Insurtech UK

Insurtech UK response to HM Treasury's Review of Solvency II: Call for Evidence

About Insurtech UK:

Insurtech UK is a trade association of over 100 members, associate and partner members. This mainly consists of insurtech startups which cover the full spectrum of the sector; including intermediaries such as MGAs and brokers, as well as non-regulated businesses such as platforms, claims and analytics technology providers. We also have members who are traditional insurers and service partner members who are from a range of professions who serve the insurance market. Insurtech UK's mission is to transform the insurance industry through technology and to make the UK the global leader for insurance innovation.

What is insurtech?

Insurtech is an umbrella term for the use of any technological innovation designed to improve existing insurance industry models. Similarly to other sectors (such as fintech), the acceleration of insurtech integration and adoption in the UK has been led by a thriving community of technology-driven startups and scaleups who operate within the insurance industry. These businesses can broadly be split into two categories; either providing technology tools, platforms or services to the insurance market, or acting as insurance intermediaries (in the form of brokers or Managing General Agents) to sell insurance policies directly to customers.

Introduction:

HM Treasury has a stated objective to spur a "vibrant, innovative and internationally competitive insurance sector"[1] at a time when **36%** of adults believe insurers did not do enough to help customers during COVID-19.[2] The UK insurance sector needs more innovation if it is to rebuild consumer trust.

The UK insurtech sector - described by the PRA as promoting "developments in digital insurance technology and innovation"[3] – has been driving innovation within the industry for several years. But these businesses have often been constrained in their growth and limited in their impact. This is due to the regulatory environment, which forces them to remain as intermediaries or mere service providers; partnering with existing insurers, rather than controlling the whole insurance value chain as authorised insurers in their own right, with the freedom to innovate and adapt at speed.

[1] HM Treasury's Solvency II Call for Evidence, Page 3
[2] FCA Financial Lives 2020 Survey: The impact of coronavirus
[3] Prudential Regulation Authority Annual Report 2020, Page 48

Insurtech UK believes that by releasing the constraints on insurtechs to provide insurance capacity themselves, it will increase competition and innovation in the UK insurance market, leading to improved outcomes both for the UK economy and for policyholders.

There are currently 189 insurtech businesses operating in the UK, but only two of these businesses have a carrier licence. Both of these businesses chose to gain their licence through the Gibraltar Financial Services Commission (GFSC) instead of the Prudential Regulation Authority (PRA)[4] – **meaning that there are 0 insurtech businesses regulated by the PRA**.

It is difficult to see how HM Treasury can fulfil its mandate of promoting competition and innovation in the insurance sector if the most innovative new entrants to the market keep choosing to be regulated in another jurisdiction. Insurtech UK is aware of several UK insurtech businesses who are interested in becoming a carrier, but are currently discouraged by the application process and the PRA's application of the Solvency II capital requirements. Insurtech UK is concerned that unless changes are made, insurtech businesses will continue to be discouraged from becoming carriers or choose Gibraltar over the UK to establish themselves.

This response will outline the changes that should be considered to improve the process to encourage a larger and more diverse insurance landscape in the UK.

Application Process

In the Call for Evidence, it is suggested that:

> *"Under current requirements, new insurance firms that are expected to exceed Solvency II minimum size thresholds within five years are subject to the full application of Solvency II from the point of authorisation. This outcome may not be proportionate for 'start-up' insurance firms and may discourage new entrants in the sector."*[5]

Insurtech UK does not believe that this outcome is the only factor discouraging new entrants in the sector. Indeed, we believe that the application process itself is discouraging 'start-up' insurance firms from applying for their licence before they even face any Solvency II related challenges.

The process to set up a PRA and FCA regulated carrier is currently too long and too uncertain as to whether authorisation will be granted for insurtech businesses, which puts the UK at a significant disadvantage in comparison to other jurisdictions. The areas of the application which Insurtech UK would like HM Treasury, the PRA and the FCA to review will be addressed individually:

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[4] It is noted that insurers are in fact dual regulated by the FCA and PRA, but the PRA leads the authorisation process.

[5] HM Treasury's Solvency II Call for Evidence, Page 28

Speed

In discussions with the PRA, the speed of the application process has repeatedly been set at 12 months, including the pre-application phase. This timescale is simply incompatible with fast moving tech businesses. To provide a comparison, an insurtech business who secured their licence in Gibraltar highlighted that their *entire* process, from the very first engagement with the GFSC to being regulated, took less than twelve months; a significant contrast to the PRA's timelines given the amount of pre-application work and research that was needed for their application.

Insurtech UK believes this twelve-month process can be accelerated for insurtechs. This is because any insurtech applicant for a licence will most likely have an insurance intermediary already regulated by the Financial Conduct Authority (FCA) and operating in the UK market within the group, particularly those operating as a Managing General Agent (MGA).

MGAs are specialised insurance intermediaries who act on behalf of insurers, vested with underwriting authority from an insurer and distributing insurance policies directly to customers. The underwriting capacity comes from insurers, which means that the MGA does not use its own balance sheet to support new business. Many MGAs undertake nearly all of the functions that an insurer would normally undertake, for example offering actuarial (underwriting) expertise, pricing, product design and analysis, tech infrastructure, governance, claims management and other insurance related services, as well as distribution services. Therefore, these kinds of intermediary have the capabilities of traditional insurers, albeit, they do not directly bear the underwriting risk, nor regulatory capital burden themselves.

An MGA that is authorised by the FCA has the option to convert to an insurer by seeking to vary its permissions (VoP), or it could establish a new entity within the same group as the MGA and apply for that new entity to be an authorised insurer. Whether the route is conversion, or using a newly created group entity, the authorisation process should logically be more straightforward for an MGA that is already FCA authorised (and take less time) than for a completely greenfield application. However the timeline for both a VoP process and a greenfield insurer are the same.

The PRA says on its website[6] that it will, where possible, process a VoP by a date requested by the application, but that is only a soft commitment. This one-size-fits-all approach should be reviewed. Firms are already categorised for different purposes by the PRA and FCA and applying criteria to differentiate between applicants and designing tailored processes and timelines accordingly should be considered.

Insurtech UK believes that the PRA should aim to respond to an application (whether under the VoP process or applying for a new entity to be an insurer) within **three months** from receipt of a completed application, with a total process of **six months**, to allow for the necessary pre-application phase. This would be supported through committed resource from

[6] https://www.bankofengland.co.uk/prudential-regulation/authorisations/variation-of-permission

the PRA and FCA (such as direct access to resources) and more prominent involvement from the FCA as the existing regulator.

This can only be achieved if the process is clear to applicants so that they can submit a completed application easily to start the clock running and if the PRA and FCA dedicate sufficient resources to the process, who are sufficiently skilled (see below).

Technology

Insurtech businesses have a much stronger and more advanced tech component to their business in comparison to incumbent insurers. Instead of legacy systems, insurtechs are much more focused on using AI, machine learning and complex data algorithms. Currently there is a perception from members that this will add complexity to the application because it is different from applications that the PRA and FCA are used to. Insurtech UK believes it would be helpful for members to get reassurance that the PRA and FCA understand the operating models and idiosyncrasies of tech-enabled businesses. This is vital to ensure that the most innovative businesses enter the market.

Unless changes are made to improve the speed and format of the process, it is likely that insurtech businesses will continue to choose other jurisdictions to establish themselves, which ultimately reflects negatively on the UK insurance market and the wider UK fintech business environment.

Insurtech UK Recommendations:

1. **Build PRA and FCA resources that are familiar with tech-enabled operating models.**
2. **Move away from a one-size-fits-all approach to authorisation.**
3. **More proportionate approach to insurtech applications that reflects their FCA regulated status and MGA business model.**
4. **A statutory shorter timeframe for VoP and new insurer processes.**

Capital Efficiency

Insurtech UK does not advocate any changes to Solvency II regulation, because any divergence from EU rules could lead to increased costs for the UK insurance sector and create additional challenges for insurtech businesses to access EU markets. However, **Insurtech UK does support a more proportionate approach to capital for insurtech businesses**.

Clearly the priority for capital must be for businesses to maintain solvent. This is vital to support the integrity of the market, as well as maintain customer trust and protection. But there are a number of areas where the current approach could be improved to allow insurtech businesses to become a carrier – without compromising stability. These points are listed as follows:

Growth

We note the PRA in its 2020/2021 business plan[7] proposes to develop a tailored approach to the supervision of small and fast-growing firms and setting capital requirements in a proportionate manner, reflective of the risk profile of the individual firm and reviewing capital requirements for new insurers annually for the first five years.

We welcome this commitment as the PRA's current approach penalises ambitious growth plans, because regulatory capital requirements are judged based on an applicant's projected three-year business plan, rather than on only the first-year business plan. The PRA could consider a more proportionate approach to setting regulatory capital for applicants and allow capital to be built-up over time as the business grows. This could possibly be facilitated through the Mobilisation Regime for insurers, which is being considered according to the PRA's Annual Competition Report published last year.[8]

Approach to Capital

The PRA currently takes a stricter approach to capital requirements in comparison to other jurisdictions. Often, capital is required in excess of the Solvency Capital Requirements (SCR), which already has stress tests built-in. The strict requirements mean that the capital requirements are higher – which is difficult for insurtech businesses reliant on external funding – and they give the perception that the PRA is a strict regulator that is not as friendly to insurtech businesses as other jurisdictions.

The PRA says it takes a proportionate approach based on the risks of the business, but a mobilisation phase that allows smaller buffers, if necessary, with corresponding business volume constraints, for new businesses could be considered. Initial capital should be set at **100-120%** of SCR. This is permitted by Solvency II but the PRA, we understand, can take a conservative approach here.

The PRA could also consider if there is anything that can be done in setting regulatory capital requirements for new applicants, that takes into account that start-up businesses do not usually have diversified product lines and so, by their nature, are unable to take advantage of Solvency II diversification benefits. Startups are also usually lossmaking as they divert funding and revenues into investing in tech and growth in their initial years. This should be taken into consideration by the PRA as common practice for innovative startups, and they should not penalise insurtechs for this business model.

Sources of Capital

Insurtechs have higher costs of capital than traditional players, so finding efficient ways of funding the regulatory capital is critical to enable these companies to become carriers. The highest quality capital from a regulatory perspective is fully paid equity, but shareholders expect a certain return on their investment. It is harder to attract investment to fund regulatory capital than to fund other areas of a business such as growth, so Insurtech UK is concerned that the current prudential regime for insurers is restricting opportunities for

[7] Prudential Regulation Authority Business Plan 2020/2021, Page 15
[8] Prudential Regulation Authority Annual Report 2020, Page 48

insurtechs to seek an insurance licence, as well as restricting growth opportunities. Again, looking at a mobilisation phase that reduces capital buffers in the first few years, would assist together with raising the threshold for when Solvency II applies to firms, although this would be an express deviation from Article 4 of the Solvency II Directive.

Monoline insurers

Insurtech businesses are unique in that it is common to specialise in a specific product area – either entering into previously underserved/unrecognised markets (e.g. drone insurance) or by creating innovative approaches in existing markets (e.g. parametric insurance[9] or pay-per-use pricing). There is a concern that the specialist nature of insurtechs' business lines could be penalised by the Standard Formula approach. On the other hand, an internal model is costly to maintain, leaving insurtechs in an unfavourable position.

Insurtech UK Recommendations:

1. **Proportionate approach to Solvency Capital Requirements (SCR) – initial capital requirements based on first year of business plan**
2. **Dedicated team to discuss SCR specific to individual cases**
3. **Openness to find solutions to allow an efficient use of capital whilst ensuring solvency of business – still the primary objective**

Conclusion

HM Treasury outlines that a vibrant and prosperous insurance sector is one in which "competition works well and which promotes innovation."[10] However, since 2013 only 12 new insurers have been authorised in the UK, which is a stark comparison to the 9 banks that were set up in the financial year 2019-20. The PRA's New Insurer Startup Unit – set up in 2018 - has yet to authorise a single application.

The UK insurtech sector is described by the PRA as promoting "developments in digital insurance technology and innovation"[11], which reveals that the PRA recognises that insurtechs are a vehicle for driving innovation within the insurance sector. It is widely believed by Insurtech UK members that gaining a carrier licence would allow insurtechs to become even more innovative as they would control the entire insurance value chain, free from the constraints involved with partnering with incumbent insurers who currently provide underwriting capacity.

Removing the existing barriers in the application process to help insurtechs gain carrier licences would improve competition by introducing new entrants to the market, and increase innovation in the sector by giving businesses more freedom to offer new innovations to customers at speed. At present, it is difficult to see how HM Treasury is achieving its stated

[9] An insurance policy where a claim is triggered automatically following pre-agreed framework – e.g. a flood insurance policy is triggered automatically when flood reaches a pre-agreed depth on a property – detected by a motion sensor.
[10] HM Treasury's Review of Solvency II: Call for Evidence, Page 3
[11] Bank of England Annual Report 2020, Page 48

objectives when the number of new entrants into the market has been so low, and the only two insurtech businesses who have sought a carrier licence have chosen Gibraltar over the UK.

Insurtech UK believes that the barriers identified in the application process and regulatory capital requirements are the primary reasons discouraging insurtech businesses from gaining licences in the UK. If the recommendations outlined in this response are taken into consideration, the PRA will be able to offer a process that is much more appealing to insurtech businesses, and this will help drive competition and innovation in the UK insurance sector; both by encouraging domestic firms to seek carrier licence and to become a 'landing spot' for insurtechs globally to build their businesses in the UK.

Insurtech UK believes that creating a more proportionate process is vital in our mission for the UK to become the global leader for insurance innovation. Given HM Treasury's stated objectives to promote innovation and the Department for International Trade's mandate to promote the UK as a global destination for investment and talent, this should be an adopted ambition of the UK Government. Therefore Insurtech UK encourages these recommendations to be considered as part of HM Treasury's Solvency II review.