For professional clients only

Regulation of UK insurers

Settlement market growth supported by reforms

On 17 November 2022, the UK Government published the results of its Solvency II review and – after much industry debate and lobbying – outlined its planned package of reforms.

Why bring you this note?

The Treasury has now announced its reforms to Solvency II aimed at tailoring the Solvency II regime to the UK economy post-Brexit.

Aon's Insurer Due Diligence team consider these changes and the impact on the market.

Summary

The Government has now released its response to consultations over changes to Solvency II, the regulatory regime for insurance companies in the EU. The changes aim to deliver on the Government's objective of tailoring financial services regulation in the UK post-Brexit.

Insurers responded positively and indicated that this will – as the Government hopes – open up more opportunity to invest in the UK.

The primary legislative changes announced were:

- **A reduction in the Risk Margin (an extra reserve for risks that are harder to hedge, mostly longevity risk for annuity funds) of around 65% for long term life insurers; and**
- **Broadening the available pool of assets that can back annuities, to improve investment flexibility.**

The Government has decided against materially changing the methodology for the discount rate used to calculate liabilities in insurance company reserving. Changes had been put forward by the Prudential Regulatory Authority (PRA), which believed that the existing approach could be altered to better reflect prevailing market conditions. These changes might have *increased* reserving if implemented, and at least partially offset the proposed reduction to the risk margin.

In practice, the reforms will be accompanied with additional powers for the PRA which will be responsible for implementing the regime and the subsequent ongoing supervision. The PRA will be focused on ensuring policy protection is not materially affected by the reforms once implemented in practice.

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Prepared by: Aon's Risk Settlement Group
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Expected impact on insurance market

We do not expect significant step changes to insurer pricing or capital levels.

The wider pool of eligible assets should help with capacity constraints for annuity funds, potentially supporting higher bulk annuity volumes without price rises, by opening up more illiquid asset opportunities with a favourable yield. Time will be needed for the steps to make this happen: passing of legislation (expected in 2023), the PRA determining how to implement the revised requirements, and the asset and insurance industry structuring new investments accordingly.

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Background

At present, UK insurance companies continue to follow the Solvency II requirements of the EU.

The Government has been seeking a ‘Brexit dividend’ by devising UK insurance regulation which would be more supportive to the local market.

This is a highly complex area, and it has taken some time to conclude the areas of change, with consultations from both the Treasury and the PRA (whose remit is focused on policyholder protection) contributing to the debate.

The headline proposals put forward by the Government are:

- Releasing capital by changing the calculation of the Risk Margin and cutting the margin substantially, assessed as a 60-70% reduction for long-term life insurers under recent economic conditions;
- Unblocking long-term productive investment by making it easier to include a wider range of assets in annuity portfolios;
- Reforming the fundamental spread of the matching adjustment; and
- Reforming reporting and administrative requirements.

These areas are considered in turn on the following pages.

The Government reported that the responses it had received to the consultation largely supported most of its proposals.

Coincidentally, the EU is in the advanced stages of making its own changes to Solvency II, which like the UK proposals, include a relaxation to the Risk Margin. These separate changes will not directly impact UK insurers.

However, the extent to which UK and EU requirements diverge will affect the UK’s ability to seek “equivalence” status with the EU, to allow UK insurers to write business across Europe. So far it is unclear if the Government plans to seek this status in the future.

Consultation responses

The Government’s consultation received 67 responses, including from insurers, consultancies, industry groups and members of the public.

Reducing the Risk Margin

Reducing reserves for some risks including longevity

The Government has proposed a significant reduction to the Risk Margin, with the revised approach estimated to reduce the capital required to cover the Risk Margin for long term life insurers by 65%.

The Government's hope was that a smaller risk margin would reduce the financial incentive for insurers to reinsure longevity risk, often to non-UK companies where different solvency regimes applied. This practice of transferring risk makes the task of monitoring the strength of UK annuity funds more involved, and slightly reduces the Government's ability to influence behaviour for the overall network of firms backing UK pension promises.

However, insurers have suggested that a change of this magnitude would not impact levels of longevity reinsurance seen in practice.

Prior to 2016 (i.e. before Solvency II – including the Risk Margin – was introduced), reinsurance levels were typically lower, although practice varied between insurers with mono-lines reinsuring to a greater degree given their lower scope for risk diversification.

Most annuity funds have reinsured between 75% and 100% of the longevity risk for their post-2016 business, with higher proportions applying for brand new business, reflecting the competitiveness and increased scope of the reinsurance market.

Several of the larger financial groups use internal reinsurance - in part to transfer longevity risk to a sister company structured for this purpose - and adopt this approach for annuities sourced in a range of territories, not just UK annuities.

It will therefore take some time to see if these now-embedded reinsurance strategies change over time. However, they may not change significantly until reinsurance pricing becomes more expensive (which may happen eventually, as more risk from the UK, US and other markets is passed to reinsurers). At that point, the Risk Margin change could become much more relevant.

The change will still free up capital on implementation (which might be for end-2023 reserving) as some insurers have retained more longevity risk for individual annuities and older business (noting that pre-2016 business is only gradually becoming subject to the full Solvency II reserving requirements). Legal & General is one such beneficiary and they have estimated a 3-4% improvement to their Group level solvency coverage (which is currently already over 200%).

What is the Risk Margin?

The Risk Margin is intended to represent the cost of transferring liabilities that the insurer is not able to hedge, to a third party. It is added to the best estimate of the insurer's liabilities and is intended to ensure that the insurer has sufficient assets to transfer its business to a third party.

The main component of it relates to retained longevity risk for annuity funds (despite the existence of a reinsurance market for hedging longevity risks).

At the end of 2021, the Government assessed that the Risk Margin for life business amounted to £32Bn across UK insurers. However, the Risk Margin is sensitive to interest rates and its impact will already have reduced from recent rises in market yields.

Opening up investment

Increasing investment flexibility to allow assets with “highly predictable” cashflows

In the consultation, the Government proposed to widen the assets that an insurance company could hold while retaining Matching Adjustment eligibility. One expressed aim was more investment in UK infrastructure projects and greener assets. The proposed changes do not directly focus on incentivising such opportunities, but should widen the pool of eligible assets, with the hope that the insurance and investment industries (who have been lobbying for these changes) use them to benefit the wider UK economy.

Eligible assets will now have to meet a less stringent test of demonstrating "highly predictable" cashflows, rather than the more onerous current “fixed” cashflows requirements. This could, for example, support more investment in infrastructure projects where it is difficult to structure fixed cashflows at the planning and construction phases, and support investment in convertible bonds.

Some insurers originate assets from other internal business lines such as mortgage issuance and use them to back annuity business. They have to employ financial engineering to restructure asset cashflows from this debt into more predictable income to ensure matching adjustment eligibility. The reforms will lead to fresh thinking on the required extent of this restructuring activity, which does currently lead to some value loss from frictional costs incurred.

The Government states that the changes to the matching adjustment will enable insurers to increase their investment in productive assets. Initial insurer responses echo this, with Aviva suggesting that the reforms will allow the insurer to invest at least £25Bn over the next 10 years in social housing, schools, hospitals and green energy projects. Phoenix have made a similar comment and are targeting £30-40Bn of investment over the next five years. The impact will depend partly on whether assets backing existing business are changed to capture new illiquid asset opportunities, noting that Phoenix has a particular opportunity here from rethinking the investment strategy of the various legacy annuity funds that it has acquired in recent years.

Skilled people and available asset opportunities are the current key constraints on the ability of the bulk annuity market to grow to meet the increasing demand from closed final salary pension schemes. Accordingly, this change could add more much-needed capacity by tackling the second of these challenges.

While the change is potentially supportive of affordable annuity prices, we expect this to allow greater volumes to be written without a price hike, rather than for pricing generally to reduce substantially – given the high demand for bulk annuities. As ever, prevailing market conditions will continue to cause fluctuations in pricing levels.

Matching Adjustment

The Matching Adjustment provides an important benefit to insurers who hold long-term assets matching the cashflows of long term insurance liabilities. It allows insurers to recognise in reserving calculations part of the excess return above swap yields (considered the risk-free benchmark) that their assets will provide over time.,.

The matching adjustment currently has strict rules on what assets are eligible for inclusion. For example. they must provide fixed cashflows and so only certain ‘bond-like’ investments can quality.

The consultation notes that at year-end 2020, insurer balance sheets benefit by £81Bn from the Matching Adjustment. Without this benefit, an insurer would not be able to offer a competitive annuity price.

Discount rates in reserving calculations

Current fundamental spread methodology retained

As part of the consultation, the Government sought views on the current methodology to calculate the fundamental spread used to determine how much of the yield on an asset can be taken into account in reserving calculations.

The PRA had proposed reform to the fundamental spread citing concerns that it may have become a less reliable assessment of credit risk over time (although any assessment of risk is subjective). It is worth noting that the fundamental spread is designed to be conservative – it includes a prudent allowance for future asset defaults relative to actual past experience.

Insurers had concerns with the proposed PRA changes, noting they could add greater volatility to reserving calculations and hence capital requirements, and may increase reserving in currently prevailing market conditions.

With no consensus approach emerging, the Government stated that no change will be made to the design and calibration of the fundamental spread, although it will increase the risk sensitivity of the current approach to allow different 'notched' allowances to be made within credit rating bands (for example, a higher fundamental spread for an asset rated A- than one rated A).

Changes will also be made to help insurers avoid forced sales of bonds if the rating temporarily falls below investment grade (i.e. below BBB).

The Government will review whether this calibration remains appropriate in five years' time, with the PRA being instructed to keep use of the matching adjustment under close scrutiny in the meantime.

The PRA had backed a package of proposals including greater change to the fundamental spread. Given these changes have not been included in the latest Government package, the PRA will doubtless consider this in its policing of insurer behaviour following these changes, and as part of their focus on ensuring policyholder protection.

Fundamental spread

Even where insurers closely match assets and liabilities and hold these assets to redemption, they retain credit and other residual asset risks.

These risks are reflected in the matching adjustment by excluding an allowance for them – the 'fundamental spread' – in the yield that can be assumed in reserving calculations.

The higher the fundamental spread, the lower the benefit from the matching adjustment.

The fundamental spread is higher for assets with a lower credit rating, and it hence pushes insurers towards holding only investment grade assets.

As insurers have increasingly invested into higher-yielding illiquid assets such as mortgages and infrastructure debt, decreasing the proportion of the annuity fund backed by listed bonds, the level of "fundamental spread" has become a more important consideration.

Reducing reporting and administrative burdens

As expected, the reforms also included some reductions in the level of reporting required to ease administrative burdens on insurers. These include:

- Updating the approval process for internal models to streamline the number of requirements;
- Removing onerous branch capital requirements for non-UK insurers looking to do business in the UK; and
- Easing the entry requirements for prospective insurers into the industry.

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What role does the PRA play?

The key changes announced by the Government will be implemented through legislation rather than changes to the PRA rulebook. Some commentators have noted this as a reflection of a partial shift in the balance of powers from the PRA to the Treasury, and that this was enabled by recent legislation (the Financial Services and Markets Bill).

It will be up to the PRA to implement the legislative changes announced by the Government. The Government has also declared additional powers for the PRA to support policyholder protection:

- A requirement for insurers to report regular stress testing to the PRA (an update to existing practice);
- Insurers to be required to nominate a senior individual to report formally to the PRA on fundamental spread calculations; and
- An allowance for the PRA to apply a higher fundamental spread where appropriate.

In addition, the PRA will now be expected to regularly publish technical information to insurers to reflect the reformed UK regime. This role was previously carried out by a European body prior to Brexit.

Role of PRA

While the Government is responsible for providing the legislative framework for insurance regulation, the PRA is responsible for the practical implementation and oversight.

Conclusion

The reforms have been expected for some time since Brexit and it was clear that the Government's aim was to reduce regulatory burdens on insurers, both from a capital and administrative perspective, with the intention of tailoring the regime to the UK economy.

A reduction in the Risk Margin and a broadening of asset availability have been welcomed by the insurance industry. It is expected that insurers will be able to utilise a wider asset pool which may help to alleviate asset sourcing constraints.

It is clear that the reforms are aimed at easing capital burdens on insurers, which of course raises questions on the strength of policyholder protection, especially compared to the existing Solvency II regime in force in the EU. It should be noted however that the EU is also currently considering reducing the Risk Margin in its own separate changes to Solvency II.

The consultation responses indicated that capital levels held by insurers are unlikely to change materially and other aspects of the regime, such as the Solvency Capital Requirements to reserve for 1-in-200-year stress events, are not changing.

Overall, we do not expect the reforms to result in any observable changes at any specific point, rather a more gradual process as insurers change behaviours and optimise strategies. At this stage, the Government and PRA have yet to announce when the various changes will be in force, but we presume the Government are planning to legislate within 2023.

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