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PRA Announces Final Adjustments to 'Solvency UK' Rules and Consults on Requirements for 'Solvent Exit' Plans

Solvency UK Update – Near-Final Policy Statement PS2/24 and PS3/24

As discussed in our previous updates, in June 2020 the UK government announced a wide-ranging review of the Solvency II framework in the UK, aimed at reforming the insurance regulatory framework inherited from the EU given the UK's withdrawal from the EU. This was followed by Consultation Paper (CP12/23) and Consultation Paper (CP19/23), each of which sets out a number of important reforms to the UK regulatory rule set and which also complement the changes set out in the UK government's legislation implemented through the Financial Services and Markets Act 2023 (FSM Act).

On 28 February 2024, the Prudential Regulation Authority (PRA) published Policy Statement (PS2/24) which provides the PRA's feedback to consultation responses received as part of CP12/23, and sets out near-final rules and near-final policy materials. This includes, importantly, material changes to draft policy set out in CP12/23. Further, on 29 February 2024 it published Policy Statement (PS3/24) covering changes to the Solvency II reporting and disclosure requirements.

With the publication of PS2/24 and PS3/24, the PRA considers that it has completed its consultation on the substantive reforms consistent with the Solvency II review, although it is still to pending certain policy changes to the matching adjustment described in our October Client Update.

Although the PRA's policy statements are lengthy and provide a comprehensive overview and responses to CP12/23 and CP 19/23, there are only a few material changes set out in these near-final rules. Our summary and analysis of these follows.

Transitional Measures on Technical Provisions (TMTP)

As discussed in our previous update, currently the TMTP allows the Solvency II regime to be phased in on a straight-line basis over a 16-year period for liabilities that were in force prior to the introduction of Solvency II on 1 January 2016. These measures will be simplified with a view to a complete transition to Solvency UK by 2032, and will benefit any firm that is granted TMTP permission in the future through accepting business that already benefits from TMTP (*e.g.*, by portfolio transfer or a 100% reinsurance transaction).

The PRA has amended and finalised the proposals set out in CP12/23 as follows:

- In connection with the simplified new default method for calculating TMTP, amendments to the proposed rules to allow matching adjustment (MA) — eligible business (rather than annuity business) to be used to calculate the dynamic best estimate liability (BEL) component of the new TMTP method.
- In connection with the removal of the financial resource requirement (FRR) test, for firms whose TMTP is limited due to the test (see also the PRA's 8 December 2023 Statement, "Solvency II Review – considerations for year-end 2023"), the PRA will

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consider removing this test on case-by-case assessment. The PRA intends to remove the FRR test from the TMTP framework entirely at year-end 2024.

- Requiring all firms to amortise TMTP so that it decreases to zero by the end of the transitional period. The PRA has clarified that, when calculating the projected risk margin and dynamic portions for the purposes of the amortisation adjustment of the TMTP, the chief actuary may select appropriate methodologies consistent with the calculation of technical provisions and the principles set out in subsidiary legislation to Solvency II.[1]
- Requiring calculation of TMTP at the final day of each reporting period. The PRA has amended the reference to the "reporting periods" to clarify that this refers solely to the firm's PRA reporting. TMTP can be calculated more frequently for the firm's own internal management purposes.
- In connection with business that is transferred or 100% reinsured, amending the draft rules to provide an example of when the PRA would consider a waiver or modification to the requirement that aggregate TMTP should not increase at the point of transfer. The example given is that where changes in diversification have caused the risk margin of the firms to increase or decrease.
- Requiring preliminary calculation of the new TMTP method. The PRA has clarified that for the purpose of the "base TMTP" calculation (the final recalculation based on the existing calculation method), firms should use their agreed methodology as at the last recalculation prior to 31 December 2024 that adjusts for a "double run-off" effect.
- Only granting any new permissions to apply TMTP in circumstances where a firm without an existing TMTP permission acquires or accepts business that already benefits from TMTP. The PRA has amended their Statement of Policy to note that this is their expected approach to new TMTP permissions, but acknowledges there may be unforeseen exceptional circumstances in which the PRA may consider granting a new TMTP permission.

Internal Models (IMs)

Under the proposals, the PRA will move away from a number of prescriptive requirements towards a smaller number of more principles-based requirements, *e.g.*, around modelling standards. The PRA will also introduce an alternative to outright rejection of an IM application, namely imposition of one or two new safeguards: a residual capital add-on tool, and model use requirements.

The PRA has confirmed its intent in PS2/24 to determine the outcome of a complete application within six months from the date of receipt of the application, to provide the firm with a written notice of that determination and will make reasonable efforts to do so.

Further, it has clarified that splitting or combining risks already within the IM scope or adding risks which fall within the sub-modules of risks already within the scope of the IM, may not necessarily amount to including new risks in the IM.

Capital Add-Ons (CAOs)

The PRA's proposed approach for setting capital add-ons (a regulatory tool to address a deviation in a firm's risk profile) broadly reflects the current Solvency II approach. The proposal of a new "residual model limitation" (RML) CAO acts as a model permission safeguard, promoting a more flexible approach to insurers to use an IM with an RML. Further, the PRA's consultation proposed a new method for calculating a CAO for an IM significant risk profile deviation, to be deployed in exceptional circumstances.

In PS2/24, the PRA has made the following changes to its policy on CAOs:

- The requirement to disclose CAOs in solvency and financial condition reports has been removed. Instead, these will be included in the SCR calculated using internal model and the reported SCR split by risk modules.
- In its publication of regular reports summarising its use of CAOs and IM permission safeguards, only publish CAOs and not include its IM permission safeguards. It will, however, publish a summary report on the use of safeguards in 2027.
- Amending the CAO Statement of Policy to allow for the possibility of a CAO which moves dynamically in line with certain outputs calculated by the firm (traditionally, such CAOs had been applied as a fixed amount).

Group SCR

The PRA will broadly implement the full proposals from CP12/23 to introduce more flexibility in the methods available to calculate the group SCR (whether via a group internal model or otherwise) for any group for which the PRA is group supervisor. Further, the PRA will permit a group to add the results of two or more calculation approaches for up to two years.

The PRA made minor changes to the Group Supervision Part of the PRA Rulebook and to the Statement of Policy for insurance group supervision. In particular, it has added a new definition for "significant transaction" under Group Supervision 16.3 and allowed firms a temporary modification for six months to create a clear and realistic plan to integrate multiple calculation approaches.

Third Country Branches

The PRA will broadly implement the full proposals from CP12/23. These remove requirements for UK branches of foreign insurers to calculate and report branch capital requirements and minimum capital requirements and to hold local assets to cover them. This significant reform should benefit around 130-plus branches of foreign insurers (except Swiss

[1] Commission Delegated Regulation (EU) 2015/35

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general insurers, which are handled separately) immediately, as well as any other branches that seek authorisation to operate as a branch in the UK in the future.

Solvency UK Thresholds

The PRA has increased the annual gross written premiums threshold at which Solvency UK will apply from £15 million to £25 million. There is a £50 million threshold relating to gross technical provisions (double the current threshold), which is aimed at nurturing insurtech businesses.

Further, the PRA has increased the thresholds for reinsurance operations such that a firm will be subject to Solvency II if its business includes reinsurance operations exceeding £2.5 million of its gross written premium income, or £5 million of its gross technical provisions rather than the thresholds of £530,000 or £2.4 million, respectively, as provided in CP12/23.

Mobilisation

The PRA will implement its proposals for a new mobilisation regime for startup insurers, with adjusted entry requirements such as a lower capital floor, lower expectations for key personnel and governance structures, and exemptions from some reporting requirements, which is also aimed at developing the UK insurtech sector. A firm is expected to remain in the mobilisation period for 12 months, and will need to apply for a variation of permission to exit mobilisation.

Initially, to qualify, firms must meet the following criteria:

- A total net policy exposure of £50,000 or less.
- Policies must be short-term (maximum policy term of two years).
- Policies must be on a "claims-made" basis.
- Policies have no exposure to liability, large or long-tail risk.

Currency Redenomination

The PRA's proposed rules redenominate references in its existing rules from euros to pounds sterling. The PRA's PS2/24 proposes no changes to the draft rules set out in the initial consultation.

Reporting and Disclosure

In PS3/24, the PRA set out a near-final policy statement regarding changes to the Solvency II reporting and disclosure requirements. This includes the introduction of a new policy on reporting waivers. The revisions set out in PS3/24 are in line with the PRA's objectives of reducing reporting requirements (the proposals include the removal of 55 reporting templates) while enhancing the quality of the data reported to it.

In amending final policy, the PRA has relaxed certain data fields and requirements where the cost/burden on firms may outweigh the supervisory benefit to the PRA. The changes include:

- Further simplifying the proposed reporting on reinsurance;
- Reverting back to quarterly reporting of life and non-life technical provisions;
- Removing the requirement of reporting a new template of activity per country, and instead using simplified versions of the existing solo level reporting on insurance activity and best-estimate liabilities as the basis for country-level reporting.

Next Steps

The publication of PS2/24 and PS3/24 mark a significant milestone in the UK's transition from the EU's Solvency II framework towards a new "Solvency UK", moving the UK back towards a less prescriptive and more principles-based regulatory rule set. The changes to systems and controls set out herein will need to be implemented by insurers by 31 December 2024.

The next and final milestone as part of the Solvency UK set of reforms will be the PRA's publication of a policy statement setting out final rules for changes to the matching adjustment, which expected in mid-2024.

PRA Consultation on Solvent Exit

The PRA has, since January 2023, prioritised "ease of exit" for (re)insurers that cease business or, worse, fail. It is now consulting on a requirement for UK (re)insurers to produce a "solvent exit" plan.

By way of context:

- All (re)insurers operating in the UK are already required under the PRA's Fundamental Rule 8 to prepare for resolution to exit in orderly fashion.
- The largest and systemically most important global (re)insurers have been required for some time now to develop and maintain "living wills" under IAIS requirements.
- In February 2023, the PRA consulted on the introduction of a resolution regime for UK (re)insurers, laying out sweeping powers for the Bank of England to act as "resolution authority" in the event of actual or potential failure. See our 28 February 2023 article, "(Re)insurers in Financial Difficulty".
- The current consultation mirrors a similar PRA exercise in June 2023 (CP10/23) detailing equivalent proposals for non-systemically important banks and building societies.

The current consultation paper (CP2/24), released on 23 January 2024, outlines requirements for PRA-regulated (re)insurers to prepare for (and if necessary execute) an orderly solvent exit. Solvent exit is defined as the process by which a (re)insurer ceases its insurance business in an orderly manner whilst still remaining solvent through the process of winding down. A firm may execute a solvent exit for a range of reasons. These include:

- Financial issues (such as underwriting losses).

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- Non-financial issues (such as governance failure or loss or failure of IT infrastructure).
- Business model unsustainability (such as inability to secure capital or reinsurance).
- Change of strategic direction or priorities.
- Where part of a group, other group members facing the above issues.

The PRA recognises that firms will often pursue recovery ahead of solvent exit. That said, the PRA has observed that, compared to insolvency, solvent exit is seen as a more efficient, cost effective and less disruptive mechanism for a (re)insurer to cease engaging in regulated activities. The proposals address PRA concerns that (re)insurers may struggle to execute a solvent exit successfully. Whilst many solvent exits have concluded without significant issues, the PRA observes that some orderly exits have been delayed by barriers to exit only being identified once solvent exit execution planning has already begun.

The proposals relate to all PRA-regulated (re)insurers, including UK Solvency II (re)insurers, non-Directive (re)insurers, and the Society of Lloyd's and its managing agents. The proposals do not apply to (re)insurers in passive run-off (*i.e.*, those that have ceased effecting contracts of insurance or whose PRA permission has been removed and those which are not run-off acquirers) or to UK branches of overseas (re)insurers.

The proposals do not apply on a group level basis, but solo (re)insurers should consider the implications and risks arising from group membership when preparing the solvent exit analysis (SEA). However, subject to prior approval from the PRA, solo (re)insurers can prepare a group-wide SEA should they prefer to do this.

Under the proposals, an (re)insurer must:

- Prepare for a solvent exit as part of its "business as usual" activity and document those preparations in an SEA.
- Monitor and manage a solvent exit if that becomes a reasonable prospect.
- When required, prepare a detailed "solvent exit execution plan".

Solvent Exit Analysis

The SEA must be updated at least every three years (at minimum, with updates also being required where a material change occurs). The SEA must detail how (re)insurers can exit from their insurance business including at a minimum information on (and to a level proportionate to the nature, scale, and complexity of the (re)insurer), the following:

- Solvent exit actions.
- Solvent exit indicators.
- Potential barriers and risks.
- Resources and costs.
- Communications.
- Governance and decision-making.

The PRA provides non-exhaustive examples of the contents of each of the above categories, including as follows:

- Solvent exit actions should include how the (re)insurer would carry out a solvent run-off of its liabilities and set out appropriate options such as transfer/ partial transfer of its assets or business (including of renewal rights or underlying liabilities by portfolio transfer), solvent scheme of arrangement and/ or restructuring plan. These actions should result in transfer/ repayment of all insurance liabilities.
- Solvent exit indicators should identify the trigger point at which the (re)insurer would need to move to solvent exit. These indicators should include financial and non-financial metrics, to include: solvency coverage, relative loss of capital, profit and loss, underwriting loss, reserves deterioration, asset losses, and relative increase in lapse rate, operational difficulties and staff turnover.

Solvent Exit Execution Plan (SEEP)

A SEEP must be produced within one month of a reasonable prospect arising that the (re)insurer may need to execute a solvent exit, or when requested by the PRA. The SEEP — which must be shared with the PRA — should include at a minimum detail on the following:

- Actions and timeline.
- Identification and mitigation of barriers and risks.
- Communication plan for stakeholders impacted.
- Execution of the solvent exit.
- Assessment of the financial and non-financial resources needed, and how the (re)insurer will monitor and maintain these resources.
- Governance arrangements.
- Organisational structure, operating model and internal processes.

The PRA provides non-exhaustive examples of the contents of each of the above categories.

The consultation is open until 26 April 2024, and the PRA intends to publish a Policy Statement on this topic in Q2 2024. The proposed implementation date for the changes that would result from this CP is Q4 2025.