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HMT CONSULTATION ON THE REVIEW OF UK SOLVENCY II

HM Treasury consultation on its Review of Solvency II

HM Treasury has published its long-awaited consultation on its review of Solvency II. This follows the publication of a call for evidence in October 2020 and a response document in July 2021.

It is clear from the consultation, however, that there is still a long way to go before any reforms of the UK Solvency II regime are brought to fruition. The consultation narrows down the areas which are to be subject to review but concrete proposals are relatively limited. There is some detail on proposals for changes to the risk margin and matching adjustment, which will be of interest mainly to the life sector, but even here a lot is left open for consultation. At the same time, the PRA has published a discussion paper setting out its views on potential reforms to the risk margin and matching adjustment (DP2/22).

The risk margin

The risk margin has been top of the list of priorities for reform from the perspective of the insurance industry. It has also attracted the focus of Government, particularly as it sees reform of the risk margin as a way of releasing capital held by insurers to be invested in the UK economy.

HMT's starting position is that it wants to cut the risk margin by around 60-70% for long-term insurers. It suggests that this reduction is consistent with the prices at which insurers can in practice transfer longevity risk in the market, although it does not offer any evidence to support this statement. HMT would like to achieve this reduction by changing the methodology used to calculate the risk margin and, following advice from the PRA, it proposes doing this using a "modified cost of capital approach".

The risk margin issue is less acute for general insurers and the reduction in the risk margin for general insurers is likely to be more in the nature of 30%.

HMT suggests that the benefits of reducing the risk margin are threefold:

- it will mean additional resources are available to insurers, although there are some caveats here, discussed below
- it will reduce balance sheet volatility, which HMT claims will increase incentives for insurers to write new business and increase the affordability and range of products
- it will reduce incentives for insurers to reinsure longevity risk outside of the UK, which it suggests would boost the economy as a result of premiums received by insurers being retained in the UK (and presumably invested in UK assets).

In terms of increasing resources available to insurers, HMT notes that this will become available as the TMTP is phased out in accordance with the existing rules. In its discussion paper, the PRA comments that its estimates of the potential capital impact of proposed reforms are based on calculations assuming that existing transitionals have run off in full. Given that many life insurers will be applying transitional measures to their technical provisions calculations, and therefore not yet feeling the full impact of the risk margin, this suggests that elements of the expected capital release may be prospective rather than immediate.

There also remains the question of what insurers will do with any release of capital resulting from a cut to the risk margin. In his introduction to the consultation, John Glen (Economic Secretary to the Treasury) suggests that the reforms could release as much as 15% of the capital currently held by life insurers. One of the questions in the consultation is, however, how can the Government be assured that this released capital would not be distributed to shareholders or paid as increased remuneration to employees? Without specific safeguards (none of which have so far been proposed) it is difficult to see how Government can be assured of this. The PRA assumes in its discussion paper that insurers would be free to choose how to use any released capital and might therefore return some to shareholders as well as, it hopes, using some to support the writing of new business and, therefore, further investment in the economy.

The fundamental spread

HMT's proposals include amendments to the fundamental spread methodology and the PRA is clear in its discussion paper that it considers a material reduction to the risk margin can only be prudentially justified if it is accompanied by such amendments. The fundamental spread is the part of the matching adjustment calculation intended to capture retained risks (such as default risk) on the assets held to back matching adjustment liabilities.

HMT argues that the fact the floor to the fundamental spread has generally applied since Solvency II was introduced, coupled with the fact that the floor is calculated using a 30-year average, means that it is insufficiently sensitive to changing spreads. It is also insufficiently granular in its treatment of different assets. The PRA suggests that this lack of granularity incentivises insurers to invest in assets with a higher than average spread for their ratings. The PRA also considers that the fundamental spread does not currently sufficiently take into account the uncertainty around expected losses due to default on assets, which it says should be reflected in the fundamental spread as a "credit risk premium" (CRP).

The introduction of a credit risk premium would be a change to the way in which the matching adjustment is currently structured and would make the fundamental spread more sensitive to movements in credit spreads. In its discussion paper, the PRA acknowledges that this can lead to increased volatility but argues this can be mitigated by looking at average spreads over a reasonable averaging period and that it would allow "structural changes in credit risk" to be appropriately reflected in insurers' balance sheets.

There are a range of possibilities for calibration of the fundamental spread using the new methodology. This is likely to be driven by economic policy as well as prudential factors. The HMT consultation comments that "A lower calibration may be appropriate if this delivered significant benefits for the wider economy …". By contrast, the PRA is clear that it would find it difficult to support a calibration involving a CRP of less than 35% of credit spreads, if the risk margin is reduced by approximately 60% for life business.

It is worth noting that the PRA's views on reform of the matching adjustment are partly influenced by changes in the risks being taken on by life insurers, in particular the continuing growth in the market for pension scheme de-riskings, and ongoing changes to the types of assets in which life insurers are typically invested. The PRA reports that as at the end of 2020, c.45% of matching adjustment assets were assets other than corporate or UK government debt, compared with c.15% of equivalent backing assets as at the end of 2014.

Other amendments to the matching adjustment

As well as restructuring of the fundamental spread, HMT proposes introducing a number of changes to the matching adjustment which would be beneficial to insurers, although these are arguably relatively limited in nature:

- relaxing asset eligibility criteria to allow some assets where the issuer has the option to repay the asset early to be included in the matching adjustment portfolio. This would apply to assets such as callable bonds, commercial real estate lending housing association bonds and loans, infrastructure assets and local authority loan portfolios. This would be accompanied by some safeguards such as firm-specific exposure limits, reporting requirements and changes to liquidity plan requirements. Some amendments to the treatment of assets with construction phases are also proposed

- allowing products which insure against morbidity risk, such as income protection products, as well as with-profits annuities and deferred annuities in with-profits funds, to be eligible for matching adjustment treatment
- removing the cap on sub-investment grade assets
- introducing more flexible and proportionate approaches to matching adjustment approvals and breaches of the matching adjustment rules (although there is little detail on what this would involve).

Other reforms

If the proposals in respect of the risk margin and matching adjustment are arguably lacking in detail, the remaining proposals set out in the consultation are almost entirely devoid of it. Most of them have been flagged in previous communications. They cover:

- reducing the requirements applying to internal model standards
- removing requirements for branches of foreign insurers to calculate local capital requirements and hold local assets
- increasing the thresholds before Solvency II applies
- further simplification of reporting requirements
- the introduction of a 'mobilisation regime' for insurers (discussed further below)
- amendments to the rules on calculation of group capital requirements following an acquisition or merger
- simplification of the calculation of Solvency II transitional measures.

The mobilisation regime is a new proposal. Drawing on the existing mobilisation regime used in the credit institutions sector, this would introduce the option for a new insurer to take advantage of modified entry requirements such as a lower capital floor and modified governance and reporting requirements. This would be accompanied by some restrictions on the firm's activities during this (time limited) mobilisation phase. HMT suggests that this could enhance competition by making it easier for start-up firms to obtain authorisation and attract capital.

What about investment in infrastructure and other "green" assets?

The foreword to the HMT consultation suggest that the package of reforms could unlock tens of billions of pounds for long term productive investments, including infrastructure. The PRA discussion paper suggests that it will allow insurers to invest in assets which support "growth, infrastructure and the transition to net-zero". In reality, there is only a limited amount of specific incentives for insurers to invest in particular types of assets (even assuming that released capital is invested at all). The matching adjustment relaxations are likely to make it easier for infrastructure assets to be used within matching adjustment portfolios. There is no suggestion in the HMT consultation, however, that capital requirements should be reformed to give a preferential capital treatment for particular types of asset. The PRA was clear in its Climate Change Adaptation Report, published in October 2021, that it did not believe such capital treatment was appropriate.

Comment

The consultation leaves open a number of questions (in addition to those specifically asked by HMT in the paper).

It is clear that the Future Regulatory Framework Review will ultimately lead to the majority of prudential rules for insurers being set out in the PRA Rulebook. HMT states that it will consider feedback from this consultation before deciding which aspects of the reforms should sit in legislation and which in the PRA's rules. There is a degree of tension between HMT and the PRA on the calibration of the key reforms and it may be, therefore, that HMT will want to embed elements of these reforms in legislation. The PRA has set out its view that the reforms will result in a decrease in financial resilience but that this is

consistent with its statutory objectives provided that what it sees as an appropriate combination of reforms to the risk margin and fundamental spread is adopted. It is not clear how the PRA would respond if a different combination is adopted by Government.

The consultation closes on 21 July 2022 but there is no timetable set for HMT to publish feedback on the responses. Given the relative lack of detail on most of the proposals a further consultation seems to be the most appropriate next step rather than finalised policy. This is likely to push any actual reforms into the end of the year at the earliest. The PRA is due to publish its own consultation on reforms to Solvency II "in due course" but there is no clear timeline for this.

It will, of course, be interesting to see what the substance is of the PRA consultation when it finally arrives. Is the HMT consultation intended to cover all areas where reforms might be introduced? If so, the PRA consultation will contain only detail in respect of these topics. Some of the areas included in the consultation are of a sufficiently mundane nature to suggest this might be the case. There are, however, a whole range of other areas addressed by the European Commission in its recent proposals for reforms to the Solvency II Directive, many of which are intended to make improvements to the operation of the regime in practice rather than introduce any major policy changes. It would not be surprising if some at least of these proposals find their way into the PRA consultation.

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