



## HMT Review of Solvency II

### IFoA Response

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide and oversee their education at all stages of qualification and development throughout their careers.

#### Key points

The IFoA welcomes the opportunity to respond to HMT's Consultation Paper on the review of Solvency II (SII). There is scope both to improve the efficiency and effectiveness of SII in the UK, and also to allow the regime to better-reflect the particular features of the UK insurance sector.

We have considered HMT's SII review from an independent, public interest perspective. In doing so we have focussed on the impacts of SII on consumers and society as a whole.

The IFoA reiterates our support for HMT's underpinning objectives in this SII review, including the need for a prudential regulatory regime which fosters innovation and international competitiveness, appropriate policyholder protection/ soundness of firms, and facilitates long-term infrastructure and 'green' investment.

In principle, we welcome HMT's proposals to reform the Risk Margin. The current formulation of the Risk Margin means it is too interest-rate sensitive and also too high, particularly in the prevailing low-interest-rate environment. It adds to procyclicality and may be an artificial incentive to insurers to increase offshore reinsurance. We broadly support retaining the cost of capital methodology, particularly as that is the current method applied within SII.

We believe that the PRA has justifiable concerns over certain elements of the current Fundamental Spread (FS) methodology, such as limited risk sensitivity and the extent to which different assets should be treated differently. However, under HMT's proposed FS methodology, research we carried out on the FS indicated that an example life insurer's Own Funds would be more sensitive to credit spread movements. Using an FS that moves materially with market credit spreads creates undesirable levels of volatility for insurers' balance sheets, and this volatility may be procyclical.

In our research we have considered how adjustments could be made to the existing FS methodology to help address some of the PRA's concerns, to increase the risk sensitivity, and to better reflect the characteristics of different asset classes. Amongst other approaches, an FS approach based on a percentile approach might be a relatively simple alternative and reflects how many insurance firms apply risk-based capital approaches for other purposes.

The IFoA supports broadening the range of assets available to insurance company investment via the Matching Adjustment (MA). An appropriate increase in the availability of MA-eligible assets would provide insurers with a greater range of investment opportunities. There are potential societal benefits should more of these assets be invested in long-term infrastructure development.

We believe HMT's proposals to streamline SII reporting can be done without compromising the safety and soundness of firms, or of policyholder protection. In our view, public reporting is one area where SII has resulted in a step backwards.

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1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HMT's Consultation Paper on the Review of Solvency II (SII). We agree there is scope both to improve the efficiency and effectiveness of SII in the UK, and also to allow the regime to better-reflect the particular features of the UK insurance sector.
2. In developing our response, we have drawn upon input from a wide range of members working in both life and general insurance, together with specialists on institutional investment and sustainability issues. In particular, we have had significant input from our Matching Adjustment Working Party (MA WP), who have undertaken research on the Fundamental Spread (FS); their research activity has been influenced in part by HMT's SII review.
3. It is important to note that, as for any IFoA response, we have considered HMT's SII review from an independent, public interest perspective. In doing so we have focussed on the impacts of SII on consumers and society as a whole.
4. Given the above, we believe that the IFoA has an important role to play in the debate on the future evolution of SII in the UK, including both the approach to the FS and wider aspects of the review. We would therefore be delighted to discuss our response with HMT in due course.
5. For the record, we reiterate our support for HMT's underpinning objectives in this SII review, including the need for a prudential regulatory regime which fosters innovation and international competitiveness, appropriate policyholder protection/ soundness of firms, and facilitates long-term infrastructure and 'green' investment. We have borne these objectives in mind in drafting this response.
6. As we noted in our response to HMT's earlier Call for Evidence into SII (February 2021), the IFoA supports the fundamental principles of the SII regime, and we take a pragmatic approach to its future development.
7. We note the scope of this SII consultation is focussed on a discrete range of topics, with a particular interest in feedback on the future approach to the FS. Accordingly, we do not revisit the wider topics consulted on in the earlier Call for Evidence, and much of this response focuses on providing our insight and analysis on the questions relating to the FS.
8. In parallel to submitting this response to HMT, our MA WP are publishing their separate research paper on the SII FS and MA. This submission includes our full response to the relevant consultation questions on the FS, but the separate research paper provides further context and complements this submission. A copy of the research paper will be forwarded to HMT for completeness.
9. Given the nature of SII, many aspects of the review are unavoidably technical, and our answers to some of the consultation questions are quite detailed. In the light of this, our full response to the questions is given in the appendix. It is however worth highlighting below key aspects of our full response.

### ***Risk Margin***

10. In principle, we welcome HMT's proposals to reform the calculation of the Risk Margin. The current formulation of the Risk Margin means it is too interest-rate sensitive and also too high, particularly in the prevailing low-interest-rate environment. It adds to procyclicality in interest-rate markets. In addition, although offshore risk transfer is not in itself a bad thing, the Risk Margin may be an artificial incentive to insurers to increase such offshore reinsurance.

11. Considering together HMT's distinct proposals for the Risk Margin and MA/ FS, the impact on annuity business may be a reduction in the Risk Margin, offset by an increase in the best estimate liability resulting from the proposed MA changes.
12. The proposals in respect of the Transitional Measure on Technical Provisions (TMTP) are currently unclear. Based on the current arrangements, the Risk Margin release will largely be offset by a decrease in the TMTP, and firms are unlikely to realise the envisaged benefit in the Risk Margin while the TMTP applies.
13. In this case, the reduction will do little to change the current circumstance whereby in order to be competitive in the annuity market, insurers will need to find ways to reduce their risk exposures. In recent years, this has largely led to the transfer of longevity risks to offshore companies that use an alternative, economic capital, basis.
14. Our overarching concern with the Risk Margin is with its size, volatility and procyclicality. We broadly support retaining the cost of capital methodology, particularly as that is the current method applied within SII. As such, the dynamics of the method are well-understood and little modification to process will be required.

### ***Matching Adjustment***

15. We believe that the PRA has justifiable concerns over certain elements of the current FS methodology, such as limited risk sensitivity and the extent to which different assets should be treated differently. A key question is the balance to be struck between the use of credit ratings and the use of credit spreads.
16. The current FS methodology is driven by credit ratings which, whilst not perfect, are singularly focused on forming a view of creditworthiness and involve scrutiny of individual assets and their credit fundamentals. Credit ratings may be considered insufficiently risk sensitive as the ratings may not immediately reflect changing circumstances. However, they appear to be the best solution available to assess the credit risk inherent in individual assets and are subject to regulatory oversight to ensure they are being used appropriately.
17. The use of credit ratings does introduce an undesirable step change in FS within the current methodology, between the BBB and A ratings to which MA portfolios are primarily allocated. Within each credit rating, investments are not all equally risky, but rather there is a continuous spectrum of degrees of risk, and this could be better allowed for by using notched ratings such as BBB+ and BBB-.
18. HMT proposes using an FS methodology which uses a Credit Risk Premium. The Credit Risk Premium has no unique interpretation and academic research estimating its size varies significantly; there is no single, universally accepted method for deriving it across all market conditions. It is not a fixed proportion of spread over time.
19. The higher the Credit Risk Premium, the higher the best estimate liabilities and the lower the Own Funds. Our MA WP has estimated that a notional annuity writer's excess Own Funds would be significantly lower under the new FS methodology as compared to the status quo FS formulation.
20. We expect annuity prices to increase under the proposals to strengthen the FS. The higher the Credit Risk Premium, the higher will be the price of annuities, assuming no offsetting impact through a reduction in the Solvency Capital Requirement. Higher annuity prices will lead directly to lower benefits for policyholders, whether through the bulk purchase market or individual annuities.

21. Under the current regime, higher yielding assets with a particular credit rating generate a higher MA. Any reduction of that relative benefit would make investment in those assets commensurately less attractive. As such, we expect that investment in infrastructure assets including environmentally friendly investments may be disincentivised, relative to the current position. This is likely to be to the detriment of UK Government ambitions to increase investment of annuity writers into productive finance.
22. Our MA WP has estimated that an example life insurer's Own Funds would be more sensitive to credit spread movements, but less sensitive to credit rating downgrades due to the removal of the MA cap for sub-investment grade assets. Using an FS that moves materially with market credit spreads creates undesirable levels of volatility for insurers' balance sheets. Where long term liabilities have long term matching assets, the balance sheet should be immunised against interest and credit fluctuations.
23. Credit spreads tend to widen during economic downturns and so this balance sheet volatility may be procyclical, causing investors to require a higher rate of return, increasing the cost of capital to annuity providers within the insurance industry sector, and hence increasing annuity prices. There has been increased use of asset-based reinsurance in recent years, particularly in the bulk annuity market with associated offshoring of assets. Any increase in the cost of retaining credit risk may make further such reinsurance more attractive.
24. Our MA WP has considered how adjustments could be made to the existing FS to help address some of the PRA's concerns, to increase the risk sensitivity, and to better reflect the characteristics of different asset classes. These include moving to notched ratings, reflecting rating agency indicators, use of spread thresholds and expanding the FS asset class categories to align to a wider range of rating agency methodologies.
25. SII currently attempts to deal with the issue of compensation for uncertainty for risks where a market value is unobservable via the Risk Margin. A similar concept could be employed for credit risk, noting the importance of correct calibration, to avoid the issues we have seen with the Risk Margin. This is also likely to be consistent with the way an acquirer of an annuity portfolio might think about quantifying compensation required for the risks to be run post-acquisition.
26. An FS methodology based on a percentile approach might be a relatively simple alternative and reflects how many insurance firms apply risk-based capital approaches for other purposes. Such a method would be consistent with a Margin Over Current Estimate approach to the Risk Margin and may be relatively easy for firms to adapt for the purpose of valuation under other metrics.

### ***Increasing Investment Flexibility***

27. The IFoA fully supports the continued inclusion of the MA, and since its introduction in 2016, it has successfully helped reduce procyclical investment behaviour amongst UK insurers. However, as we noted in our response to HMT's earlier Call for Evidence into SII, we believe that the MA framework needs to incorporate more pragmatic flexibility. We therefore welcome HMT's proposals to ease the restrictions on insurers in applying the MA.
28. In particular, we support broadening the range of assets available to insurance company investment via the MA. An appropriate increase in the availability of MA-eligible assets would provide insurers with a greater range of investment opportunities. There are potential societal benefits should more of these assets be invested in long-term infrastructure development.

29. However, we believe the ambition for reform is limited to an extent and a more wide-ranging reform of the way eligible assets are determined would provide greater likelihood of these aims being met. For example, a more flexible approach to assets which carry risk in either the timing or amount of payments could be applied. There may also be an opportunity for the regulator to rethink its approach to asset securitisation and to establish direct ways of limiting the MA where necessary.
30. We believe that HMT's proposed reforms do not correspond to a lowering of regulatory standards, but the removal of blockers created through a set of rules which were quite binary in nature.
31. Widening the range of investments eligible for the MA does not appear to pose additional risks from a policyholder perspective, given a wide range of existing safeguards within the SII regime (which we support retaining). We believe that the greater variety of assets envisaged by HMT's proposals is well within the risk appetite of most insurers and would not endanger policyholder protection.

### ***Reducing Reporting and Administrative Burdens***

32. We welcome HMT's proposals to streamline SII reporting to make it more proportionate and fit-for-purpose. We believe this can be done without compromising the safety and soundness of firms, or of policyholder protection.
33. In our view, public reporting is one area where SII has resulted in a step backwards: we are aware that the SII Solvency and Financial Condition Report is neither valued nor used by market commentators or policyholders.
34. The internal model approval and change processes and associated documentation requirements are onerous. They could be more proportionate by taking a more principles-based approach, backed up by a range of relevant safeguards. Although capital add-ons could potentially be appropriate in this context, they would need to be applied with care to avoid firms becoming over-capitalised.
35. The calculation and maintenance of the TMTP is highly complex, and its objective could continue to be met through simpler methods. We see considerable benefit if firms can agree a set of pragmatic simplifications to their TMTP calculation which removes the areas of associated complexity. This has the potential to reduce balance sheet volatility making firms' capital positions easier to understand and supervise. However, as the Risk Margin typically comprises the largest part of the increase between Solvency I and SII currently, if the Risk Margin were revised as proposed this would have a corresponding impact on a given insurer's TMTP calculation.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager ([steven.graham@actuaries.org.uk](mailto:steven.graham@actuaries.org.uk)) in the first instance.

Yours Sincerely,

Matt Saker

**President, Institute and Faculty of Actuaries**

## Appendix: Responses to Questions within Call for Evidence

### Risk Margin

1. In principle, we welcome HMT's proposals to reform the calculation of the Risk Margin. As we noted previously, the current formulation of the Risk Margin means it is too interest-rate sensitive and also too high, particularly in the prevailing low-interest-rate environment. It adds to procyclicality in interest-rate markets. In addition, although offshore risk transfer is not in itself a bad thing, the Risk Margin may be an artificial incentive to insurers to increase such offshore reinsurance.

#### **Question 2.1: How would a reduction in the Risk Margin for long-term life insurers toward the bottom or top of the 60%-70% range impact on:**

- **policyholders and their level of protection; and**
  - **insurers and their reinsurance, investment and product pricing decisions?**
2. As articulated in the SII Directive Recital 54, the technical provisions are intended to be market-consistent. Following from this, the Risk Margin should be the amount that a market participant would expect to pay as compensation for risk in excess of the best estimate liability. Considered on its own, a Risk Margin reduction of 60% - 70% brings the total technical provisions significantly closer to that intention, but compared to historical reinsurance prices, is unlikely to be sufficient to fully offset the cost of reinsurance.
  3. It should be noted that insurers make decisions based on more factors than costs alone. These include, for example, increasing capacity for exposure to risk, access to data and expertise, and to attain more stable financial results. Narrowing the difference between the cost of reinsuring and the cost of retaining the risk will shift the balance between these considerations.
  4. Considering together HMT's distinct proposals for the Risk Margin and Matching Adjustment (Fundamental Spread), the impact on annuity business may be a reduction in the Risk Margin, offset by an increase in the best estimate liability resulting from the proposed Matching Adjustment changes.
  5. The proposals in respect of the Transitional Measure on Technical Provisions (TMTP) are currently unclear. Based on the current arrangements, the Risk Margin release will largely be offset by a decrease in the TMTP, and firms are unlikely to realise the envisaged benefit in the Risk Margin in the short to medium term.
  6. In this case, the reduction will do little to change the current circumstance whereby in order to be competitive in the annuity market, insurers will need to find ways to reduce their risk exposures. In recent years, this has largely led to the transfer of longevity risks to offshore companies that use an alternative, economic capital, basis.
  7. We note that for companies that do not write annuity business, the Risk Margin reduction will result in a release of technical provisions, where these companies do not apply the Matching Adjustment. However, the total assets allocated by these companies to the type of productive finance that HMT wish to promote is small compared to insurers that write annuity business.
  8. Although this question focuses on long-term life insurers, general insurers with Periodical Payment Order (PPO) liabilities may also have very long-tailed liabilities (equally as long as long-term life insurers). It is unclear why the suggestion of a 60-70% reduction in the risk margin is suggested only for life insurers, and not also in relation to a general insurer's PPO liabilities.

**Question 2.2: How would a reduction in the Risk Margin for general insurers of 30% impact on:**

- **policyholders and their level of protection; and**
  - **insurers and their reinsurance, investment and product pricing decisions?**
9. A reduction in the risk margin would reduce the security to policyholders unless it were accompanied by a corresponding increase in capital.
10. In (general insurance) commercial business, insurers often hold capital above the SII Solvency Capital Requirement at a level to meet external rating requirements. Rating agencies may well increase the levels they expect to be held which may result in a shift between technical provisions and risk capital, rather than a fall overall in the assets backing policies. This may be advantageous especially where the Risk Margin is potentially large and volatile, and where it is calculated using quite broad approximations - for example for long-tail business. It may also enable insurers to invest more flexibly.
11. In relation to (general insurance) personal lines business, the target level of capital may be much closer to the Solvency Capital Requirement, in part because policyholders are all protected by the Financial Services Compensation Scheme (FSCS) and firms are less likely to use financial strength as a marketing or selling point. If the Risk Margin and hence technical provisions were to reduce for these firms without any corresponding increase in capital, there would be a greater burden on the FSCS: i.e., greater mutualisation of costs across the market.
12. The SII Own Risk and Solvency Assessment (ORSA) of personal lines firms may lead them to hold more capital, or to arrange for access to capital. This could increase the proportion of policyholder security (effectively FSCS security) that was backed by contingent capital. It is worth noting that a high proportion of the liability for PPOs lies with personal lines businesses, and these liabilities are long-tailed and attract a high Risk Margin.
13. Hence it may be appropriate to distinguish between personal lines and commercial insurances. A weakening of the technical provisions basis for commercial insurance may be neutral or even an improvement; for a similar change for personal lines business some compensating change to protect policyholders or the FSCS may be appropriate.

**Question 2.3 Do you agree that a modified cost of capital methodology should be used to calculate the Risk Margin?**

14. Our overarching concern with the Risk Margin is with its size, volatility and procyclicality. We broadly support retaining the cost of capital methodology, particularly as that is the current method applied within SII. As such, the dynamics of the method are well-understood and little modification to process will be required.
15. A modified cost of capital methodology can deliver the right outcome but that depends on the modifications proposed and the exact calibration, of which we have not yet been informed.
16. We also note that, although not for the same purpose, under IFRS17 there is a requirement to determine a risk adjustment which has some similarities to the Risk Margin. IFRS17 does not mandate the form of risk adjustment, which recognises that for some firms, alternatives to a modified cost of capital methodology may be more representative.

17. In addition, for those firms which are also required to report under the EU version of SII (e.g., because their parent company is authorised in the EU), use of a modified cost of capital methodology will be more closely aligned to the changes to the EU Risk Margin currently proposed by the European Commission. Maintaining close alignment in this respect may enable the same models to be used for reporting under both UK and EU versions of SII, reducing the costs of implementation for such firms.

**Question 2.4 Is there any further information about actual transfer values of insurance risk that should be taken into account when finalising the calibration of the Risk Margin reforms?**

18. As life insurance portfolios are not traded very often, there are few data points in respect of actual transfer values. In the experience of our members the transfer value is typically derived using a cost of capital style approach, rather than the percentage of spread approach proposed in the PRA's Discussion Paper, although we note that when portfolios are bought or sold, the price can also be influenced by other factors such as brand, goodwill and synergy benefits.

19. The most tangible traded 'non-hedgeable' risk, therefore, is reinsurance of mortality and longevity risk. Although the prices of these transactions are not in the public domain, it is clear that since 2016, these risks have been increasingly offloaded by UK life insurance companies.

20. We note that the run-off market within Lloyd's of London may provide some insight on actual transfer values. In this context, any margins over a discounted best estimate would not typically be set using a cost of capital approach.

**Question 2.5 How could the Government be assured that resource that becomes available following a reduction in the risk margin would not be distributed to shareholders or used to increase remuneration to parties within the insurance firm?**

21. Each insurer will decide for themselves the best use of their own capital, which may include:

- investing in growth of the business;
- reducing prices for policyholders;
- reducing gearing and obligations such as repaying debt or paying down pension deficits; or
- returning capital to shareholders where, for example, no better options are deemed to exist

22. The decisions should reside with the relevant insurance Board and management based on their own judgement and circumstances, providing those decisions do not put at risk the safety of policyholders or the wider market. In these cases, the PRA has powers to prevent insurers from acting in ways that result in harm.

23. However, as noted above, it is unclear that there will be a significant release in surplus if proposals for both Risk Margin and Matching Adjustment (and offsetting TMTP impacts) are taken into account (as is applicable for most large life firms).

24. In practice, should a restriction on any overall capital benefit be imposed by HMT, this may then be counterproductive. It would imply that the changes to the Risk Margin were just 'window dressing' to make it look to policyholders and analysts that firms had a stronger capital requirement coverage ratio, when in fact they were not able to take credit for this benefit in the running of their business.



## Matching Adjustment

25. In framing this consultation response, we have not performed independent quantitative assessment of the potential impacts of HMT's proposals. We are aware of quantitative assessments having been performed by individual companies, but we have not attempted to reflect the results of these in our response. As noted above, our Matching Adjustment Working Party (MA WP) produced research on the Fundamental Spread (FS)/ Matching Adjustment (MA). Where relevant our response makes reference to key observations/ conclusions from this research.

**Question 3.1 Taking into account the fundamental spread methodology needing to be sufficiently responsive to changes in investment decisions and reflect long-term exposure to credit risks, do you agree with the above assessment that the current methodology does not:**

- **sufficiently address the risks associated with assets with the same credit rating but different market measures of retained risks?**

26. The IFoA believes that the PRA has justifiable concerns over certain elements of the current FS methodology, such as limited risk sensitivity and the extent to which different assets should be treated differently. A key question is the balance to be struck between the use of credit ratings and the use of credit spreads.
27. The current methodology is driven by credit ratings which, whilst not perfect, are singularly focused on forming a view of creditworthiness and involve scrutiny of individual assets and their credit fundamentals. Credit ratings provide a reference point for assessing credit risk but may be considered insufficiently risk sensitive as the ratings may not immediately reflect changing circumstances. However, they appear to be the best solution available to assess the credit risk inherent in individual assets and are subject to regulatory oversight to ensure they are being used appropriately. External Credit Assessment Institutions (ECAI) are regulated by the Financial Conduct Authority in the UK and European Securities and Markets Authority (ESMA) in the EU. The PRA has powers to ensure internal ratings are appropriate.
28. The use of credit ratings introduces an undesirable step change in FS within the current methodology, between the BBB and A ratings to which MA portfolios are primarily allocated. Within each credit rating, investments are not all equally risky, but rather there is a continuous spectrum of degrees of risk, and this could be better allowed for by using notched ratings such as BBB+ and BBB-.
29. This would provide a more granular assessment of the probability of default and a more accurate reflection of the credit risk in a portfolio. It would reduce the current incentive to invest towards the lower end of each big letter rating. The FS would be more sensitive as assets would move between notch ratings more regularly than they move between credit ratings.
30. These more granular FS could be calculated using simple linear interpolation between the Credit Quality Step-based FS. If the PRA can set out an interpolation approach for firms to apply, this would limit the increase in the volume of data the PRA must produce. This would address a concern raised by the PRA.
31. Granularity could be extended further, for example by asset class, but this would introduce increased complexity for increasingly marginal insight and potentially (in the case of liquid assets) more active trading.

32. As noted above, there is greater inertia in published credit ratings as compared to credit spreads, ratings watch and some other market indicators. This is partly due to the rich variety of data used by credit rating analysts, whereby a smoothing effect from so many inputs contributing to the rating result might be expected. There is evidence of a link between spreads and realised losses, but this is not a fixed percentage over time, and the relationship can change significantly following periods of market stress.
33. Spread variances between assets of the same rating may reflect alternative market views on credit risk. This means that credit spreads may include a signal that is a leading indicator of potential downgrades and defaults. The allowance for this signal under the new proposals would remove the step change in FS between each 'big letter' rating. However, this step change would be significantly reduced if a more granular (e.g., 'notched') approach were applied.
34. Credit spreads also reflect other factors including market pressures of supply and demand, including liquidity risk premium, and structural and funding effects, which may be unrelated to credit risk.

**Question 3.1 (continued) Taking into account the fundamental spread methodology needing to be sufficiently responsive to changes in investment decisions and reflect long-term exposure to credit risks, do you agree with the above assessment that the current methodology does not:**

- **take account of all the risks associated with holding internally rated or illiquid assets?**

35. Many internally rated illiquid assets are valued on a mark to model basis because there is no (regularly) traded market value that can be used for valuation purposes. As a result, firms tend to apply techniques such as use of comparators and indices. This means that valuations can drift from the transaction value observed at origination, effectively becoming internal valuations over time. As such, a credit deduction based upon the modelled spread may be less certain and harder to validate. Introducing a positive Z parameter would avoid overreliance on this modelled spread but a large Z parameter may have undesirable implications in terms of discouraging investment in illiquid assets.
36. Whilst there is already a strong framework for valuation methodologies under IFRS (including sign-off by audit committees, etc.), there is still more uncertainty in these valuations. This may be particularly true in relation to how the value moves in times of stress where the underlying valuation assumptions may no longer hold. This means that the use of the signal from modelled credit spreads may not significantly reduce the reliance placed on an insurer's internal methodologies for ratings and valuations.
37. We believe that it should be possible for internal ratings to be appropriately managed through firms' own processes and that any regulatory concerns with these processes be addressed separately from quantitative distinction within the FS. Potential model risk arising from uncertainty around internal ratings could be captured as a quantifiable risk in the Solvency Capital Requirement, or (where less material) monitored in Stress and Scenario Testing.

**Question 3.2 What is the impact of the fundamental spread including a credit risk premium of 25, 35 or 45% of spreads on life insurers':**

- **a) key balance sheet metrics including best estimate liabilities, own funds and the solvency capital requirements;**

**When answering this question please set out the assumptions you are making, including the size of X and Z.**

*We have not performed independent quantitative analysis for the purpose of this response. The IFoA's MA WP's analysis is referred to below. This assumed, for the purpose of discussion, that  $X = 35%$ ,  $n = 5$  years and  $Z = 0%$ .*

38. The higher the Credit Risk Premium, the higher the best estimate liabilities and the lower the Own Funds.
39. Our MA WP has estimated that a notional annuity writer's excess Own Funds would be significantly lower under the new FS methodology as compared to the status quo FS formulation.
40. We note that the PRA said in its discussion paper that it does not expect levels of Solvency Capital Requirement to change materially under the proposal. However, it is not clear why any recalibration of the FS in the base scenario should necessarily impact the appropriateness of the FS under stress as currently determined. So we might expect that:
  - for Internal Model firms, an increase in the base FS may be associated with a reduction in the credit risk Solvency Capital Requirement, subject to model change governance requirements;
  - consideration should be given to refining the calibration of the credit stress for the Standard Formula.
  - **b) incentives to provide annuities;**
41. We would not expect the pricing framework by which firms set pricing rates on annuity business to be changed fundamentally by HMT's proposals, with consideration continuing to be given to profitability targets and availability of capital. However, given the possible increase in pricing rates due to increased capital requirements (as noted below), market supply may be impacted. Additionally, to the extent that access to sufficient capital is a constraint, any increase in combined day 1 capital requirements may lead companies to restrict new business volumes or to reinsure the credit risk offshore.
42. Notwithstanding the challenges introduced by the proposed changes, we would expect underlying competition in the annuity market to continue. Competition between firms has increased following a period of consolidation in the market, driven by mergers and acquisitions. More participants are entering the market to meet the demand for bulk purchase annuities from Defined Benefit pension schemes looking to de-risk. Smaller insurers have grown to become larger market participants.
  - **c) annuity prices;**
43. Other things being equal, we expect annuity prices to increase under the proposals to strengthen the FS.
44. Most firms reinsure a significant proportion of the longevity risk on new business, meaning that reductions to the Risk Margin will be expected to have a limited impact on annuity prices.
45. The higher the Credit Risk Premium, the higher will be the price of annuities, assuming no offsetting impact through a reduction in the Solvency Capital Requirement. Higher annuity prices will lead directly to lower benefits for policyholders, whether through the bulk purchase market or individual annuities.
46. We would expect in turn that this reduces the attractiveness of these products, particularly to trustees who may find that marginal increases in annuity prices make such transactions unattractive,

and consequently lead to a contraction of the insured annuity market. This may lead to trustees deciding to retain longevity and credit risk within Defined Benefit pension schemes.

- **d) investment in economic infrastructure, such as clean energy, transport, digital, water and waste;**

47. The degree to which annuity providers support investment in economic infrastructure will be driven by the size of the annuity market and the proportion of their assets allocated to these particular industry sectors. As noted above, we believe that an increase in annuity prices may reduce the overall amount of new annuity business written by insurance firms.
48. Infrastructure assets are illiquid with a limited secondary market on which to make disposals. This means that the allocation is limited by an insurer's appetite for liquidity risk, as the achievable sale price at short notice may be below market value. Around 35% - 40% of MA portfolios are, on average, already being invested in illiquid assets leaving limited headroom for further increases on existing business.<sup>1/</sup>
49. Increased investment would require a wider scope of infrastructure assets both to access the available supply of investments and due to the need to diversify. Total returns on a portfolio of infrastructure assets tend to be higher where any impaired assets are actively managed, because of the higher achievable recovery rates. This requires the (in-house) expertise to be able to manage these assets to be successful.
50. Firms' investment teams have grown significantly in both size and capabilities in recent years to support a rising proportion of MA portfolio assets that are illiquid. Further increases in this proportion may require further expertise in the management of impaired infrastructure assets. For example, following a covenant breach or technical default on a clean energy infrastructure asset, an insurer may find itself managing an underperforming offshore wind farm.
51. In question 4.1 below, the benefits of broadening the range of assets eligible for the MA portfolio are discussed, in terms of increasing the supply of eligible infrastructure assets to insurers. This would be one way to facilitate support from annuity providers in this area.

- **e) investment to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and**

52. Under the current regime, higher yielding assets with a particular credit rating generate a higher MA. Any reduction of that relative benefit would make investment in those assets commensurately less attractive, i.e., through any positive calibration of Z. To the extent that the excess yield on such assets relates to their illiquidity, the proposals will act to render such assets less attractive than they are currently, whether in respect of backing existing portfolios or future new business. As such, we expect that investment in infrastructure assets including environmentally friendly investments may be disincentivised, relative to the current position.
53. However, at present, the demand for investments aligned to Environmental Social and Governance (ESG) requirements, including to support the transition to net zero, currently exceeds the supply of investments that demonstrably qualify. There are three key reasons for this imbalance:

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1. Chart 4: Illiquid proportion of MA portfolio assets. Source: Speech given by Charlotte Gerken, 29 April 2021.

- first of all, the supply is low because of an absence of high-quality market disclosures on carbon emissions for individual corporations. This was noted by the Bank of England in the results of its Climate Biennial Exploratory Scenario;
  - secondly, the demand is being driven by an expectation of an impending market correction whereby asset prices may transition to reflect any stranded assets and any increases in the effective price of carbon emissions arising from projected legislative and regulatory changes. There is an advantage to anticipating and being in front of this transition in order to benefit from the relative changes in prices. Institutional investors are more likely to have the economies of scale to be able to do this;
  - thirdly, the demand is supported by consumer preference making ESG credentials a potential source of competitive advantage. This is particularly the case for asset managers looking to attract individual investors.
54. A higher or lower size of FS would not be expected to increase the supply of suitable investments in the short term and the existing demand is already very high.
55. The existing demand is highest for green technologies at the later stages of development, where assets are most likely to be eligible for the MA portfolio:
- at the near-completion stage where debt might support research and development, there is already significant investment in innovations such as driverless cars by big technology companies, and the biting constraint relates more to a shortage of skilled labour;
  - at the growth stage, taking electric vehicles as an example, there is arguably no shortage of investment in more established green technologies, including by manufacturers of petrol, diesel and hybrid vehicles. Uptake is more likely to be driven by consumer preference, the chosen date from which the sale of non-electric vehicles will be restricted, and tax incentives such as the lower Benefit in Kind rate on low emission vehicles purchased through Salary Sacrifice.
56. At the start-up stage, venture capital is required, i.e., equity, which would not be eligible for the MA. Rather than annuity providers, this would be more likely to come from private equity firms and individual investors making use of tax incentives such as the Venture Capital Trust scheme. Annuity firms could be encouraged to invest in green venture capital equity using shareholder funds, outside of their MA portfolio, subject to the Prudent Person Principle.
57. In the longer term, where supply can be separately and significantly increased, it will be important to ensure that green investments are attractive to insurers. The proposals do not provide any specific incentive to invest in any green sectors and, as noted below, relative to the current regime, may disincentivise investment in infrastructure and other illiquid assets. For example, the Z parameter could be lower for green investments on the basis that they are more sustainable so will have lower credit risk in the long term compared to their current credit spreads.
- **f) relative incentives to invest in different types of assets, including assets of different credit ratings and different risks, assets with different liquidity, assets that are internally or externally rated, and assets in different sectors?**
58. Excessively prudent treatment of assets whose valuations are not publicly observable may serve to disincentivise firms' investment in such assets. This is likely to be to the detriment of UK Government ambitions to increase investment of annuity writers into productive finance.
59. There are particular difficulties with quantifying credit risk for illiquid assets. Academic research on credit risk understandably focusses on publicly traded assets and therefore it is (even) less clear

how compensation for credit risk within the spreads of illiquid and/ or more complex assets can be derived objectively.

60. A methodology based on credit ratings may be able to reflect more accurately the credit risk of individual assets as a result, albeit noting that credit rating analysis can be flawed. Credit ratings are not influenced by structural factors affecting the trading levels of assets and hence credit spreads. These structural factors include issue size, new issuance premia and domestic market bias.
61. The relative incentives for investment in different types of assets within a MA portfolio are complex, with some firms dedicating resource to optimising the allocation across assets of different credit ratings and terms, driven by the available yields and relative to the profile of expected liability cash flows.
62. Alternative assets including economic infrastructure are attractive relative to equivalent corporate bonds due to the higher spreads available in the market to compensate for the greater illiquidity. This effect would be dampened were Z to be too high. There may also be basis risk between the available reference index and the illiquid asset that may cause unwanted volatility in the FS.

**Question 3.3 What is the threshold for any increase in the fundamental spread above which adverse effects become significant, such as excessive balance sheet volatility or increased reinsurance of risks off-shore?**

63. Our MA WP has estimated that an example life insurer's Own Funds would be more sensitive to credit spread movements, but less sensitive to credit rating downgrades, such as those experienced during the global financial crisis, due to the removal of the MA cap for sub-investment grade assets.
64. Using a FS that moves materially with market credit spreads creates undesirable levels of volatility for insurers' balance sheets.
65. There is a strong investor preference for stability of earnings and dividends because this is indicative of a low risk investment. It is important that the volatility of an insurer's balance sheet reflects the riskiness of the investment. Where long term liabilities have long term matching assets, the balance sheet should be immunised against interest and credit fluctuations.
66. Procyclical investments such as luxury retail are typically more volatile due to decreased sales during economic downturns. MA portfolios, in contrast, have predictable asset and liability cashflows that are in balance, and so the volatility of this investment is closer to the utilities sector for which income and price elasticity is more limited.
67. The limited price elasticity of the utilities sector is exemplified by the recent dramatic rises in oil and gas prices following Russia's invasion of Ukraine. Increased prices have not led to a proportionate decrease in the demand for petrol, gas or electricity, but rather have increased the cost of living and reliance on the state and charitable organisations.
68. Annuity rates will be affected not only by the total amount of technical provisions and Solvency Capital Requirements, but also by the cost of capital required per annum by investors to compensate them for the risks. Introducing unnecessary volatility into insurers' balance sheets may increase this cost of capital, because of the need for buffer capital and additional hedging.
69. Credit spreads tend to widen during economic downturns and so this volatility may be procyclical, causing investors to require a higher rate of return, increasing the cost of capital to annuity providers within the insurance industry sector and hence increasing annuity prices.

70. There has been increased use of asset-based reinsurance in recent years, particularly in the bulk annuity market with associated off-shoring of assets. Any increase in the cost of retaining credit risk may make further such reinsurance more attractive.
71. The larger the increase and volatility of the FS, the more attractive offshore reinsurance will become. This effect can be seen with the Risk Margin where, due to it being very high and very volatile, insurers have reinsured the vast majority of their new longevity risk since the advent of SII.
72. Funds held by offshore reinsurers are less likely to be invested into the UK. The risks associated with the investments move to overseas jurisdictions, away from the UK regulatory regime. Profits and hence tax revenue are also paid overseas.
73. Whether in respect of increased volatility or the attractiveness of asset-based reinsurance, we do not believe there is a single threshold, rather there is a spectrum within which decisions are taken. For example, offshore reinsurance may currently be attractive for some schemes/insurers and not others. Any marginal increase in FS would increase the relative appeal of such reinsurance, but only impact on practical decisions at the tipping point for any particular scheme.

**Question 3.4 What is the impact on policyholder protection of a credit risk premium of 25, 35 and 45% of spreads, when accompanied by a risk margin reduction for long-term life insurers of 60-70%?**

74. The Credit Risk Premium has no unique interpretation and the academic research estimating its size varies significantly. Different investors in differing circumstances may have alternative views both on its size and formulation. There is no single, universally accepted method for deriving the level of Credit Risk Premium across all market conditions. For example, the Credit Risk Premium is not a fixed proportion of spread over time.
75. All else being equal, the higher the Credit Risk Premium, the larger will be insurers' technical provisions:
- for those in retirement who have already purchased an annuity, this means increased protection, ensuring that they receive their income for life. Beyond a certain point though, there are diminishing returns from each marginal increase in protection;
  - for those nearing retirement, it may increase the cost of an annuity such that whilst they are guaranteed an income for life, the level of this guaranteed income is low. In such cases many retirees may then choose not to buy an annuity, and so will not be protected from the risk of outliving their pension pot. The proportion of retirees that go on to exhaust their funds would be expected to rely on support from the state, in turn funded by future taxpayers;
  - for pension schemes which have already de-risked, this also means increased protection;
  - for pension schemes considering de-risking, it may increase the cost of bulk purchase annuities, such that they are unable to buy-out or buy-in, so remain in scope of the Pension Protection Fund.
76. The IFoA's Great Risk Transfer campaign has identified a long-term trend for risks that in previous generations were pooled and managed by governments and companies, to be transferred back to individuals. In the case of longevity risk, low annuity rates driven by the low interest rate environment, seen since the global financial crisis, have led to underinsurance with more and more individuals retaining their longevity risk. Individuals may not be well-placed to determine the appropriate rate to draw down pension pots and often underestimate their future life expectancy.

**Question 3.5 What is the impact of selecting an averaging period (n) of 0.5, 1, 2, 5, 10 and 30 years?**

77. The length of the averaging period will be most important when credit spreads have recently and dramatically increased. For example, at the outset of the great depression or global financial crisis:
- a shorter averaging period (e.g.,  $n = 0.5$  years) would have been beneficial during the great depression to allow more of the signal from the market of the potential for increased defaults and downgrades to be acted upon by insurers;
  - whereas a longer averaging period (e.g.,  $n = 30$  years) would have been preferable during the global financial crisis to prevent over-reaction to the 'noise' in credit spreads arising from the temporary credit crunch.
78. It is difficult to know in advance whether an increase in credit spreads represents signal or 'noise'.
79. A medium averaging period (e.g.,  $n = 5$  years) may be seen as an attempt to strike a balance between a through-the-cycle FS that could be considered insensitive, and a faster-moving FS that might be criticised as procyclical. However, this creates an undesirable lag in the recognition of changing credit conditions that may persist for some time after an event has occurred.
80. The technical annex, chart 7 in the PRA's SII Discussion Paper, illustrates that a 5-year averaging period would have meant very low FS in the early stages of the global financial crisis and significantly elevated FS for a time after conditions returned to (more) normal. This has the potential to drive incongruous behaviour.
81. The length of the averaging period may affect the speed at which insurers react to increasing credit spreads:
- following a sizeable increase in credit spreads, insurers should be encouraged to take preventative measures at an early stage. These may include suspending dividend payments to shareholders or discretionary bonuses to with profits policyholders;
  - we would not want irreversible measures to be taken such as a flight to quality, which may crystallise losses and reduce, post-crisis, the financial resources available to protect policyholders. Such measures may also be procyclical creating a negative feedback loop.
82. Note in particular that after a short term crisis followed by a gradual reversion to a lower level of spreads the impact on Long Term Average Spread will drive investment decisions throughout the averaging period.

**Question 3.6 Are there other ways to achieve the same outcomes that changes to the fundamental spread would have?**

83. The PRA's preferred concept of a Credit Risk Premium is a common approach when considering the decomposition of asset spreads. This approach has significant academic research behind it but the proposed changes to the FS contain a number of downsides discussed above.
84. Additionally, we are aware that many firms' Internal Models for credit risk and IFRS17 discount rate allowances are driven by models for ratings migrations - hence moving away from ratings/ downgrade-based approaches wholesale is likely to create additional work and cost for the industry and regulators, which may be unwarranted, given the above points.



85. Our MA WP has considered how adjustments could be made to the existing FS to help address some of the PRA's concerns, to increase the risk sensitivity, and to better reflect the characteristics of different asset classes. These include moving to notched ratings, reflecting rating agency indicators, use of spread thresholds and expanding the FS asset class categories to align to a wider range of rating agency methodologies.
86. The current regulations already attempt to deal with the issue of compensation for uncertainty for risks where a market value is unobservable via the Risk Margin. A similar concept could be employed for credit risk, noting the importance of correct calibration, to avoid the issues we have seen with the Risk Margin. This is also likely to be consistent with the way an acquirer of an annuity portfolio might think about quantifying compensation required for the risks to be run post-acquisition.
87. An FS methodology based on a percentile approach might be a relatively simple alternative and reflects how many insurance firms apply risk-based capital approaches for other purposes. Such a method would be consistent with a Margin Over Current Estimate approach to the Risk Margin and may be relatively easy for firms to adapt for the purpose of valuation under other metrics. Our Future of Discounting Working Party has suggested such an approach for IFRS17 purposes. However, such an approach is likely to be relatively static over time and unlikely to respond to any great extent to perceived increases in market-implied levels of credit risk. So the structure and calibration of the model may need to be refined to include some allowance for current /recent spreads. For example, the chosen percentile could depend on credit spreads and other market indicators.

### **Increasing Investment Flexibility**

88. The ability for life insurers to be a provider of long-term finance across a diverse range of assets is important for a number of reasons, including:
- supporting the UK government to achieve its climate change objectives;
  - providing much-needed financing to support the growth of the UK economy;
  - ensuring attractive annuity pricing for those reaching retirement;
  - facilitating greater diversification of asset risk across the industry.
89. The IFoA fully supports the continued inclusion of the MA, and since its introduction in 2016, it has successfully helped reduce procyclical investment behaviour amongst UK insurers. However, as we noted in our response to HMT's earlier Call for Evidence into SII, we believe that the MA framework needs to incorporate more pragmatic flexibility, albeit with a risk-based assessment of assets (and liabilities). We therefore welcome HMT's proposals to ease the restrictions on insurers in applying the MA.

#### **Question 4.1: What would be the impact of these reforms on insurers' use of the matching adjustment and investment:**

- **in economic infrastructure, such as clean energy, transport, digital, water and waste;**
  - **to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and**
  - **in any other asset classes?**
90. The IFoA supports broadening the range of assets available to insurance company investment via the MA. An appropriate increase in the availability of MA-eligible assets would provide insurers with a greater range of investment opportunities.

91. The UK insurance and long-term savings industry is responsible for the stewardship of circa £1.7 trillion assets and there are potential societal benefits should more of these assets be invested in long-term infrastructure development. Infrastructure assets are inherently attractive for insurers as they provide long-dated cashflows, often with inflation linkage. They typically provide high levels of security through their linkages to key services for the economy and/ or physical assets acting as security for the insurer. The strong sense of social purpose behind many of these assets is also aligned with the increased ESG focus insurers are placing on their investment activities.
92. By their nature however, less 'standard' assets are less likely to fit into existing tick-box requirements of more established assets and so greater flexibility over determining MA eligibility of such assets is also important, as firms look to include a wider array of projects and asset variants within MA portfolios.
93. We also welcome HM Treasury's openness to innovative investments. Taking measured risks is essential in order to make an impact by investing in economic infrastructure and the transition to net zero. This can include suitable allocations to unproven technologies (just as, for example, offshore wind was in this category a few years ago). We appreciate the PRA's focus on the stability and security of investments; in our view, carefully considered investments in such areas need not conflict with overall prudence.
94. We support greater freedom for insurers to invest in equities or equity-like assets, provided these have good dividend security. Such assets can compare favourably with corporate bonds. The latter may offer better liability matching but their default risk also needs to be taken into account. There is an apparent inconsistency between the proposals to remove the cliff-edge around investment grade corporate bonds, yet to increase capital charges for equity investments.
95. In our view many insurers are likely to welcome the opportunity to make allocations alongside their gilt holdings, to productive assets such as real estate, infrastructure and equities with adequate income streams. Some may also choose to invest in growth assets like venture capital and private equity.
96. Although the proposed reforms will help to some degree by making additional assets eligible for the MA, we believe the ambition is limited and a more wide-ranging reform of the way eligible assets are determined would provide greater likelihood of these aims being met.
97. A more flexible approach to assets which carry risk in either the timing or amount of payments could be applied. For example, stress testing of the asset could be carried out to understand whether this variability is material to an insurer's MA portfolio and to identify what actions they would take if these events occurred.
98. Limits on the magnitude of variability in timing and payment amounts could also be used to ensure inappropriate assets, for example equities (without good dividend security) or other assets where a substantial element of the payment profile is uncertain, are not included within MA portfolios.
99. Currently, the approach to assets with variable cashflows requires insurers to undergo burdensome securitisations of the assets. The securitisation splits an asset or group of assets into an MA-eligible part and residual non MA-eligible junior notes, but in practice insurers hold both parts and so these securitisations do not change the underlying risk profile. Insurers are further required to value and establish a credit rating for these structured assets which requires considerable judgement.
100. Furthermore, even when this is done it does not always result in levels of MA that the regulator is comfortable with. Additional tests (through the regulatory supervision statement SS3/17)

are then applied to such assets which may restrict the MA by a further amount. The level of complexity introduced by having multiple tests and internally-securitised assets actually makes it harder for insurers to understand and monitor their MA portfolios. We believe there is opportunity for the regulator to rethink this approach and establish direct ways of limiting the MA on such assets to appropriate levels without requiring securitisation.

101. Whilst the above reforms apply generically to all assets, we believe insurers' requirements naturally incline them towards the economic infrastructure type assets described above. These natural incentives include net zero targets and other wider ESG commitments made by insurers which will need assets of this nature to fulfil.

102. Similarly, insurers have established transition to net zero plans that will necessitate them prioritising greater investment in green assets and technologies. Some investment trusts hold low-risk, equity-like assets (such as wind farms). By enabling insurers to do so also, HMT's proposals could have a significant positive impact on green technologies and the transition to net zero.

**Question 4.2: What are the additional risks that these reforms may pose to policyholder protection?**

103. Overall, we believe that HMT's proposed reforms to increase investment flexibility do not correspond to a lowering of regulatory standards. Rather, they remove unhelpful blockers created by rules which were quite binary in nature.

104. In our view, the current processes are too onerous. There is also further inefficiency as the restrictive rules require significant insurer resource to apply; there are also significant regulatory resources required to approve (or otherwise). Despite the effort involved, a number of the rules and procedures insurers need to follow deliver little in increased policyholder protection. This means there is scope for reform without adding risk to policyholder protection, given there are other safeguards within the SII regime.

105. Widening the range of investments eligible for the MA does not appear to pose additional risks from a policyholder perspective, given the safeguards we outline below in response to Question 4.3.

106. The greater diversity of investment opportunities can also make investment portfolios less concentrated and increase stability to credit downturns.

**Question 4.3: What safeguards are appropriate to protect policyholders from the risks posed by following a wider range of assets into matching adjustment portfolios?**

107. Insurers have demonstrated (both before the introduction of SII and subsequently) that they have the required capability to measure and monitor investment risk arising from a wide range of assets. Prudence is vital, but it can be achieved through principles and scenarios rather than rigid rules.

108. We believe that the greater variety of assets envisaged by HMT's proposals is well within the risk appetite of most insurers and would not endanger policyholder protection.

109. There is a comprehensive range of existing safeguards within the SII regime and PRA regulatory framework which we support being retained within any revised SII framework within the UK. In our view these should be sufficient to protect policyholders. Example of safeguards include:

- **Prudent Person Principle** - the requirements of Prudent Person Principle already require insurers to identify, monitor and manage the risks of investments prior to investment taking place;
- the **SII Own Risk and Solvency Assessment (ORSA)** - processes are used to stress test the insurance firm across a wide range of circumstances. Where predictability of asset cashflows carries sufficient uncertainty this should be explored through stress and scenario testing to understand the impacts and consider the range of actions available to the firm should they arise. This can be used as an input to the firm establishing risk limits on the level of investments in each asset class to avoid concentrations of risk;
- **MA approval process** - the initial approval for a firm to benefit from the MA should consider the firm's processes for monitoring of risk within their MA portfolio and the assessment process that they will undertake to confirm asset eligibility. Insurance firms are also required to maintain extensive process and controls around the operation of their MA portfolios;
- **liquidity risk policy** - it is a SII requirement to establish a liquidity risk policy to ensure policyholder payments can be met with sufficient certainty. The MA principles also set out that insurers should be in a position to buy and hold assets to maturity to avoid reliance on the sale of assets to meet policyholder payments. Stress and scenario testing of liquidity risk is an existing requirement for insurers;
- **capital requirements (internal model firms)** - for insurers using an internal model, it would be appropriate to consider how the MA may vary due to features of the asset portfolio such as timing or payment variability;
- **capital requirements (standard formula firms)** - for insurers using the standard formula there is scope to apply different capital stresses on assets. SII regulations also require firms using the standard formula to justify the appropriateness of their risk profile to the assumptions underlying the standard formulae and where this is materially not the case it is expected that internal models are developed;
- **external audit** - requirements were introduced recently for external auditors to consider whether the audited insurer's MA portfolio has met the approval conditions and regulations.

110. Given these extensive safeguards it seems appropriate that once an insurer has met the above standards, they should be able to invest and allocate investments to their MA portfolios without need for further regulatory approval.

**Question 4.4: What impact will these reforms have on insurers providing a greater range and more affordable pricing of products?**

111. In widening the range of MA-eligible assets this will reduce insurers paying an 'eligibility premium' on assets by better balancing the supply and demand for MA-eligible assets.

112. Currently Defined Benefit pension funds are paying a 'premium' to buy out their liabilities with an insurer, yet if they choose instead to manage the run-off of their liabilities themselves, the cost is lower, due to the capital constraints faced by insurers under the existing SII regime. Under the status quo, there is a risk that some funds will seek pension buy-out deals overseas, where the capital requirements are less onerous.

113. By placing greater reliance on the SII framework and not requiring approval for minor changes, the investment decision process will be faster. Insurers could therefore take advantage of tactical opportunities in investments; this contrasts with a 6-month approval window which can mean opportunities no longer remain by the end of the window. There would also be expense savings from more operationally efficient MA regulations.

114. Reform of other matters such as eligible product features (*see examples in response to Question 4.5*) will enable insurers to better match customer requirements, for example bespoke features that trustees deem beneficial in the buy-out process, and deliver products aligned to customer needs rather than regulatory rules.
115. Whilst difficult to quantify, the more ambitious reforms should support better customer outcomes in both product and price.

**Question 4.5: What changes to the matching adjustment approval process are necessary to ensure that applications to use the matching adjustment are approved more quickly?**

116. The MA is highly material to the reported solvency position of most insurers who have permission to apply it. We consider it appropriate therefore that there is an initial approval process for the regulator to ensure that the insurer has appropriate processes, systems and controls to manage its MA portfolio appropriately.
117. However, insurers currently have to reapply for a new approval for what can often be minor changes to their MA portfolios. This is both resource intensive for insurers and regulators and causes significant delays to insurers actually making investments. We believe that only material changes to insurers' process or restructuring of the MA portfolio should necessitate a further approval process. Other more minor changes can be adequately dealt with through normal supervisory engagement activities and requirements for insurers to notify the regulator of minor changes.
118. The current approval process relies heavily on the 'same features assessment'. This concept is not defined adequately and focuses too heavily on comparing asset features with existing assets of the portfolio. The question of MA eligibility should instead focus on whether the asset is appropriate for the MA fund (which should be clear from the regulations). Once an insurer has satisfied themselves that an investment is appropriate and meets the regulations for permitted MA assets there should not be a need to obtain further approvals.
119. Insurers should be able to update their internal MA processes and documentation (covering how they assess, value and determine credit ratings of new asset types) and then be in a position to invest. A short - say one month - advance notification of minor changes to the MA portfolio could be used for any routine supervisory activities the regulators undertake.
120. This MA eligibility process can also be clearly separated from other regulatory approvals or supervisory discussions regarding capital, rating and valuation through appropriate initial limits.
121. We believe there are existing safeguards in the firms' already approved processes, reporting of MA portfolios in regulatory returns, and the duties of external auditors, such that further regulatory approval should not be required. Once these other thresholds have been met and insurers are ready to invest, in our view they should not be required to undertake a further approval process purely for MA eligibility.
122. It is appropriate for insurers to be able to identify clearly assets and liabilities within their MA portfolio. However, some elements of the regulation take this to extremes in trying to achieve near complete separation of the portfolio from the remaining business, as if it were a separate entity itself. We do not believe all of these elements are necessary given firms' management of risks at a whole company level; firms should also be in full control of what constitutes the MA portfolio. Examples of this include:

- **surrender values** - the requirement for surrender values to be less than the value of assets held in the MA portfolio can be unduly restrictive. Whilst the ability to hold investments to maturity is an important feature of MA portfolios to ensure with sufficient certainty that insurers will earn the benefits they obtain from the MA, there is no reason that the insurer's other assets could not be used to increase payments to policyholders;
- **no future premiums** - the requirement for no future premium payments on MA liabilities is unnecessarily onerous. Whilst we agree insurers should not be able to take credit for MA on premiums not yet received and invested - as there is a risk of economic conditions changing - we do not believe the framework should be so restrictive to prevent all future premiums: future premiums that purchase additional benefits on terms set at the time of payment do not create additional risk;
- **reinsurance/ contract scope** - contracts such as reinsurance often cover multiple products some of which are MA eligible and others not. Where the insurer can reasonably allocate the value between the MA and non-MA business, they should be permitted to do this without requiring duplicate contracts;
- **counterparty collateral** - counterparties, commonly for derivatives and reinsurers, require collateral to be based on the overall exposure to an insurer rather than the individual exposure of the MA portfolio. There should be greater freedom for insurers to manage these processes without requiring internal procedures to calculate notional amounts for each fund. This is another example of detailed regulations creating unnecessary cost and administration for insurers which have no real impact on policyholder protection.

123. Currently it is very challenging for general insurers to meet the (liability) requirements to use the MA. However general insurers with exposure to PPOs often have very long-tailed liabilities with a steady stream of cashflows; they are much akin to long-term life insurers' annuity portfolios. Adjusting the MA liability criteria in a way that general insurers could use the MA on these PPO exposures would have several benefits:

- encourage better matching of assets to these long-tailed liabilities, which would ultimately be beneficial to policyholder security;
- encourage firms to invest in assets such as infrastructure debt and other similar investments which can be in the public interest.

## Reducing Reporting and Administrative Burdens

### Question 5.1: What is the impact of these reforms on regulatory costs incurred by insurers?

124. We do not have access to data indicating the potential impact of HMT's proposals on insurance firm/ industry regulatory costs. However, we make the following qualitative points on a number of the reporting/ administrative changes proposed, which we hope are helpful.

125. We welcome HMT's proposals to streamline SII reporting to make it more proportionate and fit-for-purpose. We believe this can be done without compromising the safety and soundness of firms, or of policyholder protection. Public reporting is one area where SII has resulted in a step backwards: we are aware that the SII Solvency and Financial Condition Report is neither valued nor used by market commentators or policyholders.

126. We believe that the SII reporting requirements are disproportionate in some areas, and this adds to the cost burden for insurers. In many cases, it seems that much of the reporting adds little value. For example, in our experience, generally very few queries arise from the required Solvency and Financial Condition Reports.

127. The reporting burden has been particularly marked for smaller insurers, and an increased use of waivers to make reporting less onerous for smaller insurance companies is welcome. However, we believe that waivers should be granted taking a risk-based approach, noting that a small firm may still be complex, or operate in a niche area, such as trade credit. We acknowledge that the PRA has already reduced the financial reporting and disclosure burden to an extent, with further related consultation activity due later in 2022.
128. Reporting could benefit from a complete overhaul and more risk-based approach being taken. For example, many reporting templates could be removed and others required to be updated if a firm exceeded a given risk threshold; or more granular data could be required where material to the business in question.
129. The internal model approval and change processes and associated documentation requirements are onerous, and could be more proportionate, taking a more principles-based approach. We therefore support HMT's aim to avoid time-consuming insurer/ regulator discussions on points of technical detail in modelling issues. A more proportionate approach could be applied backed up by a range of relevant safeguards. Although Capital add-ons could potentially be appropriate in this context, they would need to be applied with care to avoid firms becoming over-capitalised.
130. The calculation and maintenance of the Transitional Measure on Technical Provisions (TMTP) is highly complex, and its objective could continue to be met through simpler methods. As mentioned in our response to HMT's earlier SII Call for Evidence, we see considerable benefit if firms can agree a set of pragmatic simplifications to their TMTP calculation which removes the areas of associated complexity. This has the potential to reduce balance sheet volatility making firms' capital positions easier to understand and supervise.
131. It should be noted that as the Risk Margin typically comprises the largest part of the increase between Solvency I and Solvency II currently, if it were revised as proposed this would have a corresponding impact on a given insurer's TMTP calculation.

**Question 5.2: What would be the impact of removing capital requirements for branches of foreign insurers operating in the UK, both on existing branches and on the decision to establish new branches?**

132. As we noted in our response to HMT's earlier SII Call for Evidence, a branch and its parent have a single legal personality. Allowing the parent company to consolidate the branch's risk into the parent's capital requirement may better align how the parent manages its risks in practice.
133. Under the current SII rules, the branch capital requirements are based on a notional balance sheet of insurance business effected by that branch. This introduces frictions, e.g., because the branch's notional balance sheet does not recognise any diversification benefits from business written elsewhere within the parent. The regulatory cost and or capital requirements generated as a result of current rules could be put to more productive use without obviously compromising the parent's safety and soundness; or the security of policyholder benefits.
134. Removing the branch capital requirement would improve the capital fungibility of the parent as a whole; and the ability to move capital around more quickly and or easily.
135. On the other hand, removing capital requirements for branches could potentially create a risk for UK policyholders if the relevant entity were to fail, as it may be difficult to repatriate assets to the UK in such a circumstance.

**Question 5.3: What would be the impact of a new mobilisation regime for insurers and changes to thresholds at which Solvency II applies on:**

- **businesses currently considering whether to become an authorised insurer; and**
- **small insurers' ability to expand before Solvency II applies?**

136. We welcome the proposals to introduce a new mobilisation regime for insurers, noting the safeguards suggested including proportionate restrictions on activity and time limited nature of the mobilisation phase. There is a parallel here with Lloyds of London who have long taken a similar approach with new syndicates. However, one lesson to be drawn from this experience is the need for more bespoke oversight in the initial phase of mobilisation.