating market cycles in long-dated interest-rates;
- **ease of implementing changes** - while the cost-of-capital approach was relatively complex to implement, it does have the advantage that insurers have now undertaken the necessary work. We note that the introduction of the tapering parameter would be easy for firms to implement. Whilst not all firms have taken part in the ICS field testing, implementation of the P-MOCE would also be relatively straightforward as it is derived from SII outputs that are already available;
- **consistency with IFRS17** - IFRS17 includes the parallel concept of a Risk Adjustment, albeit with a wider range of possible approaches. Ideally any SII approach could also be used for IFRS17, with minimal modifications. Based on what we have seen so far, firms appear to be adopting something more similar to the P-MOCE than to the cost of capital method under SII.
- **consistency with International Capital Standards (ICS)** - ICS, and international best practice generally, appears to be favouring the use of the P-MOCE approach over the SII cost-of-capital method;
- **impact on SII equivalence for the UK** - if relevant;

- **creating appropriate incentives** - the current calibration of the risk margin arguably over-incentivises the transfer of longevity risk offshore. It also has acted to increase the price and reduce sales of individual annuity business as reinsurance is harder to obtain compared with pension risk transfer business;
- **theoretical soundness** - potentially many of the criteria above could be met with simple techniques or pragmatic changes to the cost-of-capital method. However, it is also important that any proposals for the risk margin are theoretically sound.

Adjustments to the cost-of-capital approach: general insurance considerations

30. From a general insurance perspective, there is minimal appetite for material changes/ over-complication of the current risk margin methodology, which is already very complex. However, the cost of capital calculation does not reflect the current economic reality, and adjusting this approach could better-align with economic reality.
31. Conversely, adjusting the cost of capital could increase complexity (particularly if the calibration were to be dynamic over time). Any increase in the cost of capital during periods of stress or economic crisis could lead to adverse countercyclical effects, especially as interest rates may not currently be capable of absorbing shocks as much as they have done in the past.
32. Allowing for the dependency of risks over time has the attractions of being simple and pragmatic. From a general insurance perspective, its impact may also largely be limited to long-term business, although it could benefit general insurance firms with PPO liabilities.

Matching Adjustment

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

33. The ability for life insurers to be a provider of long-term finance across a diverse range of assets is of significant importance for a number of reasons, including:
 - supporting the UK government to achieve its climate change objectives;
 - providing much-needed financing to support the growth of the UK economy;
 - ensuring attractive annuity pricing for those reaching retirement;
 - facilitating greater diversification of asset risk across the industry.
34. To ensure these ambitions can be achieved, we believe there are three key aspects of asset eligibility for the MA which need to be revised:
 - requirement for fixed of cashflows;
 - the need for separate management of the MA portfolio;
 - eligibility criteria.
35. This does not mean a lowering of regulatory and capital standards, instead it means removing artificial barriers created by a set of rules which are black and white in nature. We do not believe that the changes will impact financial stability nor reduce levels of policyholder protection. Policyholders will continue to benefit from safeguards such as the Prudent Person Principle, internal governance frameworks and the (SM&CR) together with on-going regulatory supervision.

36. It should be noted however that in any extension of scope and eligibility of the MA, changes to MA framework should not dilute the MA benefit on existing assets.

Requirement for fixed cashflows

37. The SII rules require cash flows to be fixed (and further interpreted by the PRA to be fixed in both timing and amount). This is overly restrictive and:

- prevents investment in otherwise suitable backing assets for annuities; and/or
- adds a requirement to put in place expensive hedging/ structuring solutions for risks that insurers have historically been happy to accept and manage.

38. Much effort has been spent by the industry in avoiding relatively immaterial features in assets because of the binary nature of the rules, rather than necessarily posing a material real-world risk.

39. A more suitable framework would give firms more flexibility and allow for materiality considerations, but still with sufficient controls to ensure that cash flows are well matched. A range of techniques could be used to ensure sufficient matching, such as:

- limits around timing and amount such that a high proportion of expected cash flows are fixed or a time window around their receipt applies;
- allow firms to develop more bespoke cash flow modelling or haircuts (rather than needing to map to a prescribed Fundamental Spread);
- a scenario-based approach where several stresses are run to show that asset cash flows are not materially different to liability cash flows;
- the use of liquidity reserves to smooth out temporary cash flow shortfalls;
- a 'tiering' approach, whereby assets with an absolute fixed nature achieve a higher MA benefit than similar assets with more variable cash flows.

Separate management of MA portfolios

40. The interpretation of the requirements to separately identify, organise and manage the assets backing the MA portfolio is unduly restrictive. There are a number of areas that lead to firms spending time/ resources on the minutiae of the MA requirements rather than more fundamental areas of risk. Some examples include:

- costly restructuring of assets;
- separation of collateral requirements and their management;
- separate investment / cash accounting processes;
- structuring of bulk annuity contracts to ensure there are no non-compliant features.

41. It is questionable whether these requirements provide material benefits in terms of the management of the risks associated with annuity portfolios; if anything, the associated operational complexity increases the risk of non-compliance. Firms spend significant time on these aspects - an opportunity cost that could be better spent elsewhere.

42. As touched on above, the requirement to formally and legally restructure asset portfolios to meet the 'fixed cashflow' requirement within the SII Directive is an example of this:

- the restructuring of assets for MA purposes has been a defining feature of SII in the UK. Firms have utilised Special Purpose Vehicles (SPVs) in order to create instruments with the fixed cash flow nature required by the MA rules - as described above;

- the need for restructuring would diminish if a more flexible framework were adopted. For example, firms could determine whether a notional separation of cash flows (between those that are fixed and those that are not fixed) is appropriate, or whether a more formal structure (and full legal separation of cash flows) is required;
- we recognise that restructuring may help to create rigour around the separation of cash flows, however the costs (both setup and ongoing) associated with formal structures and legal separation are in many instances unnecessary.

43. We have set out a specific case study on Equity Release Mortgage (ERM) assets below to support this point around asset restructuring.

Case study: ERM restructuring

44. The PRA advised firms in 2014 that they would have to restructure ERM assets through securitisation. This would create MA-eligible senior tranches that provided sufficiently fixed cash flows to overcome the mismatch risks due to the variability in the underlying loan cash flows. The residual variable cash flows produced by the underlying loans would flow to the junior tranche holders. Both tranches are owned by the firm that owns the underlying loans. The senior tranche is assigned to the MA portfolio and the junior tranche assigned to a portfolio outside the MA portfolio.

45. It is important that firms have robust processes, systems and controls in place to identify, measure, manage, monitor and report their mismatch risk; this is to the ultimate benefit of policyholders and the wider economy. However, these benefits can be achieved without the significant cost in time and resources and additional operational complexity needed in the legal securitisation of ERMs: this legal form in itself makes no change to the insurers' risk exposure, as confirmed by the PRA, and adds no enhancement to policyholders' security.

46. The need to restructure ERMs at significant cost has created significant barriers of entry to new entrants and slowed the agility of innovation in the equity release market. By way of example:

- the securitisation approach requires the development and on-going cost of separate legal entities, governance and operational systems and resources to manage the securitisation. The expense is significant as it requires a variety of skills and competencies including legal, finance, actuarial, operational, treasury and customer areas;
- it introduces legal and operating complexity, such as formalised intra-company liquidity arrangements;
- an MA and internal model approval is required for the securitisation. These processes take up a significant amount of management time and resource including external support from legal and actuarial consultants. For example, the regulator is permitted 6 months to consider a firm's MA application from the point of receipt. The regulator permits one internal model application each year. Industry surveys have consistently shown that the approval process is a significant barrier to innovation where the process of adding new features to the MA portfolio such as ERM assets can take a number of years from start to finish;
- for standard formula firms, the securitisation approach is not financially viable as the capital charge is likely to be 100% of the value of the securitisation⁴. Therefore, firms wanting to restructure ERM assets are required to invest in the development of partial or full internal models

⁴ Under standard formula the ERM securitisation would be classified as a Type 2 securitisation and require an ECAI credit rating or approved internal rating from a credit institution. The spread risk capital charge is the product of $b \times$ duration capped at 100%, where b depends on the credit rating and duration is dependent on the tenor of the underlying loans typically at least 10 years or more. The minimum b can be is 12.5% for the highest possible credit quality step 0 equivalent to AAA ECAI rating. Therefore, for ERM Type 2 securitisation, AAA ECAI rated senior tranche with a duration of 10 years the capital charge would be 100% i.e. lessor of $12.5\% \times 10$ and 100%.

to enable the capital held to be appropriate to the underlying risk. The significant costs and capital inefficiency under the standard formula acts as a significant disadvantage to smaller firms and deterrent to new entrants. As a result, the ERM market is left to existing players and larger firms that have deep enough pockets and resources. This is not a healthy situation for any market but particularly for an important product in the later life lending market. The ERM market is expected to grow strongly with an ageing population and demand for financial solutions such as ERM to provide a safe and secure income in their retirement is likely to grow accordingly.

Eligibility criteria

47. The MA requirements have resulted in significant scrutiny of minor clauses of bond/ loan documentation. This has helped firms better understand the risks they are exposed to from individual assets and should be seen as a positive step. Examples include callable bonds and prepayment events.
48. However, the inability of firms to hold assets with any material prepayment or cash flow variability risks is not proportionate. For example, the current rules prohibit some 'market-standard' conditions within bond/ loan documentation such as credit related protections and early repayments. Some of the MA requirements can be difficult for borrowers to understand, potentially skewing market dynamics.
49. We encourage HMT (and the PRA) to review other equivalent regimes, as well as the emerging Insurance Capital Standard, to identify and incorporate pragmatic elements into UK regulations to ensure that the UK regime remains competitive.
50. Firms should be allowed to hold assets with such clauses, subject to appropriate treatment of the risks. For example:
 - callable bonds could be modelled on a less penal basis (such as yield to worst);
 - firms could hold capital against prepayment events (where they are only likely to occur when spreads are tight, this could be diversified against spread widening events).
51. In addition to the general changes to MA eligibility requirements suggested below, we would also recommend the following changes in relation to ERM assets:
 - include morbidity risk within permitted underwriting risks in the MA. This will address the fact that ERM assets are exposed to a risk not mentioned in Article 77b (1) (e). An alternative solution would be to apply a materiality threshold such that morbidity risk would need to be material risk exposure for it not to be compliant;
 - permit firms to hold ERM assets in the MA portfolio using 'notional' rather than 'legal' separation of the fixed cashflows from the rest of the underlying portfolio under the following conditions:
 - the firm only takes credit in the MA calculation for a fixed schedule of cash flows ('fixed cash flows') that can be supported by the underlying loan cash flows in both amount and timing under stressed conditions;
 - the firm will assign a credit quality step to the fixed cash flows in order to determine the MA calculation. The firm may use an internal credit assessment for the fixed cash flows in compliance with PRA supervisory statement 3/17;
 - residual cash flows from the ERM portfolio will be held in the MA portfolio and classified as component C assets that are deemed surplus to matching requirements;
 - permit internal rating assessments compliant with PRA supervisory statement 3/17 to be used to calculate the spread risk capital and MA under the Standard Formula or develop part of the standard formula that sets out standardised capital requirements for vanilla ERMs that are held

in the MA portfolio. This may require some adjustments to the standard formula to ensure that the amount of capital held for ERM assets remains appropriate, but such tailoring could be appropriate given the increasing importance of the asset class in UK insurance investment portfolios;

- a proportionate solution should also be found for calculating the standard formula SCR for the residual cash flows that are not in the MA portfolio (e.g. treat as Type 2 equity risk).

52. The rationale for these changes is:

- to maintain the resilience of the MA portfolio by ensuring firms only take credit for the fixed component of ERM cash flows;
- to reduce the significant MA compliance costs of the current securitisation approach which deliver no obvious benefit to policyholders or wider economy;
- thereby reduce the barriers to entry for new entrants to enable innovation and choice for consumers;
- standard formula firms should be able to take credit for internal rating assessments in the same manner as internal model firms.

MA considerations: general insurance firms

53. The MA is not of primary concern to most general insurers. Generally there is little desire for change to the MA from a general insurance perspective, other than a potential concern that any material changes to the MA may have second-order impacts on other SII operational processes, which may have unintended consequences for general insurers.

54. However, one notable exception relates to general insurers with Periodical Payment Order (PPO) liabilities. PPOs can be awarded alongside or as an alternative to lump sum compensation in personal injury claims. Existing MA requirements do not cope well with the idiosyncrasies of UK PPO liabilities. In particular, the use of the Annual Survey of Hours and Earnings (ASHE) data to index annual PPO payments (to meet inflation of costs) is problematic. Currently, there are no investment vehicles that have been shown to match to ASHE data. As a result, this increases uncertainty around whether the assets will cover the liabilities, and also reduces the ability of the insurer to apply an MA.

55. Changes to MA eligibility requirements for assets backing PPO liabilities would thus be beneficial, and could better reflect firms' actual management of PPO liabilities.

56. Most firms reserve PPOs based on Ogden-style process: i.e. where future mortality is based on general population mortality tables using the PPO recipient's true age with adjustment (an addition to age to give higher mortality) reflecting the expected longevity impact of the injury(ies); this would also use an interest rate to discount the future PPO payments combining an assumption about the future rate of indexation and the discount rate specified within SII. An MA process consistent with this (i.e. using a government defined assumption / prescription) would be most practical for general insurers with PPO liabilities.

57. The benefits of this simplification would be:

- the MA would affect a minority of general insurers and therefore a simplification would be practical and proportional relative to the overall liabilities held;
- the Odgen discounting approach is a well understood method within the UK market and therefore a similar approach for MA would not cause operational issues.

58. Disadvantages of this approach would be:

- risk of overconfidence on the Solvency Capital Requirement versus the statutory reserves because of lower discounting;
- given there are currently no ASHE-linked assets available on the financial markets such an adjustment would be incorrect from a technical point of view and risks understatement of reserves.

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

59. The future specification of the 'Fundamental Spreads' (FS) requires careful consideration in order to:

- strike an appropriate balance between technical dynamics and desirable balance sheet behaviour (e.g. higher degrees of market-consistency versus immunisation against short-term fluctuations);
- avoid unintended consequences (particularly at times of stress e.g. capital strain or procyclical investment behaviour).

Dynamics and behaviour under stress

60. The MA plays a vital role in immunising annuity writers' balance sheet from the effects of short-term fluctuations in credit spreads, helping to avoid procyclical investment behaviour and allowing annuity writers to deploy capital over the long term. A critical element of the MA calculation are the FS prescribed haircuts to be used in the calculation to allow for defaults and downgrades.

61. The FS - mainly based on 30 years plus of historical data - are relatively stable, which could mis-state future expectations of loss (both during benign conditions and at times of stress). Considered in the context of total credit risk provisions (incl. SCR), this may be particularly relevant for standard formula (and some internal model) firms where the stressed level of FS (and hence SCR) is calculated independently from the starting (or best estimate) level of FS. Conversely, some internal model firms may be able to adjust the SCR to reflect a more risk-based view of overall credit provisions, allowing for the risk (and any prudence) already captured by the FS at any point in time.

62. It is important that the FS methodology is transparent and allows the haircuts to be reliably determined in an objective manner. Therefore we do not advocate wholesale changes to the current approach and, for example, we do not believe that a forward-looking, market consistent approach should simply be adopted (not least because of the challenges of trying to deduce a market-based illiquidity premium). Instead, we recommend a comprehensive review of the current methodology to ascertain which aspects should be refined. This review should examine whether:

- the expectations of loss retained by insurers are properly reflected by the FS;
- there is a clearer link between day-to-day balance sheet behaviour (e.g. changes in FS) and more extreme stresses or risk (e.g. calculation of SCR and its interaction with the FS).

63. These issues are technical in nature. It is therefore vital that the industry is given sufficient opportunity to provide input into any future review. This will help to ensure there are no unintended consequences for areas such as

- firms' investment behaviour;
- double-counting of provision between the various SII balance sheet components;
- effective risk management.

64. Care is also needed to ensure that any methodology is transparent and allows the FS to be reliably determined in an objective manner.

Specific changes to be implemented

65. One area of excess prudence that is not as easily absorbed through the SCR arises when calculating the MA for sub-investment grade bonds. We advocate the removal of the so-called ‘BBB cliff’ whereby the MA benefit that may be taken on sub-investment grade assets is limited to that from similar BBB assets. This restriction is not, in our view, risk-based and there are other safeguards within the SII regime e.g. the 1 in 200 capital requirements that make this restriction unnecessary. If this restriction were not removed, then alternative approaches to mitigate ‘cliff-edge’ effects should be considered.

66. We also suggest the following specific changes (independent of broader direction):

- publication of a more granular set of FS tables (beyond rating, tenor and fin / non-fin), or the ability for firms to propose their own, approved methodology. For example, to make better allowance for esoteric risks embedded in infrastructure assets or expected recovery rates in private debt;
- removing the long-term average spread (LTAS) part of the FS calculation.

Other areas of concern / potential technical inconsistency

67. Other areas of concern or of potential technical inconsistency are the:

- inclusion of assets with maturities beyond the lifetime of the liabilities within the MA calculation. Such ‘tactical’ mismatches can be used to boost MA benefits;
- approach for allowing for risks retained when assets are paired with derivatives (e.g. swaps);
- distinction between ‘Component A’ and ‘Component B’ assets. We query whether the assets backing the Best Estimate Liabilities need to be split into these two components (as well as performing certain matching tests using the Component A assets only).

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

68. The MA approval process is widely regarded as too bureaucratic and taking too long for approvals, with significant effort expended by both the firm and the PRA. This arises primarily from the requirements of paragraphs 2-5 of the MA Implementing Technical Standard (Commission Implementing Regulation (EU) 2015/500), and also the PRA’s interpretation of these requirements. The interpretation and subsequent implementation of this should be reviewed to remove excessive or inefficient requirements.

69. The penalty for non-compliance with the MA requirements, i.e. total loss of MA, are such that firms have no appetite for breaching the rules. This leads to a process whereby firms pre-apply for MA approval before investing in assets. If firms can be more confident that their reasonable assessments of MA eligibility will not be overruled by the PRA (followed by a potentially costly unwind), or that appropriate approval applications will be efficiently executed, firms may be more inclined to invest more readily in a broader variety of MA-eligible long-term opportunities.

70. By way of example, the current MA approval process in respect of ERM assets is costly, time-consuming and inhibits management ability to plan ahead. A new application process from start to finish can last more than 24 months, and firms can be forced into buying assets / liabilities and

holding them in a capital inefficient way until this process has concluded; PRA approval cannot be granted in advance of the new features being on the balance sheet. Whilst ERM assets are a clear example, these issues are not unique to this asset class.

71. The consequences are higher up-front capital strain for writers, lower productivity and innovation in the market.
72. An example of another, more appropriately defined, approval process within UK regulation already is with Insurance Special Purpose Vehicle (ISPV) authorisation in the UK. At the highest level, the PRA's process (as set out in supervisory statement 8/17) for initial ISPVs:
- allows approvals to be granted in advance of execution, subject to final terms being provided to the regulator post execution;
 - allows companies to obtain approval for a range of future transactions within this initial scope;
 - has a 6-month approval timetable that can be accelerated to 6-8 weeks for vanilla deals with effective PRA pre-engagement.

Approvals process and accountability

73. We recommend that an approach be adopted whereby firms can self-approve minor or less material changes, which the PRA could monitor retrospectively, but where firms would have to approach the PRA for approval of more material or less straightforward arrangements or proposals. This could reduce the scale of review effort required of the PRA while allowing firms more certainty.
74. We would also recommend greater transparency from the PRA in:
- sharing information/ examples of good practice within MA portfolios. This would benefit both existing participants and new entrants;
 - developing standardised approval sets/ features/ structures that are commonly and openly shared to improve the speed and efficiency of the approval process, with appropriate incentives put in place to avoid the desire not to be 'first mover'. This would benefit both consumers, firms and the wider economy through supporting innovation and promoting competition in the growing retirement market e.g. wider choice of later life lending solutions for growing older age group, support agile and productive firms seeking to improve customer outcomes.
75. Given the increased accountability of those running insurance firms, through the SM&CR, we consider that HMT and the PRA could place much more reliance on the judgment and responsibility of such individuals who manage MA portfolios to assess MA eligibility.

Approvals process and changes to approvals

76. The PRA's approach to major/ minor internal model change approvals could be mirrored for MA approvals. Alternatively, perhaps an approach similar to that taken by the PRA on longevity risk transfers, as set out in PS1/20, may be more appropriate; here 'large or complex' changes would require PRA pre-approval, with firms approving and retrospectively notifying the PRA of changes not meeting this trigger.
77. This process could be formalised through a firm's MA documentation, which could set out the internal governance pathways and triggers for pro-actively raising proposals with the PRA, drawing on paragraphs 9.4 and 9.5 of PRA SS7/18.

78. The PRA would review the principles, internal governance framework, and internal approval pathways set out by a firm in the firm's MA application, or any necessary subsequent updates. The PRA would then place reliance on the firm's internal governance and transparency of reporting, as an extension of paragraph 9.3 of PRA SS7/18.
79. An important consideration for firms is to be wary of an aggregation of features, which are each MA-eligible in isolation, but when considered collectively present a single asset, liability or other arrangement that would not be judged as MA-eligible when assessed directly against the original MA approval.
80. We recommend revising the position that MA approvals can only be obtained once respective assets/liabilities are on the balance sheet, to remove the need for firms to take short term capital inefficient positions due to regulations.
81. For ERM assets, we recommend a fast-track approach for new product features that do not require a complete new MA application, subject to a materiality threshold.
82. We also recommend that (the PRA) seek to be more pragmatic in the documentation and data it asks of firms to support MA applications. Firms should be able to point to Quantitative Reporting Template data, responses to previous information requests, or existing internal documentation, rather than producing lengthy bespoke documentation, management information or analyses. We note that the wider reforms of data collection by the Bank of England may well assist in this. Firms could provide the PRA with a roadmap of larger expected MA developments, to assist with planning.

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

83. Insurers can play a key role in supporting and funding UK infrastructure development. However, in order to participate in infrastructure and other long-term productive asset classes, expertise within such asset classes and an understanding of the risks inherent in individual assets is essential.

Flexibility needed for MA eligibility

84. Infrastructure and other private asset classes introduce features and risks to an insurance balance sheet that are not present in a 'vanilla' corporate bond portfolio. Whereas capitals models may allow for flexibility of treatment, and the opportunity to develop an appropriate treatment for such asset classes, the MA framework is not adaptive to these characteristics.
85. Infrastructure assets are highly idiosyncratic, and greater flexibility and operational ease of determining the MA eligibility of single features is key, as firms look to include a wider array of projects and asset variants within MA portfolios.

Infrastructure-specific calibrations

86. Infrastructure-specific calibrations - and more generally, calibrations on other assets with lower expected default losses - would be consistent with a lower level of risk due to the nature/ features of such assets.
87. Projects can be made more economically attractive by reducing the associated capital charge, made conditional upon specified project requirements. Capital incentives are included in the standard formula capital framework for insurers, and a number of internal model firms have been able to

reduce the capital requirements for infrastructure and other long-term assets. A similar incentivisation can be achieved through adjustments to Fundamental Spreads specific to certain asset classes.

88. Default and downgrade adjustments can be modified, either at an industry standard-level, or by permitting firms to calibrate their own, where assets provide additional security. Default and credit migration adjustments can reflect an increased recovery rate, the stability of underlying cashflows, and the availability of future capital support.
89. A data-driven calibration for infrastructure and other private asset classes may evidence a lower expected loss, or reduced likelihood of credit migration, based on historical experience in these asset classes. Related studies on this topic are available from a variety of sources (e.g. [EIOPA-16-490](#), [S&P Global](#), [Schroders](#)).
90. The capital structure of infrastructure projects may include both equity and debt components, and wider investment can be encouraged by supporting investment in both parts of the capital structure, reflecting the long-term nature of the equity investment and shared characteristics with the accompanying debt.

Impact of credit quality and central bank support

91. Many projects, particularly those associated with emerging technologies, hold lower credit ratings. Where these issues are sub-investment grade, regulatory capital and non-economic features in the MA treatment makes investment less economically attractive, and internal investment constraints around credit quality act as a further deterrent.
92. State agencies can incentivise investment by providing explicit support to service and maintain this debt, improving the credit quality and increasing the insurance investible universe. Implicit state support could also be reflected where strict legally binding state support is not present.

Requirements on insurance company internal capabilities

93. In order to invest in infrastructure and other long-term productive assets, firms are developing significant internal capability in investment class expertise within asset management and the ability to independently generate credit ratings consistent with those of an External Credit Assessment Institution (ECAI).
94. This presents a significant barrier to entry for smaller firms without the scale to develop these functions, and are excluded from investment in these asset classes. Supporting a greater use of external managers and expertise, within the framework of the Prudent Person Principle, would allow more market participants while reducing the burden for firms maintaining these internal functions.
95. The participation of more firms in the ERM market would be supported by reducing the significant barriers to entry as a result of the MA. *See response to Question 4 for recommended actions to lower these barriers and support growth and innovation in the ERM market.*

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

96. Embedding climate change is a rapidly evolving area for insurers. Where risks are not factored in today, we expect this to happen in the near-term. We favour incentivisation of 'green' investment rather than overly penal disincentives for 'brown' asset classes, noting that sectors considered

'brown' must also be part of the solution to the challenges of climate change. As the risks for 'brown' assets are factored-in, we expect a natural shift towards greener investment.

97. To encourage and speed up this process, there are a number of approaches to incentivise and contribute to sustainable investment including: government subsidy, guarantees for green investments and expanding the universe of assets that MA funds may invest in. A further option may be through favourable tax treatment.
98. The MA could better reflect climate change-related risks arising from investments by considering how these risks are reflected in:
- internal credit ratings (note this is not a change to the MA itself);
 - MA-eligibility, and management of the MA portfolio;
 - calibration of the Fundamental Spread.
99. Given that this is an evolving area, there will be practical difficulties to overcome - such as limited experience data. It is important that these difficulties are not used as reasons to restrict firms from investing in green investments. Expert judgement techniques may need to be relied on, similar to what we see applied in formulating the calibrations for other new and emerging risks.

Internal credit ratings

100. In principle, credit risks of investments (including those from climate change and other Environmental, Social and corporate Governance [ESG] factors) are captured within the assigned credit rating. This determines the allowance for this risk in the MA (through the fundamental spread which corresponds to that rating). This is an area of focus from ECAs.
101. The PRA expects firms to have fully embedded climate change in their risk management frameworks by the end of 2021 (cf 'Dear CEO: Managing climate-related financial risks' letter from Sam Woods). As these approaches mature and fully-embed, there can be greater integration of ESG considerations into internal rating models and internal governance processes.

Eligibility and portfolio management

102. To make significant shifts to greener investments, firms will need greater scope to conduct higher levels of trading into greener assets, rather than hold less green assets purely to satisfy the 'buy to hold/ maintain' criterion of the MA.

Calibration of the Fundamental Spread

103. The calibration of the FS could be enhanced to be more forward-looking, (rather than based on historical default/ downgrade data), and consider emerging risks including climate change and wider ESG in its calibration.
104. Reaching a forward-looking view to quantify the risks of climate change is challenging. There are limited data and tools currently available and the degree to which physical and transition risks manifest themselves is highly contingent on the speed and scale of government responses around the world. Sizing this might be informed by results from the PRA 2021 Climate Biennial Exploratory Scenario (CBES) exercise.

105. We support changes to the FS to recognise genuine differences in default/ downgrade risks between 'brown' and 'green' investments'. This would incentivise sustainable investment as it would mean a larger MA benefit from these investments.

MA and sustainable investment: Equity Release Mortgage Assets

106. ERM assets provide funds that give an opportunity for customers to invest in their homes to reduce their carbon footprint, through use of renewable energy and reduction in energy consumption via means such as insulation and triple glazing. We therefore see an opportunity for ERM providers to offer incentives to customers (e.g. through lower pricing or other benefits) to invest some of the funds released in this way.

107. To help incentivise insurers to provide these benefits, the MA could potentially reflect these climate benefits in some way through a:

- revision to the FS applied in the MA calculation (as described above);
- lower deferment rate used in the PRA's Effective Value Test.

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

108. The benefit of changes (and any implications for safety/ soundness of insurers) are discussed in our answers to questions 4 - 8 above.

109. As mentioned in our response to question 4 however, we do not suggest in any way that the requirements or way in which firms comply with Prudent Person Principles requirements are softened. In allowing a more flexible approach to achieving MA eligibility, we would also expect the PRA to put in place measures to ensure that there is no inadvertent weakening.

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

110. The process for making changes to existing MA approvals can be inefficient. This is particularly the case for incremental changes to firms' existing MA approvals. We have proposed next steps in our response to question 6. In our view, these approaches will help to change the existing process to be more flexible, transparent, and proportionate.

PRA matching tests

111. The PRA sets out three matching tests and thresholds in PRA SS7/18. The design and thresholds of the tests have not changed since publication.

112. We recommend that the PRA review the formulation and appropriateness of the tests and thresholds to ensure they contribute to good risk management and protection of policyholders, while not being overly-restrictive or giving rise to unintended consequences.

113. Additionally, the tests and thresholds may need to accommodate any changes made to other areas of the MA as a result of the SII review; for example, if eligibility requirements are broadened, the 3% threshold in Test 1 may need to be more dynamic.

Two-month window to restore compliance

114. Where a firm's MA portfolio(s) do not meet the MA requirements (a 'breach'), the firm has two months (as per legislation) to restore compliance. Failing this, the MA is then withdrawn for two years.
115. We suggest the PRA reconsiders the appropriateness of this very short time period and potential unintended consequences (e.g. firms disposing of assets to detriment of policyholders). In addition, we see no logic or policyholder benefit for the need for the MA to be withdrawn for two years; we believe the MA should be restored as soon as compliance is restored.
116. It would also be useful to clarify the range of management actions available to firms to restore compliance. For example, we consider it appropriate for a firm to be able to remove a subset of liabilities from the MA portfolio until such time as compliance can be restored.

Work of external auditors on the MA

117. The PRA could increase its reliance on the work of external auditors on the MA, as consulted on within PRA CP11/20. This may work well in combination with our suggestions for changes to the MA approval process set out in question 6; for example, where external auditors can carry out an assessment of firms' changes against its change policy. Note that the IFoA responded to this PRA consultation; in our response we suggested the PRA's proposals needed refinement in places, including guidance on the general information sharing/ reporting process between the auditor/ the firm's senior management/ the PRA.
118. In addition to the proposals in PRA CP11/20, external auditors could be asked to assess whether a firm manages its MA portfolio in line with its approved MA application, and notify the PRA where it does not.

Increased individual firm guidance and feedback

119. As noted in our answer to question 6, when firms develop their approach to the MA (e.g. adding new asset classes to their MA portfolios), the process for making changes to existing MA approvals can stifle firms' ability to innovate and react quickly to effectively manage their business.
120. In addition to our points made to question 6, more direct and timely feedback from the PRA on what it considers to be MA-eligible, and providing lists of approved assets/ liabilities/ management approaches could help facilitate innovation/ timely business management. It could also remove the likelihood of (lengthy) dialogue between a firm and the PRA.

Additional issue on MA: Treatment of liabilities under MA

121. The Call for Evidence does not explicitly consider changes to the liability rules under the current MA framework. Nevertheless, there is scope for potential improvements to the eligibility requirements which would enable the MA to operate in a more beneficial manner for policyholders and pension scheme members. Of particular importance is the requirement around policyholder surrender options and future premiums.
122. The rules require that the exercise of surrender options should always be done on cost-neutral terms. The scope of cost-neutrality is typically interpreted relatively narrowly; e.g. equal to best estimate liabilities (with some margin for error around this). This means that any benefits being surrendered require a material haircut relative to the premium originally paid to the insurer.

123. The rules also place implicit limits on the level of restructuring a pension scheme can effect after entering into a buy-in with an insurer. Many pension schemes rely on liability management exercises and future sponsor contributions on their journey to buyout. Additional flexibility may be especially valuable to pension schemes that have sponsors in financial distress.

Surrender risk capital

124. Any payments that insurers make in excess of cost-neutral would lead to losses relative to their best estimate liabilities. The current MA rules are set up to prevent this and maintain integrity of the cash-flow match. However, insurers do not only hold best estimate liabilities; they also hold a risk margin and SCR. One potential alternative to mitigate the risk of loss on surrender could be for insurers to hold additional capital against these losses (i.e. within the SCR). Provided their total capital buffers are sufficient, firms would have more flexibility with any additional risk capitalised.

Future premiums

125. Prior to SII, it was much more capital-efficient for insurers to issue deferred premium products, which offered certainty to those pension schemes depending on future sponsor contributions to reach buyout. However, under MA rules, liabilities secured through future premiums are ineligible. We believe some flexibility in the MA rules (for example allowing the non-MA fund to provide a loan to a scheme or its Sponsor) could encourage innovation in this area, offering a wider range of de-risking choices to pension schemes.

Flexibility for liability management exercises

126. Recently emerging Superfunds/ Pension scheme consolidators, aimed at achieving affordable de-risking for pension schemes, typically highlight liability management exercises as a key part of their business strategy. It follows that more flexibility for insurers could similarly unlock value for pension scheme members - if trustees wanted to follow a buy-in or buyout route.

127. Member benefits could potentially be secured earlier if trustees were given more flexibility to trigger exercises post buy-in. Such flexibility is unlikely to be compatible with the current MA rules, e.g. given the potential for surrender risk or future premiums. However, insurers may be able to facilitate them, provided they put in place frameworks or rules governing how exercises are conducted. The aim of such a framework should be to ensure that any risks for the MA portfolio can be appropriately mitigated and managed.

Uplifts to policyholder benefits post buy-in or buyout

128. Where a buy-in is in place, insurers could consider arrangements with the pension scheme to share any excess surplus realised on surrender. This idea could possibly be extended to buyout.

129. Where such an arrangement is contractual, it would require insurers to reserve for surplus outside of the MA portfolio. We believe that, under the current rules, such an approach would not meet the MA eligibility requirements.

Calculation of the solvency capital requirement

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

130. Insurers already produce substantial amounts of information which can be used to assess the adequacy capital holdings. In addition, the PRA has made a number of requests for information, including industry stress tests and specific analyses of some items of interest. Furthermore, the PRA undertakes thematic reviews or insurer site visits. Although these tools/ reviews should be sufficient for supervisory needs, it would be helpful to have a clear steer from the PRA on which tools/ metrics it does use in its capital assessment work; this would help firms prioritise their efforts to the most important tools/ measures.
131. There is also a significant focus on benchmarking to ensure appropriateness of capital levels. Whilst benchmarking is a common and useful tool to assess the overall level of capital held by firms that can identify outliers and areas for further investigation, some caution should be taken to prevent over-reliance on benchmarking. It is very difficult to appropriately allow for differences between firms' risk profiles. When comparing absolute amounts, factors such as investment portfolio, legal entity structure, product mix and reinsurance strategy need to be considered to avoid comparing 'apples and oranges'. There may be genuine reasons for firms having significantly lower or higher capital requirements than their competitors. Internal models create an incentive for firms to compete with one another on risk understanding and risk management, because innovative ways of mitigating risk can be reflected in reduced capital requirements.
132. Over-reliance on benchmarking may lead to herding behaviour whereby firms adopt the same models and assumptions in order to secure regulatory approval. Arguably one of the causes of the 2008-2009 financial crisis was over-reliance on a single model for Collateralised Debt Obligations (CDOs) secured on US sub-prime mortgages. In particular, the users of the models for CDOs did not understand their limitations and appropriately adjust for them. The use of different internal models across the industry removes this systemic model risk, and replaces it with idiosyncratic model risk strengthening the stability of the financial system. Moreover, there are requirements for firms with internal models to have them independently validated, which mitigates the idiosyncratic model risk.
133. An additional tool that would be useful for supervisors is a standard model calibrated 'to-ultimate', i.e. to the point where all liabilities are paid. Existing tools focus substantially on 1-year measures of solvency and not the ultimate time horizon. The ultimate time horizon corresponds most to the needs of policyholders. The 'to-ultimate' model would also assist supervisors in assessing situations where the liabilities stretch a long period of time into the future, and would benefit both life and general insurers and their customers. However, care would be needed with a 'to ultimate' approach, to avoid the risk of over-capitalisation.
134. It would also be useful to extend the use of stress and scenario testing to both standard formula and other internal model firms. Whilst there are limits to benchmarking the results from these stresses, it could help reduce regular thematic regulatory reviews, the number of reports/ disclosure and extent of ad-hoc data requests.
135. The current lines of business used in premium risk and reserve risk could be defined into more granular 'buckets', so that they distinguish risks better, especially 'general liability' and 'miscellaneous' categories. This may help the regulator develop a clearer view of the specific risk profile of given insurer, reducing the need to request multiple sets of data.

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

136. Under the current approval process, a firm that identified (i) a major new risk, (ii) a significant increase in the magnitude of an existing risk, or (iii) a change in risk profile in response to advances in data or methodologies, may be constrained in their ability to react quickly and allow for these dynamics within their detailed internal model by the process to obtain prior regulatory approval. The current approval process requires a long re-engagement timeline and submission of completed documentation six months in advance. In practice there is only one scheduled opportunity to do this in each year.
137. The documentation required is also very onerous. It should be proportionate and take a more principles-based approach.
138. The current approval process for new internal models and changes to models is also onerous for Lloyds of London/ the wider London Market. The current process results in many major changes being triggered by the aggregation of minor changes, leading to a large work-load for firms and their supervisor. It also discourages firms from using their models widely in the business, for fear of this use being curtailed by the inability to make changes to the model in a timely manner.
139. Within the UK's former ICAS regulatory regime, the possibility of a capital add-on covered situations where a firm's management disagreed with the regulator as to the appropriate methodology or assumptions to use. This supervisory tool could be used either indefinitely to reduce the overall burden of the approval process, or during an interim period whilst approval is being sought to reduce the timelines. However, some care would be needed with such add-ons to avoid unintended consequences, such as situations where firms might become over-capitalised.
140. There were a number of flaws with capital add-ons under the ICAS regime. Some useful safeguards for the future use of capital add-ons could include the:
- need for agreement for the use of the add-on between the firm and the PRA. In the event there is no agreement, the application for change may be withdrawn by the firm;
 - reason for the add-on should be clearly articulated;
 - methodology and basis for the add-on calculation should be clearly defined and agreed between the firm and the PRA. Capital add-ons under the former ICAS regime were reported privately. There would need to be some form of disclosure given the public basis of SII;
 - steps that the firm has to take to remove the add-on are clear, well-defined and achievable.
141. Part approval of an application, or a requirement from the PRA to run the proposed internal model on modified assumptions, would be alternatives to rejection.

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

142. The standard formula was calibrated on European data. Although the UK provided some input to the calibration, the results are naturally different from what a hypothetical standard formula calibrated on UK data would look like. It is therefore not surprising that the standard formula is unsuited to the risk profile of the UK insurance industry in some respects. These include:
- the catastrophe risk charge for non-proportional property reinsurance;
 - risk mitigation in the catastrophe risk module;

- calibration of Cov premium risk and reserve risk;
- diversification assumptions for casualty business and for natural catastrophe exposures;
- charges for fixed income investments;
- index-linked liabilities, including PPO liabilities.

143. A recalibration of the standard formula based on UK data would therefore improve its appropriateness for the UK. Such a recalibration should however maintain SII equivalence in order for its benefits to outweigh any costs.

144. It is clearly in the wider public interest that interested commentators have a way of comparing the capital requirements of internal model firms. Whilst using the standard formula is one way of achieving this, internal model firms generally have complex structures, which are not well-captured by the standard formula. In these circumstances the standard formula may not be an appropriate benchmark, and other alternative disclosures could achieve a similar outcome at a lower cost to the industry.

145. Insurers are obliged to include Internal Model and Standard Formula comparisons in their SFCRs and form part of the Own Risk and Solvency Assessment (ORSA) process. However, there is minimal benefit for Lloyds syndicates and UK insurers who are using Internal Models in making such comparisons. In these cases the Standard Formula calculation is unlikely to be used elsewhere in such firms other than for this report. Hence, it would be beneficial to cease this requirement to run these calculations in parallel, given Internal Models are much more bespoke and complex in nature and are used by the firms to run their business. Internal models are also subject to extensive review and validation (internally by risk, externally by Lloyd's LCR submissions and by the PRA).

146. However, where companies do not have an approved internal model, it may be useful to include a means by which to reflect the risks of ERM assets within the standard formula to remove this barrier to entry.

147. The standard formula could make some allowance for climate change, with lower charges to incentivise investment in 'green' assets. However, this needs to be carefully considered as the categorisation of investments into 'brown' and 'green' is complex and should not be oversimplified. An orderly transition requires many of the high carbon emitters to transition their business model to support the climate change agenda, supported by institutional investors. Penalising these issues through higher capital charges would stifle the investments necessary to support their transition activity, especially if this was the only response applied. Further, a blanket increase in capital charges could reduce the international competitiveness of UK firms.

148. Given the increased accountability of those running insurance firms, through the SM&CR, we consider that even within the standard formula calculations, the HMT and PRA could place much more reliance on the judgment and responsibility of such individuals. For example, by allowing increased usage of internal robust risk assessments (such as internal credit ratings that incorporate an assessment for future credit impacts from sustainability impacts). Encouraging firms to reflect their risk exposures within the standard formula capital requirements and incorporating emerging best practices in a controlled, but flexible framework.

149. The premium risk calculation in the standard formula does not currently take account of a firm's expected underwriting profits. When a firm is making profits, the SCR may be relatively high; when the firm is loss-making, the SCR may be relatively low. It would thus make sense for the standard formula to reflect the expected profits.

150. Natural Catastrophe risk is currently split into individual EEA countries, and further split into CRESTA zones; all of these segmentations have individual parameters and dependencies. This contrasts with some countries overseas which are grouped at a high level: e.g. the US is split into North-East, South-East, Mid-West and West. The result is a poor mapping of the firm's true risk profile if they write business in such territories. To date, most UK entities with significant natural catastrophe risk would have opted for an internal model; those that have not are likely to have less overseas country exposure. Going forward, it may support UK firms to define the overseas countries in a more granular basis in order.

151. A number of risks are not reflected explicitly in the standard formula:

- inflation risk - given insurers with index-linked liabilities are likely to hold index-linked assets, it is sub-optimal that inflation risk is not modelled explicitly. There is also a mismatch in the context of PPO liabilities, given that they are subject to escalation in line with the ASHE index. Inflation may be less material currently given inflation is low, but it could be a greater problem with high inflation;
- PPO reserve risk is modelled through 'annuities stemming from non-life', but the basis of that line of business's reserve risk parameter was calibrated for annuities, which is inappropriate for PPOs. Whilst annuities and PPO have similarities, there are differences: annuitants are likely to be older and a relatively healthy population; whereas PPO claimants are likely to be younger and suffer from long-term illness. Firms that have significant PPO risk may have pursued internal models. Going forward, specific separate treatment of PPO liabilities would be helpful if firms are to compare meaningful results against their internal model;
- likewise, PPO premium risk is modelled under 'motor liability', but again the calibration of that line of business's premium risk parameter does not include PPOs which is largely a UK concept rather than being prominent in the EEA;
- pension risk arising from defined benefit obligations.

152. Costs or disadvantages to adapting the standard formula include:

- wholesale adaptations to the standard formula by a wide range of firms would reduce the extent to which the standard formula were regarded as a 'standardised' capital requirement;
- where firms have a challenging approval process for the use of (standard formula) undertaking specific parameters, the process could be akin to a shadow internal model approval process;
- a firm using an internal model could find (even) less value in producing standard formula calculations (and associated disclosures).

153. Benefits of adapting the standard formula include:

- the option of an intermediate approach between the 'default' standard formula and an internal model. This intermediate option could see fewer firms running expensive internal models, and consequently a lower regulatory burden;
- the standard formula could be adapted to reflect more granularity of risk, such as allowance for climate change and the non-life risks noted above. Greater use of a revised standard formula approach (where more appropriate to a firm's risk profile) may reduce costs for the insurance industry overall.

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

154. More use of undertaking-specific parameters or modifications to the standard formula to adapt it to the specific risk profile (subject to supervisory review).
155. The supervisor's own to-ultimate model could be used as a tool to calculate SCR for these firms and to come to an agreement on an appropriate capital add-on.

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

156. The UK insurance and long-term savings industry is responsible for the stewardship of circa £1.7 trillion assets⁵ and there are potential societal benefits should more of these assets be used to fund long-term productive assets.
157. By their nature, less 'standard' assets are less likely to fit into the tick-box requirements of more established assets. There is often insufficient data to calibrate and model idiosyncratic risks and so proxies and expert judgements are required. A more pragmatic and principles-based approach would be helpful. Where there is a lack of data, it can be challenging for a firm to evidence to current regulatory standards their true assessment of the risk profile of such assets, and thus justify an appropriate capital requirement. In many cases, the asset classes are new and innovative, and companies are exploring them in the light of potential capital requirements; a pragmatic approach would also be important for the encouragement of 'green' investment.
158. Alongside allowing life insurers the ability to hold ERM assets in the MA portfolio without the need for a securitisation structure, we would recommend that standard formula firms are able to assign credit quality steps based on internal rating assessments that are compliant with PRA SS 3/17 for the purpose of calculating MA and incentivise increased infrastructure investment. A further alternative would be to develop part of the standard formula that sets out standardised capital requirements for vanilla ERM assets that are held in the MA portfolio. In addition, allowing standard formula firms to assign credit quality steps based on external Asset Manager credit ratings (which are not an ECAI rating) could encourage investment in Infrastructure and other long-term productive assets. Firms would be able to benefit from investing in highly rated projects, which are currently treated as Credit Quality Step 3 where not rated by an ECAI.
159. Arguably one of the lessons learnt from the attempts made by the European Commission/ EIOPA to amend the standard formula to stimulate greater investment in assets such as infrastructure was that any such methodology change should be applied pragmatically to target a desired policy outcome, rather than expecting a technical recalibration to necessarily produce the desired result. An example is permitting firms that increase their investment in specified asset classes beyond that set out in their current five-year business plans to hold a reduced capital amount (for example at a 1-in-100 year level) on the additional marginal investment in long-term productive assets.
160. An alternative to methodology change would be a government sponsored reinsurance vehicle that paid an additional recovery rate on defaulting long-term productive assets. Even if government

⁵ UK Insurance & Long-Term Savings Key Facts, ABI, December 2019

sponsorship was designed to only be required 1-in-100 years (so in practice might never be required), it could produce an immediate reduction in capital requirements and incentive for greater investment.

161. Similarly, a government sponsored remediation vehicle that worked through long-term productive assets suffering short term issues, could remove the barrier to investment whereby firms must convince their boards and the regulator that they have the capability to manage these illiquid assets throughout the entire lifetime of the asset. For example, an insurer investing in infrastructure debt being used to fund construction of a hospital currently needs to consider the scenario where they become the owner of a partially constructed hospital, which may be outside their area of expertise.
162. There may be a greater barrier to investment in long-term productive assets on the supply side and so an argument against making such changes would be that it may simply drive up prices of the existing pool of assets without necessarily leading to a greater quantity of long-term productive assets available for societal use.
163. Allowing general insurers to use to-ultimate methodologies to assess their SCR would help make it easier for general insurance investment in assets of greater duration. This would support the government's objective of enabling more investment in infrastructure. 'To-ultimate' methodologies are also more consistent with capital modelling performed by general insurance firms, which tends to be on an economic basis.
164. As mentioned in question 13, there may be limited benefit in insurers with internal models also having to run calculation exercises using the standard formula.

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

165. The capital requirement should focus on capturing the uncertainty and variability underlying the own funds and to be meaningful must be consistent with these best estimate assessments. In respect of climate change this means that the proposals to encourage better measurement and capitalisation of these risks have been outlined in our response above should be incorporated into the capital assessment.
166. Additional supporting guidance on the considerations that firms should take into account to highlight the unique challenges associated with climate change related risks would encourage further actions from companies to ensure a consistent approach across the industry.
167. A consistent approach could also be encouraged by:
- identification/ reporting of assets to help determine suitable loadings;
 - enhanced reporting of catastrophe probable maximum losses/ alternative assumptions;
 - creation of 'qualifying investments' class, with qualification to be based on principles, attested by the firm's Board;
 - if the associated disclosure were not onerous, it may also encourage greater 'buy-in' to such reporting as being 'standard'.
168. The one-year time horizon of the SCR calculation makes it difficult to make allowance for climate change-related risk, whereby many of the risks are longer term. The SCR calculation could be modified to put the ultimate time horizon at the centre of the calculation, for general insurance firms. This would promote better measurement and capitalisation of climate change-related risks, given the time horizon relevant to climate change-related risks. This approach also provides better protection for policyholders, as they are reliant on the insurer's solvency beyond a one-year time horizon.

169. There may also be more scope to consider the impact of climate change-related risk within a firm's emerging risk framework, or their ORSA / SFCR reporting (e.g. scenarios around potential future climate behaviour).
170. With respect to general insurers, where products are typically repriced on an annual basis, much of the increased costs are likely to be passed on to consumers; for example, reinsurance costs for catastrophes arising from weather events. Whilst this creates its own issues, in respect of the SCR in this example it may be that limited additional capital would need to be held.
171. The regulatory regime should include sufficient flexibility to accommodate future developments in order to avoid multiple regulation changes in future.
172. A lower capital charge could be justified for 'green' assets that are likely to benefit from policy changes required to transition to net-zero emissions (e.g. subsidies and carbon pricing). Due to the lack of historical data or means to demonstrate that the 'green' assets entail lower risks than 'non-green' ones, calibrations of climate risk factors will need to be judgement-based.

Calculation of the consolidated group solvency capital requirement using multiple internal models

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

173. The two approaches currently used to incorporate an acquired group into the acquirer's group SCR are via the standard formula (on a consolidated basis), or by using the acquired insurer's existing internal model (on a deduction and aggregation basis). Neither approach may lead to the overall group SCR reflecting the risk profile of the enlarged group.
174. The existing SII framework includes an ability for a capital add-on to be applied at the group level (e.g. see article 232: Group capital add-on of the SII Directive). The real or perceived difficulties in applying such capital add-on could partly explain the workarounds observed in practice.
175. Exploring the impediments that are preventing capital add-ons from being applied to a single group internal model (post-merger or acquisition) could be a positive step forward in this area.
176. One possible issue with the current SII capital add-on is that it is framed as a reasonably well-defined measure of last resort⁶. The prescription set out in the Commission Delegated Regulation (for example, Article 279: Add-ons in relation to deviations from Solvency Capital Requirement assumptions prescribes the percentage(s) of the SCR that must be triggered before a capital add-on 'may' or 'must' be applied by supervisory authorities) further reinforces the idea of capital add-on as a measure of last resort.

⁶ For example: Recital 27 of the Solvency II Directive states "The imposition of a capital add-on is exceptional in the sense that it should be used only as a **measure of last resort, when other supervisory measures are ineffective or inappropriate**. Furthermore, the term exceptional should be understood in the context of the specific situation of each undertaking rather than in relation to the number of capital add-ons imposed in a specific market." [emphasis added.]

177. Increasing the ability for insurers to apply a single group internal model with a capital add-on used to address any deficiencies (set out in Article 37: Capital add-on of the SII Directive) other than by last resort could also reduce the regulatory costs of maintaining and running multiple internal models.

178. Current requirements allow only for the use of one group internal model in the calculation of the group SCR. This restriction may result in temporary substantial increases in group SCR following merger and acquisition activity, deterring or increasing the costs associated with, acquisitions by insurance groups.

179. More specifically, if an insurance group with a group internal model is acquired by another such insurance group, the group internal model of the acquired group cannot be used in the consolidated group SCR of the expanded group. By default, the purchasing group must include the acquired group in the consolidated group SCR using the standard formula, but this may not appropriately reflect the enlarged group's risk profile.

180. Alternatively, the purchasing group may seek a waiver to include the internal model SCRs of each of the entities in the acquired group under Method 2 (deduction and aggregation method the alternative to group consolidation), but this would result in the loss of diversification benefits within the acquired group and the potential double-counting of risks.

181. Although we are not aware of specific merger and acquisition activity that has been cancelled as a result of the temporary rise capital requirements as a result of using a single model, the types of firms most likely to be affected will be where:

- the acquired group has a unique risk profile and not suitably represented by the standard formula, i.e., does not represent an 'average EU' firm/the acquired firm is large enough and already have an approved internal model. The costs associated with going back to using the standard formula could be considered a retrograde step and not best use of resources;
- the current approach can be viewed as an internal model plus standard formula add-on; the internal model being that of the purchaser, and the standard formula representing the acquired company.

182. The risk profile of the group may not be reflected in the SCR calculation in a number ways which include:

- catastrophe risk aggregation;
- simply adding the two catastrophe risk charges on acquired and acquirer's models will not adequately reflect the risk aggregation from specific cat events/ especially ex-Europe exposure;
- it is likely that total catastrophe risk will be understated and capital add-on may be necessary;
- reinsurance;
- the acquired company's non-proportional reinsurance not reflected as intended under the standard formula, leading to a higher net underwriting risk charge;
- the approach is unable to reflect multiline reinsurance treaties that cover both acquired and acquirer's business;
- reporting burden (this is increased as a result of having to report under both internal model and standard formula);
- financial risks within the market risk module is not adequately represented, and diversification benefit between the acquiring and acquired company not achieved.

183. Two potential alternative approaches are considered below: multiple internal models and a consolidated (purchaser's) internal model.

Multiple internal models

184. The temporary use of multiple internal models for the calculation of the consolidated SCR is a potential solution. Using multiple internal models will enable appropriate reflection of the individual companies' risk profiles. It will avoid duplication of effort and each internal model will have undergone the approval process. However, the aggregate risk profile may need an appropriate aggregation methodology.
185. The aggregation methodology would need to be specified and agreed by all parties of the deal, including the regulator. This can become complex if aggregating from ground-up versus top-down, which will also have to be agreed.
186. Regulatory approval will be required on the methodology and factors used to calculate the aggregated SCR, allowing for any diversification benefit. Timely approval would be needed to ensure this is set up at day 1 of the combined entity operation. The results of the aggregation would also need to be independently validated.
187. The methodology used to aggregate the SCR across multiple internal models can be standardised, achieving the following benefits:
- regulatory approval efforts are required to be streamlined and focus on the aggregated SCR figure (as the individual internal models would have already been approved);
 - each entity's risk profile is appropriately represented.

Consolidated internal model - using purchaser's internal model

188. An alternative approach would be to use a consolidated internal model i.e., develop or build on the purchasing company's internal model in order to incorporate the acquired business. The following would need to be considered with such an approach:
- whether this approach is suitable if similar business is written by both companies; if not then the approach of using multiple internal models described above would be more efficient;
 - using one internal model to report on aggregate SCR would be simpler going forward and appropriately allow for diversification benefits and avoid double counting of risks;
 - where the underwriting business and investment mix are similar across both firms the risk profile may be adequately represented by one internal model;
 - regulatory approval would be required for the acquired business to be represented using the purchaser's internal model;
 - the methodology and parameterisation applied to the acquired business will need to be agreed, checked and validated, leading to additional workload and resource strain.
189. In relation to PRA powers to allow for temporary calculation of the consolidated group SCR using multiple group internal models following an acquisition or merger, the following factors should also be considered:
- whether key risk areas by entity and material aggregations are captured appropriately;
 - whether the group SCR should be calculated using a simpler factor-based approach akin to that used by rating agencies;
 - if firms insist on using internal models then the PRA should require appropriate model certification processes;

- the risks associated with mergers and acquisitions are often high and there should be additional and explicit capital charges for groups that have engaged in recent such activity;
- whether there should be a capital add-on to allow for operational risk, given the risk associated within merger and acquisitions activities;
- some thought could be given to the use of a grace period.

Calculation of the Transitional Measure on Technical Provisions

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

190. The purpose of the Transition Measure on Technical Provisions (TMTP) is to smooth insurance firms' transition from the SI regime to the SII regime. In general, SII technical provisions are significantly higher, and so the TMTP has proved to be an invaluable tool in managing the transition, particularly in mitigating the impact of the risk margin.
191. In the experience of our members who are practitioners in this area, the calculation and maintenance of the TMTP is highly complex. We believe that the objective of the TMTP could continue to be met through simpler methods. Our members have also highlighted the significant diversity in the approaches to TMTP calculation adopted by UK firms, and it would be challenging to define a single set of changes that will meet every firm's objectives. It should also be noted that as the risk margin comprises the largest part of the increase between SI and SII, if the proposals set out in Section 2 are adopted, the need for reform to the TMTP may be reduced.
192. We note that there are some modifications that are relatively simple and uncontroversial, and which would greatly reduce firms' operational burden and these changes, at least, should be implemented. These include the removal of:
- the error that inadvertently results in a doubling of the run-off profile of the TMTP over the transition period. With PRA agreement firms have been adjusting their run-off profiles to eliminate the double-count;
 - the requirement that TMTP can only be recalculated every 24 months, or on a change in risk profile. This means that, other than at the point of recalculation, the published TMTP is not consistent with the rest of the balance sheet. In order to provide stakeholders with a consistent view of solvency, firms monitor and publish the 'true TMTP'. A more flexible policy that allows recalculation using an agreed methodology would remove this issue. Rather than burden the PRA with an increased level of review, the methodology and calculation could be overseen by the firm's external auditor and Audit Committee.
193. We believe that there would be significant benefit in simplifying the TMTP framework even further in the following areas:
- the non-changing nature of the former ICAS regulatory regime can be problematic. Legislation requires that the methodology used to calculate ICAS Pillar 2 (ICA) best estimate liability should be unchanged from the methodology in place at 31 December 2015, with no allowance for methodology improvements, error corrections or updating for changes in the risk profile of firms. This makes the calculation very onerous (as firms are required to maintain legacy models) and potentially unrealistic;
 - in addition to the comparison of the technical provisions, firms are also required to compare the overall Financial Resources Requirements (FRR) on the pre and post SII balance sheets. This comparison is becoming increasingly onerous to perform and any capital guidance provided

under the SI (ICAS) regime is outdated. The comparison can also lead to cliff-edges where the TMTP benefit reduces as market conditions change.

194. We see considerable benefit if firms can agree a set of pragmatic simplifications to their TMTP calculation which removes the areas of complexity above. This would reduce cost and complexity and has the potential to reduce balance sheet volatility making firms capital positions easier to understand and supervise.

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

195. We agree that the TMTP should allow for the changes introduced elsewhere in the review. In particular we note:

- for many firms, the largest part of the difference between SI and SII technical provisions forming the TMTP is likely to be the risk margin. In the event that the risk margin is reduced, it seems appropriate to adjust the TMTP to allow for the much smaller difference;
- for most firms, the cash flows underlying the SI Pillar 2 best estimate liabilities are discounted using firms' own view of the illiquidity premium, whereas under SII, they are discounted using the risk-free rate plus, where applicable, the Matching Adjustment. For firms applying the Matching Adjustment, e.g. annuity providers, the difference can be material. In our response to Question 8 we recommend changes to the Matching Adjustment; in the event that these do not follow through into the discount rate used for the SI (ICA) liabilities, they could have unintended consequences on the TMTP.

Reporting requirements

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

196. Although the development of SII has enhanced many insurers' risk management, we believe there is scope to streamline significantly SII reporting and the associated documentation requirements, to make it more UK-specific but also fit-for-purpose. We believe this can be done without compromising the safety and soundness of firms, or of policyholder protection.

197. SII reporting consists of quantitative and qualitative requirements for public disclosure, and private disclosure to the PRA. The SII reporting /disclosure requirements are more extensive than those under the former UK SI regime.

198. We believe that the SII reporting requirements are disproportionate in some areas, and this adds to the cost burden for insurers. In our experience, generally very few queries arise from the required Solvency and Financial Condition Reports (SFCRs). For publicly quoted firms, the SFCR is also quite repetitive in relation to their annual report and accounts. The following sections of the SFCR could be simplified by cross-referencing relevant annual report and accounts:

- Section A *Business Performance*;
- Section B *System of Governance*;
- Section C *Risk Profile*.

199. In addition, *SFCR Section D Valuation for Solvency Purposes* would benefit from a major re-cast. It lacks useful sensitivity analysis, and the lack of analysis of change is a significant gap. Furthermore,

the typical lack of disclosure of assumption values is an omission that should also be addressed: it is very difficult to compare/ judge the robustness of technical provisions without this information. The former SI reporting to the PRA was better in this regard.

200. The reporting burden is particularly marked for smaller insurers. Whilst some allowance does exist for exclusions for smaller insurers in the form of waivers, we recommend an increased use of such waivers to make reporting less onerous for smaller insurance companies.
201. The need for firms to provide both Q4 quarterly and annual returns just a few weeks apart is an obvious example of the highly duplicative and burdensome nature of the reporting requirements. Whilst we acknowledge that the PRA's reporting waiver framework has been helpful in reducing the reporting burden for smaller firms, for larger firms, quarterly reporting remains highly burdensome. Year End / Q4 reporting is clearly necessary, but we believe it would be more proportionate for firms to provide solvency updates at other quarter ends via robust estimation tools, rather than the current quarterly reporting requirement. Less frequent reporting - particularly for smaller firms - could be supplemented by additional ad-hoc reporting requests by the PRA where necessary (as currently happens).
202. Reporting could also benefit from a more risk-based approach being taken. For example, some templates could be required to be updated if a firm exceeds a given risk threshold; or granular data is required where it is material to the business in question.
203. A further source of reporting burden stems from tight reporting deadlines, with some insurers being required to move to an 'early close' process, increasing both uncertainty and cost. We suggest that reporting deadlines are extended where challenging to meet.
204. Whilst the overall reporting burden is onerous, we propose that there is some value in adopting some of new Quantitative Reporting Templates (QRTs) proposed by EIOPA such as those relating to cyber risk.
205. The benefits to the industry would manifest through a reduction in the time spent, and cost of producing, the reporting material, whilst stakeholders including policyholders, regulators and industry commentators would benefit from reporting that is streamlined to meet their requirements, is clear, easy to navigate and complements other reporting produced by firms.

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

206. As noted in our response to Question 20 above, there is currently significant duplication within the SII reporting requirements. Examples include:
- duplication between the SII SFCR and, for publicly listed firms, their report and accounts. This includes both the narrative content and the contents of the accompanying QRTs, a number of which simply repackage information in the report and accounts;
 - (however, the SFCRs do not include the deterioration/ improvement in prior year reserves in form 5; this would be useful for many readers and should be included. It used to be included in SI reporting);
 - some QRTs may not be relevant anymore, e.g. S04 series for a solo company;
 - a number of National Supervisory Templates reproduce material already presented in the QRTs and there is scope to rationalise these;

- the need to produce both quarterly and annual returns as at Q4;
- the contents of the Report to Supervisor is normally a re-presentation of material that has already been shared with the PRA (including in the ORSA);
- the purpose of some information required on annual basis is not always clear, and can be onerous to prepare. Specific examples include detailed Internal Models Output templates collecting gross, net, discounted, undiscounted, own class, Solvency II class data. A single perspective would simplify reporting.

207. More coherent reporting could also be facilitated by:

- greater clarity (from the PRA) on the purpose of data requests. These can be onerous to produce, but firms are often unclear on how the data is to be used;
- the level of detail/ granularity desired by the PRA should be reviewed (and use this opportunity to drop reports not used by the regulator but were a function of EIOPA reporting);
- reviewing SII reporting deadlines. These deadlines are in advance of equivalent UK GAAP accounting timelines (whilst the latter reporting is required as an input to the former).

208. In addition to the duplication certain requirements are, we believe, overly burdensome for the regulatory benefit. An obvious example is in the area of asset reporting where firms are required to provide detailed listing on their assets on a quarterly basis. In addition, the requirement for so called 'look through' of exposures of collective undertakings is particularly onerous and the benefit is not obvious. We would recommend a move to annual reporting and a simpler approach to asset look through.

Branch capital requirements for foreign insurance firms

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

Benefits

209. A branch and its parent have a single legal personality. Allowing the parent company to consolidate the branch's risk into the parent's capital requirement may better align how the parent manages its risks in practice.

210. Under the current SII rules, the branch capital requirements (SCR and Minimum Capital Requirement [MCR]) are based on a notional balance sheet of insurance business effected by that branch. This introduces frictions, e.g. because the branch's notional balance sheet does not recognise any diversification benefits from business written elsewhere within the parent⁷. The regulatory cost and or capital requirements generated as a result of current rules could be put to more productive use without obviously compromising the parent's safety and soundness; or the security of policyholder benefits.

211. Removing the branch capital requirement would improve the capital fungibility of the parent as a whole; and the ability to move capital around more quickly and or easily.

212. The current SII text (see Article 166(4): Solvency Capital Requirement and Minimum Capital Requirement of the Solvency II Directive) only requires assets up to the MCR to be held in the jurisdiction of the branch: the excess (between the SCR and MCR) can be held within the EEA.

⁷ A similar issue exists at Group level where the consolidated Group solvency capital requirement is smaller than the sum of the subsidiary SCRs.

Adopting a similar approach ⁸ for a parent situated in a jurisdiction assessed as Equivalent to SII would achieve an identical outcome as the existing SII text.

213. A branch is required to hold assets of an amount equal to at least one half of the absolute floor ⁹ in respect of the MCR and deposit one fourth of that absolute floor as security as a condition of authorisation. Removing the branch capital requirements will not change this amount, which provides some buffer on top of the assets supporting technical provisions.

Costs

214. The elimination of branch capital requirements could reduce the incentive for the parent to retain assets at least equal to the MCR within the branch's jurisdiction. This could increase the branch's reliance on parental support, e.g. to support policyholder claims following the emergence of adverse experience.

215. No longer calculating the branch capital requirements on a standalone basis would reduce the overall level of capital that the parent is required to hold for regulatory purposes.

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

216. The branch quality of capital rules are identical to the solo SII requirements, which follows strict quantitative tier limits. This ignores a branch's lack of legal personality and is arguably overly-restrictive. The PRA's published policy ¹⁰ lists UK policyholders being given appropriate seniority and not being discriminated against in a wind-up as one of the considerations for authorisation. Reducing or removing the prescribed level of a branch's quality of capital would not obviously reduce policyholder protection.

217. Non-retail branch clients are generally sophisticated and will write non-Financial Services Compensation Scheme (FSCS) - protected liabilities. For example, clients of a reinsurance branch are likely to have at least a similar level of experience and expertise as regulators. Non-retail branch clients are also more likely to negotiate bilateral agreements in-line with their own risk appetite and internal processes. This could support a case for lowering the regulatory requirements of commercial facing branches relative to their retail branch counterparts.

218. Commercially focussed branch reforms (over and above the ideas already set out in this section) could include:

- removing the requirement for assets supporting a branch's non-FSCS protected liabilities from being held within the UK altogether;
- removing the minimum deposit requirement as a condition of authorising a branch that writes non-FSCS protected liabilities.

⁸ *i.e. allowing the parent to hold the branch's contribution to the parent SCR*

⁹ *The absolute floor varies between €1.2m to €7.4m depending on the authorisation permissions.*

¹⁰ *For example, see e.g. see paragraph 2.1 of SS2/18: International insurers: the Prudential Regulation Authority's approach to branch authorisation and supervision.*

Thresholds for regulation by the PRA under Solvency II

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

219. There are many small general insurers in run-off, and other small insurers which are not subject to SII requirements. It may make sense to have all entities within any revised PRA regulatory framework, but with relevant elements waived for such firms on the grounds of materiality.

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

220. Regulatory requirements for firms currently categorised as non directive firms should be straightforward and proportionate to the size of the firm's balance sheet (whilst providing adequate policyholder protection). Consistent with comments for firms under the scope of SII, the reporting burden should be proportionate (e.g. with a focus on aspects such as the ORSA and a stronger focus on governance [e.g. quality of Boards/ roles of individuals]).

221. Although non directive firms are still subject to PRA regulation, FCA regulatory requirements (including policyholder protection) are particularly relevant where SII requirements do not apply.

Mobilisation of new insurance firms

We do not have any points to raise on the questions within this section.

Risk-Free Rates: transition from the London Inter-bank Offered Rate (LIBOR) to Overnight Indexed Swap (OIS) rates

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

222. The aims of the proposed transition should be to encourage insurers to make the switch from LIBOR to OIS in their asset portfolios with minimal disruption to markets, to avoid artificial volatility in insurers' balance sheets during any transition period, and to mitigate any adverse impact on solvency.

223. With these aims in mind, our response below considers both the timing of any transition and how the OIS curve should be adjusted for use as a discount curve.

224. We note that since the publication of HMT's Call for Evidence, the PRA have subsequently published a consultation paper CP1/21, which encourages transition to the SONIA rate as the risk-free interest rate for sterling liabilities¹¹. We support this, but also recommend that the PRA publish a SONIA-based risk free curve with immediate effect, rather than before the 31 July date envisaged in their consultation paper.

¹¹ See: topic <https://edu.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2021/january/cp121.pdf>

225. During 2021, we recommend insurers should be free to elect to use either the LIBOR-based risk-free curve or the SONIA-based curve, or any blend of the two. This would avoid artificial volatility as insurers transition hedges, and also avoid any market impact from introducing a change of discount curve on one-day (which might incentivise insurers to then shift hedges at the same time).

226. The PRA should make it clear that insurers do not need to hold basis risk capital in internal models versus LIBOR or SONIA risk during the transition period, to ease transition.

227. The PRA's recent consultation paper CP1/21 proposes that for the next 24 months, the 'PRA relevant currencies' are GBP, USD, EUR, CAD, SEK, AUD, JPY, NOK and DKK, for which the PRA will provide the market with risk-free rates. This does pose a question for insurers who hold liabilities in other currencies on how and where to source this information, if the PRA do not provide these rates; pre-Brexit, such rates could be sourced from EIOPA.

228. It would therefore be helpful for the PRA to align to EIOPA and also provide these wider rates, or provide a market reference so that insurers can refer to that same source. If not, there is a risk that UK insurers might be inconsistent when using non-PRA relevant currencies depending on where they source the data from. Additionally, if the solution is simply to continue using EIOPA rates for those non-PRA relevant currencies, it poses a wider question on why UK insurers need to stop using EIOPA rates going forward and the 'standard' risk-free rate to use for other reporting purposes, e.g. IFRS17 discounting. Therefore, clarity from the PRA on what UK insurers should do for non-PRA relevant currencies would be helpful.

229. Furthermore, it would be useful if the PRA were to give advance notice (say at least two submissions) on what the future PRA relevant currencies will be. In their consultation CP1/21 they note that the above nine currencies might change in 24 months. A longer notice period would give insurers more time to source the non-PRA rates elsewhere if required.

Credit risk adjustment

230. The current SII LIBOR-based curve includes a deduction for a credit-risk adjustment (CRA), with a floor of 10bps and a cap of 35bps.

231. For a SONIA-based curve, a zero CRA deduction would seem most appropriate for the basic risk-free rate given the designation of SONIA as near-risk free. The new near-risk-free reference rates have been developed in each country by national working groups following the lead of the G20 and the Financial Stability Board from 2014, using overnight rates which are robust and anchored in active, liquid underlying markets¹². We do not believe it is appropriate or necessary for insurance regulators to second-guess these efforts by making their own assessment of the rates chosen.

232. In eliminating the CRA, given the stated 10bps floor in the regulations:

- we concur with EIOPA's stated view that a zero CRA is technically achievable without needing to change the regulations;
- however, it would be preferable if this were made explicitly clear by the PRA, and in due course via an amendment to the UK regulations.

233. Further, we believe there is an argument for an upwards adjustment to SONIA rates for use in the SII discount rate.

¹² See: <https://www.fsb.org/2019/06/overnight-risk-free-rates-a-users-guide/>

234. The change from LIBOR- to SONIA-based discounting in SII is driven by the wider reform of interest-rates and not by any perception that existing SII discounting rates are too high, so the change should ideally have a minimal impact. The PRA consultation does suggest that any impact could be covered in the TMTP, but this only supports pre-2016 business, so is not an ideal solution.
235. The original credit risk adjustment was based on an approximation to 50% of the spread between IBOR and OIS rates, reflecting the greater illiquidity of IBOR rates versus overnight bank deposits.
236. We would support a fixed upwards adjustment to SONIA rates in the discount curve based on 50% of the recent historic average spread between the curves for a typical insurance profile. This would avoid any short term adverse impact on insurers' balance sheet, and could apply temporarily on a transitional basis to business written pre the planned change in discount curves in 2021. This approach would also be consistent with that applied on the asset side of insurer's balance sheet via the ISDA fallback protocols.

Specific General Insurance Considerations

237. The PRA propose an implementation date for GBP SONIA rates of 31 July 2021. It would be beneficial to London Market insurers / Lloyd's syndicates (many of which will have heavy exposure to USD) to have more information from the PRA on the transition date for that particular currency. The PRA states that some USD LIBOR panels will cease to exist by the end of 2021, with other USD panels ceasing to exist by the end of June 2023. We would therefore need clear understanding on when this particular transition would take place, as it could have a material impact on the valuation of such liabilities e.g. US Casualty business which is long-tailed in nature and also an area of concern for Lloyd's.
238. Furthermore, in respect to Lloyd's reporting, it was noted that for December 2020 reporting (the first instance for when PRA rates rather than EIOPA rates should be used by UK general insurers), the PRA rates were published almost a week after the EIOPA rates. This does put Lloyd's syndicates at a disadvantage, as reporting deadlines remain unchanged but the data is now published at a later date. It is therefore important that the PRA reconsiders their publication dates, and tries to ensure it aligns to existing EIOPA timescales going forward. This scenario was not advantageous and had an adverse impact on Lloyd's syndicates working day timetables.
239. It would also be important for the PRA to work with Lloyd's of London and assess whether any change from LIBOR to SONIA rates impacts interest rate risk or other assumptions/methodology within internal models, and provide market-wide communications on any allowances that UK general insurers must make to accommodate the change or validation to be performed e.g. backtesting.
240. Generally, given current yield curves are very low, there might be minimal impact for general insurers with short-term liabilities. However, general insurers writing casualty or longer-term liabilities e.g. PPOs might be concerned about the initial impact of the change from LIBOR to SONIA. Therefore, the most challenging aspect of the change from LIBOR to OIS for general insurers will not be the process but rather the communication to Board and management on the impact of the change.
241. It would therefore be beneficial to allow some transitional arrangements in cases where the shift causes significant Balance Sheet of SCR impacts, to allow general insurers adequate time to communicate to internal stakeholders the impact of the change from LIBOR to OIS. This is an important consideration in determining the date of the transition period, and we propose that the change is not implemented until December 2021/Early 2022 at the earliest. This would allow Q3 2021 and Q4 2021 comparisons (when the PRA will start to use SONIA but LIBOR is still available) of LIBOR and SONIA to be shown to management.

242. There may be some merit in questioning the need for discounting of some general insurance business, given the minimal impact on those holding short-term liabilities. Alternatives could include using a factor based scaling such as the 6% cost of capital (currently used for) the risk margin.
243. More generally, the HMT review of SII may be an opportunity to consider different approaches to life and general insurance business depending on the term of the liabilities held (i.e. using yield curves or a set factor).
244. As mentioned above, the current proposed changes may have minimal impact on the process aspect of general insurers. Where the UK does diverge from the current SII framework, it is also important to clarify the impacts on IFRS 17 reporting. If not, there is a risk of additional regulatory burden (and costs) to be faced by UK insurers relative to pre-Brexit requirements. IFRS 17.

Other Areas for Review

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

We suggest HMT consider reviewing further aspects of SII as set out below:

Insurance linked securities

245. HMT signalled its intention to work with the London insurance market to design a new framework to attract Insurance Linked Securities (ILS) business, as part of the March 2015 Budget. HMT subsequently published a consultation document seeking views on the regulatory, tax and corporate structure framework for ILS business in the United Kingdom in March 2016¹³.
246. The PRA and FCA subsequently issued a joint consultation paper setting out more detail on the regulators' proposed authorisation and supervision regime for ILS in the UK, in November 2016¹⁴.
247. We suggest HMT's SII review could present a good opportunity to assess:
- the success of the ILS regime since its launch in 2017;
 - what, if any, SII design features could hinder ILS vehicles from being used as a venue to transfer (re)insurance risks. Potential constraining features include the definition of Aggregate Maximum Risk Exposure, the fully funded requirement, governance and disclosure requirements.
248. The global ILS market is comprised predominately of short term, e.g. conventional property catastrophe non-life risks. The ability to use ILS as a venue to, amongst other things, transfer longer tailed risk could materially increase the attractiveness and opportunity for the UK to become a leading ILS centre.

¹³ See:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/504046/Insurance_linked_securities_consultation.pdf

¹⁴ See: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2016/cp4216>

Asset look through

249. As noted in the reporting section above, the requirements to look-through holdings in collective investment schemes to the underlying securities is highly burdensome.

250. We support the aim to understand and model/ manage the risks that the underlying economic exposure of the assets represents. However, the effort required to assemble the underlying data is a highly onerous and expensive requirement. Many collective investment vehicles will have holdings of other investment vehicles managed by external investment firms; to achieve the standard required companies and their investment managers have to look through several layers of holding, often from different asset managers.

Risk Mitigating Techniques and Basis Risk

251. We suggest that current limitations on the recognition of risk mitigating techniques should be reviewed. At present, firms need to assess the extent of basis risk when considering the benefit of a risk mitigating technique: essentially how closely the risk-mitigating technique offsets the risk across a range of scenarios. Where the benefit of the technique is not closely matched in all scenarios, the technique might be considered to have 'material' basis risk.

252. EIOPA guidance states that firms using the standard formula should not recognise risk mitigating techniques that have material basis risk. This is an 'all or nothing' approach and potentially stops firms recognising in the SCR the benefits of techniques that, for example, do not avoid losses in all circumstances but which limit losses to a maximum amount in all circumstances. The result of this is inconsistent with the intended risk-based approach.

Other areas: summary view

253. Brief comments are also provided on the following areas:

- **Volatility Adjustment** - regulatory approval is straightforward and significantly easier than that for the matching adjustment. The reference portfolio used for calculating the volatility adjustment is currently based on European data and should be adjusted for UK-specific data; however there may be a relative lack of volume of data;
- **role of risk management function on internal models** - it would be useful to have greater clarity over the role of the risk management function in relation to the internal model. The risk function is currently required to be responsible for the design and implementation as well as the validation of the model. These requirements can be difficult to meet in practice and cause confusion around roles and responsibilities;
- **One year view of risk versus ultimate view** - the one-year view is still the 'second thought' for many firms in the general insurance sector. 'Value at Risk' as a risk measure is not stable enough and not appropriate for tail heavy risks like reinsurance credit risk. Flexibility for firms to select one year or ultimate risk depending on their risk profile would be helpful;
- **Prospective emphasis for reporting** - reporting and supervisory effort could be more focussed on RSR/ ORSA prospective solvency reporting, rather than historic 'accounting' reporting;
- **receivables 'due'/'overdue'** - there should be clarity over the definitions of receivables 'due' and receivables 'overdue'. There should also be clarity over what 'cash at bank' really means, and how bank deposits (even short term) should be treated (e.g. in counterparty default or market risk modules);
- **role of ENIDs** - there should be clarity over the use of Events Not In Data (ENIDs). Currently SII is ambiguous here with (for example) some regulators requiring ENIDs (e.g. UK, Ireland). By contrast, some EU regulators do not; in France any such allowance may be implicit;

- **benchmarking** - the PRA receives a much reporting data from across the UK market. Greater value could be derived from this data gathering if the PRA were to produce appropriate benchmarking data to provide cross-industry insights;
- **reporting timelines** - reporting requirements have evolved with the unintended impact of increasing the regulatory burden, whilst also potentially reducing the quality of some submissions. Reducing the reporting burden (by removing non value-adding reporting) could make UK firms more nimble and competitive.