Birth of Solvency UK

July 2023

For Professional Clients Only

Regulation of UK Insurers

In June 2023, HM Treasury published the draft regulations to reform Solvency II in the UK, followed by the release of a Prudential Regulation Authority (PRA) consultation.

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

Summary

In November 2022, HM Treasury released its response to consultations over changes to Solvency II, the regulatory regime for insurance companies in the European Union (EU). The changes aim to deliver on the Government's objective of tailoring financial services regulation in the UK, post-Brexit.

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 percent for long term life insurers.
- Broadening the available pool of assets that can back annuities, to improve investment flexibility.

The reforms will be accompanied by additional powers for the PRA, which will be responsible for implementing the regime and the subsequent ongoing supervision. The PRA's focus will be on ensuring policyholder protection is not materially affected by the reforms.

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.

Publication of Draft Regulations

On 22 June 2023, HM Treasury published the draft regulations to achieve the legislative changes previously announced in November.

While relatively short, the draft regulations did confirm the key expected changes:

- Changes to the Risk Margin to release capital from insurers' balance sheets.
- Creating a mechanism whereby insurers can invest in assets that do not meet the existing 'fixed cashflows' requirements of the Matching Adjustment, subject to controls around the materiality of risks.

The reforms will come into force over 2023-24, with the key change to the Risk Margin being implemented by the end of 2023.

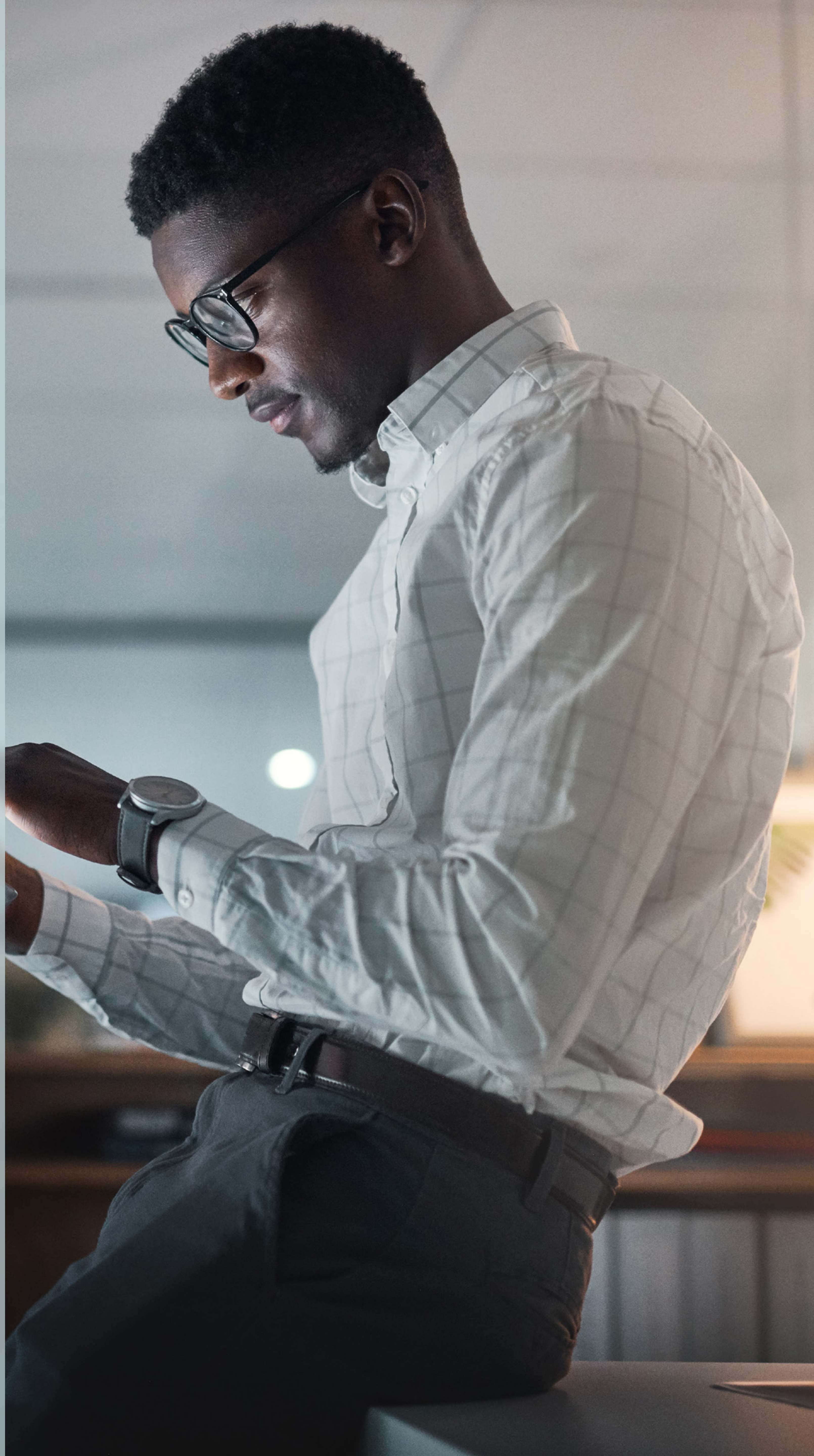
What Is the Risk Margin?

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).

What Is Matching Adjustment?

The Matching Adjustment provides an important benefit to insurers who hold long-term assets which match their 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.



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.

Following various consultations, the headline proposals put forward by the Treasury in 2022 were:

- Releasing capital by changing the calculation of the Risk Margin.
- 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.
- Reforming reporting and administrative requirements.

These areas are considered in turn on the following pages.

EU Review of Solvency II

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.

Draft Regulations Published by HM Treasury

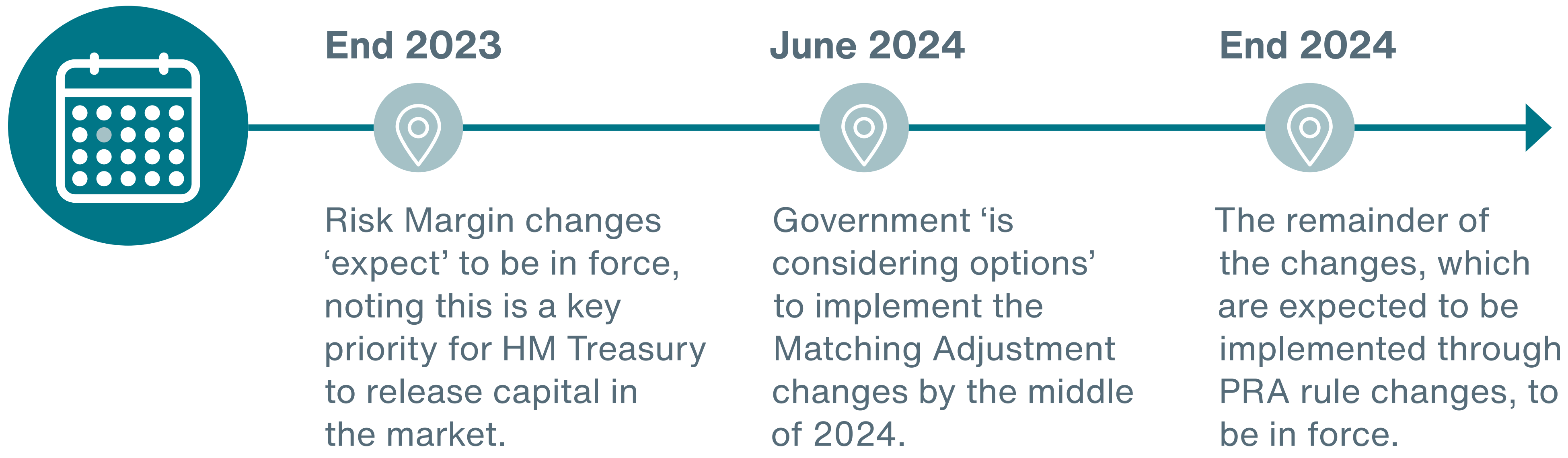
The draft regulations provide more clarity on some of the Treasury's proposals:

- Risk Margin — amending the formula for calculating the Risk Margin, including reducing the cost of capital assumed from 6 percent to 4 percent, which will reduce capital requirements.
- Matching Adjustment — sets out how the reforms will increase the flexibility regarding the requirement for assets to provide fixed cashflows.
- PRA role — the announcement signals that the Treasury's intention in the future is to remove the vast majority of statutes relating to Solvency II and instead have regulations set out in the PRA rule book.

However, there were some areas that the draft regulations did not cover:

- Expected technical changes in the calculation of the matching adjustment and fundamental spread.
- Reducing reporting and administrative requirements on insurers.

These intended timescales for implementing reforms were given:



PRA Consultation

Following the draft regulations released by the Treasury, the PRA released the first of three consultation papers regarding the changes to Solvency II.

The first PRA consultation paper, issued in June 2023, set out the detailed proposed changes to some technical aspects of Solvency II and provided information on the expected streamlining of administrative/reporting requirements for both insurers and the PRA. The consultation will close on 1 September 2023 for most of the content with more minor proposals due to close consultation on 31 July 2023.

The PRA will follow with two additional consultation papers in September 2023 (covering investment flexibility and matching adjustment changes) and early 2024 (to deal with transferring remaining Solvency II requirements into the PRA rulebook).

Reducing the Risk Margin

Reducing Reserves for Some Risks, Including Longevity

In November 2022, the Government proposed a significant reduction to the Risk Margin, estimated to reduce the capital required to cover the Risk Margin for long term life insurers by 65 percent.

The Government wants to reduce the financial incentive for insurers to reinsure longevity risk, with risk often transferred to non-UK companies where different solvency regimes apply. This complicates monitoring of financial strength and reduces the Government's ability to influence insurer behaviour.

The draft regulations released set out the revised formula for calculating the Risk Margin and include a reduction in the cost of capital rate from 6 percent to 4 percent.

Coincidentally, the EU is separately making changes to ease the Risk Margin within its own legislation, but this is also taking some time to resolve.

Reserving Impact in Practice

Insurers have, however, suggested that a change of this magnitude may not dramatically impact levels of longevity reinsurance.

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 monoline insurers reinsuring to a greater degree given their lower scope for risk diversification.

Most annuity funds have reinsured between 75 percent and 100 percent of the longevity risk for their post-2016 bulk annuity business, in part reflecting the Risk Margin, but also reflecting the competitiveness and increased scope of the reinsurance market.

Several of the larger financial groups also 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 take time to see if these embedded reinsurance strategies change. They may not change significantly until reinsurance 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.

Matching Adjustment — Opening Up Investment

Increasing Investment Flexibility

In the 2022 consultation, the Government proposed to widen the assets that an insurance company could hold while still retaining Matching Adjustment eligibility. It was expected that the reforms would mean eligible assets have to meet a less stringent test of demonstrating “highly predictable” cashflows, rather than the more onerous current requirement for “fixed” cashflows.

The draft regulations instead focus on some exceptions where assets are not required to be fixed, with a requirement instead that the additional risks are not material to the quality of an insurer’s investment portfolio and that only a limited proportion of the portfolio is affected.

The threshold of materiality has not been set out, and we expect the details of the implementation to be down to the PRA.

Impact on Insurer Investment Strategies

Some insurers originate assets from other internal business lines such as mortgage issuance and use them to back annuities. They have to employ financial engineering to restructure asset cashflows from this debt into a 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 the frictional costs incurred.

The Government states that the changes to the matching adjustment will enable insurers to increase their investment in productive assets, and insurers have echoed this, citing examples such as social housing and green energy projects.

Given the high demand for bulk annuities, we expect this greater flexibility to allow larger volumes to be written without a price hike, rather than for pricing in general to reduce substantially, with prevailing market conditions likely to prove a greater driver of fluctuations in pricing.

Discount Rates in Reserving Calculations

Fundamental Spread

The “fundamental spread” determines how much of the yield on an asset should be excluded in reserving calculations. It, for example, takes into account possible asset default risk.

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.

While the Government did not agree to this, the current approach is to be refined to include 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).

The draft regulations did not cover this, and we expect it to be part of the PRA’s practical implementation of the new regulation.

However, the draft regulations did set out a provision for insurers to optionally increase the fundamental spread where necessary to cover all risks retained. The PRA will have supervisory powers to intervene if they believe an insurer’s matching adjustment allowance reflects too high a discount rate.

HM Treasury will review if fundamental spread rules remain appropriate in five years’ time, with the PRA being instructed to keep use of the matching adjustment under close scrutiny in the meantime.

What Is The Fundamental Spread

Even where insurers closely match assets and liabilities and hold these assets to redemption, they retain credit and other residual 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 an important consideration.

Reducing Reporting and Administrative Burdens

While not covered in the draft regulations, future reforms are expected to ease some administrative burdens on insurers, specifically:

- 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.
- Easing the entry requirements for prospective insurers into the industry.

These may be implemented via the PRA rather than by statutory instruments.

Role of the PRA

HM Treasury have confirmed that in due course much of the detailed regulation relating to Solvency II will be removed from the statute book and replaced by the PRA rulebook. The Government has 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.
- 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 carried out by a European body prior to Brexit.

Expected Impact on Insurance Market

We do not expect significant step changes to insurer pricing or capital levels, and consequently do not expect these changes to have notable adverse implications for policyholder protection compared with current market practice.

The wider pool of eligible assets should help with capacity constraints for annuity funds, potentially supporting higher bulk annuity volumes without notable increases to pricing, by opening up more illiquid asset opportunities with a favourable yield. Time will be needed for the steps to make this happen including any further legislation, PRA guidance and changes to asset structuring.

Insurers are supportive, although some impatience may grow over the pace of change.

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