



Illuminate

KPMG's insurance regulatory newsletter

2016 could be summarised as a year of 'shocks', especially on the political front. As we move into 2017, the word changes to 'uncertainty'. For UK insurers, the biggest uncertainties remain around Brexit and the UK's future trading relationship with the EU. Although the Supreme Court's ruling on 24 January has added another step into the UK process before Article 50 can be triggered, the government has reaffirmed its commitment to its end of March deadline for doing so. Notwithstanding this, it will be many months before we begin to get any clarity on the terms of the UK's exit and future trade agreements.

The issue of access to European insurance markets remains close to the hearts of many within the sector and we saw a significant increase in contingency planning as 2016 came to a close. Given the time required to establish a revised operating structure, it is vital that companies wishing to retain the ability to conduct insurance business across Europe finalise their plans quickly and move forward with putting these into effect. Regulatory capacity to process multiple new authorisation applications is likely to become strained, especially if (as seems likely) these focus on only a few key jurisdictions. Waiting until the shape of the deal is known may simply not allow sufficient time, unless significant transitional/grandfathering arrangements are agreed, and agreed relatively quickly. Political uncertainty in Europe, particularly as we move through Dutch, French and German elections, is certainly not going to help in accelerating clarity.

KPMG's latest insights can be found on our website.

2017 will see the first full public Solvency II disclosures through the Solvency and Financial Condition Reports and time will tell how analysts will respond. We provided observations from the voluntary disclosures in our August 2016 edition of *Illuminate*. The FRC guidance for auditors is in the process of being finalised and insurers and auditors will need to work together to ensure that deadlines can be met.

Following our previous article on capital management within the non-life sector, our first article in this edition discusses developments in this area from a life sector perspective.

Our second article considers the challenges faced by the life sector as it prepares for the Packaged Retail and Insurance-based Investment Products (PRIIP) Regulation, which comes into force at the start of 2018.

Our final article considers the main implications for insurers from the FCA's recent Mission Statement. We end with the usual overview of key future regulatory milestones.

If you would like to talk to anyone about any of the topics covered, please contact the respective author or your usual KPMG contact.



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Solvency II has fundamentally changed how life companies' solvency is assessed. However uncertainty regarding interpretation and application by regulators resulted in a number of companies not taking early action to actively manage their capital position. This left them exposed to a number of adverse market developments, which are only partially mitigated by transitional measures. The reduction in interest rates during 2016 put further strain on, and highlighted the volatility of, insurers' Solvency II balance sheets, increasing the urgency for companies to implement effective capital management programmes.

Annuity providers

The low interest rate environment has put additional strain on UK annuity writers, due to liabilities being discounted at a risk-free rate while the backing assets are valued at market value. A number of annuity providers have obtained some mitigation through the matching adjustment (MA) to take into account a portion of the spread above the risk-free rate, resulting in a discount rate closer to that previously used under the previous regulatory regime.

The biggest challenge to gaining MA approval has been the significant restrictions on both the types of assets for which it is permitted and the liabilities to which it can be applied. This resulted in a number of insurers divesting certain ineligible assets and restructuring others (such as equity release mortgages and commercial real estate assets) to meet the MA eligibility criteria.

The other major issue for annuity companies has been the size of the risk margin. This addition to liabilities aims to reflect the cost (at a rate of 6%) of holding non-hedgeable risk capital until the maturity of the insurance contracts. The long-tailed longevity exposures of annuity companies has typically resulted in high risk margins.

In order to reduce the risk margin, a number of annuity providers have sought to pass longevity risk to other parties, via longevity reinsurance and swaps, especially to jurisdictions that are not bound by Solvency II. This has raised regulatory concern about whether all arrangements are for genuine risk transfer reasons. However, this trend continues, with insurers effectively replacing an element of the risk margin with counterparty default and (possibly) concentration risk solvency capital charges.

Interest rate exposure

Another concern is the risk margin sensitivity to interest rates, leading to a number of companies considering interest rate hedging of the risk margin (and in some cases, the solvency capital requirement).

Such hedging started as a theoretical consideration, as the use of the transitional measure for technical provisions (TMTP) largely offset the initial risk margin impact. Further, the PRA's mid-year invitation to recalculate the TMTP when interest rates had significantly reduced allowed the TMTP to be increased, working as a natural hedge against the increased risk margin.

However, as the TMTP can only be recalculated when interest rates move by a certain level, while this helped companies manage their balance sheet, it cannot act as a continuous hedge. The continuation of the low interest rate environment has therefore led some insurers to consider interest rate hedging in addition to use of the TMTP (which is made more complex when deciding whether to hedge the pre- or post-TMTP position). We expect these activities to become more prevalent going forward.

Unit-linked providers

For unit-linked providers, the focus has been on managing Solvency II's unfavourable contract boundary rules. One idea that has been contemplated by companies for over 18 months is "unit shorting", where the unit-linked assets held are lower than the unit reserves, although there has been a reluctance to implement the idea. Other companies are considering whether they can simply add an element of life cover to extend the contract boundary. Either approach needs careful consideration and, likely, regulatory input.

Future action

In addition to the areas covered above, we are also seeing a move to more general asset restructuring as companies seek the efficient frontier of assets with highest return and lowest capital charges. This includes looking across the whole asset portfolio, removing concentration risks and hence increasing capital diversification benefits.

The focus on daily solvency monitoring came to the fore over 2016 as interest rates reduced, with intra-day solvency monitoring required by the PRA on the day the 'Brexit' referendum result was announced. This put a lot of pressure on insurers' solvency monitoring tools and, although a number were demonstrated to be at least adequate, some had issues in estimating the solvency position to the required level of accuracy. Solvency monitoring tools received far more focus following this and improvements have been made, but the importance of such tools cannot be underestimated in the current volatile market environment.



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Packaged Retail and Insurance-based Investment Products (PRIIP) Regulation

A PRIIP can be broadly defined as any form of packaged investment where the amount repayable to the investor is subject to fluctuations in underlying assets or reference values. For life insurers, this captures both unit-linked policies and with-profits policies. Pension products are out of scope, as are whole of life, health contracts and general insurance policies. Fluctuating return annuities (that are not pension products) are caught, but pension annuities and fixed annuities are excluded.

The PRIIP Regulation aims to improve retail customers' protection through provision of simple and harmonised pre-sales information. The Key Information Document (KID) is intended to be a clear, concise and consumer-friendly document, providing prescribed key information to prospective investors/policyholders. This includes the key features, risk, rewards and costs associated with the product, all within a short document.

Recent developments

The European Parliament's rejection of the draft regulatory technical standards (RTS) on the KID in September was not unexpected. However, its comment that the drafting was "*flawed and misleading*" was somewhat damning.

After initial uncertainty about next steps, in November the Commission announced a one year delay to implementation of the PRIIP Regulation (to 1 January 2018), which was subsequently ratified by the European Parliament on 1 December. This delay provides a much-needed opportunity for the Commission to redraft the KID RTS to address the major concerns raised.

What should insurers be doing now?

It is becoming clear that revisions to the RTS are likely to be limited, addressing only the key areas challenged by the European Parliament. Insurers are therefore able to make progress in a number of areas without waiting for the revised RTS. For example, insurers need to:

- have a full inventory of their insurance policies that meet the PRIIP definition and of their internal/external distributors
- understand the additional information required in the KID above the current Key Features Document requirements (which will cease to apply to PRIIPs)
- divide disclosures into static and active components, and draft static elements
- understand key external dependencies (for example data needs from fund managers)
- create a central repository for KIDs and establish a mechanism to ensure their timely and accurate updating
- determine how to meet the information needs of all distributors, both tied and independent, including determining at what stage in the pre-sales process the KID should be shared
- establish a process to ensure distribution of the most up-to-date KIDs to prospective policyholders
- develop a training programme
- consider whether a separate complaints procedure needs to be established
- update roles and responsibilities with regards to the KID in their agreements with distributors.

Key Challenges

In addition to meeting the above items, the practical challenge of writing a concise, consumer-friendly document, using jargon-free language, which remains accurate and covers all salient points within no more than three pages of A4 in a reasonable font size cannot be underestimated.

Insurers also need clarity regarding whether (and if so, when) a KID will be required for contracts sold before 1 January 2018.

Insurers have already raised a number of technical challenges, including in relation to the costs calculation (especially regarding the treatment of insurance premium) and the disclosure required in relation to policies offering a range of investment options, such as under unit-linked insurance contracts (so-called multi-option PRIIPs or MOPs).

It is not clear that the proposed solution for MOPs (permitting use of UCITS KIDS to meet the underlying investments disclosure) will be sufficient to address insurers' concerns, as many unit linked policies are not invested wholly in UCITS. Further, it is unclear whether the redrafted RTS will sufficiently address the costs concerns. We also understand that the scenario analysis section could be revised.

Insurers will need to await the revised draft RTS (expected early in 2017) to progress work in these areas.

Firms will be held liable where damage is suffered by the investor as a result of a misleading or inaccurate KID. Given the scale of the workload, difficulty in implementation and penalties for getting it wrong, firms will need to find a balance between the significant cost of producing the documentation and managing the conduct implications to customers.



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The FCA issued this consultation on 26 October 2016 explaining how it determines priorities, and seeking views regarding how the FCA can meet its objectives (ensuring financial markets work well, contributing consumer protection and competition) in a proportionate way. The FCA's aim is a well understood framework to help prioritise its work.

The need for consumers to take more responsibility for financial decisions raises a number of challenges, especially for longer-term arrangements such as life assurance contracts. Given the infrequency with which consumers buy such products, they have limited opportunity to learn from any past mistakes and make different choices.

There are a number of themes within the paper, based around minimum standards for firms and timely intervention from the FCA when required. The main aspects are summarised below.

Harm

The FCA defines harm by considering its potential impact (both at an individual level and cumulatively). FCA intervention depends on both harm and the severity of any misconduct, taking action where the level of harm is significant and/or the severity is high.

Redress

The form of redress will depend on a number of factors, including how urgently the redress is needed and number of consumers affected. The FCA aims to improve communication with firms and consumers, so all parties know what to expect.

FCA transparency

Greater transparency includes the FCA being clearer about what it decides to do and areas it decides not to pursue, setting out its priorities annually. The FCA will be clearer about the aims of new proposals, including its assessment of the underlying cause of harm, how firms should respond and how it will assess the changes made. FCA analysis and lessons learnt will be shared.

Disclosure

The general principle is that consumers should have the right information to be able to make clear and informed decisions. However, the information asymmetry between firms and customers is recognised as a challenge.

For insurers, the forthcoming disclosure requirements under the Packaged Retail and Insurance-based Investment Products (PRIIP) Regulations and the Insurance Distribution Directive (IDD) will result in a dramatic increase in the level of pre-sales information provided to policyholders, both of which come into effect early in 2018. UK insurers will need to comply with these requirements, notwithstanding the FCA appears to prefer a 'less can be more' approach. The FCA believes that consumers do not always use 'official' material and are more likely to make decisions based on assumptions (for example about what risks the insurance contract covers) and headline figures (for example the disclosure on general insurance renewals of prior year premium).

The FCA will monitor sales approaches used by firms, including so-called 'nudging' approaches (for example general insurance add-on products), to assess whether these could lead to consumer detriment.

Technology

The FCA recognises the need to encourage change and innovation, but must balance this with reducing the risk of consumer detriment. An example cited is using telematics to reduce car insurance premiums.

It will also make use of new technology itself, such as machine learning to better analyse the large volume of data received, to enable it to better target firms with a higher perceived risk.

Protecting vulnerable consumers

Vulnerability is not a static state - it can be temporary, sporadic or permanent and can arise at different points in a consumer's life.

For insurers, access to insurance can be an issue for some customers. Examples cited include the challenges faced by cancer sufferers in obtaining insurance, the decline in annuity sales, mis-selling and financial scams. The advent of pension scams following pension freedom demonstrates that vulnerable customers are not just those on low incomes. Although the FCA aims to provide greater protection to those with less financial capability, it will take action depending on its assessment of the potential harm caused.

Looking ahead

The FCA proposes to assess how effectively it is meeting its objectives in three ways: ensuring it operates a value for money framework, assessing the impact of FCA interventions (both direct and indirect impacts) and assessing outcomes across the sectors as a whole. Its next focus areas are financial crime, insider trading, market manipulation and anti-money laundering.

Implications for insurers

Although the messages are not new, the clarification of how the FCA will address its work going forward offers a timely reminder to all firms to consider whether there is anything in their business model that could lead to consumer detriment and to address this.



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Future regulatory milestones

Date	Activity/Topic	Impact on industry
Solvency II	Reporting dates shown below relate to insurers whose year-end date is 31 December. Insurers whose financial year ends on a different date should consult the PRA website .	
3 March 2017	Response deadline for EIOPA's discussion paper on possible changes to the standard formula solvency capital (SCR) calculation.	<p>The Commission has accelerated its information gathering in relation to its required review of the standard formula SCR calculation. The Commission intends to review this by 2018 and has requested EIOPA's final advice by 31 October 2017. EIOPA issued this discussion paper as a first step in this process. The main areas of focus relate to potential extension of the simplifications available and addressing cross-sectoral inconsistencies.</p> <p>A matter of particular relevance for UK life insurers will be the possible future revision of the risk margin. In this regard, the Commission has requested EIOPA to consider in particular the cost of capital rate, but has also asked for information on the relative size of the risk margin to the balance sheet.</p>
15 March 2017	Response deadline for PRA consultation paper on the maintenance of the transitional measure on technical provisions (TMTP) (CP47/16)	<p>The PRA proposes expanding (and renaming) supervisory statement 6/16 to clarify insurer's responsibilities for maintaining the accuracy of the TMTP throughout the transitional period.</p> <p>A key element of the proposals relates to the maintenance of the predecessor individual capital adequacy (ICA) basis which forms part of the calculation. In particular, the PRA requires changes to the Solvency II technical provisions calculation basis to be made consistently in the ICA basis, to avoid assumption changes affecting the amount of TMTP benefit taken.</p> <p>Other changes relate to the need to analyse material components of the TMTP and the role of the Audit Committee in ensuring that the amount of TMTP taken complies with the rules.</p> <p>Given the first mandatory two-yearly recalculation of the TMTP will fall due on 31 December 2017, insurers will need to ensure they are compliant with these additional PRA expectations.</p>
20 May 2017	First Solvency II Solo annual reporting	Comprising QRTs, Regular Supervisory Report (RSR) and public Solvency and Financial Condition Report (SFCR).
1 July 2017	First Solvency II Group annual reporting	<p>For EEA parented groups, this will comprise the QRT templates, RSR and SFCR.</p> <p>For non-EEA parented groups, reporting will be either as above or in accordance with the 'other methods' requirements agreed with the group supervisor.</p>

Date	Activity/Topic	Impact on industry
31 October 2017	Deadline for EIOPA's advice to the Commission related to the review of the standard formula SCR calculation	See 3 March above.
31 December 2017	Recalculation of the TMTP	The first required two-yearly recalculation will fall due on 31 December 2017. See 15 March entry above.
FCA reviews	This section provides a brief overview of recent developments in key FCA initiatives. It does not represent a comprehensive list of all FCA thematic reviews.	
9 March 2017	Fair treatment of long-standing customers in the life insurance sector (FCA FG 16/8)	The FCA finalised guidance was issued on 9 December and firms have been given three months to review their business practices and make any necessary changes. The guidance applies to life insurers who have closed-books in individual personal pensions (including SPPs and retirement annuity contracts), whole-of-life (individual), endowments and/or investment bonds.
Mid-2017	Retirement Outcomes review	The findings from the FCA review on competition in the retirement income market following the introduction of the pension reforms are expected to be published in summer 2017.
2017	Ageing population and financial services	The FCA Strategy on the Ageing Population is expected to be launched in 2017. This strategy will make recommendations about how outcomes for older people can be improved, with a series of recommendations for future action planned.
Packaged Retail and Insurance-based Investment Products (PRIIP)	The PRIIP Regulations introduce standardised pre-contractual disclosure requirements, including the Key Information Document (KID). KIDs must comply with both the supporting regulatory technical standards and guidelines issued by the Joint Committee of the European Supervisory Authorities.	
1 January 2018	PRIIP regulations enter into force	All life insurers will need to comply in respect of contracts issued with an investment element. Firms face a significant challenge to meet the pre-sales disclosures required in the prescribed 3-page KID template.
Insurance Distribution Directive (IDD)	The IDD will replace the Insurance Mediation Directive (IMD) in Europe, including requirements for an Insurance Product Information Document (IPID).	
1 February 2017	Deadline for EIOPA delivery of IDD draft technical standards to the European Commission	The draft will cover product governance and oversight, conflicts of interest, inducements and assessment of suitability and appropriateness and reporting, building on EIOPA's preparatory phase guidelines. This should reduce the impact for insurers that are already compliant with these guidelines.

Date	Activity/Topic	Impact on industry
23 February 2017	Deadlines for EIOPA delivery of draft technical standards on the IPID	The IPID will apply to any insurance contracts that are not subject to the PRIIP KID requirements.
23 August 2017	IDD Guidelines finalised	Deadline for EIOPA to publish its final guidelines relating to products that can be sold on a non-advised basis.
23 February 2018	IDD becomes effective	In particular, firms will need to ensure their pre-sales literature will comply with the required IPID and address the remuneration disclosures.
23 February 2018	Deadline for EIOPA evaluation of the structure of insurance intermediaries' markets	N/A
International Association of Insurance Supervisors	The section provides key future plans in place by IAIS.	
July 2017	Insurance Capital Standard (ICS)	Expected due date for ICS Version 1. This will be applicable to the confidential reporting for all internationally active insurance groups (IAIGs). Public reporting is expected from 2020.
Mid-2018	ComFrame consultation	The Common Framework (ComFrame) sets out the international regulatory requirements regarding IAIGs. The IAIS plans to issue a consultation on the entire Framework, including the second version of the ICS that will be used for the public reporting from 2020.
Recovery and resolution	To date within the UK, only the global systemically important insurers (G-SIIs) have been subject to formal requirements in this area, but this may need to be expanded as a consequence of European and international developments.	
28 February 2017	Response deadline for EIOPA discussion paper on Potential harmonisation of recovery and resolution frameworks for insurers (CP-16/009)	<p>EIOPA believes there is a need for minimum harmonisation of national recovery and resolution frameworks for insurers in the EU. This would include pre-emptive recovery planning, pre-emptive resolution planning, resolvability assessment, early intervention powers, resolution authority and cooperation and coordination between national authorities and with third country authorities. Following the consultation, EIOPA will further develop its views and might decide to publish a formal Opinion.</p> <p>EIOPA have made this a priority for 2017 and the UK may decide to issue its own consultation in this area in due course to expand on Fundamental Rule 8 ('A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services.')</p>
Summer 2017	IAIS consultation on recovery and resolution expected	IAIS favours application to all insurers (not just IAIGs) on a proportionate basis. As the UK is a member of the IAIS, its final proposals will need to be taken into account by the PRA in developing any further requirements in this area.

Date	Activity/Topic	Impact on industry
UK exit from Europe	The formal timeline and negotiating positions currently remain uncertain. The milestones below are the most important at this stage.	
31 March 2017	UK government imposed deadline for triggering Article 50	The triggering of Article 50 enables the formal negotiations between the UK and EU to commence.
30 September 2018	EU deadline for finalised exit terms	Michel Barnier, the EU's chief Brexit negotiator, has indicated that the UK's exit terms must be finalised by 30 September 2018, to allow time for legal processes to be completed.
Spring/summer 2019	UK formally exits the EU	The UK withdrawal terms will need ratification by Member States, which may delay the process. It is currently unclear whether transitional arrangements (and whether these would be sectoral based) will be agreed to ease transition.
Other key dates		
14 February 2017	Response deadline for PRA consultation paper on cyber insurance underwriting risk (CP39/16)	<p>The paper sets out the PRA's expectations regarding prudent management of cyber underwriting risk, both arising from cyber insurance policies (affirmative cyber risk) or implicit exposures through other insurance policies (silent cyber risks). The PRA believes that most insurers are not currently able to properly monitor, manage and mitigate both types of cyber risks and expects insurers to significantly enhance their internal expertise to address this.</p> <p>All insurers are required to assess and manage their exposures, including from silent cyber risks. Where exposure exists, there should be a clear cyber strategy (owned by the board). The Board is also responsible for signing-off related internal management information, including cyber underwriting risk stress tests.</p> <p>Although not stated as a requirement per se, insurers with significant cyber exposures should expect to build the cyber stress tests into their own risk and solvency assessment report (ORSA).</p>
7 March 2017	Small non-directive firms (NDFs)	Scope of Responsibilities deadline for Significant Influence Function holders in small NDFs.
31 March 2017	Insurance Block Exemption Regulation (IBER)	The IBER exempts certain types of co-operation in the insurance sector from EU antitrust rules under certain conditions and is due to expire on 31 March 2017. This mainly relates to joint compilations, tables and studies and co-(re)insurance pools. A decision on whether to renew or remove the IBER is expected in early 2017.
1 April 2017	General insurance renewals increased transparency	New FCA requirements (rules and non-handbook guidance) include: requiring firms to disclose last year's premium at each renewal, including text to encourage consumers to check their cover and shop around for the best deal at each renewal, identifying consumers who have renewed with them four consecutive times, and giving these consumers an additional prescribed message encouraging them to shop around.

4 May 2017	Enterprise Act 2016 comes into effect	This will mean policyholders have an implied right to claim settlement within a reasonable time, enabling them to claim damages for late payment.

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