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Solvency II newsflash

UK Solvency II reforms – will they deliver what was promised?

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HM Treasury has said that the reforms being consulted on could result in a release of as much as 10% to 15% of life insurers' capital, unlocking tens of billions of pounds for long-term productive investments. But is this really an unbridled good news story for the industry?

The proposals in a nutshell

On 28 April, HM Treasury and the PRA simultaneously published papers on potential reforms to Solvency II in the UK. The PRA's paper covered only the Risk Margin and elements of the Matching Adjustment. Key points include:

- a claim that, taken together, the reforms could result in a material release of as much as **10% to 15% of the capital** currently held by life insurers – although the PRA didn't confirm its final proposals would achieve this,
- a proposal to **reduce the Risk Margin by 60% to 70%**, achieved by modifying the existing "cost of capital" approach – the PRA confirmed they would target a 60% reduction for Life and 30% for Non-Life Insurers
- the benefit of the reduced Risk Margin being partially offset by an increase in the Fundamental Spreads, leading to **reduced Matching Adjustments**,
- the **Fundamental spreads will become more sensitive to changes in credit spreads**, with the PRA proposing an addition of at least 35% of the spread which will need to be reflected in internal models,
- proposals that would partially relax some of the rules around **assets that can be added to MA portfolios**,
- other relaxations that had been trailed previously, including to **Internal Model approval requirements**, **branches** of overseas insurers, **reporting** requirements, and the **authorisation** of new insurers.

As expected: good news on the Risk Margin

The proposed reduction of 60% to 70% to the Risk Margin had already been mentioned in a speech to the Association of British Insurers in February by John Glen, Economic Secretary to the Treasury. The Life industry will nevertheless be pleased, not to mention relieved, that the PRA has also noted a reduction of c. 60%.

New information contained in the latest publications was that the reduction is to be achieved by modifying the existing cost of capital approach. The PRA has previously asked firms to test the impact of either modifying the cost of capital approach or moving to a new approach which is similar to the "Margin Over Current Estimate" used in International Capital Standards. A modified version of the current approach should reduce the implementation costs.

Details of the changes in parameters haven't been released, although the "tapering approach" proposed by EIOPA as part of its 2020 review of Solvency II seems likely to be adopted for Life business. It also looks likely the PRA will reduce the 6% cost of capital rate, although we should expect that the UK probably won't follow EIOPA's proposals exactly, since these are expected to reduce the Risk Margin by only c.20%.

One of the main criticisms of the Risk Margin has been that it is too sensitive to changes in interest rates. We'll need to wait for details of the precise changes to the methodology before we can tell whether they reduce volatility, although volatility is perhaps less concerning if the Risk Margin is much smaller.

Matching Adjustment to become less favourable

The MA is calculated (broadly) by taking the spread on the assets and deducting a quantity called the Fundamental Spread. At present, the Fundamental Spread has remained stable with limited variation over time, consistent with one of the objectives of the MA, to stabilise the balance sheet.

The latest proposals would make the Fundamental Spreads both larger and less stable. The Fundamental Spreads continue to allow for the expected cost of future defaults but, instead of also allowing for the expected cost of future downgrades, they would allow for uncertainty around the level of future defaults. This would be based on a percentage – which the PRA proposes to be at least 35% - of the spread on an index of comparable assets, averaged over the economic cycle.

Basing the Fundamental Spreads on a medium-term average of market spreads will mean that insurers will not be fully exposed to market volatility. However, Fundamental Spreads will become less stable than they are at present, and the additional balance sheet volatility coupled with the lower MA benefit will be unwelcome for insurers. It appears that firms will also need to allow for the reduced stability of the Fundamental Spreads in their internal models, potentially increasing capital requirements.

What does this add up to?

The Treasury and the PRA seem confident that the net effect of the changes will be to release capital for the industry. The Treasury has repeated the figure first mentioned by John Glen in February that as much as 10% to 15% of life insurers' capital could be released across the industry. Interestingly, the PRA has not confirmed this amount, instead suggesting only that certain packages of reform could result in that sort of release.

It's not entirely obvious how this figure has been calculated. At present, insurers tend to reinsure upwards of 80% of the longevity risk associated with new in-payment annuities, meaning that Risk Margins tend to be relatively small. This means that annuity writers may face a strain from the change in the Matching Adjustment calculation, without much offsetting benefit from changes to the Risk Margin.

The expectation of an overall release of capital may be based on an assumption that the changes to the Risk Margin will result in insurers reducing their use of longevity reinsurance. However, this is not clear and so it is difficult to say how realistic it is. It doesn't seem out of the question that the overall impact may be neutral, or even disadvantageous, for some firms.

What might the implications be?

Regardless of the net impact, it seems clear that demographic risk will become more attractive for insurers and that asset risk will become less attractive. Ways in which the industry might respond include:

- **The bulk annuity market could grow faster than expected:** if the reforms result in insurers having to hold less capital against annuities then this could increase their capacity to write new business – both by releasing capital from the back book which can be deployed to write new business, and by reducing the amount of capital that each new bulk scheme requires.
- **Annuity prices may decrease:** the increased competition that might arise from increased new business capacity could put some downward pressure on prices.
- **The proportion of longevity risk that is reinsured could fall:** as mentioned above, insurers currently reinsure a very high proportion of the longevity risk on new annuities. A lower Risk Margin might reduce the incentive to do this. But it's worth noting that many insurers believe that the SCR for longevity risk is too high. With no proposals to change this, incentives for reinsuring the risk will remain.
- **Incentives for investing in illiquid assets may reduce:** the devil will be in the detail here – for example, it may depend on how granular the comparator indices used in the calculation of the Fundamental Spreads are – but it's possible that some types of illiquid assets may become less attractive for insurers if the associated MA is lower than at present.
- **Use of funded reinsurance may increase:** if the changes to the MA proceed, it may prove advantageous to transfer asset risk out of the UK.
- **Insurers may look for solutions to stabilise their balance sheets:** if the changes to the MA increase the sensitivity of balance sheets to changes in spreads, insurers may look for ways of mitigating this, for example using derivatives.

What about the promise of greater investment freedom?

The Treasury's consultation discusses a range of relaxations to the requirements for including assets in MA portfolios. These include:

- Allowing the inclusion of assets that expose the insurer to **prepayment risk**, such as callable bonds or infrastructure assets with a construction phase.
- **Removing the rules that cap the MA on sub-investment grade assets** to be no more than that on equivalent BBB-rated assets. This could be advantageous for infrastructure projects that have a low rating initially but which become investment grade rated once the construction phase is complete.
- Proposals to **reduce the time taken to add new asset classes into MA portfolios**, including separating the MA application from the review of asset valuation, credit rating and capital modelling. There is also a suggestion that, if one insurer has already received approval to add a particular innovative asset class to their MA portfolio, the PRA may consider this when reviewing the same applications from other firms.

The flexibility to add a greater range of assets to MA portfolios will be welcomed by insurers, but the precise details about how this will be done will be important. Unfortunately, this issue wasn't mentioned at all in the PRA's discussion paper other than to note that the changes to the Fundamental Spread will come first.

What comes next?

The deadline for both responding to the Treasury's consultation and commenting on the PRA's discussion paper is Thursday 21 July. We're still a long way off the having a date for when rule changes might happen.

We continue to speak to a wide range of insurers across the UK and abroad about Solvency II developments and how this could impact their business. If you would like to discuss these points further, please get in touch with your usual Hymans Robertson contact or any of the authors of this Newsflash.