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AFM Response to PRA CP12/23, Review of Solvency 2: adapting to the UK insurance market

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

- Comment on the proposals, and
- Explore the consequences for members of AFM and their customers.

About AFM and its members

2. The Association of Financial Mutuals (AFM) represents insurance, as well as healthcare and indemnity providers that are owned by their customers, or which are established to serve a defined community (on a not-for-profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 32 million people in the UK and Ireland, collect annual premium income of over £22 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2] and to take account of corporate diversity[3].

[1] ICMIF and AFM, 2022: https://financialmutuals.org/wp-content/uploads/2022/10/UK-Market-Insights-2022.pdf
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

AFM comments on the proposals

4. We welcome the opportunity to respond to this consultation paper. The reforms provided via the Government consultations, and in PRA Discussion Papers, provide important improvements to the operations of insurers in the UK, and will enable Solvency UK to provide a better fit with the needs and specificity of the insurance market in the UK than was possible across the entire EU market.

5. The UK insurance industry remains the largest and most mature market in Europe. The size of the market, and the sophistication of UK insurers in meeting the needs of the market as well as the demands of regulators, is world-leading. As a result UK insurers, whilst not being immune from problems when markets falter, have proved resilient and have resolved problems without significant failures, and without the need for Government support. It is appropriate therefore that a key element in the development of Solvency UK should be to make the regime more proportionate, and in so doing, to better reflect the maturity of the UK market.

6. Our response focuses on the practicality and value of the proposals in the consultation, as they affect AFM members. Hence, we are not commenting on the proposals in the following chapters, which do not have an impact on most/all AFM members: 2. TMPT changes; 3. Internal Models; 4. Capital add-ons; 5. Group SCRs; and 6. Third Country branches. The issues covered have no specific mutual impact in 11. Administrative amendments, and again we are not commenting.

Reporting and disclosure

7. **We welcome PRA's ongoing efforts to simplify the amount and complexity of Solvency 2 reporting**. We are pleased that PRA has proposed to remove the triennial RSR (and annual statement of changes): we suggested this in our responses to Treasury and PRA in February 2021. We consider this is a valuable amendment for firms, and removes a low-value task from supervisors.

8. The proposed amendments to Group SCR reporting should help streamline work, with a number of simplifications for insurance groups. However, whilst Chart 8 indicates that up to 17 templates will be deleted for insurance groups, it is less clear to what degree the information has been shifted to new or different templates or reports. It would be helpful therefore to see an assessment of how much data gathering has been reduced, as well as a figure for the net change in the number of templates reported.

9. For groups, and indeed in respect of other proposed changes, we would encourage PRA to exercise some discretion in errors submitted to revised templates when the new rules come into force. Small firms in particular will take time to absorb all the amendments proposed.

10. The changes proposed to templates for asset reporting are welcome, though we consider these can be further simplified: we wrote to PRA with a summary of which elements of the asset data reports were unused or problematic back in 2019 and would be happy to re-share this analysis.

11. We have no comments on the other proposals in this chapter. The assessment of costs and benefits in Table 3 indicates that for small insurers, the implementation costs of the changes to reporting will be between £3,000 to £10,000 on average, and that the annual benefit to firms will be £10,000. We have not undertaken a review of this; however, where much of the work for regulatory reporting is produced by, or reviewed by external consultants, we recognise that this may be an underestimate of the benefit for some firms, though for others the net impact may be marginal.

<u>Mobilisation</u>

12. As a trade association, AFM regularly receives queries from organisations that are exploring whether and how to establish a new UK mutual insurer. These include queries from groups of organisations, via their own representative body, who have identified poor value in the provision of general insurance to their members. However, in most cases they are dissuaded from pursuing the venture, or find a different solution to meet their needs, such as by creating an Appointed Representative model.

13. This is because **the costs and complexity of establishing a new insurer, even with the support of PRA and FCA's new insurer start-up unit, are prohibitive**. We therefore commend any actions to support the development of new insurers, such as the proposals in Chapter 8 of the consultation. However, we are also very mindful of the risk of broader reputational damage of failures in new insurers or overseas insurers who enter the UK market but are poorly capitalised or lack an understanding of the market here.

14. We recognise the challenges cited in paragraph 8.8 and 8.9 (including access to capital, the recruitment of senior staff, and the difficulties in meeting the standards required for authorisation), as well as the floor for the MCR (of £3.5 million for life companies and £2.4 million for general

insurers). To this we would add experiences we have seen from people looking to set up a new mutual:

a. the lack of a soft launch process that would remove much of the complex requirements today (such as that available to new credit unions);
b. the legislative barriers (including the outdated Friendly Societies Act 1992[4]);
c. resistance by regulators to new monoline providers, even where the managers exhibit an expert knowledge of the sector they are working with, including of the particular risks it is exposed to and the underwriting rigour that is needed to maintain solvency; and
d. the actions of incumbent insurers and brokers to raise new barriers to entry once they become aware of a potential new competitor.

15. The minimum capital requirement for a new insurer looking to enter the mobilisation stage is proposed as £1 million, on the assumption that little or no business is written during mobilisation (as per paragraph 8.22). That is significantly lower than the MCR required for a new insurer, but may still represent a significant investment for a new insurer, particularly if they are planning to operate in a limited/ niche market. That is especially the case for a new mutual, which may be entirely reliant on contributions from its members, and/ or be reluctant to take on any debt in its early stages.

16. We suggest that rather than setting a minimum level for an insurer to enter the mobilisation stage, the level is adopted on a case-by-case basis, after careful assessment of the business model of the new firm and the perceived risks of the sector it is planning to operate in, and of the products it is planning to offer. This might indicate that for a monoline insurer, operating in a tightly defined sector, with a distinct product offering and extensive expertise within the business, the minimum capital may be reduced. In other cases a higher level may be more appropriate, for example where a firm is heavily reliant on debt or reinsurance, or where the level of solvency could rapidly deteriorate, because potential exists for adverse claims experience or premium inflation in the early years.

17. We consider that the assumption that firms in mobilisation will write little or no business, may detract from the value of a mobilisation state. The authorisation process is already prolonged, and may take many years to complete. Whilst mobilisation may not add to this, the extra resources

[4] The Law Commission is due to start a review of this legislation in Autumn 2023, and removing barriers to entry is likely to be one element of their analysis. https://www.lawcom.gov.uk/law-commission-invited-to-review-legislation-on-cooperatives-and-friendly-societies/

required to satisfy the regulators will put further strain on the capital position of the business, as well as their ability to attract effective leaders. We suggest extra consideration of the barriers to entry more generally and how regulation can address these, would be valuable for firms who have a more urgent need to start writing business than the mobilisation process would allow.

18. Moreover, as summarised in Table 4, it is not clear how attractive the mobilisation stage will be. The minimum expectations set out are broadly the same as they are for an authorised firm, with some simplifications of Board structure and policies, weighed up against the added expectation of producing a mobilisation plan. The benefit of a lower MCR would be a tangible benefit, though not where the firm is actively discouraged from writing business.

19. We also ask that the New Insurer Start-Up Unit, whose webpage provides no guidance on business ownership [5], should include information about mutuality and its possible relevance to people considering the establishment of a new insurer.

20. **AFM is very supportive of the opportunity to create new insurers in the UK**. We have regularly approached PRA to discuss obstacles to entry, but have not been taken up on our offer. We consider the PRA and FCA should be actively targeted by Government on the diversity of supply of insurance in the UK, recognising that this will include a consideration of different business models and maturity of business, as well as how well the sector meets the needs of consumers and companies in the UK, and further the UK's ambitions internationally. Evidence from many sectors confirms that factors like corporate diversity, and the replenishment of firms leaving the sectors with new ones, generates better competition and more innovation[6].

Thresholds

21. **We are very keen to see a sizeable upward revision of the thresholds for entry to Solvency UK**. As stated in paragraph 9.3, the amendments to FSMA provide the necessary ability for PRA to amend the threshold. This would therefore enable PRA to opt for a higher threshold than the proposals set out in the Government's Call for Evidence. We contend that this should be the case.

22. PRA proposes that firms that are currently in scope of Solvency 2, and who drop below the threshold once it has been raised as part of this

[5] https://www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit
[6] For example: https://hbr.org/2019/01/is-your-companys-strategy-aligned-with-your-ownership-model,

review, have the capacity either to remain subject to Solvency 2, or to opt out and adopt the simpler regulatory approach available to non-directive firms. We have tested the appeal of this approach with a range of organisations that are currently in the scope of Solvency 2, and the overwhelming view was that they would actively consider how to approach becoming a non-directive firm.

23. Adopting a new capital regime would involve a significant amount of effort and some cost, so it is perhaps surprising that firms would be willing to sacrifice the investment made in complying with Solvency 2. However, **there are compelling reasons for firms to not opt into Solvency UK if they fall below the new threshold**:

    a. Solvency 2 has brought with it some very valuable tools for assessing and understanding risk, and the impact of management decisions on the capital position of the firm. Firms would consider how best they might retain a simplified version of tools like the ORSA to ensure the organisation was well-run.
    b. Solvency 2 requires a significant investment of resource, much of which is not scalable to the size of the business. Smaller Solvency 2 firms often lack the resources internally required to undertake compliance, and therefore make extensive use of external consultations. The NDF rules are much more proportionate for smaller insurers.
    c. In addition to the Solvency 2 rules, moving to NDF status would mean a firm would gain from simplified governance arrangements, including SMCR requirements, and would fall outside the current operational resilience requirements.
    d. Beyond PRA rules, a firm that opted to move from Solvency 2 to NDF regulation would cease to be treated as a Public Interest Entity[7]. This has a profound effect on the cost and availability of external audit for the firm, and therefore on its future viability. AFM research on 2021 report and accounts published in 2022 identified that the average cost of external audit for an AFM member in scope of Solvency 2 was £187,200 (rising to £325,000 if they used one of the Big 4 audit firms); by comparison, the average cost of audit for a non-solvency 2 firm (below the Solvency 2 threshold) in 2021 was £12,000[8]. One Solvency 2 firm calculated that with all the ancillary costs involved, being a Public Interest Entity entailed a cost of £44 per policyholder per year.

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[7] PRA's PS16/16 and CP34/15 states that "In light of the transition to the Solvency II regime on 1 January 2016, for the purposes of the Statutory Audit Directive, insurance undertakings that are PIEs are those firms in scope of Solvency II, including the Lloyd's market."
[8] AFM Corporate Governance Report 2022, page 5

e. We have made representations in the past for a Solvency 2 Lite option for smaller firms below the new threshold. However we have seen no appetite from PRA to explore this or to commit resources to considering it, and whilst this option might streamline solvency requirements, it would not address some of the other consequences of remaining a Solvency UK firm, as elaborated above.

24. In order for a firm to move from Solvency 2 to the NDF regime, they would need a clear path provided by the PRA on what they needed to do. The proposals in the consultation envisage the new rules take effect from the end of 2024, with the provision that a firm will not have exceeded the new threshold for three consecutive years, and would not expect to exceed it in the next five. Hence, a detailed assessment of what would be required to adopt NDF requirements would need to be in place by the end of 2023. We would be happy to work with PRA on this.

25. **The level of the new threshold needs fuller debate**. In 2018, the Office for National Statistics calculated that around 97% of UK insurers' economic activity was in the scope of Solvency 2[9]. We think this is likely to be an understatement as many large insurers undertake non-Solvency 2 activity. Amongst AFM's 47 members for example, around a third fall below the current threshold; these firms account for less than £100 million assets, and under £25 million gross premium income. This means around 99.8% of AFM member premium income from insurance activity is currently inside the scope of Solvency 2[10].

26. Unlike many countries in the EU, the Solvency 2 regime covers practically all insurance activity in the UK. That was not the original intention of the regime, and is only partly caused by the slow review of the threshold since Solvency 2 came into full effect in 2016. At that time, EIOPA estimated that 90% of EU insurance assets were in the scope of Solvency 2, though this has since risen to around 95%[11].

27. Accordingly, in its own consultations on raising the EU Solvency 2 threshold, EIOPA has proposed a revised threshold of €50 million technical provisions and up to €25 million in premium income (with discretion for national supervisors to set a level appropriate to their industry). This would mean that the proportion of insurers in scope of Solvency 2 would fall back to the low-90s in percentage terms.

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[9] https://www.ons.gov.uk/economy/nationalaccounts/uksectoraccounts/articles/experimentalfinancialstatisticsforinsuranceusingsolvencyiiregulatorydataenhancedfinancialaccountsukflowoffunds/2018-04-30

[10] This figure excludes large discretionary mutuals, since the contributions they receive are not classified as insurance premiums.

[11] Insurance statistics (europa.eu)

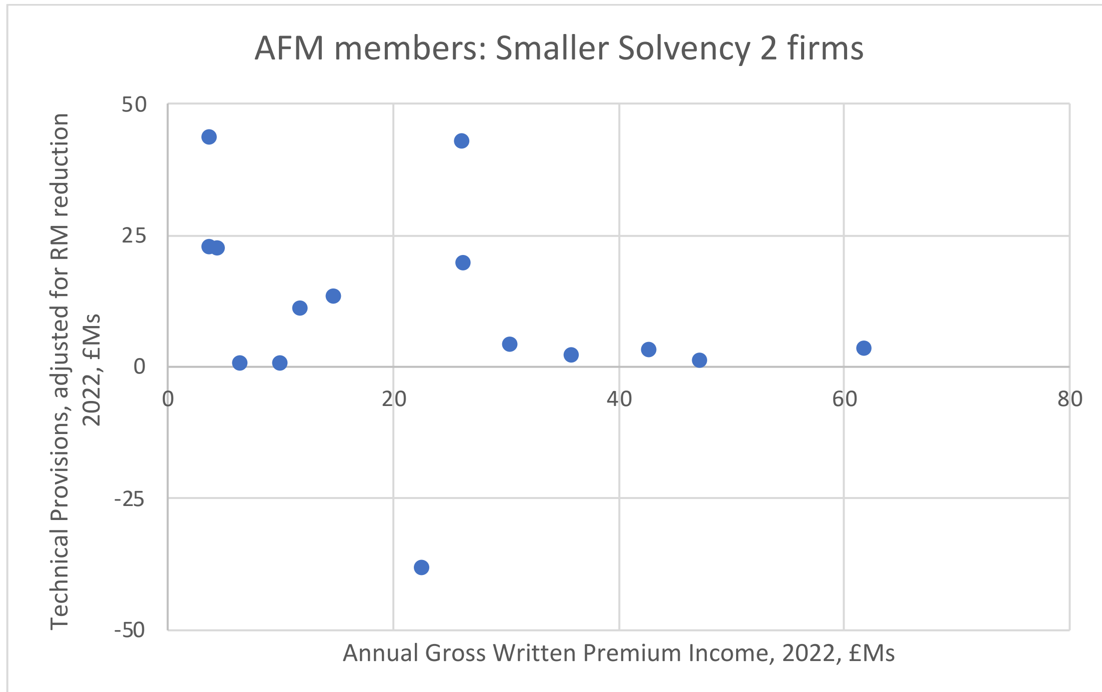
28. PRA's central proposal is to raise the threshold to £15 million premium income and £50 million in technical provisions. This is projected by PRA to affect nine firms, who accounted for gross premiums in 2021 of £77 million. The cost benefit case also helpfully shows that if the threshold was raised to £20 million premium income and £75 million technical provisions, a further eight firms, with premiums of £91 million would be affected.

29. We note that, despite the average premium income of these eight organisations of £11 million (£91 million in total), in paragraph 9.18 these are described as "significantly larger firms". Consequently, based on the PRA figures, these firms appear to drop under the alternative, higher threshold as a result of their assets not premiums, and may therefore be closed books. If this is the case, the concern raised that "the alternative proposals could increase the risks to its primary objectives", and "undermine effective competition", is misleading. If there is a concern regarding closed books, there is scope elsewhere in the PRA rulebook to address this, without penalising open books or new insurers.

30. AFM has looked at the impact of raising the threshold across a range of its smaller members, using data supplied by OAC as part of a review of the SFCRs for 2022 of 27 mutual and not-for-profit firms, of whom 24 are members of AFM[12]. The analysis included firms with premium income of up to £200 million, but for the purposes of the chart below, we have excluded larger firms. The chart shows technical provisions at the end of 2022, but these have been adjusted for the expected risk margin adjustment, to make the data more useful.

31. The chart shows three firms with premium income below the current £5 million threshold (and with technical provisions close to or above the current threshold). It shows a further eight with premium income of between £5 million and £15 million, of whom three have technical provisions above £50 million (in fact these three have technical provisions of over £100 million). None of the firms in the review had premium income in 2022 of between £15 million and £20 million.

[12] https://financialmutuals.org/wp-content/uploads/2023/07/OAC_SFCR-Analysis-2022_approved.pdf



32. On this basis, a threshold of £15 million premiums and £50 million technical provisions would result in up to eight mutuals/ not-for-profits qualifying to drop out of Solvency 2. No further firms would be added in the alternative proposal (of £20 million premiums and £75 million technical provisions) if this were adopted. In total the eight firms in the possible scope for a higher threshold had premium income in 2022 of £65 million, an average of just over £8 million.

33. According to Swiss Re, total UK premium income in 2022 was £300 billion[13], so the £65 million provided here, or the total £168 million projected by PRA, will reduce the proportion of UK insurance in the scope of Solvency UK by no more than a trivial amount (less than 0.1%). It is difficult to imagine therefore how PRA's contention, that its proposals will "support competitiveness and growth of the UK economy", can be realistic, as it means the Solvency UK threshold, even at £20 million premium income will be lower than the equivalent for EU insurers, both in absolute terms, and relative to the size and maturity of the UK market. It also means that whilst the EU regime will set a threshold that affects under 95% of insurance activity, PRA's will continue to impact over 99%. Far from increasing UK competitiveness therefore, the PRA proposals will make the UK market less attractive for existing or new insurers, compared to the likely operating environment in many EU countries.

[13] https://www.swissre.com/institute/research/sigma-research/sigma-2023-03.html

34. We consider there is scope for greater boldness, and in June we wrote to the Economic Secretary to the Treasury with calls for a more progressive approach. To illustrate, a threshold for Solvency UK of, say, £100 million premium income and £500 million technical provisions would place 24 mutuals and not-for-profits below the entry thresholds for Solvency UK, with total premium income of £625 million. Of course, not all these firms would elect to drop out of Solvency UK, due to their growth plans, larger group operations or because of the significant investment they have made in Solvency 2 systems and processes. Development of a Solvency 2 lite option might reinforce that, but even if all 24 firms did become NDFs, at only 0.2% of the UK insurance market, we consider this is non-material and would not create a risk to PRA's primary objective.

35. We accept that we do not have data for non-mutuals, but we encourage PRA to show more ambition in its proposals, and to consider whether the powers provided to it by changes to FSMA might enable it to vary the threshold according to business model or whether the business is open to new business or not. This is particularly the case as the benefits to a firm falling out of Solvency UK, as per paragraph 21 above, would vary beyond the capital regime: for example a listed company would still be subject to the Public Interest Entity rules.

Currency Redenomination

36. We agree with the general approach. With regard to the MCR, we would appreciate confirmation that, in line with the rest of the consultation, the redenomination from EUR to GBP, would mean that the absolute floor (of £2.4 million for most general insurers or £3.5 million for life companies), will be implemented in December 2024. We note that a change was made to the floor in December 2022, and whilst there may be a further change in December 2023, it is important at this stage to provide certainty, to help firms in the planning process.

37. Overall, we are grateful to PRA for the work it has done on exploring the relevance and proportionality of the Solvency UK regime in future, though we were also disappointed that the level of industry engagement has been low (on topics other than the risk margin, matching adjustments and reporting). We wrote to Sam Woods with our views on making the regime more proportionate in 2022, and we would be keen to explore in future some of the issues raised there, where we feel there is still more PRA can do to make the regime proportionate and effective.

38. We would welcome the opportunity to discuss further the issues raised by our response. We are happy to be included in the published list of respondents.

Yours sincerely,

Martin Shaw
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