

Client Update

UK and European Insurance Regulatory Developments, Autumn 2017

INTRODUCTION

In this client update, we highlight some recent insurance regulatory and legislative developments, including the latest report on Solvency II published by the House of Commons Treasury Committee and a consultation on Solvency II initiated by the Prudential Regulation Authority. We also examine the latest proposals for Insurance Linked Securities by HM Treasury, a recommendation on delaying the implementation of the Insurance Distribution Directive by the European Parliament's Economic and Monetary Affairs Committee and proposed amendments to the Financial Services Compensation Scheme by the Financial Conduct Authority.

HOUSE OF COMMONS TREASURY COMMITTEE—SOLVENCY II

On 27 October 2017, the House of Commons Treasury Committee published its third [report](#) on the Solvency II Directive and its impact on the UK insurance industry. It relates to the enquiry into the Directive launched in [September 2016](#).

In the report, the Committee encourages the Prudential Regulation Authority (“PRA”) and the insurance industry to cooperate more closely on matters of importance to the industry and criticized the PRA’s application of some Solvency II rules.

Specifically, the report contains 11 recommendations to the PRA, including recommendations that it should:

- develop proposals for the Matching Adjustment and the Volatility Adjustment which allow more flexibility and a more principles-based approach and which reduce the requirement for insurers to develop complex structures in order to achieve the regulatory treatment that they warrant;

- agree with the industry on an approach to the treatment of illiquid assets, balancing prudential concerns with the desire not to create unreasonable barriers to insurers investing in long term assets;
- set out proposals which reduce the amount of data required from firms to the level that the PRA can clearly demonstrate is proportionate and necessary for prudential safety;
- develop rules for contract boundaries which reflect their economic substance rather than their legal form;
- provide a view of where it might be possible better to align UK regulation post Brexit with IFRS17, weighing the disadvantages of change against the benefits of harmonisation; and
- develop a solution for firms that will lose the legal validity of their contracts after Brexit.

The Committee requested a progress report from the PRA by 31 March 2018, including commentary on the extent to which there has been change or substantive progress and where the industry agrees with the approach taken. The Committee would also like to see the development of an agreed strategy designed to provide a roadmap for:

- what changes to insurance regulation can be implemented now, unilaterally, by the UK authorities;
- what steps the UK regulator would like to see taken to refine the Directive or its applicability to the UK, post-Brexit;
- what action can be taken post-Brexit to foster innovation, competition and competitiveness for the benefit of UK consumers and the UK insurance industry more broadly; and
- how UK insurance regulation will harmonise with international capital standards and emerging accounting standards.

PRA LAUNCHES SERIES OF CONSULTATIONS: FIRST CONSULTATION – MATCHING ADJUSTMENT UNDER SOLVENCY II

On 25 October 2017, the PRA published the first in a short series of consultation papers aimed at improving the implementation of Solvency II. The consultation paper ([CP21/17](#)) concerns the application of the matching adjustment under Solvency II. Further consultation papers in the series will shortly follow; the PRA will consult on the model change process in December 2017, and the reporting obligations in January 2018.

The matching adjustment allows firms to adjust the relevant risk-free interest rate term structure for the calculation of a best estimate of a portfolio of eligible insurance obligations. The conditions to apply the matching adjustment set out in Solvency II are stringent, however, and the PRA has been working with the industry since before the implementation of Solvency II on its interpretation of various aspects of the regime's matching adjustment.

In this consultation paper the PRA proposes to consolidate and update the material previously set out in executive directors' letters and feedback statements into a new supervisory statement. The PRA is also proposing to introduce updated guidance in relation to various aspects of the matching adjustment, including how to demonstrate final cash flows, criteria for assessing sufficient compensation on a change of assets, asset restructuring, trading in the matching adjustment portfolio and changes to the portfolio approval.

HM TREASURY & THE PRA – INSURANCE LINKED SECURITIES

On 12 October 2017, HM Treasury published updated drafts of the [Risk Transformation Regulations 2017](#) and the [Risk Transformation \(Tax\) Regulations 2017](#), which implement the new regulatory and tax framework for Insurance Linked Securities (“ILS”). The Regulations are now finalised, and await Parliamentary scrutiny.

The Regulations make provision for a bespoke regulatory, supervisory, and tax framework for ILS business in the UK. Such a development has been long discussed as a result of the significant growth of ILS business in recent years, currently amounting to around \$70bn, or about 12%, of reinsurance capital, which is projected to continue growing.

The main amendment to the Risk Transformation Regulations is the inclusion of insolvency provisions for protected cell companies. For the Risk Transformation (Tax) Regulations the main amendment is the omission of the penalty condition from of the Regulation.

Draft explanatory memoranda to [the Risk Transformation Regulations 2017](#) and the [Risk Transformation \(Tax\) Regulations 2017](#) were published on 16 October 2017.

In conjunction with the regulations, on 1 November 2017 the PRA published a supervisory statement ([SS8/17](#)) on its approach and expectations in relation to the authorisation and supervision of insurance special purpose vehicles (“ISPVs”) that issue ILS. It also applies to multi-arrangement insurance special purpose vehicles (“MISPVs”).

The statement is relevant to parties that wish to apply for, or have obtained authorisation as, an ISPV, and to insurers and reinsurers seeking to use UK ISPVs as risk mitigation in accordance with Solvency II.

The PRA collaborated with HM Treasury to design a new safeguard which removes the need for an ISPV to notify supervisors of a proposal to assume new risks before it takes effect. In July 2017, the PRA announced that it will authorise each ISPV’s Scope of Permission, including the parameters within which future cells may be established.

This proposal is confirmed in the supervisory statement. It also contains additional guidance in other areas, including:

- the fully funded requirement;
- the Senior Insurance Managers Regime;
- the fit and proper assessment of shareholders with a qualifying holding; and
- circumstances in which ISPVs may be authorised prior to receiving funding.

The PRA have, however, resisted giving into industry criticisms that a 6-8 week period for authorisation will make the UK regime incompatible with offshore jurisdictions.

The supervisory statement will be formally adopted once the Risk Transformation Regulations 2017 have passed through Parliament.

ECON—IMPLEMENTATION OF THE IDD

At a meeting held on 17 October 2017, the European Parliament's Economic and Monetary Affairs Committee ("ECON") voted to adopt a recommendation calling on the European Commission to extend the application date for measures implementing the Insurance Distribution Directive ("IDD").

ECON agrees that the transposition deadline for IDD should remain 23 February 2018 but requested the Commission to assess whether the application date for measures implementing IDD could be extended to 1 October 2018.

Delayed implementation of the IDD is likely to be widely welcomed by the insurance industry.

FCA—AMENDMENTS TO THE FSCS

On 30 October 2017, the Financial Conduct Authority ("FCA") opened a [public consultation](#) on amendments to the Financial Services Compensation Scheme ("FSCS"), which is funded by a levy on financial firms. Currently, the size of the levy corresponds to the size of the firm. Under the proposed scheme, it would depend on the level of risk the firm poses to the fund.

This would result in a scheme where firms (including insurers) that design financial products contribute more towards compensation costs, including where their financial products are sold through intermediaries. This may result in firms bearing additional costs to guard against failures by intermediaries and other outside advisors over whom they have little influence.

The reform has been prompted by new "pension freedoms" that allow individuals to cash in their pensions and seek advice on putting the money into potentially riskier products.

The scheme's coverage will be extended to include some aspects of fund management and to certain debt management activities. The FCA also proposes to raise the compensation limit for

investment provision, investment intermediation, home finance intermediation and debt management claims from £50,000 to £85,000.

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Please do not hesitate to contact us with any questions.

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