MILLIMAN BRIEFING NOTE

The UK Review of Solvency II

Considerations for the future regulatory landscape in the UK

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Following the end of the Brexit transition period, from 1 January 2021, the UK insurance market has been regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), using the Solvency II regime as set out by the European Insurance and Occupational Pensions Authority (EIOPA). The PRA now has full authority to make changes and design its own insurance regulatory regime, and the first such changes (in relation to the risk-free discount rate) have already been made. At the present time, the UK regime does not have equivalence with the EU, and there is no indication that this situation will change in the near future[1].

The UK Government, in particular HM Treasury (**HMT**) and the PRA, have started to review the current application of Solvency II in the UK and to make amendments to the regulatory environment to tailor it to the UK insurance market. The review and subsequent amendments have arisen, and will continue to arise, from a number of different initiatives by HMT and the PRA, with further releases expected in the coming months and years. A limited number of aspects of the review or the possible amendments resulting from them have been confirmed at the point of writing[2] and there is still much uncertainty over what the future UK insurance regulatory landscape will look like.

The full PRA QIS exercise was published on 20 July 2021. This will be covered in detail in a subsequent paper by Milliman.

This paper, drafted by Milliman consultants in the UK, aims to summarise the aspects of the review released to date.
The areas we have focused on are:

- HMT Review of Solvency II, including the Call for Evidence and the responses to it
- The background to the PRA's Quantitative Impact Study (**QIS**)
- The PRA's Phase 1 consultation on the Review of Solvency II Reporting
- Overall considerations of the UK's review of Solvency II

HM Treasury Review

THE CALL FOR EVIDENCE

In October 2020, HMT released a Call for Evidence seeking views on the potential reforms of Solvency II and the regulation of the UK insurance market. The Call for Evidence remained open until February 2021. On the 2 July 2021, a follow-up paper was released by HMT summarising the responses received to the Call for Evidence on the Review of Solvency II.

In summary, the responses to the Call for Evidence demonstrated a strong support for Solvency II and stressed that any potential changes need to factor in the associated cost and disruption as well as the level of divergence from the Solvency II framework that will apply in the EU following any changes.

Many of the respondents believe that the current Solvency II framework is overly rigid and rules-based and would like to see a better mix of judgment and rules with a more proportionate and flexible approach to regulation.

The following diagram shows the timeline of the Review of Solvency II to date including the change reflecting the transition of the risk-free rates.

[1] The UK Government considers the UK's regime equivalent, however the UK regime has not received equivalent status from the EU at this time.

[2] Changes to the calculation of the equity symmetric adjustment have already taken place and the transition from LIBOR to SONIA will take place at end of July 2021.

FIGURE 1: TIMELINE OF THE UK REVIEW OF SOLVENCY II

The Call for Evidence focussed on ten major areas:

1) The Risk Margin
2) The Matching Adjustment (**MA**)
3) The calculation of the Solvency Capital Requirement (**SCR**)
4) The calculation of the consolidated group SCR using multiple internal models
5) The calculation of the Transitional Measures on the Technical Provisions (**TMTP**)
6) Reporting requirements
7) Branch capital requirements for foreign insurance firms
8) Thresholds for regulation by the PRA under Solvency II
9) Mobilisation of new insurance firms
10) Risk-free rates: transition from LIBOR to SONIA

Each of the ten areas in the Call for Evidence are covered in greater detail below.

THE RISK MARGIN

Many industry participants (particularly those in the life insurance sector) believe that the Risk Margin is too large and volatile—specifically to changes in interest rates given the current economic environment. This means that the current calibration and calculation of the Risk Margin does not actually reflect transfer pricing, which leads to firms transferring longevity risk outside the UK and impacts the availability and pricing of certain products.

The responses to the Call for Evidence presented a number of alternative methods to reform the Risk Margin which may lead to a reduction in the range of 20% to 75%. The methodologies proposed included:

- A reduction in the assumed cost of capital rate
- The introduction of a time-sensitive ("lambda") factor similar to that proposed under the EIOPA Solvency II Review[3]
- The percentile Margin Over Current Estimate (**MOCE**) approach currently proposed under the Insurance Capital Standards (**ICS**)[4]
- To allow for diversification between lines of business and group entities
- To treat longevity risk as partly or fully hedgeable
- To set the Risk Margin as a percentage of the Solvency II Best Estimate Liability (**BEL**)
- To include the Risk Margin in the SCR rather than the Technical Provisions
- To change the discount rate used in the calculation (perhaps to include the volatility adjustment (**VA**) or MA)
- To apply a "principles-based" approach rather than a prescriptive approach

THE MATCHING ADJUSTMENT

The responses to the Call for Evidence identified that some support the principles of the MA, highlighting that it helps to reduce procyclicality, while others are against it (stating that it is imprudent and has no clear economic rationale).

Some key areas mentioned in the paper relating to the MA include:

- Re-examining the basis for the MA and the risks to which firms that most benefit from the MA (i.e., annuity writers) are exposed
- Considering the calculation and calibration of the Fundamental Spread (**FS**) and whether companies should determine their own FS

[3] Milliman summary of EIOPA's Solvency II 2020 Review

[4] Milliman publication on the ICS

- Considering the use/impact of internal credit ratings (with respondents' opinion divided between a tightening and a loosening of the requirements)
- Whether the benefit arising from the use of the MA should be presented separately on the Solvency II balance sheet
- The potential for the MA (or illiquidity premium) to be set by the PRA and be more focused on the features of the liabilities

It was highlighted that the PRA may consider compelling firms to use external ratings if it believes that the internal ratings are too optimistic and/or that the PRA may investigate cases where a high MA benefit is coupled with a low capital charge.

Other potential changes to the MA cover a number of areas set out below.

The eligibility of assets and liabilities for the inclusion in an MA portfolio

There were mixed views from respondents regarding whether the current eligibility rules should be loosened or tightened and whether or not they hinder investment in suitable matching assets.

Those in favour of a loosening of the requirements stated that they unintentionally lead to certain assets (such as Equity Release Mortgages (**ERMs**)) being restructured to meet the criteria which adds unnecessary cost and complexity (which can be a barrier for smaller firms). Other respondents stated that ERMs are not appropriate assets for inclusion in MA portfolios

The suggestions put forward to reform the MA eligibility rules include:

- Changing the requirement for assets to have "fixed" cashflows to "highly predictable" cashflows
- To focus only on asset matching and remove asset eligibility criteria all together
- To allow for assets with prepayment risks (such as ERMs)
- To vary matching test limits by asset type
- To increase the focus on the Prudent Person Principle and liquidity management

The calculation of the MA

Respondents also provided their views on the calculation of the MA itself. In line with the comments on the eligibility rules, some respondents thought that the MA should be increased while others thought it should be decreased.

Those in favour of an increase stated that:

- The "BBB cliff"[5] impact should be removed
- The granularity of the FS should be increased
- The Long-Term Average Spread (**LTAS**) should be removed from the calculation of the FS
- The 30% recoverability assumptions used in the FS should be removed and set individually by firms

On the other hand, those in favour of a decrease to the MA stated that:

- The FS should be made more responsive to, amongst other things, current market conditions
- The credit element of the FS should be recalibrated, for example by separately specifying the best estimate and risk premium components
- Other general uncertainties in its specification

The MA approval process

Overall, respondents felt that the MA approval process is too costly and time/resource consuming. Suggestions were made that:

- The approval process should not simply result in a binary outcome
- "Minor" changes to the MA portfolio should not require formal approval

The MA and Climate Change/Infrastructure assets

Once again there were mixed views with some respondents suggesting that the MA could incentivise investment in green assets/infrastructure (or disincentivise investment in "brown" assets[6]) via the MA calculation. This could be achieved via changes to the FS, via changes to credit ratings, or via the asset eligibility rules. Other respondents stated that, as a technical item, the FS should not be used to create such incentives.

THE CALCULATION OF THE SCR

Overall, the respondents showed support for the risk-based nature of the Solvency II framework and the use of internal models as they provide firms with a better understanding of risks and capital adequacy. However, some respondents stressed that the framework needs to be efficient in both the calculation of the SCR and the Internal Model (**IM**) approval process. As well as these issues, the responses covered a number of areas detailed below.

[5] The 'BBB cliff' refers to limiting the MA of sub-investment grade assets so that it does not exceed the MA of similar assets of investment grade, as set out in Article 77c of the Solvency II Directive.

[6] Brown assets refer to assets which represent investments which damage the planet and contribute to climate change.

Internal Model approval process

Regarding the approval process, some respondents commented that the current approval process was lengthy, costly and burdensome, and that a proportionate, flexible and more transparent approach should be considered.

Some specific suggestions that were put forward by respondents were:

- Components of the Standard Formula would be allowed to be used in Internal Models
- Replacement of Major/Minor model changes with Complex/Simple and/or the introduction of a "Significant Minor" category
- A more flexible internal model application process with reduced documentation requirements and a shortened review period
- The use of capital add-ons or PRA-specified assumptions as part of the approval decision to potentially lower the bar for model approval and make the decision less binary
- Removal of the need for Internal Model firms to submit information on a Standard Formula basis

Calculation of the Standard Formula SCR

Once again, there were differing views from respondents. Some stated that it was a useful default option but others said that it was too onerous, particularly for smaller firms. In addition, some commented on the limited ability to adapt the Standard Formula while others warned that introducing such flexibility may no longer make the model "standard."

Some of the other limitations of the Standard Formula raised by the respondents were:

- That some of the risk charges for certain risks (or the assumptions underlying these) are not appropriate and may not factor in prevailing market conditions
- That certain risks are omitted and that some modules are at an insufficient level of granularity
- That inappropriate allowances are made for:
  - Certain risk-mitigation techniques and hedging strategies
  - Diversification benefits
  - Certain asset types (such as restructured assets)

The following changes to the Standard Formula were suggested by respondents:

- Recalibrating the Standard Formula so that it is more relevant to UK firms, though some respondents thought there would be limited benefit from this
- To expand the scope for the use of Undertaking-Specific Parameters (**USPs**)
- To permit the Standard Formula to be combined with external/proprietary models without the need to apply for a Partial Internal Model (**PIM**)
- To reduce the time period that derivatives need to be held to be treated as investment hedging

Alternatives to the current Internal Model options

Some respondents put forward suggestions for alternatives to the current capital models (Standard Formula, PIM, and IM). These included:

- Making approval for the use of USPs easier and also extending their use to cover operational risk and credit risk as well as lapse risk for non-life insurers
- Introducing an "Undertaking-Specific Methodology" which would be a different approach to a PIM as the methodology would bear a strong resemblance to the Standard Formula

The paper also covered two other related topics to the Standard Formula—the tools used by the PRA to assess firms' solvency levels and the treatment of climate change.

PRA tools to assess solvency levels

In general, respondents felt that the current process works well and that the PRA already have sufficient information, tools, and powers. In fact, others highlighted that they would like the PRA's processes to be more transparent and efficient, particularly with reference to the number of information requests. Some specific tools were mentioned:

- The use of further stress testing for all firms but some respondents commented that this may put a strain on resources and potentially lead to over capitalisation
- Greater use of capital add-ons, for example, to make model approval more flexible when it relates to a specific area (as detailed above). If capital add-ons are increasingly used, respondents mentioned that they should be used transparently, particularly in relation to how the capital add-on can be removed.

Climate change

In relation to climate change there was discussion as to whether the Standard Formula already covers this. Some respondents suggested it was covered (potentially in external credit ratings) while others think a one-year VAR approach will not capture such risks and that a more flexible approach would permit this.

One of the main topics covered was whether the Standard Formula risk charges should be used to incentivise investment in green assets or disincentivise investment in brown assets. Some respondents warned against this approach without legitimate justification and proposed that the ORSA or scenario analysis may be a better way of achieving a similar outcome.

THE CALCULATION OF THE CONSOLIDATED GROUP SCR USING MULTIPLE INTERNAL MODELS

Some respondents provided quite specific feedback in relation to the calculation of the group SCR following a merger or acquisition. In general, respondents stated that a more flexible approach to calculating the group SCR would be helpful with specific areas of the calculation being highlighted. Similar to the comments on the solo SCR, the use of group-level capital add-ons was mentioned as a possible tool to address any deficiencies and operational risks associated with mergers/acquisitions.

THE CALCULATION OF THE TMTP

It was noted that any reforms to the TMTP must be considered in the context of other reforms—particularly the MA. The main areas of feedback related to the calculation of the TMTP, including views that:

- The current process is excessively long, complex and time-consuming, and that the requirement to retain legacy models is burdensome
- The frequency of the recalculation is artificial and the TMTP should be calculated on a continuous basis
- The current formula leads to a doubling of the run-off profile of the TMTP
- The current calibration leaves firms exposed to the sensitivity of differences in illiquidity premium and MA
- The Financial Resources Requirement test should be removed

REPORTING REQUIREMENTS

Over half of all the respondents to the Call for Evidence shared the view that the current Solvency II reporting requirements are onerous and the volume of data submitted to the regulators should be reduced. Some respondents did, however, feel that the current requirements were appropriate and should be retained to maintain consistency with other jurisdictions applying Solvency II.

A number of respondents suggested options to reduce existing reporting requirements. These included:

- Reductions to the frequency of reporting, e.g., removal of quarterly reporting so that firms only submit data on either a half-yearly or annual basis
- Increased proportionality by a reduction in the volume of data collected, including removal of items which are duplicated with accounting and other disclosures
- Alignment of supervisory reporting with the internal information used for insurers' internal management and monitoring
- Removal of some reporting entirely
- Increased use of waivers
- Extension to reporting deadlines
- Minimisation of ad hoc reporting
- Merging of Solvency II requirements with the PRA's National Specific Templates (**NSTs**)

There were also suggestions for areas where current reporting requirements do not capture sufficient data such as:

- Profit reporting to support financial analysis
- Cyber risk
- Climate change risk

As part of the wider review of Solvency II in the UK, the PRA published its Phase 1 consultation paper on potential changes to the Solvency II reporting requirements for UK insurers in July 2021. This is covered in detail later in this paper.

BRANCH CAPITAL REQUIREMENTS

Most respondents were supportive of a removal of the capital requirements for branches of foreign insurance firms noting that the existing requirements added limited prudential benefits and that removal may increase the attractiveness of the UK as a destination for foreign insurers.

Some respondents highlighted concerns about such a removal citing that it could place domestic insurers at a disadvantage competitively while others suggested alternative ways to reform the branch reporting requirements, including:

- Reducing the capital requirements for branch reinsurers, rather than removing them
- Only considering UK-related underwriting activity of the branch firm
- Excluding pure reinsurers from branch requirements
- Removing reporting requirements for branch firms

THRESHOLD FOR REGULATION BY THE PRA UNDER SOLVENCY II

With regards to the threshold for the regulation of an insurance firm by the PRA under Solvency II, respondents to the Call for Evidence shared a number of views. Some industry participants supported an increased threshold for Solvency II to increase the proportionality of the regime, while others supported retaining the current threshold as proportionality is already embedded in the Solvency II regime. It was also noted that the Solvency II regime creates a level playing field for insurers.

Where firms are currently below the threshold for Solvency II (non-Solvency II firms) it was highlighted that proportionality should be the key consideration, with a number of respondents suggesting that non-Solvency II firms have the option whether to comply with Solvency II or the alternative regime for smaller firms depending on the firm's own circumstances.

MOBILISATION OF NEW INSURANCE FIRMS

Many respondents observed potential barriers to entry for new insurance firms as a result of Solvency II, in particular the complexity of the regime and the high cost of compliance with the requirements. Other barriers to entry identified included:

- The difficulty raising capital without authorisation
- The length and uncertainty of the current authorisation process
- The lack of clear guidance for new firms
- Excessive documentation and system requirements for authorisation
- Inability to apply for use of the MA or VA until after authorisation

Respondents also suggested that firms should not necessarily have to comply with Solvency II from outset and suggested alternative approaches to help new firms get started, including thresholds that the firm would need to surpass in order to fall under the Solvency II regime.

Greater proportionality in the mobilisation of new insurance firms was highlighted as having a number of potential benefits including enhanced competition, increased range of products in the market, and an overall increase in the level of insurance business being written and regulated in the UK.

RISK-FREE RATES: TRANSITION FROM LIBOR TO SONIA

The risk-free rates for GBP published by the PRA will transition from using LIBOR to SONIA rates at the end of July 2021.

Industry participants flagged a number of considerations about the transition in response to the Call for Evidence, including:

- The need for clear guidance to avoid any unnecessary disruption
- The need for an upward adjustment to the SONIA curve to reduce the balance sheet impact
- That the transition should aim to have minimal impact on firms
- That firms should be able to calculate their own risk-free rates based on principles established by the PRA; and
- The timing of the transition, with some respondents favouring a transition at the end of 2021 over the current proposed timeline.

Firms can make an allowance for the transition from LIBOR to SONIA in any recalculation of their TMTP which takes place as at 30 June 2021. This would be an additional recalculation allowed by the PRA[7] due to other recent movement in interest rates and would be in addition to the required two-yearly recalculation due at 31 December 2021.

For further information on the transition of the UK Solvency II risk-free rates to SONIA please see Milliman's detailed paper on the proposals published in February 2021.

The PRA's Quantitative Impact Study

Following on from the Call for Evidence and its responses, the Government has asked the PRA to model the different options under consideration to better understand the potential impact of any reforms. To achieve this, the PRA has launched a Quantitative Impact Study (**QIS**) exercise on 20 July 2021. The deadline for submitting a response to the QIS exercise is 20 October 2021. Completion of the QIS is voluntary; however certain firms will be encouraged to submit a response.

This QIS exercise will focus on the following areas:

- The Risk Margin
- The MA
- The calculation of the TMTP

The above areas were highlighted in a speech given by the PRA's Anna Sweeney on 15 June 2021. In this speech, the PRA made it clear that the QIS exercise will require significant resource and in particular that they expect high-quality validated responses from firms. The speech also noted that changes to the Standard Formula SCR are not going to be considered as part of this QIS exercise.

Details of the initial speech given by the PRA can be found here and the PRA has subsequently set up a QIS webpage where the details of the QIS and related matters will be published. In particular, alongside the QIS exercise itself, the PRA has launched an initial data gathering exercise in relation to the MA.

MA DATA REQUEST

On 16 June 2021, the PRA launched its initial data request to firms with MA approval seeking to collect detailed data on asset and liability cashflows relating to insurers' MA portfolios.

The MA data request is not directly part of the QIS; however it is expected to inform the PRA's wider review of the MA and Solvency II. As with the QIS itself, the submission is entirely voluntary but the PRA does encourage firms to take part.

The information request template is available here and requests details as at year-end 2020 covering:

[7] PRA statement on the recalculation of the Transitional Measure on Technical Provisions (TMTP)

- Detailed information on eligible assets held by firms as part of their MA portfolios including the monthly cashflows expected over a fifty-year period
- Further details on assets which are internally rated, or which are externally rated but not by specified External Credit Assessment Institutions
- The monthly liability cashflows of the MA portfolio over a fifty-year period broken down into:
  - Level or fixed claim cashflows
  - Inflation-linked cashflows
  - Expense cashflows
  - Other cashflows
- Description of the items categorised as Expense or Other Cashflows
- Details of the MA benefit calculation
- The results of the PRA Matching Tests for the MA Portfolio

If firms choose to submit the requested data they must do so by 20 August 2021.

As noted above, the full QIS exercise is not summarised in this paper and a subsequent paper focusing on the details of the QIS exercise from Milliman consultants will be released shortly.

Review of Solvency II: Reporting (Phase 1)

On 8 July 2021, the PRA published a consultation paper (**CP**) on proposed changes to the Solvency II reporting requirements for UK insurers and the expectations of the PRA in respect of this. The proposals set out in this CP (CP11/21 – Review of Solvency II: Reporting [Phase 1]) have been created in conjunction with the wider HMT review of Solvency II.

The proposals focus on changes to the Quantitative Reporting Templates (**QRTs**) and generally look to reduce the reporting burden for firms. The following sections summarise the PRA's proposals.

The CP is open for responses until 8 October 2021.

REMOVAL OF CERTAIN QRTS FROM THE REQUIRED REPORTING

The CP proposes that a number of currently reported QRTs would be deleted where the information has been deemed not relevant or could be derived from other information by the PRA to fulfil their role. The QRTs proposed for removal are:

- S.01.02 templates which show basic information on the firm
- S.06.01: summary of assets
- S.15.01 and S.15.02 covering the guarantees of variable annuities
- S.29.01, S.29.02, S.29.03 and S.29.04 covering the variation of excess of assets over liabilities over the reporting year
- All templates submitted under the financial stability reporting requirements which are only reported by firms with total assets on the Solvency II balance sheet in excess of €12 billion

The expectation is that firms would select the 'not reported' option for the templates listed above when creating their submission.

Removal of templates will reduce the reporting burden for firms. Some QRTs such as the S.29 templates can be complex and consequently quite onerous for firms to complete and so we expect these proposed removals to be welcomed.

MINIMUM CAPITAL REQUIREMENTS REPORTING FREQUENCY

The PRA proposes reducing the frequency with which firms are required to report the detailed calculation of the Minimum Capital Requirements (**MCR**).

Currently firms report either S.28.01 or S.28.02 in respect of their MCR each quarter depending on their type of business. The PRA proposes to reduce the frequency to only require firms to complete these templates at the fourth quarter (Q4) and half-year (Q2) valuation dates.

Firms are likely to still require an MCR calculation each quarter to complete S.23.01 covering Own Funds; however where firms have an existing reporting waiver and do not need to complete S.23.01, the MCR calculation will only need to be carried out semi-annually.

This will reduce the reporting requirements for all firms at Q1 and Q3 each year.

PROPORTIONALITY FOR S.16.01

The PRA proposes to exempt pure reinsurers from reporting QRT S.16.01—"Information on annuities stemming from non-life insurance obligation." This would not apply to any reinsurers who write direct business.

EXTENSION TO THE QUARTERLY REPORTING WAIVERS

In the CP, the PRA sets out plans to expand the scope of firms eligible for quarterly reporting waivers to include Category 3 firms. Currently Category 4 and 5 firms only are eligible for quarterly reporting waivers; however other categories of firms have been able to apply for waivers which have been considered by the PRA on a case-by-case basis.

It is expected that this proposal will lead to an increase in the number of firms making use of the quarterly reporting waivers.

Firms which have a quarterly reporting waiver which reduces their Q1 and Q3 submission requirements are likely to see an additional benefit from the removal of the S.01.02, and reduced reporting frequency of S.28.01 and S.28.02, resulting in no quarterly submission at Q1 and Q3 for firms with such a waiver.

IMPLEMENTATION

If the PRA's proposed reporting changes come into effect, they will be applicable from 31 March 2022.

The PRA does not plan to deviate from the EIOPA taxonomy at this date and instead firms can select not reported' in the submission template for any QRTs they are no longer required to complete. This means that the proposed changes in the CP should not require any systems redevelopment to accommodate them.

It is worth noting that there is an expected update to the Solvency II taxonomy due to be published by EIOPA. This update may require some systems redevelopment work; however what this will be is not yet certain and is separate to the PRA CP.

The PRA will make amendments to the necessary supervisory statements to reflect the changes.

CONCLUSION

Overall, the changes outlined in CP11/21 are likely to reduce the reporting burden for all UK insurers, and in particular benefit small to medium sized firms.

Overall Considerations

HMT and the PRA have clearly been very active in commencing their reviews of the UK Solvency II regime following the end of the Brexit transition period on 31 December 2020. Although not Brexit related, one of the first actual changes to come into force, driven by the PRA, is the move to the SONIA-based, risk-free discount curve as from 31 July 2021.

As noted above, we now have the Review of Solvency II initiated by HMT, the data collection exercise in respect of the MA initiated by the PRA, and the PRA's QIS exercise. Although these reviews are split across HMT and the PRA, we would fully expect that HMT and PRA will be liaising closely in receiving consultation feedback and formulating their proposals. We also note that the first PRA consultation stage of the rationalisation of the QRT reporting requirements has been launched, with more expected to follow next year.

Whilst we will clearly need to wait and see what transpires from the above exercises, it is interesting, and potentially useful, to consider together a number of comments which have emerged from industry discussions and from PRA comments.

It is, we believe, quite well established that the Solvency II Risk Margin is regarded as unduly onerous, and/or too sensitive to interest rate movements, particularly for life insurers, and so we can reasonably expect some reduction in or change to the Risk Margin[8] as considered across the industry. Clearly there may be winners and losers at individual company level. Two particularly relevant points here are, we believe:

- Much (but not all) of any reduction in the Risk Margin will be negated by a reduction in TMTP (for those companies which still have a TMTP).
- Will the PRA continue with a cost of capital approach for the Risk Margin (i.e., similar to the EIOPA review of this item), or will it prefer a move to a confidence level approach? Such a move would be in line with the ICS approach from the International Association of Insurance Supervisors (**IAIS**), and would also be in line with that which several companies are now adopting for the (similar concept) Risk Adjustment under IFRS 17, where there is a requirement to disclose the confidence level of the Risk Adjustment. The PRA might be attracted by an approach which moves away from the EIOPA cost of capital approach, but which is nevertheless founded in existing international standards.

In relation to the MA, statements from the PRA may imply some widening of the scope for when the MA can be used,[9] and/or some reduction in the burden of legal structures and documentation/governance when using the MA—for example in relation to illiquid assets. However, we believe that there may be the possibility of the PRA making some aspects of the quantum of the MA more prudent—either in the base balance sheet, or in the SCR scenario. We note that, through the March 2020 COVID-19 market volatility, increases in the MA generally counteracted virtually all of the widening of spreads. Clearly this aspect is what the MA is designed to do. But, arguably, one might say that there probably was some increase in genuine credit risk during this period (even if only temporary) and perhaps the MA did its job a little too well.

The PRA has also stated that it is generally content with the overall level of capital requirements across the industry, and thus the industry should not expect any material reduction in capital requirements overall (this general term incorporating liabilities as well as capital requirements themselves). As noted above, there are likely to be winners or losers at the individual company level.

There are no doubt a number of different "solutions" which would satisfy all the above aspects and emerging comments for the industry overall. Individual companies may however find the above summary helpful in considering how the possible solutions would affect them when framing their responses to the consultation and QIS exercise.

[8] HMT's Review of Solvency II: Call for Evidence – Response, paragraph 1.13.

[9] Treasury Committee, Oral Evidence: The work of the Prudential Regulation Authority, HC 415, Sam Woods response to Q49.

How Milliman Can Help

Participation in the Solvency II QIS is voluntary; however, it is expected that many companies will be keen to submit responses or at least to understand the potential impact any changes to the Solvency II regime may have on their balance sheets.

Milliman would be happy to discuss with firms how best to approach the QIS exercise and can offer a wide range of services to assist firms, including:

- Assisting in performing the QIS exercise, including:
  - Performing part or all of the exercise
  - Working on a consulting or seconded basis
  - Quantifying balance sheet impacts using Milliman's sample business portfolios
  - Reviewing the work carried out by the firm's internal teams
- Providing "backfill" resource to free up team members to carry out the exercise
- Training on the changes covered in the QIS and other PRA publications, including to Boards and Senior Management
- General support on the changes that may impact the firm more widely, including on:
  - Asset-liability matching
  - Reinsurance arrangements
  - Risk management
  - Cross-border arrangements

Please get in contact with your usual Milliman consultant if you wish to discuss further.

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