reinsurance advisory board

Position Paper

RAB response to HM Treasury Solvency II review consultation

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Introduction

The Insurance Europe Reinsurance Advisory Board (RAB) welcomes the opportunity to respond to HM Treasury's consultation as part of the review of Solvency II.

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

The RAB strongly supports HMT's objective of protecting policyholders through the safety and soundness of firms. As global reinsurers, the RAB also welcomes HMT's objective to support the UK's ability to be a vibrant, innovative, and competitive (re)insurance hub. This response outlines the areas of improvement that would allow the reinsurance industry to support (re)insurers as long-term investors and key players in the UK's growth and climate-change goals.

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

The outcome of HMT's review of Solvency II must continue to recognise the specific treatment of reinsurance in regulation as a cross border, business-to-business activity and build on the elements of the existing Solvency II and UK frameworks which recognise this. In particular, a pure reinsurance branch of an undertaking situated in a country which has been deemed equivalent should be subject to very limited – if any – additional UK regulation with respect to the local UK branch activities (please refer to the RAB's responses on Chapter 5).

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Executive summary

The RAB is supportive of the UK government reviewing and refining Solvency II to ensure that it is the most appropriate regime for the UK's insurance and reinsurance market. The RAB also supports the three objectives of the review, and notes that the challenge will be calibrating the correct balance between each, namely to:

- Spur a vibrant, innovative, and internationally competitive insurance sector.
- Protect policyholders and ensure the safety and soundness of firms; and
- Support insurance firms to provide long-term capital to underpin growth.

The RAB supports the removal of branch capital and asset localisation requirements, which will enhance UK market openness and competitiveness

Branches of foreign (re)insurers cannot fail independently of the legal entity to which they belong. The RAB therefore sees little benefit in a branch capital and asset localisation requirement, and is supportive of this being removed, especially when the legal entity is domiciled in a jurisdiction with a solvency and supervisory regime that is of a similar strength and sophistication to the UK's.

This would increase the openness of the UK's (re)insurance market to foreign (re)insurers while not undermining policyholder protection, reduce the cost of writing business in the UK by eliminating 'trapped capital', and increase the ability of the sector to pool and diversify risk.

The RAB would encourage the UK government to implement this reform swiftly as a 'quick win' (or one of a number of 'quick wins'). The Modification of Consent waiver[1] that the PRA has already developed for reinsurance branches provides a template that could be followed, and the benefit would be immediate for the (re)insurance branches currently in the process of seeking permanent authorisation in the UK following the UK's exit from the EU.

The review should ensure the continued recognition of the important role of reinsurance

Reinsurance is a fundamental part of a vibrant, innovative, and internationally competitive insurance sector. Reinsurance is a well-established, recognised, and regulated risk mitigation technique which helps to manage risk and build resilience across the industry, benefiting primary insurers and their policyholders. Reinsurers facilitate the pooling and diversification of risk across markets and lines of business, which is fundamental to the insurance business model, reducing volatility and increasing efficiency. In addition, overseas reinsurers' (including RAB member companies) UK operations employ highly skilled people in the UK, contribute to the underwriting expertise of the UK market and contribute to the UK's tax revenue.

The RAB supports HMT's proposal to reduce the level and volatility of the risk margin. A stated aim of the proposed reform to the risk margin is "a reduction in incentives for life insurers to reinsure longevity risk outside the UK" as "a greater proportion of life business remaining in the UK would retain the associated premiums in the UK and hence boost the UK economy". The consultation further notes that this would also "reduce supervisory and regulatory risks associated with the offshore reinsurance of longevity risks". However, the RAB does not believe that reducing incentives to reinsure should be a desired outcome in itself and, therefore, the UK government should not introduce any barriers or disincentives.

As the consultation also notes, there are a range of factors that insurers take into account when deciding on their reinsurance strategy. Even with a reduced risk margin, and accompanying matching adjustment reforms, the RAB expects there will still be a range of factors which will drive the use of reinsurance in the UK.

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[1] PRA Modification by consent for pure reinsurance branches, published 30 November 2021

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The RAB supports close cooperation between insurance supervisors to ensure appropriate management of any supervisory or regulatory risks arising from cross-border reinsurance.

Reducing restrictions on ancillary services would help the UK to seize the initiative and also enhance UK competitiveness

A further barrier to innovation concerns restrictions on (re)insurance licensing and the scope of (re)insurance activities under the Solvency II Directive, as onshored to the UK. The RAB would encourage HMT to also examine reform here as part of this review.

There are significant limitations on the types of products/solutions that (re)insurers can offer, beyond the reinsurance and/or insurance contracts they are authorised for. As (re)insurers are increasingly looking to innovate through technological development, it is unclear, for example, whether a reinsurer could receive fee-based remuneration for the risk-based services it provides to clients where no reinsurance contractual relationship exists.

Restrictions around business activities which are not directly linked to (re)insurance should either be abolished or at least liberalised to ensure incumbents are also able to pilot new business models or technology, and to benefit from the same innovation opportunities as other market players.

The RAB notes that this barrier has recently been acknowledged in the EU[2]. The UK could seize the initiative and promote digital finance solutions by enabling (re)insurance companies to offer related (ancillary) services which are not themselves regulated activities. This would help spur innovation in the sector, without the additional cost burden associated with setting up subsidiaries as is currently required of firms offering ancillary services.

<u>Detailed comments</u>

Chapter 2: Risk margin

Question 2.1
How would a reduction in the risk margin for long-term life insurers toward the bottom or top of the 60%-70% range impact on:
- *policyholders and their level of protection; and*
- *insurers and their reinsurance, investment and product pricing decisions.*

The RAB supports HMT's proposal to reduce the level and volatility of the risk margin.

Reinsurance is an important, well established, recognised, and regulated risk management technique. It facilitates the pooling and diversification of risk while enhancing policyholder protection. For example, longevity risk reinsurance enables diversification with mortality risk in other markets and/or geographies, which benefits each market and/or geography by reducing their risk exposure. It also contributes to the underwriting expertise in the UK market – with such concentration of expertise being an enabler of the UK market's global status and itself bringing benefits to the UK economy.

The RAB notes the comment that reducing the proportion of life business that is reinsured outside the UK would also "reduce the supervisory and regulatory risks associated with the offshore reinsurance of longevity risk". The RAB believes this analysis to be too blunt. In fact, in the case of two jurisdictions with similarly strong

[2] Joint ESAs Report on Digital Finance (7 February 2022)

regimes (eg the UK, EU or Switzerland) and with strong supervisory relations, the benefit of reducing regulatory risk is likely much lower than the loss of diversification which the two markets currently benefit from.

A reduction in the risk margin may change the use and type of longevity risk reinsurance in the UK. But reducing the reinsurance of longevity risk outside the UK should not be an end in itself — given the above benefits of reinsurance to financial stability, insurance companies and their end-customers.

Question 2.2
How would a reduction in the risk margin for general insurers of 30% impact on:
- *policyholders and their level of protection; and*
- *insurers and their reinsurance, investment and product pricing decisions.*

The RAB makes the same comment here regarding reinsurance for general insurers as in its response to Question 2.1 regarding reinsurance for long-term life insurers.

Chapter 5. Reducing reporting and administrative burdens

Question 5.1
What is the impact of these reforms on regulatory costs incurred by insurers?

The RAB welcomes the government's proposal to reduce reporting and other administrative burdens, especially when there is little supervisory value.

There are many branch reporting requirements that provide limited benefit, duplicate legal entity level reporting or have high implementation and process costs resulting from the need to segregate data at branch level. Such data would most often not already exist within the entity as it is not meaningful nor useful to manage the business by looking at branch specifics. Indeed, a large portion of the reporting requirements for UK branches of foreign (re)insurers (quantitative and qualitative) could be removed in instances where the prudential regime of the legal entity is of a similarly high standard to the UK's and where there is a close cooperation between the supervisory authorities.

In the case of several RAB member companies, the RAB notes that the PRA, which supervises their UK branches, the national supervisory authorities, where the legal entities are based, and, if that is the case, the national supervisory authority where the group is headquartered (eg Switzerland), are part of the Group College of Supervisors, which ensures regular regulatory dialogue.

Question 5.2
What would be the impact of removing capital requirements for branches of foreign insurers operating in the UK, both on existing branches and on the decision to establish new branches?

An appropriate regime for UK branches of foreign (re)insurers is critical to maintaining and expanding the UK as an internationally competitive (re)insurance hub, based on the principle of open markets.

The RAB supports removing branch capital requirements to ensure the UK's international competitiveness.

The RAB is in favour of removing the requirement for UK branches of foreign (re)insurers to calculate branch capital requirements and to hold local assets to cover them, as the government proposes. There would be an immediate benefit to current branches of primary insurers as well as the benefit of greater certainty to current branches of reinsurers who would no longer have to place reliance on a temporary waiver.

The RAB agrees that the removal of the requirement for UK branches of foreign (re)insures to calculate capital requirements and to hold local assets to cover this would enhance the UK's attractiveness to branches of foreign insurers. This would in turn help to boost UK competitiveness and offer more competition to UK market participants. It is also a likely incentive for foreign (re)insurers to continue to keep branches in the UK and/or establish new UK branches, especially for these foreign (re)insurers that have the option of writing business on a non-admitted basis.

The RAB believes that branch capital requirements provide limited prudential benefit in terms of policyholder protection. The primary purpose of capital requirements in any solvency regime is to reduce the likelihood of the regulated entity failing, thus enhancing policyholder protection. However, a branch, as a subset of a larger legal entity, cannot fail independently of that legal entity. A robust prudential regulatory framework with sophisticated supervision of the legal entity is therefore essential to ensure policyholder protection.

In addition to offering limited prudential benefit, branch capital requirements do have an associated cost:

- Diseconomies of scale and lack of diversification: Holding assets and calculating capital locally inhibits the business model of the global (re)insurance sector, which is based on the pooling and diversifying of assets and risk. This increases the funding cost of writing business in the UK.
- Less meaningful regulatory reporting: Balance sheet management and asset liability management takes place at legal entity level, meaning any branch view of solvency is likely to give an incomplete, misleading, and artificial representation of branch solvency which would hinder rather than inform supervisory oversight.
- Implementation and ongoing cost: Segregating data on a branch level, which otherwise may not exist or be used by the firm to manage the business, would come at a cost which would ultimately be borne policyholders or the UK branch.

The RAB would encourage the government to implement the proposed removal of branch capital and asset localisation requirements as soon as possible and believe this could be done as a "quick win", rather than wait until full details of other parts of this review have been decided upon.

The PRA's Modification by Consent for pure reinsurance branches provides a template that sets out the modifications that are required to the PRA rulebook to implement this. These modifications could quickly be implemented permanently and more broadly. This would maximise the benefit for most branches that are still in the process of applying for permanent authorisation in the UK.

Permitting branches of foreign (re)insurers in the UK helps underline the UK's support of open markets, reducing the burden on firms and regulators alike, while still ensuring policyholder protection. The RAB notes that the PRA[3] is also open to the removal of capital requirements for branches and in light of there being broad consensus on this question, the RAB would encourage HMT to seize the UK's rule-making ability to implement reforms which deliver this.

[3] See, for example, *The future of international insurance in the UK* speech by Alan Sheppard (21 April 2022)