CLIENT MEMORANDUM

Speech by UK PRA's CEO: Solvency II – Stock Taking and Addressing "Gold Plating"

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On March 20, Sam Woods, Chief Executive Officer of the UK's Prudential Regulation Authority (the **PRA**) delivered a speech at the London Business School on insurance regulation. In the same week as the UK's Prime Minister, Theresa May, announced that the UK will trigger the "Brexit" process from the European Union on March 29, 2017, this speech serves as a timely reminder of the importance of the insurance sector to the UK's economy and of the PRA in its supervision of the insurance sector. Mr. Woods reminded the insurance market that the PRA's role in regulation and supervision is an important precondition to maintaining London's world class status as a leading insurance sector.

The future approach to insurance regulation has come under scrutiny since the UK's decision to leave the European Union, with the UK parliament's Treasury Select Committee looking into what the London Market wants from post-Brexit regulation. Against this background, Mr. Woods took stock of the impact of Solvency II since its introduction in January 2016 and addressed accusations of the "gold plating" of regulations by the PRA.

Insurance Regulation

With the Solvency II regime now having been in place for over 12 months, Mr. Woods reviewed what is, and what is not, in his view, working both for industry participants and policyholders. There has been some tension between the PRA and

the firms it regulates in relation to the implementation of Solvency II, but Mr. Woods contended that "*a degree of constructive tension between regulator and regulated firms is a sign of a healthy and properly functioning relationship.*"

In the evidence recently given to the Treasury Select Committee, the majority of interviewees expressed the view that Solvency II should not be repealed post-Brexit as (i) firms have just gone through the time-consuming and costly exercise of preparing for its implementation; (ii) most firms are hoping for some form of post-Brexit equivalence that will no doubt be aided by the UK retaining comparable legislation; and (iii) given that firms' main complaints with the Solvency II regulation have such a degree of consensus, it seems unlikely that alterations to the regime itself will not be made over time. Consequently, Mr. Woods reminded the audience that the PRA and the majority of firms it regulates are of one mind that there should not be an overhaul of the regulatory system so soon after the implementation of Solvency II.

The PRA has already been working with regulated firms and its European counterparts and supervisory bodies to effect improvements to the Solvency II regime that the industry and the regulators believe are warranted. By way of example, Mr. Woods acknowledged that the implementation of the risk margin requirement under Solvency II is flawed and the PRA is actively looking for solutions to this problem. Since the PRA is constrained by European regulation, it has adopted a two-pronged approach to dealing with the issue: (i) it has engaged with its European colleagues to design a more practical solution; and (ii) in the meantime, it has introduced the Transitional Measure on Technical Provisions, which mitigates the impact of the risk margin on business written before the implementation of Solvency II.

In another example of the PRA's approach towards Solvency II, Mr. Woods pointed out that the PRA has endeavoured to be flexible in relation to the Solvency II Matching Adjustment. For example, it has allowed the pairing of variable cashflow assets with derivatives, and restructuring of assets like equity release mortgages, and has also allowed infrastructure assets in sectors like healthcare, social housing and telecoms infrastructure to achieve Matching Adjustment eligibility.

However, Mr. Woods was not entirely conciliatory to industry pressures and pointed out that the PRA also challenges firms' investment plans. This is not limited to the publicised cases of the Matching Adjustment but the PRA is also doing so where firms are contemplating other complex investment assets. Mr. Woods pointed out that insurers are not generally in the business of making certain types of investments and so the bar should be high in convincing the PRA that a firm can adequately manage the associated risks and exposures when innovative investments are being considered.

Mr. Woods addressed a common complaint often levelled against the PRA: the increased burden of data that regulated firms must provide (and the compressed timetables in which to provide them). Mr. Woods noted that the PRA's view is that these increased burdens are necessary for the protection of policyholders, but acknowledged that the PRA proactively looks at whether it strikes the right balance and is open minded to lowering the burden, "*if it turns out that some of the new reporting doesn't deliver supervisory benefits commensurate with its cost.*"

Finally, with respect to insurance regulation, Mr. Woods addressed a familiar complaint that the PRA has overzealously "gold plated" elements of Solvency II, thus making an already complex and burdensome regulation uniquely difficult for regulated entities in the UK. With regard to this claim, Mr. Woods defended the new Senior Insurance Managers Regime

as being designed to ensure the individual accountability of senior managers and directors of insurers. He also noted that the "*overhead to gaining model approval is considerable*" due to the very limited ability of the PRA to adjust a firm's Solvency Capital Requirement following approval, reminding the market that firms with approved internal models "*in effect set their own regulatory capital requirements.*"

Mr. Woods noted the PRA has shown flexibility in relation to quantitative indicators, by way of example, when approving internal models with credit components. He noted that where such models do not meet the PRA's quantitative indicators, models are still approved if "*the firms in question demonstrated that their exposure is atypical and hence warrants a non-standard calibration, or provided off-setting conservatism in other aspects of the model.*"

In summary, Mr. Woods explained that it should come as no surprise that the PRA, given the size and complexity of the UK insurance market, adopts a diligent and rigorous approach to its duties, noting however, that the PRA continues to be flexible and is not a "one size fits all" regulator.

The PRA's Approach to Insurance Supervision

Mr. Woods also aimed to provide some insights as to why and how the PRA operates in the way that it does. The PRA has two main objectives in relation to insurance supervision: (i) the general objective of promoting the safety and soundness of insurers; and (ii) contributing to securing an appropriate degree of policyholder protection.

Mr. Woods noted that not all regulated insurers are equal when it comes to the PRA. He reminded the market that it is right that the PRA more closely monitors those regulated firms whose policyholders have the most to lose should something go wrong. In particular, Mr. Woods singled out life insurance and pensions providers as the regulated firms that require most supervision, noting that "*[s]ome of the oldest and most vulnerable people in our society are reliant upon income provided by insurers under very long-term annuity contracts, into which they have invested their life savings.*"

By way of contrast, Mr. Woods noted various classes of property insurance as examples where the consequences of a firm failure would be less severe and, accordingly, these regulated firms require less rigorous oversight. He also discussed insurance bought by commercial or corporate customers in the London Market. In circumstances where buyers often choose their cover provider based on third-party measures of financial strength (such as opinions from rating agencies or insurance brokers), Mr. Woods acknowledged that there is a case to be made that the need for the regulator to be interventionist is reduced. The debate is about how to regulate, not whether to regulate. In fact, he noted the PRA's resourcing model already works to focus its resources on those areas of most concern. Using the metrics of firm size and potential harm to policyholders, Mr. Woods noted that the PRA assigns the majority of regulated firms to the lowest category of oversight, reflecting the low level of risk that they pose to the PRA's objectives.

In closing, Mr. Woods spent a little time on the PRA's third supervisory objective: facilitating effective competition. Mr. Woods provided the market with a few examples of the steps that the PRA has taken to further this objective:

- the PRA has created a proportionate regime for the 40% of firms the PRA regulates that are not covered by Solvency II;
- the PRA has given about 85% of Solvency II firms in the UK the opportunity to avoid around 70% of the quarterly reporting burden they would otherwise face;
- the PRA is working with the Treasury, HM Revenue and Customs and the London Market to introduce a new structure for insurance-linked securities;[1] and
- the PRA authorised 19 new insurance companies and Lloyd's managing agents in the first three years of its existence.

Conclusion

As the UK triggers the process for leaving the European Union, we believe that Mr. Woods' speech informs the insurance sector that the PRA is aware of both its critics and its mission. He included assurances that the PRA is seeking to become a pragmatic and dynamic regulator in deploying its resources to supervise insurance companies whilst protecting policyholders. This aim should be welcomed by the insurance industry as it faces the opportunities and challenges that Brexit will bring.

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[1] For further information, see Willkie Farr & Gallagher LLP Client Memoranda: "An ILS Regime for the UK: Responses to UK Government Consultation Papers" (Feb. 27, 2017), available here; and "Proposed ILS Regime for the UK" (Dec. 1, 2016), available here.