The PRA's statement on the 'Review of Solvency II' consultation published by HM Treasury

This statement provides an update from the PRA, coinciding with the consultation published by HM Treasury on the Solvency II Review.

Published on 28 April 2022

Overview

The Prudential Regulation Authority (PRA) notes the publication by HM Treasury (HMT) of its consultation on the Solvency II Review (the Review).

The PRA supports the objectives of the Review and continues to work closely with HMT on the potential reforms. This statement and the accompanying Discussion Paper (DP) set out the PRA's current views on some key aspects of the potential reform package.

The PRA's approach is grounded by its statutory objectives given by Parliament for safety and soundness, policyholder protection, and the secondary competition objective. The PRA also has regard to the range of matters it is obliged to consider when making policy, including the impact on sustainable growth, innovation, competitiveness, trade, and climate change. Many of these matters align closely with the Government's wider objectives for the Review.

HMT's consultation considers its proposed reforms to Solvency II could result in a release of possibly as much as 10% or even 15% of the capital held by life insurers. It proposes reducing the risk margin for long term life insurers by 60-70% and affirms that HMT is considering the case for reform to the fundamental spread (FS) used to calculate the matching adjustment (MA). It notes the link between the FS and other parts of its proposed reforms, including to the risk margin and the eligibility requirements for assets in insurers' MA portfolios. The MA matters are primarily of relevance to the annuity sector.

In working with HMT, the PRA has explained its view on which potential combinations of reforms to the FS and the risk margin could be consistent with its statutory objectives, and which would not. The PRA has drawn on available evidence, its engagement with insurers and its assessment of the estimated reduction in aggregate capital levels for the insurance sector (and therefore safety and soundness and policyholder protection) that the reform options would imply. The data gathered in the 2021 Quantitative Impact Study (QIS) has provided useful insights in informing the PRA's view.

Provided that satisfactory reforms to the FS and risk margin are achieved, the PRA considers there exist packages within the indicative ranges included in HMT's consultation that would be consistent with its statutory objectives and that would also achieve the broader objectives of the review around competitiveness and long-term investment.

Objectives of the review

The PRA considers that reforms need to ensure the long-term safety and soundness of the UK insurance industry and deliver an appropriate degree of policyholder protection. UK insurers need to maintain the financial strength on which their policyholders depend to have confidence that claims will be paid, and for the security of their pension income and financial wellbeing in retirement. In practice, the adequacy of capital for insurers is calculated over a one-year time horizon, with the key test being that an insurer is able to transfer its business to another if it is in distress. The risk margin and MA are key to the calculation of this transfer value.

Maintaining the confidence of policyholders and investors is essential if the insurance sector is to remain strong and competitive and to play its part as an important provider of long-term investment in the UK economy. The PRA considers that the reforms outlined below would support UK insurers' ability to invest for long-term growth, and facilitate a thriving, competitive and safe UK insurance sector.

The case for reform

The trend in transfers from company pension schemes to life insurers over the last five years is projected to continue, with rapid growth in the sector. At the same time the assets insurers choose to back these liabilities are changing, and Solvency II's MA treatment was not explicitly designed to cover these new assets. The package of reforms is an opportunity to address more appropriately the risks life insurers are taking.

The current design of the FS means there is a risk insurers recognise profits upfront on their investments in MA portfolios that may not actually be realised in the future. The current prudence in the risk margin gives some mitigation of this risk. So it is important that an overall package of reforms which includes reducing the risk margin also includes a strengthening of the FS in order to maintain insurers' safety and soundness and protect policyholders, consistent with the PRA's statutory objectives.

The PRA's current assessment

The PRA is of the view that decisions on changes to the risk margin need to be taken together with decisions on the FS when assessing the overall impact of reforms on its statutory objectives. When considering the potential calibration of these reforms, the PRA has also taken into account whether long-term insurers would continue to hold sufficient assets to be able to transfer their liabilities to a third party in the event of their failure (ie whether the UK would continue to operate a 'going concern' prudential regime in line with international standards). It is on this basis that, even for long-term business, an insurer's solvency capital requirement is assessed at a 99.5% level of confidence over one year.

1. The PRA agrees that the **risk margin should be reformed** to deal with concerns that it is too sensitive to movements in interest rates and too high when interest rates are low. The PRA considers that a modification to the current cost-of-capital approach to setting the risk margin

has a number of advantages to deliver this reform, and this is currently its preferred approach for both life insurers and general insurers.

2. The MA is a mechanism that allows life insurers to recognise upfront as capital resources a proportion of the spread (in excess of the risk-free rate) they project to earn over time on the assets matching their MA liabilities. This return is allowed to be recognised before it is earned because it is judged to be risk-free given the long-term and illiquid nature of the matched liabilities. The MA provides a strong incentive for life insurance firms to match assets and liabilities, which reduces prudential risks. However, allowing firms to recognise profits before they are earned is a valuable benefit which needs to be calibrated carefully to avoid the risk that insurers recognise returns upfront which may not be earned in future.
3. The FS is the allowance made for risks that insurers are assumed to retain, when calculating the MA benefit. The PRA considers that the **current FS design does not reflect appropriately the risks retained by insurers** because it does not fully and explicitly allow for uncertainty over future credit losses. It also does not explicitly take account of the range and nature of assets held in insurers' MA portfolios. There is therefore a risk that the MA benefit currently being taken by firms is too high, particularly as insurers' investments have changed over time and the proportion of investment assets rated and valued by insurers themselves has increased. This risk becomes more acute as action is taken to remove excessive prudence from the risk margin. Although the PRA can seek to address some of these limitations through its supervision of individual firms, this is not an effective substitute for a properly constructed FS treatment for the insurance sector as a whole.
4. The current FS design is based on credit ratings and assumes: (i) there is little uncertainty involved in the judgement made by an insurer or rating agency when assigning the credit rating to an asset; and (ii) there is little uncertainty associated with the expected rate of default or loss given default attached to an asset with this credit rating. Reform to the FS is needed to allow appropriately for the risks retained, including these areas of uncertainty, so that insurers do not recognise excess levels of profit upfront. This will then facilitate other reforms within the Review, including to the risk margin and reforms aimed at widening the range of assets eligible for the MA treatment and streamlining the approval process, which can support the Government's objective to increase investment in long-term productive finance.
5. To reflect adequately the risks faced by insurers, the PRA considers that **the FS should include an explicit allowance for a credit risk premium (CRP)**, namely the uncertainty around expected loss due to default for which a willing arm's length third party would demand a premium. There are various ways this could be achieved in practice, but the PRA currently considers that to ensure retained risks are adequately captured, the **CRP needs to be calibrated to deliver an outcome equivalent to at least 35% of credit spreads on average through the cycle**. This judgement has been informed by a review of academic research (which the PRA judges supports a range of 35% to 55%, with 35% at the lower end of the range of estimates for a CRP), experience of regulating the insurance sector during the 2007-09 financial crisis and under the Solvency II regime, and supporting analysis including

stress testing against historic experience. In addition, the PRA considers that reforms to the FS should be implemented in a way that avoids undue volatility of life insurers' balance sheets, and today publishes initial thinking on a design which could achieve this.

6. If this outcome is achieved, the PRA considers that **the risk margin could be recalibrated to reduce its impact in current economic conditions by around 60% for life insurers**, and around 30% for general insurers, while continuing to ensure the UK regime provides an appropriate level of safety and soundness and policyholder protection. While at the edge of what our analysis supports, these levels are within the ranges noted in HMT's consultation.
7. **The PRA's current estimate is that a combination of reforms along these lines could reduce overall capital levels for life insurers by around 10% to 15% in current economic conditions**. This combination of reforms would involve an increase in the risk of insurer failure compared to the current position, but would still ensure the UK continued to operate a going concern regime, for example by ensuring annuity liabilities continue to be valued in line with evidence from observed transfer values for longevity risk. Such an outcome would be within the PRA's risk appetite and should continue to advance its statutory objectives, as well as having a positive impact on sustainable growth in the UK and competitiveness. The PRA has taken into account similar reforms being considered in other jurisdictions and considers that an outcome as outlined above would potentially enhance international competitiveness. However, there are other combinations of reforms that would result in outcomes that the PRA considers would not be compatible with its statutory objectives.

Implementation of the Solvency II Review

Any reforms from the Review are likely to require changes in due course to domestic legislation (which is the responsibility of HMT and Parliament) and also changes to PRA rules and supervisory expectations. HMT has explained it will be considering feedback to its consultation before deciding which reforms should be implemented through changes to legislation, and which might be taken forward by the PRA. The PRA will continue to work closely with HMT on the Review, so that it is in a position to consult as soon as possible on any proposed changes to its rules and supervisory expectations. When preparing its future consultation, the PRA will perform its usual assessment of the costs and benefits of any proposed changes against its statutory objectives and against relevant 'have regards'.

Next steps

The PRA is publishing two further documents alongside this statement to ensure potential respondents to HM Treasury's consultation understand and can take into account the PRA's position.

1. The accompanying DP2/22 – Potential Reforms to Risk Margin and Matching Adjustment within Solvency II sets out the PRA's current view on the FS and risk margin, and the calibration of these items which together would deliver an outcome consistent with its statutory objectives.

The DP also contains **a technical annex 'Solvency II Review: Matching Adjustment and reforms to the Fundamental Spread,** available on the **DP2/22 webpage**, setting out the evidence which has informed the PRA's current view that reform to the FS is required involving a CRP with a minimum calibration equivalent to 35% of credit spreads on average through the cycle. The annex also sets out the PRA's initial thinking on a possible new design for the FS, which the PRA considers could address feedback on the design variants explored in the QIS. This possible new design has been set out at a high level in HMT's consultation and this annex provides additional detail to allow further information gathering and stakeholder engagement.

2. A QIS close-out communication 'Solvency II Review: Summary of Quantitative Impact Study (QIS) Engagements, available on the **Review of Solvency II: Quantitative Impact Study (QIS) webpage**, which sets out a summary of the insights gained through the QIS data collection and related engagement with industry stakeholders.

The DP closes on Thursday 21 July 2022. The PRA invites comments on this analysis to help develop its thinking and to inform any future PRA consultation proposals. Please address any comments or enquiries to: ✉ **Solvency2Review@bankofengland.co.uk**. Your responses may be shared with HMT. This means that HMT may review the responses and may also contact you to clarify aspects of your response.

The PRA will also be setting up further opportunities for industry engagement to discuss these issues in more detail.