Regulatory Developments in the European Union and the United Kingdom in Q1 2023

26 April 2023

This note provides an overview of the regulatory developments affecting the insurance industry in the United Kingdom (the "UK") and the European Union (the "EU"), with a focus on the first quarter of 2023.

UK Solvency II Review

Background

In April 2022, HM Treasury began consulting on the UK's Solvency II review by outlining its package of proposed reforms in a consultation paper. Following the submission of comments from stakeholders, HM Treasury published its response in November 2022, with the UK Prudential Regulation Authority (the "PRA") concurrently publishing a feedback statement on the topic (FS1/22).

Reforms proposed by HM Treasury

As a result of the consultation process, HM Treasury has resolved to proceed with the following package of key reforms:

- the government will legislate to reform the risk margin in a way that will reduce it by 65% for long-term business and by 30% for general business;
- the "fundamental spread" will remain as it currently stands, save for an increase in its risk sensitivity to permit differing allowances within major credit ratings;
- the pools of assets that are eligible for the matching adjustment will expand to include assets with highly predictable cash flows; and
- the capital requirements for UK branches of international insurers will be eliminated and the calculation of group capital requirements will be relaxed.

The Response of the PRA and the Bank of England (the "BOE")

In February 2023, the PRA's CEO, Sam Woods, gave a speech that considered the final reform package proposed by HM Treasury. He noted that the changes to the capital requirements for international insurance groups is expected to reduce barriers to entry and transaction costs for M&A, and increase competition.

Mr Woods recognised that HM Treasury had chosen not to adopt the PRA's proposal to improve the fundamental spread's sensitivity to uncertainties around future losses and to differences in risks across asset classes. He confirmed that the PRA would not be using its expanded powers under the Financial Services and Markets Bill (the "FSM Bill") to implement these changes through delegated powers to enact secondary legislation.

The FSM Bill introduces a series of reforms to the regulation of the UK's financial services industry following Brexit. It has completed its passage through the House of Commons and is at the report stage in the House of Lords.

The BOE indicated in its assessment of the potential impact of HM Treasury's proposals that the reduction to the risk margin could lead to a significant outflow of the capital held by life insurance firms. According to the BOE's estimates, this could increase the likelihood of insurer failure by 20%, i.e. from 0.5% (1/200) to 0.6%. The BOE noted that the outflow of capital would have been more conservative if the PRA's proposals on the fundamental spread had been adopted.

The BOE accepted that it was difficult to draw inferences about potential costs to the Financial Services Compensation Scheme (the "FSCS") due to the potential increase in the likelihood of insurer failure. Nevertheless, it concluded that the cost of any compensation payments in the event of a failure would be borne at least in part by the surviving firms, via an increase in their contributions to the FSCS.

Review of the Senior Managers and Certification Regime (the "SM&CR")

On 30 March 2023, the PRA and the Financial Conduct Authority (the "FCA") published a joint discussion paper on the review of the SM&CR (DP1/23). As we previously discussed here, the reform presents an opportunity for reducing waiting times for the authorisation of senior managers, to promote greater regulatory alignment with other key regulatory regimes and to tailor the regime to the size and complexity of individual firms.

The SM&CR is a regulatory regime that sets standards for the fitness and propriety of senior decision-makers and the reasonableness of their actions, and governs the conduct

of almost all employees in the financial services sector. It applies to regulated financial services firms and forms a key part of the PRA and the FCA's regulatory approach based on individual responsibility. Its scope is likely to expand; the FSM Bill seeks to extend the SM&CR's reach to, among others, credit rating agencies, investment exchanges and central securities depositories. The discussion paper invites responses by 1 June 2023.

Insurers in Financial Difficulties

UK Reform

On 8 February 2023, the PRA published a consultation paper (CP 3/23) on dealing with insurers in financial difficulties (the "Consultation Paper"). As we previously discussed here, the FSM Bill clarifies and expands the 'write-down' process for insurers in financial difficulties, pursuant to which the courts will have power to write down a portion of the insurer's liabilities as an alternative to making a winding-up order. The key proposals put forward by the PRA for the implementation of this new regime are summarised below.

Top-up payments from the FSCS

- The FSM Bill envisions top-up payments being made by the FSCS to policyholders in the event of a write-down. The Consultation Paper details the triggers and mechanics for these payments.

- The insurers will act as intermediaries and deliver the top-up payments to be delivered to the policyholders. While the FSCS will retain a right of recovery against the insurer, an insurer cannot be declared to be in default as long as the write-down process is ongoing.

Notification of affected persons

- The FSM Bill will require insurers to notify those affected by the write-down process. The PRA proposes that 'affected person' is defined broadly to include, among others, policyholders, reinsurers, creditors, lenders and certain bondholders.

- Insurers will inform affected persons about the write-down order and its implications, with the PRA having discretion to provide waivers or modifications where notifications would be impractical.

The PRA's consent for a write-down application

- Under the FSM Bill, an application to the court for a write-down order cannot be made without the PRA's consent.

- The PRA proposes that any applicant for a write-down order should supply documentary information, including an explanation of the rationale for, and an outline of, the application, with a provisional timetable.

Regulatory Interventions

The sharp rises in interest rates and market volatility have placed the liquidity of certain insurers and other financial institutions under stress. Regulators in Italy and Switzerland have intervened in response.

On 31 January 2023, the Italian insurance regulator, the Institute for the Supervision of Insurance, suspended Eurovita S.p.A.'s management and appointed a provisional administrator to oversee the life insurer's activities. It also suspended the right of policyholders to redeem their policies until 31 March 2023. On 30 March 2023, the life insurer was placed in extraordinary administration, with the suspension of the policyholders' right to redeem extended until 30 June 2023.

On 23 March 2023, the Swiss Financial Market Supervisory Authority ("FINMA") published a press release (the "Press Release") explaining the basis for writing down the value of Additional Tier 1 contingent convertible bonds (the "AT1 bonds") as part of UBS Group AG's acquisition of Credit Suisse Group AG ("Credit Suisse").

The Press Release argued that the bonds contractually allow for a complete write-down in the case of a 'viability event', including the provision of extraordinary government support. FINMA pointed out that this provision was triggered when Credit Suisse was "granted extraordinary liquidity assistance loans secured by a federal default guarantee on 19 March 2023." In addition, the Press Release stated that FINMA was authorised to order Credit Suisse to write down the AT1 bonds under an emergency ordinance. The insurance industry appears to have limited exposure to the debt obligations of Credit Suisse, particularly the AT1 bonds and, notwithstanding recent events, the insurance sector as a whole remains well-capitalised.

Lloyd's Byelaw Review

On 10 February 2023, Lloyd's published a market bulletin regarding changes to its Byelaws (the "Bulletin"). The key changes introduced by the Bulletin concern the Multiple Syndicate Byelaw (the "MSB") and the Underwriting Byelaw (the "Byelaws").

- Revocation of the MSB:
    - The MSB concerned the conflict of interest issues that may arise in situations where a single underwriter acts for more than one syndicate. Under the MSB, an underwriter could not bind risks in these circumstances without prior agreement from Lloyd's. Similar restrictions applied to reinsurance agreements between syndicates with the same managing agent.
    - The MSB has now been revoked, on the understanding that these restrictions were too rigid and burdensome, save for a provision of the MSB dealing with managing agents' obligation to take into account the best interests of syndicate members. This provision has been moved to the Byelaws.
- Amendment to the Byelaws:
    - Under the Byelaws, syndicates are not allowed to exceed their capacity when underwriting risk. However, this restriction places a particular burden on syndicates that do not have a common ownership structure with their managing agents. These syndicates cannot increase their capacity partway through the year.
    - The amendment grants Lloyd's a discretionary power to permit a syndicate to exceed its capacity. The Bulletin indicates that this power would only be used in exceptional circumstances.

Sustainability and Climate-Related Risks

Regulatory Developments

Regulators in the EU and the UK have been refining their treatment of sustainability and climate-related risks. On 5 March 2023, European Insurance and Occupational Pensions Authority (the "EIOPA") finished gathering views on its discussion paper on the prudential treatment of sustainability risks (the "Discussion Paper"). The Discussion Paper forms part of EIOPA's mandate under the proposed reforms to Solvency II to consider sustainability risks and how they can best be captured within the regulatory framework. We previously discussed the ongoing EU Solvency II review here. The Discussion Paper also seeks to narrow the protection gap between the exposure of individuals and firms to climate risks and the amount that is actually insured. Natural catastrophe risk is an area of particular concern.

The Discussion Paper asked whether Solvency II should treat assets and activities that have a significant impact on "environmental or social objectives" separately. The

Discussion Paper also considered the proper definition and taxonomy for these objectives. The next steps include a public consultation focussed on possible policy reforms.

On 13 March 2023, the BOE published a report on climate-related risks and the regulatory capital frameworks (the "Report"). The short-term priority for the BOE is for firms to improve their ability to identify, measure and manage climate risks—called the 'capacity gap' in the Report.

The Report notes that regulators such as the PRA expect firms to make "continual progress" while acknowledging that most firms will not have "an end-state framework for climate risk measurement at this time". It also highlights that having high-quality information on climate risk would aid insurers and other firms in their evaluation of counterparty risk profiles. The availability and consistency of such information depends to a certain extent on the disclosure standards that are put in place, and the PRA appears to support greater disclosure obligations on insurers and other firms. Further to this, the PRA has suggested that firms develop an appropriate approach to climate-related financial disclosures as part of their disclosure obligations under Pillar 3 of Solvency II.

Going forward, the BOE will consider how the regulatory capital frameworks for (re)insurers, pursuant to UK Solvency II, can be adjusted to capture and adequately reflect the complex and long-term nature of climate risks. The frameworks may need to expand to capture additional natural catastrophe events driven by climate change. However, the PRA has previously expressed the view that reducing capital charges is not the best approach from a prudential perspective, and the Report concluded that there was no immediate need to reform the time horizons in these frameworks.

Industry Developments

On 31 March 2023, Munich Re discontinued its membership of the Net Zero Insurance Alliance (the "NZIA"), citing concerns about potential liability under antitrust laws. On 5 April 2023, Zurich Insurance Group withdrew from the NZIA as well, stating that the group would focus on assisting its "customers with their transition". Hannover Re followed suit on 19 April 2023 (although it did not give details on the reason for its departure). The NZIA brings together around 30 (re)insurers who pledge to ensure that their underwriting portfolios will reach net zero emissions by 2050.

In September 2022, U.S. regulatory authorities warned that efforts to bring about a coordinated approach to reach net zero were not excepted under U.S. antitrust law. As we previously noted here, the Chair of the Federal Trade Commission confirmed that such agreements "in as much as they can affect competition, are always relevant" to U.S. antitrust law. In contrast, the regulators in the EU and the UK are considering various

carve-outs for efforts by firms to pursue sustainability goals, such as adopting a safe harbour from liability under EU competition law for sustainability agreements.

* * *

Please do not hesitate to contact us with any questions.

LONDON

Claire Swirski
cswirski@debevoise.com

Benjamin Lyon
blyon@debevoise.com

Philip Orange
porange@debevoise.com

Laura Jackson
ljackson@debevoise.com

Katie Power
kpower@debevoise.com

Francis Walters
fwalters@debevoise.com

NEW YORK

Joey Kaminsky
jkaminsky@debevoise.com