HM Treasury Review of Solvency II: Consultation

Response from the Association of British Insurers (ABI)

July 2022

The UK insurance and long-term savings market and the ABI

The ABI is the voice of the UK's world-leading insurance and long-term savings industry. A productive and inclusive sector, our industry supports towns and cities across Britain in building back a balanced and innovative economy, employing over 300,000 individuals in high-skilled, lifelong careers, two-thirds of which are outside of London.

The UK insurance and long-term savings industry manages investments of around £2.2 trillion, pays over £16bn in taxes to the Government and supports communities across the UK by enabling trade, risk-taking, investment and innovation. We are also a global success story, the largest in Europe and the fourth largest in the world.

The ABI represents over 200 member companies, including most household names and specialist providers, giving peace of mind to customers across the UK. Please note we would be happy, and stand ready, to provide further information if this would be helpful to HM Treasury. More detailed technical evidence on the issues raised in this response can be found in the associated Annex.

For the purposes of this response, 'insurers' refers to insurance, reinsurance and long-term savings companies.

This is an ABI response. The WTW analysis and quotes referenced are to support the response but also include an ABI overlay on WTW's conclusions and key messages. For the complete WTW analysis and viewpoints please reference the WTW report directly via the following link: The WTW Report.

1. **Executive Summary**

- The ABI welcomes the opportunity to respond to this HM Treasury (HMT) Solvency II consultation.
- **In addition to its commitment to HMT's key objectives on competitiveness and policyholder protection, the insurance and long-term savings industry shares the Government's ambition to capitalise on Brexit by reforming Solvency II rules to unlock billions of pounds in new investment in the UK economy.** This new investment has never been more critical – at a time of significant economic pressure, to help level up communities and economies across the country through new infrastructure, homes and technologies.
- **But this ambition will not be realised without the right reform. While good progress has been made to deliver Solvency II reform, fundamental issues remain with the current proposals.**

Brexit opportunity

- We welcome HMT's proposals to reduce the Risk Margin and expand the Matching Adjustment (MA) eligibility criteria. However, from the long-term investors' perspective, **the overall package is significantly less favourable than the EU version of Solvency II** – where there is a clear focus on releasing capital. The proposals for reform of the MA Fundamental Spread would result in a material Brexit penalty - the package in the UK will leave annuity firms worse off than if the UK were a Member of the EU or even a 'rule-taker'.

- The European Parliament is proposing an ambitious reduction to the Risk Margin (4% of Cost of Capital, 0.9 value for Lambda and no floor). If adopted, these proposals would considerably dwarf the Risk Margin reform proposals in the UK for General Insurance (GI) firms while calling into question the Brexit dividend.

Release of capital

- **Under the current proposals, stated goals of a 10-15% release of current capital held by life insurers will not be achieved** and the needed boost to long term investment to support Government ambitions will not come to fruition. The ABI commissioned WTW to produce an independent report using previously collected member quantitative impact study (QIS) data as at year end 2020 to analyse the impact of the Prudential Regulation Authority's (PRA) discussion paper DP 2/22 and data collection exercise (DCE) proposals and calibrations. The report states that *"the PRA's 10-15% estimate of the release of current capital held does not apply in practice for many insurers (we estimate almost no change – in fact, a marginal decrease in OF".* In the case of **specialist annuity writers**, the picture is even more disappointing. Rather than facilitate a 10-15% capital release to spur growth in the sector, the WTW report estimates that the reform package offered "*would lead to specialist annuity firms requiring a capital injection*"[1].
- While the ABI welcomes the 60 - 70% Risk Margin reduction and recognises its positive impact, this reduction will largely be offset by a corresponding reduction in Transitional Measure on Technical Provisions (TMTP) and given insurers' reinsurance strategies. The remaining would be outweighed by the substantially more negative changes to the MA.

Fundamental Spread

- The WTW report concludes that *"There is no compelling evidence to suggest that the protection being afforded to existing policyholders via the solvency regime is inappropriate".*
- The ABI believes that the proposed changes to the Fundamental Spread (FS) will disincentivise investment into those assets that HMT is prioritising (further developed in point 4 below).
- There are four specific areas connected with the FS that need to be considered if we are to achieve HMT's objectives:
    1. **Unlock restrictions on long-term investors.** Investments in productive finance will come from life insurers writing annuity business. This is the main source of new asset inflows into the sector and investment in long term illiquid asset investments such as in infrastructure. Non-life insurers, with shorter duration liabilities, require shorter term investments and, hence, are not natural investors in long term illiquid assets.
    2. **We consider the current FS to be fit for purpose**, and calibrated well above the level of Expected Defaults, which implicitly provides an allowance for uncertainty.
        a. ABI Members have shown that the current FS is sufficient to cover at least **2.5 times the expected loss from defaults (vs. at least 3.5 under PRA's proposals)**. The WTW report states that its historical analysis[2] "*shows significant margin (allowance for uncertainty) between the current FS allowance within the existing regime and the actual default loss experienced.*

[1] WTW's analysis is set out in its final report, which should be considered in its entirety as individual sections are not intended to be considered in isolation.
[2] See Section 3 in the WTW report.

*The existing **FS already allows for considerable uncertainty and is set at a multiple of around three times historic default losses. The calibration in the PRA's ongoing DCE would increase this multiple to approximately five times based upon our sample portfolio**.[3]"*

b. The ABI believes that, in addition to best-estimate liabilities, insurers hold a substantial Risk Margin (even taking into account the proposed reduction), the Solvency Capital Requirements (SCR), which is capital held against a 1-in-200 year stress (where the PRA uses a reference point of the 1930s Great Depression) and capital buffers beyond the SCR itself for risk appetite purposes. Even if all 3 layers of protection (Risk Margin, SCR and buffer) were entirely burned through, insurers would still hold sufficient funds to pay expected claims as they fell due.

c. **The fact that the FS floor bites frequently is an indication of the high prudence in the current FS**, rather than a weakness in the core methodology (which is itself demonstrably very prudent).

d. **The current FS removes volatility and ensures long-term investing and improved outcomes for annuitants.** Some of the volatility arising from the Risk Margin will still be retained. However, the proposed changes to the FS will introduce material volatility and procyclicality into an MA framework that was designed as a counter cyclical measure, as long-term investors are not exposed to short term market risk, since their cash flows are closely matched. It was this counter-cyclicality element that allowed the MA to perform as intended during the market dislocations that occurred during the peak of the Covid-19 crisis.

3. **The proposed alternative method for the FS calculation fails to take a holistic view of policyholder protection. The penal impact of the proposed changes are clear:**

   a. A significant hit to annuity firms' aggregate Own Funds (OF) or capital resources.

   b. Material and unwarranted procyclicality and balance sheet volatility, neither of which are conducive to policyholder protection.

   c. As the WTW report points out *"reducing the availability and accessibility of the pension buyout market to pension schemes and scaling down an important source of long-term investment could potentially significantly hinder the growth prospects for the UK economy and perversely reduce pensioner protection if the insurance sector is used less".*

   d. The ABI believes that the proposed FS changes will mean:

      i. An increase in annuity pricing and reduced guaranteed income for annuitants – limiting the availability and affordability of products to policyholders at the same time as their cost of living is increasing.

      ii. Insurers will have less capital to invest (because of higher capital strain), and UK productive investments will be more costly to invest in than (for example) US corporate bonds. This will reduce industry's capacity to deliver the transition to Net Zero – which according to the Bank of England is "*integral to the Bank's ability to meet its remits*"[1], increasing the threat to the stability of the financial system, and the safety and soundness of regulated firms.

[3] See further details in Section 3, Figure 3.4, in the WTW report.

   iii. The competitiveness of the regime is jeopardised.

4. In addition, **the proposed changes to the FS would disincentivise investments in illiquids.** The WTW report talks about a *'significant change in the relative attractiveness of different asset classes or sub-classes will have material consequences on firms' investment approaches and allocations'*. In the ABI's view, the proposed 'Credit Risk Premium' (CRP) element is based on the premise that the risk of uncertainty in the level of Expected Defaults is not properly accounted for in the FS – a line of argument we do not accept.
   a. These reforms introduce a direct link to spreads, introducing material pro-cyclicality and balance sheet volatility. This will **penalise (not incentivise) investments in long term productive finance counter to Government goals**, especially when spreads increase from their current historically low levels.
   b. The **Z-component** of the CRP is particularly problematic as it penalises any investment (for example, infrastructure) that is not close to the reference index. Determining an appropriate reference index is likely to be challenging for many assets. Using an arbitrary bond index as a fall-back would not appropriately reflect the risk profile of assets such as infrastructure and would penalise them by resulting in misleadingly high spreads compared to the index, which would be hit by the Z factor and lead to an unduly high FS and low MA.
   c. The proposals will add considerable **extra complexity**. This is an area that would require further consideration as the proposals would introduce additional basis risk, for all assets, but especially for illiquid assets, through the increased reliance on indices to set the FS. Firms will also have to assume additional cost to secure, assure, and integrate into their business processes indices that they would not necessarily have chosen if they were not required for regulatory purposes.
   d. Firms that have spent significant sums of money on Internal Models based on credit ratings will now have to reflect this change in their Internal Models. This will also take supervisory time to approve and work through.
   e. **Ratings should remain the basis of the framework:**
      i. Given the rich and relevant information used in their determination and focus on the risk that cashflows are not received at the scheduled time (default risk), which is most relevant when asset and liability cashflows are closely matched.
      ii. Given their long-term nature, independence and comparability across markets. Whilst spreads can offer some insights to credit quality, they are driven by short term market technical responses, not actual risk of credit losses. There is good evidence that credit ratings indicate a difference in probability of default or expected losses over the holding term of assets, whilst short-term market prices reflect short-term risks, which are primarily around price volatility rather than defaults, and therefore are less appropriate for a long-term investor. The strong controls that exist over internal ratings (codified in regulation by PRA Supervisory Statement SS3/17) ensure that internal ratings are as valid for measuring risk as ratings assigned by external credit assessment institutions (ECAIs). The consultation implies that there is additional risk that needs to be captured in the FS for internally rated

assets which we rebut. Irrelevant information only impacting on short-term market prices should be absent from the calculation.

f. There should be **consistency of treatment** between corporate bonds and non-traded and illiquid assets, with differences only incorporated to reflect genuinely evidenced differences in retained risk. Higher spreads should not automatically be interpreted as proof of higher credit risk without evidence to support this. We would also note that the PRA has prescribed (in Supervisory Statement SS3/17) strong controls over how illiquid assets should be rated and treated in stress – these go beyond the requirements of the Solvency II Directive itself.

In addition to the above:

- Reforms based on anything other than well-grounded evidence will damage the willingness of capital providers to supply capital to UK life insurers – a predictable regime is far more investible than a regime where the regulator takes a different view every few years on matters that impact materially on very long-term investments.
- Any changes to the MA rate would lead to an impact on SCR. Specifically, a reduction in the MA rate would increase the SCR. This was not seen directly in the QIS results as the PRA did not request SCR figures under each QIS scenario.

Policyholder protection

- **Our industry's purpose is to protect people. Appropriate policyholder protection standards is a goal we share with our Regulators and the Government.** Far from arguing for a '*straightforward weakening*' (Sam Woods' '*Prudentist*' speech, 2021), we have argued since Brexit for the retention of the full Solvency II framework including:
    - The very low regulatory risk appetite for firm failure leading to a 1 in 200-year calibration.
    - The Risk Margin while other jurisdictions have pursued other avenues – Australia, where there is no equivalent to the Risk Margin for life insurance business; or, Singapore, where the Risk Margin is offset against capital requirements.
- As this independent KPMG report highlighted, if ABI targeted reforms are implemented, **insurers would continue to hold more than £138bn of solvency risk capital in excess of technical provisions plus capital management buffers -** firms calibrate a risk sensitive buffer to ensure that the regulatory ladder of intervention is not enacted legally (i.e. SCR <100%). Therefore, in some cases, policyholder protection is provided in instances way in excess of a 1 in 200-year event.
- **We are concerned that the PRA is ignoring the many policyholder safeguards within Solvency II** narrowly focusing on incorporating its unsubstantiated views that market credit spreads can be a reliable long-term predictor of unexpected defaults into the calculation of technical provisions and, hence, fixating on quantification of capital (Pillar 1) - and even within this has disregarded the presence of the SCR in the debate on the Risk Margin. Solvency II has encouraged (among others) better governance, better risk management, better Board understanding of risk, and better understanding of investment risk (Pillar 2). For example:
    - Under Solvency II, the Prudent Person Principle (PPP) requires insurers to only invest in assets and instruments whose risks they can properly identify, measure, monitor, manage, control and report and to appropriately consider this in their assessments of overall solvency needs.

  - The PRA also appears reluctant to rely on its own Senior Managers and Certification Regime (SMCR), which could allow firms to assess MA eligibility and consistency with rules and be accountable for their decisions.

Further discussions

As highlighted earlier, we consider the current FS to be fit for purpose, and calibrated well above the level of expected defaults, which implicitly provides an allowance for uncertainty. However, with the aim to secure meaningful reform that meets HMT's objectives and addresses the regulator's concerns, **the ABI is open to discussing certain credible alternative FS reform options.** We communicated some of these to HMT and the PRA in the past **(e.g., notching)** and we are currently actively formulating an option to include in the FS an **explicit recognition of the current implicit allowance for unexpected defaults.**

Matching Adjustment eligibility criteria

- **Current MA approval and portfolio maintenance processes restrict the Life Insurance industry's capacity to invest in appropriately structured investment opportunities.** For example, under the PRA's chosen approach to implement the current rules, it is easier to invest in a 30-year bond issued by a mining company, than it is to make a 30-year direct investment in a wind farm.
- **For this reason, we welcome HMT's consultation proposals around widening the MA eligibility criteria for assets and liabilities**. In particular, proposals for assets with prepayment risk and construction phases and the removal of the BBB cap – will allow insurers to invest in assets and on new **start-ups and some net-zero technologies**. In particular, the removal of the BBB cap will allow insurers to invest in assets with **nascent technology** or less certain underlying cash flows not considered 'investment grade' by agencies today but with a high likelihood once established. Investments impacted will be areas such as **retrofit in housing**, **energy efficiency**, **renewables** and **nuclear** that are vital to hitting **net zero targets**.
- **With estimated asset inflows of c£600bn[4] to 2035, there is considerable scope for the insurance industry to support HMT's preferred investments.** However, this is predicated on addressing **key constraints**, making the right MA eligibility reforms, **and not penalising illiquid investment through adverse quantitative FS changes**.
- Proposals are positive however **significant gaps remain**. HMT proposals do not, for example, include pragmatic proposals on a key constraint: **the fixity of cash flow requirement**:
  - A more pragmatic requirement for expected or predictable cash flows, rather than cash flows absolutely fixed in time and amount would open investment opportunities in, for example, **renewable assets such as wave, wind and solar panel farms**. Instead of involving a bank in structuring the asset into debt and equity, the insurer could take on the entire asset, considering appropriate safeguards to ensure that the resulting MA was not overstated.
  - Another example of the impact of this constraint and a potential solution can be seen in a portfolio of **equity release mortgage** loans, which we expect to become increasingly important as a means by which consumers can access retirement income in the future and to raise capital to improve the energy efficiency of their homes. The introduction of a quantitative tolerance for any uncertainty in the asset cash flow, assessed at a portfolio level, would avoid the need for complex restructuring simply to comply with MA rules on the fixity of cash flows. This adds

[4] ABI/BCG (2021) data indicates additional asset flow into the sector of 600bn between 2021-2035, predominantly driven by Annuities.

nothing in terms of risk mitigation as the underlying risks and cashflows are unaltered but adds considerable cost to products such as equity release mortgage loans.

  - Predictable cash flows would also allow insurers to provide long-term finance for **infrastructure, for instance, to NHS Trusts** that cannot afford to guarantee the timing of income irrespective of their receipts.

- On the **liabilities** side, we welcome the proposed extension of eligibility to morbidity liabilities. The ABI also believes that there are some examples, such as **Periodic Payment Orders (PPOs)** in a general insurance context, that are also long-term and predictable liabilities, and therefore appropriate for inclusion in MA portfolios.
- **We welcome HMT proposals to reduce the "approvals burden" but they should go further**. Additional actions are required to streamline MA approval processes and enhance proportionality towards MA compliance breaches.

International competitiveness

How do HM Treasury's proposals compare to those in other jurisdictions?

- **The EU's Solvency II review process is mainly focused on releasing capital.** For instance, the European Commission overrode EIOPA's proposal with a more ambitious reduction to the Risk Margin, aimed at securing a higher capital release. The European Parliament is proposing a further reduction to the Risk Margin, which would considerably increase the release of capital while, at the same time, calling into question the Brexit dividend for UK GI firms.
- **In Australia** there is no equivalent to the Risk Margin for life insurance business. Although we support an appropriately calibrated Risk Margin (possible through a more ambitious reduction), from a competitiveness perspective it is relevant to be aware of other implemented approaches in other relevant jurisdictions.
- **Bermuda**, a Solvency II equivalent jurisdiction that has a more favourable Matching Adjustment – for instance, unlike in the UK, the rules allow assets without complex restructuring up to a limit of 10%, and cash flow mismatches of up to 10%. By allowing a quantitative tolerance for any uncertainty in the asset cash flow (predictability instead of absolute fixity), they are allowing MA insurers to invest in a wider spectrum of productive assets. The right reforms to the Solvency II regime in the UK could create incentives for EU firms to reinsure certain risks into the UK, increasing the capacity of UK firms to invest. UK insurers have invested more heavily than their European counterparts in Internal Models and this may create opportunities from the greater understanding of risk this brings.
- **Singapore**, which adopted a Matching Adjustment as part of its risk-based capital regime in 2014 - therefore similar to the Solvency II MA in many ways - has also introduced greater flexibility, including a simplified 15% permissible mismatch. In terms of the Risk Margin, in Singapore we see a significant difference with the UK, the Risk Margin is offset against capital requirements.
- In Canada, it is recognised that liabilities beyond a certain number of years can be backed by less predictable cashflows. Canadian pension schemes and life insurers often compete with UK insurers for productive investments and can offer better prices because of a more favourable regime.

Reducing reporting and administrative burdens

We welcome HMT's proposals on this important area and recognise that these will no doubt be helpful in reducing regulatory costs. However, some complementary reforms are required in addition:

- The ABI recommends significant streamlining of Solvency II Internal Model processes. This is particularly important as the UK has more firms using approved Internal Models than any other country in Europe.
- The Transitional Measure on Technical Provisions (TMTP) as it is currently applied has very high operational costs for both firms and regulators, particularly associated with the maintenance of legacy systems, which we do not believe are justified and could be significantly reduced, resulting in savings being passed onto customers.
- The ABI estimates that current reporting requirements are between 4 and 8 times greater than prior to Solvency II. The scope for improvement now that the UK has left the EU is therefore considerable and should be taken during Phase 2 of the PRA's regulatory reporting reform exercise later this year.

Future Regulatory Framework

The Solvency II review should not be decoupled from the Financial Services Future Regulatory Framework (FRF) review. This is in the sense that, without advocating for any delays, the FRF could eventually define how proposals from the former are implemented and supervised therefore, fully achieving the objectives of the Solvency II review will also depend on the design and implementation of the FRF.

We support HMT's proposal for a future regulatory framework, provided it has enhanced accountability, improved scrutiny and additional transparency, and a new statutory objective for the regulator focusing on economic growth and competitiveness. These are all essential elements of the prudential regime in ensuring fairness and a level playing field, and ultimately securing the international competitiveness of the UK's insurance sector. For example, there is a need to ensure the right balance between elements that should be in legislation and in regulation to ensure that HMT's Solvency II review is implemented in its fullness and in a way that guarantees the regulatory certainty that industry needs to operate.

2. Risk Margin

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.**

We welcome HMT's intention to reduce the Risk Margin. It is widely recognised by all stakeholders that the Risk Margin is currently too large and too volatile. In last year's ABI responses to HMT's Call for Evidence and the PRA's QIS and Qualitative Questionnaire data collection exercise the ABI set out justifications for an ambitious reduction in the current level of the Risk Margin. We also highlighted that reducing the Risk Margin would contribute to improving the affordability and availability of insurance, enhancing policyholder protection levels.

It is crucial that HMT is aware that, as demonstrated by the QIS scenarios, the combination of changes to the Risk Margin and MA would mean that the benefit offered by a reduction in size and volatility of the Risk Margin will be offset by the MA re-design – giving with one hand and taking with the other.

The Risk Margin and MA are conceptually distinct - they exist for different reasons in the regime and so should be considered separately to each other. By significantly reducing the size of the MA's benefit, as proposed by the PRA, the interest rate sensitivity of the liabilities will go up in absolute terms, which could entirely offset any benefit in reduced interest rate sensitivity from the Risk Margin changes.

In contrast, the ABI's preferred reduction would significantly contribute to:

- **Fixing the design of the Risk Margin**. In his 'Brave new world' speech (March 2021), Sam Woods specifically highlighted that *"the risk margin is not correctly calibrated"*. An appropriate calibration of the cost of capital (CoC) rate and lambda (λ) will deliver this reduction, as demonstrated by the calculations in Question 2.3.
- **Creating a better environment for pricing and annuity new business.** Although we recognise that each firm is free to make its own decisions on how this reduction impacts investments and product pricing, the ABI overall agrees with the KPMG report when it says that *"The impact on annuity new business is the focus of our analysis, as firms will likely reflect the lower cost of capital in their pricing and longevity risk appetite."*
- **Consolidating a Global Britain that is well placed to compete with other key jurisdictions** including:
    - The European Union which seems to be considering more ambitious reductions to the Risk Margin with the aim to release more capital. For instance, the European Commission overrode EIOPA's proposal with a more ambitious reduction to the Risk Margin – reducing the CoC rate from 6% to 5%. The European Parliament is proposing a further reduction to the CoC, from 5% to 4%, with a lambda value of 0.9 (rather than 0.975) and no floor, which would considerably increase the release of capital from the reduction of Risk Margin. Achieving at least the same level of reduction in the Risk Margin (with no floor) and avoiding penalising the MA are necessary to avoid a Brexit penalty on UK firms
    - **Australia**, where there is no equivalent to the Risk Margin for life insurance business;
    - **Singapore**, where the Risk Margin is offset against capital requirements.

The ABI also reiterates that longevity risk should be treated as hedgeable and therefore excluded from the Risk Margin calculation. Given recent longevity risk transfer activity and longevity reinsurance deals since the implementation of Solvency II, our view is that it is now unreasonable to assume no longevity risk can be transferred throughout the period of run-off.

The ABI believes that it is **important that HMT does not ignore the conclusions of the independent Taskforce on Innovation, Growth and Regulatory Reform (TIGRR)**, led by Sir Iain Duncan Smith MP, which strongly aligned with the ABI's three key priorities for Solvency II reform, including an ambitious reduction of the Risk Margin.

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.**

We welcome elements of HMT's Solvency II reform proposals. As we also mentioned in the previous question, it is widely recognised by all stakeholders that the Risk Margin is currently too large and too volatile. In last year's ABI responses to HMT's Call for Evidence we highlighted that reducing the Risk Margin would contribute to improving the affordability and availability of insurance, enhancing policyholder protection levels.

Having said that, it is relevant to highlight that the European Parliament is currently proposing a more ambitious reduction to the Risk Margin (4% of Cost of Capital, 0.9 value for Lambda and no floor), which would affect both life and non-life sectors in the EU. If adopted, these proposals would considerably dwarf the Risk Margin proposals in the UK for GI firms and call into question the Brexit dividend for these firms. This would also jeopardise the competitiveness of the UK regime, HMT's first objective for the review.

We note that in DP2/22 the PRA considers the arguments for introducing a tapering parameter (lambda) with a value less than 1 into the Risk Margin formula. However, it concludes that lambda should not be lower than 1 for non-life insurance risks. We are unclear why the PRA believes that non-life insurance risks should be treated separately in this way, or indeed, how it intends to identify precisely which risks should and should not have a lambda lower than 1 applied. We consider that there are strong arguments for the introduction of a lambda parameter, and for it to apply to all insurance business. For instance, some risks in GI business are longer tailed, and having a lambda would mean it automatically reflected for those GI liabilities that are longer tailed, rather than create an arbitrage between life and non-life

Question 2.3

Do you agree that a modified cost of capital methodology should be used to calculate the risk margin?

We believe that focus should be on:

- Reducing sensitivity and pro-cyclicality.
- Reducing its size.
- Making the Risk Margin appropriate for long-term business.

If the current cost of capital approach to the calculation of the Risk Margin is to be retained, we consider there should be a focus on changes to three key components:

CoC rate: There is strong evidence (as set out in the Annex to the ABI's response to HMT's first Solvency II Call for Evidence in February 2021) that the CoC rate used in the Risk Margin calculation should be in the range 2-3%, rather than the 6% currently set by EU regulations. Since the onshoring of the Solvency II regulations, the EU no longer determines this rate and the UK has the ability to change this. This has the benefit of being a simple change that is easy to understand, communicate and implement.

Introduction and calibration of the tapering parameter: We welcome the fact that HMT's consultation recognises that the punitive effects of the Risk Margin are more pronounced for insurers with long duration liabilities. Risk dependence over time can occur because some risks are non-repeatable, or due to reductions in exposure in stress. For example, a cure for cancer can increase life expectancy of annuity policyholders, but this is a non-repeatable event. Conversely, a policyholder terminating a contract cannot terminate the same contract again, hence lapses reduce exposure. This disproportionately affects long-term products, particularly annuities, and should be addressed.

- The ABI and other stakeholders have proposed amending the Risk Margin formula to account for such risk dependence over time through the introduction of a scaling factor. From this perspective, we welcome the PRA's proposal in the DP2/22 to introduce a new tapering parameter, lambda, *"to allow progressively lower weight to be given to each year of projected future capital requirements.".* Therefore, we encourage HMT to introduce this scaling factor.
- However, it is crucial that this tapering parameter is appropriately calibrated. Brexit offers the opportunity to consider a calibration that is sufficient to fully address the problem. It is relevant to note that the EU Parliament report outlines more ambitious reform by proposing a lambda of 0.9 with no floor and a CoC rate reduced to 4%.
- A plausible range for the tapering parameter should be between 0.8 and 0.9. In last year's ABI responses to HMT's Call for Evidence the ABI set out data backed justifications for the suggested value range for the tapering parameter.
- In DP2/22, the PRA's view is that a tapering parameter should only be applied to life insurance business. There are some examples of non-life firms' long-term liabilities, such as Periodic Payment Orders (PPOs), and a tapering parameter would help to mitigate the adverse effects of the Risk Margin on these types of liabilities.

Other reforms that HMT should consider are:

- As we outlined in our response to Question 2.1, treating longevity risk as hedgeable, and therefore excluding it from the Risk Margin calculation should be considered. Given the recent longevity risk transfer activity and longevity reinsurance deals since the implementation of Solvency II, our view is that it is now unreasonable to assume no longevity risk can be transferred throughout the period of run-off.
- An allowance in the Risk Margin calculation for diversification between life and non-life business, and between different legal entities – this would be consistent with the assumptions adopted by the international association of insurance supervisors (IAIS) in its global Insurance Capital Standard (ICS).

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?

As we again mention in Question 3.4, in Paragraph 3.15 of its consultation, HMT refers to the 'liability transfer value'. The PRA considers that achievement of an adequate 'transfer value' (the cost of transferring the business to a third party) is one of the roles of the base Solvency II balance sheet. It considers that the current risk of the transfer value being inadequate is mitigated to some extent by the strength of the Risk Margin, which can compensate for an excessive MA. Thus, the PRA's line of reasoning appears to suggest that if the Risk Margin is reduced as a result of the current Solvency II review, the MA should be reduced correspondingly.

We do not accept this argument. The Risk Margin and the MA need to be separated. There is overall consensus that the Risk Margin is too large and too volatile. The Regulator and policymakers in both the UK and the EU agree with this. There is a separate question of whether the MA is functioning as proposed, we firmly believe that it is and the PRA has not demonstrated or provided evidence to prove otherwise.

The PRA's reasoning also appears to confuse the roles of the different elements that make up Technical Provisions on the balance sheet, namely the best-estimate of liabilities (discounted at an appropriate rate) and the Risk Margin, specifically intended to cover the transfer costs of those liabilities to a third party.

Finally, it also appears to be a point-in-time assessment. The PRA has not provided projections to demonstrate what happens to its CRP calibration under different scenarios and using different assumptions. It is possible to generate values for n, X and Z that will maintain a set transfer value for any given Risk Margin value, but it is unclear whether these values will still hold over time, under different economic conditions, and with changes to the business mix.

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?

Considered against the 10–15 % target for a release of capital currently held by life insurers, PRA FS **proposals** are unlikely to see this target met or would only see them achieved in a fictional world where transitional measure on technical provisions (TMTP) and reinsurance are not used. We acknowledge that a Risk Margin reduction for non-annuity writers could result in a capital release. However, as we have stated, the long-term investments in infrastructure and green assets the Government seeks will mainly come from annuity writers.

Fundamentally, suggestions that capital released would be transferred to shareholders by way of dividends suggest incorrect underlying assumptions:

- The benefit of any capital release will naturally be largely passed on to consumers in a competitive market – as will the impact of any capital increase. Insurers will also invest any capital in growing their businesses that is, expanding investments and increasing their ability to write new business. Dividends are only a small part of this.
- Insurers and their investors dislike balance sheet volatility. Volatile balance sheets increase the likelihood of an insurer having to behave pro-cyclically, changing its investment strategy and or restricting its ability to write new business. It is worth noting that the Risk Margin is typically significantly more volatile than the best estimate liability (BEL[5]) - the present value of expected future cashflows, discounted using a "risk-free" yield curve - for the same business. From this perspective:
    - A significant reduction of the Risk Margin would contribute to reduce the volatility in the insurers balance sheet. This helps with longer term planning and also increases the scope to allocate these resources to expand investments and increasing their ability to write new business.
    - Equally, additional volatility in other parts of the balance sheet and or reducing OF (i.e., through changes to the FS) could increase the attractiveness of using dividends as a way to compensate investors.

[5] *'A review of the Risk Margin – Solvency II and beyond'*. IFoA (2019).

- Many shareholders prefer capital gains on the value of their shares over a dividend payment now and insurers as part of their overall financial management set policies to cater to the risk profiles and return preferences of their shareholders. In other words, insurers and their shareholders consider value from the perspective of total shareholder return and capital gains not just in terms of dividends. It is therefore incorrect to suggest that an insurer would automatically pay out dividends from any capital released because this might not be the preference of their shareholders as for some investors growth in the insurer's share price is all the value they require.
- If, as intended, the review leads to an increase in the size of the annuity market then this would provide a productive opportunity for redeployment of this capital to support the new business strain on an increase in the volume of annuity business written. If the review fails to achieve this, then opportunities to redeploy this capital may be limited and hence could result in a special dividend to return this to shareholders.
- It also cannot automatically be assumed that any capital release would be used to increase the remuneration of parties within the firm. The PRA, Solvency II systems of governance and the Senior Managers Regime all ensure that firm's remuneration practices are tightly controlled, linked to the performance, promote sound and effective risk management, and strike the right balance between fixed and variable components.

3. Matching Adjustment

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

The ABI does not agree with the above assessment. Our position is that the current FS is fit for purpose, and more than prudent enough to account for risks associated with increased investments in illiquid assets that firms currently hold. We do not consider that the PRA has provided credible justification for its concerns about the existing methodology, or for its proposals to introduce a CRP into the calculation.

Current methodology

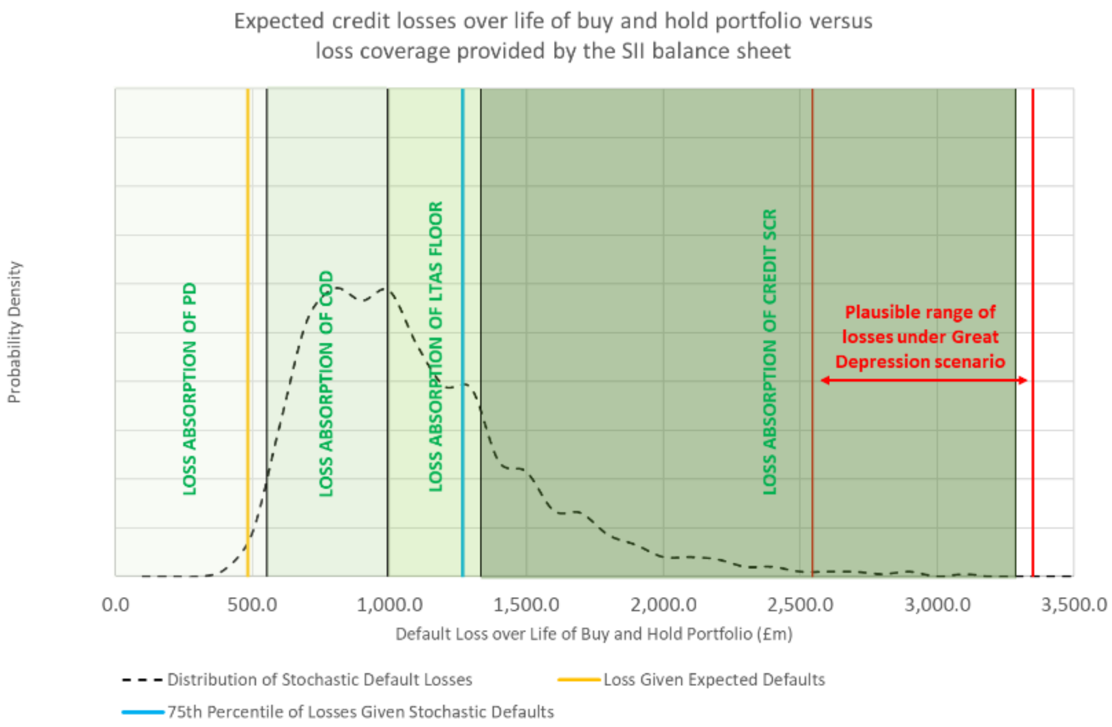
We remain of the view that the current FS is fit for purpose and is calibrated well above the level of Expected Defaults, which implicitly provides an allowance for uncertainty, largely through the Long-Term Average Spread (LTAS) underpin.

We can demonstrate using a multi-year stochastic transition projection that the current FS contains enough allowance to cover a substantial portion of the distribution of cumulative default losses over a range of time horizons from 1 to 20 years. The principal risk to which long-term insurers (operating a buy to hold strategy with close cash flow matching) are exposed is default risk, and credit ratings are the most sensitive indicator of this. We are comfortable that we can appropriately consider expected defaults and the LTAS underpin means we are already holding at least 2.5 time more than expected defaults. WTW's historical analysis[6] shows *"significant margin (allowance for uncertainty) between the current FS allowance within the existing regime and the actual default loss experienced. The existing FS already allows for considerable uncertainty and is set at a multiple of around three times historic default losses. The calibration in the PRA's ongoing DCE would increase this multiple to approximately five times based upon our sample portfolio.*[7]".

When combined with the loss absorption of the credit SCR, the current framework provides loss absorption for all plausible ranges of loss, including those incurred during the Great Depression of the 1930s. This is shown in the chart below, which shows a probability distribution for credit losses (£m) over the life of the MA portfolio for one UK insurer. This is expected to be relatively representative of the UK life insurance industry as a whole, although further analysis would be needed to confirm this:

[6] See Section 3 in WTW report.

[7] See further details in Section 3, Figure 3.4 of the WTW report.



We consider that this graph demonstrates in a compelling way the absence of any 'gaps' in coverage of both expected and unexpected credit losses in the current framework, and the strong underpin provided by the LTAS floor in addressing unexpected loss. PRA proposals for a more punitive FS would not provide additional protection for existing policyholders - risk a firm is put into run-off or administration when it was actually financially strong - and would harm the interests of future policyholders through reducing availability of products and or increasing prices of such products e.g., bulk transfer annuities from pension schemes to insurers.

Furthermore, any such punitive change to the FS would have significant downsides – a negative impact on OF, restricting insurers' ability to invest in illiquid assets in line with Government objectives, and the introduction of material volatility and procyclicality into an element of Solvency II intended precisely to mitigate against that.

Therefore, there is compelling evidence that the existing FS is sufficient in a wide range of market conditions and is consistent with a 'through the credit cycle' calibration. We would also note that the FS is not and should not be "impregnable", as the 1 in 200-year SCR is also available to absorb unexpected loss (the entire area shaded in green above). In addition, the PRA's FS reform proposals would make the FS significantly more prudent than other elements of the Solvency II balance sheet by designing it to withstand a 1930's type shock.

<u>Risks associated with assets with the same credit rating but different market measures of retained risk</u>

HMT notes that the FS is the same for all assets with the same credit rating, sector and term. It considers that this low level of granularity may mask signals of credit deterioration, and that it may also give insurers an incentive to invest in assets with a credit spread at the higher end of that which is available within a given credit rating, sector and term. However, there is no evidence that firms do in practice skew their portfolios in this way. In fact, Chart 3 in this Charlotte Gerken speech (May 2022) shows the majority of assets in MA portfolios generating a smaller MA benefit (i.e. sovereigns).

In DP2/22, the PRA introduces the concept of “MA efficiency” – the level of MA generated for a given credit rating. It notes that the MA efficiency of different asset classes varies markedly, and that this raises questions as to whether these differences are in line with the risk and reward profile of such assets. We do not agree that this conclusion necessarily follows – differences in “MA efficiency” are to be expected for different assets classes contained within wide ranging Credit Quality Step (CQS) buckets. More importantly, we believe that the focus should be on the FS adequacy to cover expected and unexpected losses, which as mentioned before, we believe the current FS achieves.

If HMT considers that the dispersion is too great, the most appropriate solution would be to make the CQS framework more granular by the introduction of ‘notching’. The current FS is set by credit rating band levels, i.e., AAA, AA, A etc, whereas there is risk information in the more granular “notches” that credit ratings agencies apply in practice e.g. A+, A- versus A. This would provide the framework with greater sensitivity, promote good risk management, and more appropriately recognise the risk characteristics of individual assets. We note that it could be applied in tandem with any compatible proposal (index spread models would not be compatible) to change the methodology for the calculation of the FS.

This should be relatively straightforward to implement in comparison to the index-spread framework, although not cost-free.

<u>Risks associated with holding internally rated or illiquid assets</u>

In Paragraph 3.6 of its consultation, HMT states that the risks of an insurer not being able to meet its contractual obligations may be heightened given the steady increase in the proportion of assets in MA portfolios that are illiquid. However, it has provided no evidence for this assertion – there is **no evidence** that (for example) the FS applied to illiquid assets are less able to cover expected and unexpected losses than those applied to more traditional asset classes. It is our view that the current FS already provides an excess of prudence, and further adjustments should not be required.

We consider that the PRA’s proposed ‘index spread’ approach would limit the industry’s capacity to reallocate long-term capital to illiquids to underpin growth, in line with Government objectives. If the MA is reduced such that it is lower than the cost of capital required to hold that asset, insurers will have no incentive to absorb the opportunity costs of giving up liquidity, and their appetite for illiquid assets will substantially reduce.

Furthermore, the proposals will add considerable extra complexity and costs. No consideration has been given to the type of reference indices (potentially based on corporate bonds) that will be suitable for unrated illiquid assets of the type in which HMT wants to boost investment.

There should be consistency of treatment between corporate bonds and non-traded and illiquid assets, with differences only incorporated to reflect genuinely evidenced differences in retained risk. Higher spreads should not automatically be interpreted as proof of higher credit risk without evidence to support this. We would also note that the PRA has prescribed (in Supervisory Statement SS3/17) the very low regulatory risk appetite for how illiquid assets should be rated and treated in stress – these go beyond the requirements of the Solvency II Directive itself.

We consider that ratings (whether internally or externally generated) should remain the basis of the framework, given the rich and relevant information used in their determination. Irrelevant information only impacting on short-term market prices should be absent from the calculation.

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’:

- **key balance sheet metrics including best estimate liabilities, own funds and the solvency capital requirements;**
- **incentives to provide annuities;**
- **annuity prices;**
- **investment in economic infrastructure, such as clean energy, transport, digital, water and waste;**
- **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**
- **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?**

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

<u>Key balance sheet metrics</u>

When analysing the change in OF under the three calibrations of the Index-Spread Model, the WTW report observed that:

- The 10-15% target is not reached by any of the firms in their sample other than one, and this is a special circumstance due to this firm's unique status.
- After allowing for the change in TMTP, the aggregate OF increase of £6.8 billion under the Index-Spread Model scenario where CRP represents 35% of spreads reduces to an aggregate OF decrease of £0.02 billion (representing -0.02% of total OF).
- Firms with MA portfolios are estimated to see a reduction in OF of £0.6 billion (-0.9%) and annuity specialists are estimated to see a £0.9 billion reduction (-5.9%) in OF under the 35% scenario.
- For the 25% of spreads scenario the aggregate OF increase is £2.4 billion (2.9% of total OF) and for the 45% of spreads scenario the OF decreases by £2.5 billion (-3.0% of OF).

These results are based on year-end 2020 QIS data and do not reflect changes in the risk-free rates experienced since then. These changes are expected to result in significantly more negative and less positive outcomes for firms.

<u>WTW's approach</u>

WTW has used the year-end 2020 QIS data to estimate the release of capital under the calibrations of Risk Margin and MA that have been set out by HMT and the PRA. One of the aims of this is to understand whether the Index-Spread Model with CRP calibrated to represent 35% of spreads provides a release of capital in the range of 10% to 15%.

The following assumptions have been made to estimate the change in OF:

- WTW has estimated the net of tax[8] movement in OF before allowing for TMTP by scaling the changes in Risk Margin and MA from QIS Scenario A.
- The Risk Margin change under Scenario A is scaled up to represent a 60% reduction in Risk Margin. This is the lower end of the 60-70% reduction proposed for long-term life insurers.

[8] A small number of firms were identified as having provided gross of tax movements in MA, Risk Margin and TMTP and in these cases the amounts were converted to net of tax using a 19% rate of tax.

- For the 35% CRP calibration, the MA change under Scenario A is scaled down to represent the expected change under this scenario based on the balance sheet impact. This includes the impact of the Z component for illiquid assets based on the same assumptions as in Section 3. For the CRP representing 25% and 45% of spreads, we have performed the same calculation as for a 35% CRP with commensurate scaling of the MA change.
- The FS and Risk Margin proposals are introduced at the same time, with no phasing in.

Incentives to provide annuities and annuity prices

The MA is part of the Solvency II framework advocated for by UK institutions as the framework was developed. When part of the EU, the UK market was the primary user of the MA. It was developed with consideration for the specific nature of the UK's annuity market and was based on a similar concept that was part of the preceding UK regime. It has allowed insurance undertakings to continue offering annuities and other insurance products that include long-term guarantees.

However, we would note the adverse effects Solvency II implementation has had on the annuity and long-term guarantee-based product markets – it has made them less attractive to firms to provide, and the products less affordable for customers. Solvency II has also had a negative impact on the availability of guaranteed drawdown products (also known as variable annuities) – at least three major insurers have exited this market. This underlines the importance of getting regulation right given the very real consequences it can have to the availability of insurance products in the UK market.

While much of the decline in the annuity market may be attributed to other factors (the Risk Margin, the Government's pensions freedom legislation of 2015, interest rates, etc.), the MA is also an important factor in determining the health of this sector. A larger and more volatile FS will deter insurers from investing in a wider range of assets with attractive returns – this in turn will be detrimental to policyholders in terms of worse annuity returns, worse product availability and higher pricing. Furthermore, this would be detrimental to financial stability by increasing volatility and pro-cyclicality, and damaging UK competitiveness and specialisation.

Conversely, independent work by KPMG published in February 2021 demonstrated that under ABI proposals (a significant reduction in the Risk Margin, no change to the calculation of the MA, and expansion of MA eligibility criteria), we see a direct benefit to consumers, in terms of up to a c6% reduction in annuity premiums. However, KPMG noted that this was an aggregated industry-wide impact estimated for modelling purposes and that in practice, the actual impacts will vary significantly between insurer and new business liabilities. In addition, the benefits of the impacts could be realised as: (1) premium reductions to policyholders; (2) profitability increases to insurers; or (3) cost of capital benefits to borrowers in other sectors.

Investment in economic infrastructure and in support of the transition to Net Zero

The introduction of material uncertainty, procyclicality and volatility is likely to have the immediate impact of reducing firms' appetite to invest in the types of assets which would support the Government's infrastructure investment and climate change ambitions.

We would note that infrastructure debt, including that associated with renewable energy production, is essentially a BBB-rated long-dated illiquid market, and would be among the worst sectors hit by the PRA's proposals – contrary to the Government's objective for greater investment in green technology.

Investment in illiquid assets such as infrastructure can take months to be completed. If a more volatile FS methodology moves against firms during that period, they may end up progressing an unattractive opportunity or pulling out of an otherwise attractive transaction, with the associated reputational and costs risks.

We would also note that the Z-component of the CRP is particularly problematic, as it penalises any investment, including infrastructure, that is not close to the reference index. There is no representative index for such assets. In contrast it favours investing passively in a corporate bond index.

Finally, it is worth highlighting that the PRA has a very narrow definition of infrastructure as infrastructure often manifests as income strips (financing the building of a student accommodation) or commercial property loans (green buildings, regeneration).

Relative incentives to invest in different types of assets

The same comments as for infrastructure and 'net-zero' assets given above can be applied to the vast majority of new asset types in which long-term investors may wish to invest – the introduction of material uncertainty, procyclicality and volatility is likely to have the immediate impact of reducing firms' appetite to invest in them and instead reverting to more vanilla gilts and bonds.

It should be emphasised that plans to widen MA eligibility requirements to support Government objectives on investments will not be successful if those (welcome) changes are accompanied by penal reform of the FS calculation.

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?

It is incorrect to say that all the adverse impacts from the PRA's proposed 'index spread' approach stem directly from the increased size of the FS that would result. The increased volatility this approach would bring is inherent in its design, in that it introduces an element of market spreads into the calculation – this additional volatility is not simply a function of the increased size.

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%?

We recognise policyholder protection as a key objective for industry, and a primary statutory objective for the PRA. In our view, policyholder protection is best achieved by ensuring that the liabilities side of the Solvency II balance sheet contains the following:

- Technical provisions, consisting of best estimate liabilities discounted at an appropriate rate, and a Risk Margin, intended to cover the transfer costs of those liabilities to a third party.
- A Solvency Capital Requirement (SCR) calibrated such that an insurer is able to absorb losses as a consequence of a 1-in-200 year shock in all the risks to which it is exposed.

The PRA's insurance objective is *'contributing to the securing of an appropriate degree of protection for those who are or may become policyholders'*[9]. We agree with this PRA general objective and stress that the best policyholder protection is obtained when these elements are set at the most appropriate level. We do not accept that there is a simple linear relationship between policyholder protection and the sum of technical provisions and

[9] Financial Services Act 2012

SCR plus relevant capital buffers, which we may refer to as 'capital held'. Excessive levels of capital held, beyond the requirements of a 1-in-200 calibration, serve only to make retirement income products less readily available and more expensive – to the detriment of future policyholders. Conversely, it is not correct to say that a more fit for purpose Risk Margin automatically equates to lower policyholder protection – even if that means it is set at a lower level.

In Paragraph 3.15 of its consultation, HMT refers to the 'liability transfer value'. The PRA considers that the achievement of an adequate 'transfer value' (the cost of transferring the business to a third party) is one of the roles of the base Solvency II balance sheet. It considers that the current risk of the transfer value being inadequate is mitigated to some extent by the strength of the Risk Margin, which can compensate for an excessive MA. Thus, the PRA's line of reasoning appears to suggest that if the Risk Margin is reduced as a result of the current Solvency II review, the MA should be reduced correspondingly.

We do not accept this argument. The Risk Margin and the MA need to be separated. There is overall consensus that the Risk Margin is too large and too volatile. The Regulator and policymakers in the UK and the EU agree with this. There is a separate question of whether the MA is functioning as proposed, we firmly believe that it is and the PRA has not demonstrated or provided evidence to prove otherwise. The PRA's reasoning also appears to rely on an unjustified assumption that the current level of Technical Provisions is 'correct', and therefore at best industry should expect a 'capital neutral' outcome from this review (giving with one hand and taking away with the other). It also appears to confuse the roles of the different elements that make up Technical Provisions on the balance sheet, namely the best-estimate of liabilities (discounted at an appropriate rate) and the Risk Margin, specifically intended to cover the transfer costs of those liabilities to a third party. Finally, it also appears to be a point-in-time assessment. The PRA has not provided projections to demonstrate what happens to its CRP calibration under different scenarios and using different assumptions. It is possible to generate values for n, X and Z that will maintain a set transfer value for any given Risk Margin value, but it is unclear whether these values will still hold over time, under different economic conditions, and with changes to the business mix.

A CRP calibrated at 25-45% of current spreads, when accompanied by a reduction of 60-70% in the Risk Margin for long-term life insurers, will result in (at best) no change in aggregate capital held, i.e., a capital-neutral outcome. At worst, it will be capital negative – although for the reasons set out above, we do not expect this to result in any improvement in policyholder protection.

Furthermore, if the CRP is calculated using the 'index spread' approach and is linked to credit spreads, as proposed by the PRA, there will be significant downsides – a negative impact on OF, restricting insurers' ability to invest in illiquid assets in line with Government objectives, and the introduction of material unwarranted volatility and procyclicality into an element of Solvency II intended precisely to mitigate against that. These will all have secondary adverse impacts on policyholder protection.

Question 3.5

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

As the PRA notes in Paragraph 79 of its Annex to DP2/22, temporary spikes in credit spreads may reflect a market over-reaction, or a response to risks to which insurers are not exposed – hence any FS methodology should include a reasonable averaging period to avoid firms taking unnecessary short-term actions. We agree with this position.

As already mentioned, we fundamentally disagree with the CRP concept and we find the introduction of spread inappropriate. Therefore, we do not find it appropriate to discuss potential calibrations. However, it is still relevant to mention that there is no definitive definition for the length of a 'credit cycle'. We consider that any averaging period should last for at least two credit cycles. For this reason, we do not consider the PRA's proposed value to be useful or relevant.

If it is the PRA's intention for the X term to be responsive to changes in spreads, then it is relevant to note that its own data (Chart 7 in the Annex to DP2/22) demonstrates that a 5-year average would not have met this standard during the 2007-2008 financial crisis. The X term would have been low going into the crisis and would not have peaked until 2012-2013 – long after spreads had returned to the more stable levels seen before the crisis – impacting insurers balance sheets at this point and potentially harming the economy during what should be the recovery period. This is likely to have driven pro-cyclical and crisis-extending behaviour by insurers, de-risking portfolios to avoid an increase in FS that they could see coming despite the market fundamentals having recovered.

We consider that for long-term insurers with liability durations typically in decades, long-term averaging periods (such as the current 30 years for the LTAS floor) are most appropriate.

Question 3.6

Are there other ways to achieve the same impact that changes to the fundamental spread would have?

We note the continued concerns about the sensitivity of the current FS element of the Solvency II MA framework to credit risk, and its ability to reflect uncertainty around defaults and downgrades. However, we maintain that these concerns are unfounded – the FS as currently formulated is fit for purpose and will remain so as insurers continue to expand the universe of assets in which they invest (in line with Government objectives). Furthermore, we are concerned that the 'index spread' proposal for FS reform, as set out in Paragraph 3.9 of HMT's consultation paper and set out in greater detail in the PRA's DP2/22, would create significant levels of artificial balance sheet volatility and procyclicality, without properly addressing these concerns.

We note HMT's concern in Paragraph 3.6 of its consultation paper that the FS is heavily driven by its floor, and this may indicate that the 'core methodology' may underestimate the risks retained by insurers. We do not accept this argument – we consider the fact that the floor is biting in most cases is an indication of the high level of prudence in the floor itself. In our answer to Question 3.1 above we set out what we believe to be a compelling case that no change to the current FS framework is needed.

However, with the aim to secure meaningful reform that meets HMT's objectives and addresses the regulator's concerns, **the ABI is open to discussing certain credible alternative FS reform options.** We communicated some of these to HMT and the PRA in the past **(e.g., notching)** and we are currently actively formulating an option to include in the FS an **explicit recognition of the current implicit allowance for unexpected defaults.**

4. Increasing investment flexibility

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.**

HMT's Solvency II objectives are aligned with industry's objective for this review. We also acknowledge the size of the opportunity ahead of us. With estimated asset inflows of c£600bn to 2035, there is considerable scope for the insurance industry to support HMT's preferred investments. However, this is predicated on addressing key constraints and making the right reforms to MA eligibility. For long-term insurers, responsible for most long-term investment activity, **the MA is the key element** of the regulatory framework and focussed, pragmatic changes to eligibility related aspects of the MA framework are required for HMT objectives to be achieved.

The ABI also welcomes HMT's proposals to increase investment flexibility, which address some key constraints referenced by industry in our response to the Call for Evidence. In particular, proposals for assets with prepayment risk and construction phases or the removal of the BBB cap – will allow insurers to invest in new **start-ups and net-zero technologies**.

However, significant gaps remain. Current MA approval and portfolio maintenance processes restrict industry's capacity to invest in appropriately structed investment opportunities, reiterating the need to rethink the way investments are structured to reverse the current lack of opportunities. For example, under the current rules it is easier to invest in a 30-year bond issued by a mining company, than it is to make a 30-year direct investment in a wind farm. This constraint is the most significant barrier to meaningful reform in this area.

A more pragmatic requirement for "predictable" rather than fixed in time and amount cash flows would open new investment opportunities in, for example, **renewable assets such as waste-to-energy, wave, wind and solar panel farms**. For example:

- A portfolio where the borrower wants floating rate loans with the ability to repay early, which while the risk was economically acceptable to firms from a prudent-person perspective, do not meet the strict MA rules for make-whole penalties and the floating rate did not provide absolutely fixed cash flows.
- Instead of involving a bank in structuring the asset into debt and equity, the insurer could take on the entire asset.
- By introducing a tolerance for uncertainty (i.e., to reflect "predictable" or "expected" rather than "fixed"), would then save the industry a significant amount of time and resource while not taking any short cuts on the risk management aspects. Portfolios of **equity release mortgage** loans, through which pensioners can make their homes more energy efficient, are a good example where current complex restructuring adds nothing in terms of risk mitigation as the underlying risks are unaltered, but adds considerable cost, introducing inefficiencies and operational complexity.
- Providing long-term finance for **infrastructure, for instance, to NHS Trusts** that cannot afford to guarantee the timing of income irrespective of their receipts.

We also welcome HMT proposals to reduce the "approvals burden" but they could go further. There is a need to remove certain elements currently included in the MA application process that could be covered by other oversight routes (e.g., valuation, rating, capital approach). Additional actions are also required to streamline MA approval processes and enhance proportionality towards MA compliance breaches.

On the **liabilities** side, we welcome the proposed extension of eligibility to morbidity liabilities. The ABI also believes that there are some examples of liabilities, such as **Periodic Payment Orders** (PPOs), that are also long-term and predictable, and therefore appropriate for inclusion in MA portfolios.

This review should embrace the opportunity to allow long-term insurers to increase their investment activity in large-scale infrastructure assets, windfarms, social housing, transport and zero-carbon electricity generation, all of which are a good fit for MA portfolios.

The ABI emphasises that any reform to MA eligibility requirements and processes must be considered holistically and in tandem with the quantitative elements of FS reform as both are intrinsically linked. **To be clear, we are not suggesting that wider MA asset eligibility criteria needs to be coupled with a stronger FS**. For instance, directly linking FS to spreads will add volatility and procyclicality into the system and the existence of the Z component will make investment into illiquids less attractive. Also, reducing the size of the MA benefit on illiquid assets, which are more costly to originate, will reduce the margins and, hence, will disincentivise investment into those same assets that HMT is trying to promote in its third objective.

Taking into account all the above messages, the table below illustrates with real case studies how unnecessarily restrictive measures under the current regime stymie the ability of life firms to maximise the capacity to support growth in a way that it is aligned with the green and levelling up agendas while upholding the high levels of policyholder protection. The table is followed by a section on the size of the opportunity and the list of constraints that industry believe need to be addressed.

Table: case studies of assets that would become MA eligible if the recommendations in this paper were adopted.

Asset type by HMT agenda – Key					
	Productive Finance		Net Zero agenda		Levelling up agenda

Type of asset	**Example**	**Constraints/Solutions**
Infrastructure / Infrastructure debt	A Portfolio of Renewable assets in 2021: a £170m portfolio composed of 95MW of operational ROC subsidy backed renewable assets; 4 onshore wind assets 30MW; 15 solar assets 65MW; The ROC subsidies mature by the 31 Mar 2037. Instead of getting a bank involved in structuring the asset into debt and equity, the insurer would prefer to take on the entire asset. It would be better economics if the insurer were itself able to undertake a notional restructuring sufficient to achieve the correct mapping to a CQS.	• **Main constraints:** No fixed cashflows • **Addressed by HMT consultation?** No • **Solution:** Sufficiently predictable cashflows – need to introduce a quantitative tolerance for any uncertainty in the asset cash flow, assessed at a portfolio level.

Infrastructure / Infrastructure debt	UK hospitals – An insurer provided long-term finance to an NHS Trust to build accommodation on a hospital site for medical students. Insurer could only invest in this because the Trust took the risk that the property will be completed and let on time and guaranteed the timing of income irrespective of their receipts. The insurer had a very similar 35-year loan opportunity with another NHS Trust but could not invest as the Trust could not afford to provide a similar guarantee.	• **Main constraints:** No fixed cashflows • **Addressed by HMT consultation?** No • **Solution:** Sufficiently predictable cashflows – need to introduce a quantitative tolerance for any uncertainty in the asset cash flow, assessed at a portfolio level.
Infrastructure / Infrastructure debt	£50m loan, 5yr tenor, A rated, G+120 coupon, principal repayment guaranteed by third party insurer; rejected due to potential 6-month admin delay in receiving an insurance pay out.	• **Main constraints:** No fixed cashflows • **Addressed by HMT consultation?** No • **Solution:** Sufficiently predictable cashflows – need to introduce a quantitative tolerance for any uncertainty in the asset cash flow, assessed at a portfolio level.
Infrastructure / Infrastructure debt	£0.7bn Export Credit Agency loans – AAA/AA rated long dated guaranteed infrastructure/social project loans. Not investable under existing applications as the dates of drawdown do not occur on fixed dates.	• **Main constraints:** No fixed cashflows • **Addressed by HMT consultation?** No • **Solution:** Sufficiently predictable cashflows – need to introduce a quantitative tolerance for any uncertainty in the asset cash flow, assessed at a portfolio level.
Infrastructure / Infrastructure debt	Waste-to-energy – A firm had the opportunity to finance a portfolio of waste-to-energy plants. The borrower wanted floating rate loans with the ability to repay early, which while the risk was economically acceptable to us from a prudent-person perspective, did not meet the strict MA rules for make-whole penalties and the floating rate did not provide absolutely fixed cash flows.	• **Main constraints:** No fixed cashflows / Pre-payment risk • **Addressed by HMT consultation?** Partially • **Solution:** Allowing assets with prepayment risk, including assets with make-whole clauses that fall short of the stringent standards currently required by the PRA, provide some allowance is held elsewhere e.g., via cashflow haircuts.

Infrastructure / Infrastructure debt	£0.4bn, A rated, floating rate, assets pre-payable at the borrowers' option. Transaction economics and structure provides make-whole protection, however, not in the form as outlined in current MA application.	• **Main constraints:** Process issues/Pre-payment risk • **Addressed by HMT consultation?** Partially • **Solution:** o Changes to the MA application
Infrastructure / Infrastructure debt	Education project - Borrower needed ability to pre-pay the finance early at par, but a bank was prepared to provide us with the protection required to be consistent with the Matching Adjustment rules. The resulting combined asset meets the eligibility requirements under the rules but we were unable to invest until we had submitted a revised MA application, which was not feasible in the timeline needed to raise finance for the project. (NB SS3/17 9.5 specifically requires a new MA application for assets with a different form of early repayment clause, as well as those requiring pairing of two assets)	• **Main constraints:** Process/Pre-payment risk • **Addressed by HMT consultation?** • **Solution:** o Accelerating and changes to the MA application process o Adopting HM Treasury's proposal to make assets with prepayment risks eligible
Infrastructure / Infrastructure debt	Infrastructure/Real estate - £1.8bn local authority loan portfolio – A/AA rated pre-payable floating rate loans. Transaction economics/structure provides make-whole protection, however, not in the form as outlined in current MA application.	• **Main constraints:** Process/Pre-payment risk • **Addressed by HMT consultation?** • **Solution:** o Changes to the MA application
Innovative assets (including Net Zero Technologies)	Some Net Zero technologies are below investment grade as they are newer technologies or more linked to commercial risks, rather than any subsidy mechanism available from the govt., or a regulatory framework like that from Ofcom, Ofwat, etc.	• **Main constraints:** BBB cap • **Addressed by HMT consultation?** Yes • **Solution:** Removing the BBB cliff edge

The size of the opportunity

- Data[10] from 2021 indicates an estimated *additional* asset flow into the sector of c£1.6trn between 2021-2035, of which £600bn are driven by annuities, hence affected by the MA.

[10] ABI/BCG (2021)

If allocated in line with Government objectives, this would contribute materially to fulfilling the UK's demands for investment.

- There is potential for investments in areas such as infrastructure, housing, exports, SMEs, innovation and other areas of productive finance. This potential has been recognised by HMT and reflected in its third Solvency II review objective, focusing on providing long-term capital to support growth.
    - Sir Iain Duncan Smith's 2021 TIGRR report[11] highlighted how Risk Margin and MA reform could boost institutional investment in the economy.
    - The former Minister for Tech and the Digital Economy, Chris Philp MP, emphasized in March the role of Solvency II reform in helping emerging Fintech companies access the capital required for growth and innovation[12].
- Underpinning the above is the significant level of investment required to make substantive progress toward the transition to a Net Zero economy, to meet the UK Government's '[Ten point plan for a green industrial revolution]' and Levelling up Agenda (roughly estimated by the thinktank centre for cities at about £2trn) ambitions.

Constraints that need to be addressed

This section highlights constraints in the current regime that prevent our industry from investing in assets aligned with HMT's Solvency II review objectives. It also suggests solutions that would super charge investment levels, boost productive finance investment and ensure industry can invest released and repurposed capital appropriately into these priority assets.

Assets with prepayment risks

- The ABI welcomes extending MA eligibility to assets with currently ineligible pre-payment risks, such as callable bonds, commercial real estate lending, housing association bonds and loans, infrastructure assets and local authority loan portfolios. This could, for example, allow insurers to invest in **waste-water treatment facilities.** Instead of preventing investment we should be allowed to invest but hold capital against the risks – including the risks of prepayment. But like any sensible person would, we should assess these risks at fund level and allow for diversification between risks. Government guarantees to allow par prepayment, which provides credit protection, rather than being seen as an option to call the debt, would help open up investments to regulated annuity funds. However, to take full advantage of the opportunity offered by this proposed change we strongly encourage HMT to also allow:
    - Assets with make-whole clauses (which are rarely exercised but allow an issuer to pay off remaining debt early) outside modified spens limits, despite having cash flows that meet the "fixed" definition required by Solvency II. Appropriate cash flow haircuts could be made to allow for the associated pre-payment risk.
    - Portfolio level eligibility assessments (as opposed to current asset level view of risk), which would allow natural hedging of risk on assets, hence making them MA suitable (e.g., assets with prepayment risk, or those with floating rates rather than fixed rates). Borrowers will typically have fixed rate financing needs, with prepayment flexibility on some part of their debt, not all. However, to maintain MA eligibility, insurance companies typically only offer fixed rates without pre-payment flexibility – borrowers are therefore incentivised to obtain debt financing from banks.

[11] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/994125/FINAL_TIGRR_REPORT__1_.pdf
[12] EmTech Global Conference . 28 March 2022 - https://www.cityam.com/digital-minister-calls-on-pension-and-insurance-firms-to-back-british-tech/

Assets with construction phases

- For those assets that have not been built yet, this proposal is critical in increasing investments of this type. However, to be fit for purpose proposals need to be expanded to encompass added key construction related risks:
  - Removing the link to the strict fixity of cashflows (we elaborate on this later in the response) could help address:
    - Issues related to the timing and size of drawdown payments. Currently, non-market standard approaches are required separate to the MA loan for the borrower to manage this risk; and
    - Requirements for spens during the drawdown period to cover the risk of the drawdown not going ahead.
  - Uncertain final build size – this can affect the amount of cash flow obtained during the operational phase of an asset and therefore can render projects ineligible until complete. This could be allowed for by taking a prudent view of the final build size (e.g., best estimate less a margin)
  - Market risks – risks such as power prices or the property rental market may mean that assets with construction phases are exposed to uncertainty in cash flow timing and amount. We would expect this to be allowed for in the rating process for such assets.

  We also note that the allowance for construction delay penalties (or similar) is not well defined, and we are concerned that it may not be sufficiently flexible. We consider that such assets should be MA eligible if it can be demonstrated that construction delays would not affect cash flow matching at the portfolio level. In addition, a proportionate approach could be adopted to make it easier to cope with short construction periods, if it is a suitably small proportion of the portfolio.

Requirement for strict fixity (rather than predictability) of cash flows

- **The consequence is that firms frequently pass over some high-quality investment opportunities that go beyond those that this consultation attempts to address with the proposals around construction phases and pre-payments.** Truly fixed significantly curtails the investible universe. Even amongst the assets that insurers do invest in, a large amount of time and resources are unnecessarily wasted assessing whether cashflow variations that would only apply in extreme cases are consistent with the MA eligibility requirements. For example, a wind farm where the borrower wanted the rights to repay the debt without spens in the event that the Crown Estate expropriated the seabed on which the wind turbines stood.

  We propose the introduction of a quantitative tolerance for any uncertainty in the asset cash flow, assessed at a portfolio level. This would run parallel to existing MA portfolio tolerances, such as for permitting a small amount of mortality risk on the liability side. Other jurisdictions allow assets without complex restructuring up to a limit of 10%, and cash flow mismatches of up to 10% (Bermuda, which is a Solvency II equivalent jurisdiction), greater flexibility including a simplified 15% permissible mismatch (Singapore) or liabilities beyond a certain number of years can be backed by less predictable cashflows (Canada). Infrastructure is typically financed by equity and debt, with debt having the more fixed (and therefore MA eligible) cash flows. For low-risk sectors such as **renewable energy generation (i.e., wave, wind and solar panel farms),** it would make better economic sense if equity and debt financing are not split, and aggregate predictable cash flows are accepted. Similarly, it would permit insurers to make investments in (for example) **NHS health care provision,** even in circumstances where the Trust involved is unable to guarantee the timing of income. It would permit investment in (for example) **infrastructure and social project loans** where the dates of drawdown are not fixed.

A need to remove the BBB cap

- We are pleased that HMT intend to remove the BBB cap. This cap disincentivises firms from holding sub-investment grade assets, or those at the lower end of investment grade. It also incentivises them to sell these procyclically during periods of market stress.
- Removing the disproportionately severe treatment of assets with ratings below BBB in MA portfolios should help insurers fulfil their role as natural funders of the increasing universe of investible opportunities. This covers assets that are perfectly appropriate to back their liabilities, but may lack an investment grade rating, such as new start-ups, some net-zero technologies, and fallen angels.
- Firms would still be expected to comply with the PPP on their investments. We believe that firms setting their own portfolio limits in line with the requirements of the PPP is a more appropriate way of addressing PRA concerns about firms moving down the credit curve. There should be better treatment for fallen angels to allow for repair of credit, e.g., project finance assets where the rating may be sub-investment grade for a relatively short period of time.

A need for a more proportionate approach to matching adjustment breaches

- The ABI agrees with HMT that the current approach is disproportionate and brings severe sanctions that lead insurers to adopt an overly cautious approach to managing the MA portfolio.
- We recognise the benefits that HMT lists from a more proportionate approach to breaches. This approach would also contribute to a move away from binary "yes or no" decisions on new features if, for instance, a firm adds an asset without a fresh MA application being approved and the PRA later determines that the asset introduced new features. Such a firm would risk a technical breach in its MA approval. A more pragmatic approach to new "features" would permit insurers to invest in more innovative assets more rapidly, rather than reverting to more traditional assets. This could for instance be an approach in which the PRA supervises firms on having the right frameworks and governance in place for assessing eligibility and then trusting the firm to apply these. The MA approval regime was originally about verifying that firms had the right setup in place to run a (matching adjustment portfolio) MAP, but with time, it has evolved into a place where subsequent changes also need to be approved.

Removing the need to restructure assets solely to meet eligibility criteria.

- Some assets provide an appropriate match to annuity liabilities when considered in aggregate (for example, a portfolio of equity release mortgage loans), but must undergo complex restructuring simply to comply with the MA rules on the fixity of cash flows. As we highlighted in our response to Question 4.1 this adds little in terms of risk mitigation as the underlying risks are unaltered, but it does add considerable cost, introducing inefficiencies and operational complexity. This also substantially extends approval timescales as the PRA then feel the need to unpick all of this complexity, gold plating the approval regime with unofficial pre-application periods.
- Furthermore, there is prudence in the preference to opt for structuring instead of applying PPP. This can for example be seen in assets that have different kinds of proceeds like income and property, assets that generate more cashflows than needed to back liabilities (e.g., ground rents), and Equity Release Mortgages.
- Regulation should remove the need to restructure assets solely to meet eligibility criteria. This requirement also diverts attention away from the real risks – for example, the PRA's Effective Value Test (EVT) for restructured equity release mortgages puts the focus on interest rate risk, when the real risk is property price inflation, creating other disproportionate requirements. In place of formal restructuring, the PRA should apply PPP

or permit wider use of notional restructuring approaches and a more flexible approach to cash flow modelling.

As referenced earlier in this question, we welcome HMT's reform proposals outlined in its Solvency II reform consultation. These proposals would certainly help increase the level of investments in line with Government objectives. However, they could go further to achieve the quantum of investment required to meet levelling up and net zero transition objectives and we consider that the changes proposed in this paper would move us even closer to achieving these goals. Furthermore, and as we alluded to earlier these qualitative changes would only be effective if adverse changes to the MA FS which penalise life insurers (annuity providers in particular) are not introduced – as these would see Government investment growth objectives unmet as most of the long-term investments required come from this group of insurers. We will continue to work closely with all stakeholders to ensure meaningful Solvency II reform is delivered.

Question 4.2

What are the additional risks that these reforms may pose to policyholder protection?

Assets with prepayment risks and/or construction phases

For prepayment risks: Refinancing risk – if you are prepaid and you then cannot source an asset of the same yield and you lose MA benefit and need an asset injection. We argue that the quantification of this risk is likely small – as prepayment risk acts in the opposite direction to credit risk, they will diversify somewhat at portfolio level. We suggest that firms should capitalise this risk, impose limits and or introduce a matching test.

For construction phases: The specific reform proposed will hardly move the dial so there will be no material change to the level of policyholder protection. The current approach is overly prudent and the reform approach will move this slightly toward reality.

For both: Risks should be considered at portfolio rather than asset level and assessed against the other controls in place. Both introduce some liquidity risks if promised cashflows are not received as expected. Firms could allow for these risks in a number of ways, such as prudently recognising only a proportion of the cashflow to account for the potential variability and or holding liquid resources to cover a high percentile stress to the cashflow timing and amount.

Removal of the BBB cap

We support HMT's proposal to remove the BBB cap. As highlighted earlier it incentivises firms to sell sub-investment grade assets, or those at the lower end of investment grade, procyclically during periods of market stress. Removing the BBB cap would contribute to reducing derived negative impacts on UK financial stability while helping insurers fulfil their role as natural funders of the increasing universe of investible opportunities (i.e., new start-ups, some net-zero technologies, and fallen angels).

Any concerns about firms moving down the credit curve would be mitigated by the fact that:

- Firms would still be expected to comply with the PPP on their investments. Firms setting their own portfolio limits in line with the requirements of the PPP would be an appropriate way of addressing any PRA related concerns.
- The SCR would respond to ensure firms remained capitalised against 1-in-200 losses.

It is important to note that any benefit here would be undone by the broader FS changes which have the opposite effect.

Sufficiently predictable cashflows

Carefully managed, a degree of non-fixity could be introduced such that policyholder protection was not negatively affected. The focus should be on being well matched, not perfectly fixed. Matching tests, cashflow or yield haircuts and additional capital requirements can all mitigate any risks to policyholder protection introduced.

The exclusion of long-term predictable assets for not having fixed cash flows - negatively impacting industry's capacity to invest in opportunities aligned with government priorities – is something that other jurisdictions have found solutions for. For instance:

- In Bermuda, which along with Switzerland is one of just two jurisdictions to be found fully equivalent with Solvency II, the rules allow imperfect assets without complex restructuring up to a limit of 10%, and cash flow mismatches of up to 10%.
- Singapore, which adopted a Matching Adjustment as part of its risk-based capital regime in 2014, therefore very similar to the Solvency II MA in many ways, has also introduced greater flexibility, including a simplified 15% permissible mismatch.
- In Canada, it is recognised that liabilities beyond a certain number of years can be backed by less predictable cashflows. Canadian pension schemes and life insurers often compete with UK insurers for productive investments and can offer better prices because of a more favourable regime.

The introduction of a quantitative tolerance for any uncertainty in the asset cash flow, assessed at a portfolio level, would parallel existing MA portfolio tolerances, such as for permitting a small amount of mortality risk.

The removal of complex restructuring

The Solvency II regime, as applied in the UK, contains elements, such as complex restructuring of asset portfolios, that on many occasions are simply designed to comply with the MA rules on the fixity of cash flows, adding nothing in terms of risk mitigation. These elements add considerable additional cost, inefficiencies and operational complexity.

Question 4.3

What safeguards are appropriate to protect policyholders from the risks posed by allowing a wider range of assets into matching adjustment portfolios?

As explained in Question 4.1 the PRA appears reluctant to rely on the PPP or on the SMCR (e.g., allowing SMFs to assess MA eligibility and consistency with rules, and be accountable for their decisions). Under Solvency II, the PPP requires insurers to only invest in assets and instruments whose risks they can properly identify, measure, monitor, manage, control and report but also to appropriately consider this in their assessments of overall solvency needs. This principle is an important safeguard under Solvency II – a more pragmatic approach to its use would allow insurers to broaden the range of assets in which they invest, to include, for example:

- Infrastructure and assets with a limited equity element.
- Sub-investment grade assets, or those at the lower end of investment grade.
- Assets that have different kinds of proceeds like income and property, assets that generate more cashflows than needed to back liabilities (e.g., ground rents), and Equity Release Mortgages without the need to restructure them solely to meet eligibility criteria.

PPP could also be used to allow firms self-certifying 'minor' MA application changes, allow firms to be able to embark on the approval process of more innovative assets with greater certainty about the outcome.

Question 4.4

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

We understand “these reforms” in the question to refer specifically to the reforms intended to increase investment flexibility as set out in Chapter 4 of the consultation. We are broadly supportive of these specific reforms, although we consider that HMT could have been more ambitious with some of them.

Although we recognise that each firm is free to make its own decisions on investments and product pricing, HMT’s proposals in this chapter (broadening the eligibility of assets and liabilities; removal of the BBB cliff edge; acceleration of MA eligibility decisions; the introduction of a more proportionate approach to MA breaches; and, the provision of greater flexibility for how innovative assets are treated) should overall contribute to more affordable pricing of products. This contribution would become even more substantial if HMT accepted our recommendations.

However, the positive impacts of these proposals cannot be taken in isolation. For instance, the proposed changes to the FS would decrease, rather than increase, confidence in these assets - contributing to a decrease, rather than an increase, of investments in HMT preferred assets. Based on the information presented we expect the negative impacts of the FS changes to outweigh any positive impacts of the eligibility proposals - making more difficult the achievement of the third HMT objective for this review.

The proposed FS changes would significantly reduce the size of the MA benefit, especially on these types of assets. The introduction of material procyclicality and balance sheet volatility combined with a higher capital strain on new business would translate in an increase, not a decrease in annuity prices, making bulk annuities more expensive and reducing guaranteed income for annuity pensioners - at a time when their cost-of-living is increasing.

The final outcome of this review could well be a Solvency II regime with greater investment flexibility in a context where firms have less capital to invest (because of the higher capital strain) and UK productive investments are less attractive, reducing industry’s capacity to deliver HM Government’s objectives, including the transition to Net Zero.

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?

<u>Accelerating the reviewing of matching adjustment eligibility applications</u>

- Quicker assessment and approval of applications for MA eligible assets should provide greater flexibility for the treatment of assets without historical data such as **new or innovative assets**.
- We consider that assets which satisfy the PPP at portfolio level for investment backing annuities should be eligible – including infrastructure investments and assets with a limited equity element. We are not proposing the removal of MA eligibility requirements – instead we propose that responsibility for ensuring these requirements are met should fall more on the insurer, especially for ‘minor’ MA application changes, and less on the regulator. The PPP requires insurers to only invest in assets and instruments whose risks they can properly identify, measure, monitor, manage, control and report and appropriately consider this in their assessments of overall solvency needs. This principle is an important safeguard under Solvency II – a more pragmatic approach to its use would allow insurers to broaden the range of assets in which they invest, to include (for example) infrastructure and assets with a limited equity element.

- A simplified MA change process should allow firms make investments in non-complex assets up to a certain level without prior regulatory approval – a strong incentive for insurers to broaden the range of assets they invest in.
- MA change process should focus solely on what has changed, with a clear definition of materiality. The current process and approvals frequently involve substantial amounts of information unrelated to the proposed changes. The focus should be on principles and outcomes and not on detailed requirements assessed in a legalistic manner.
- We propose that firms should be allowed to self-certify changes up to a certain threshold – for example, there could be a system of "minor" and "major" MA portfolio changes, as is currently the case with Internal Model changes.

<u>A need for a more consistent interpretation of how an eligible asset is defined</u>

- Currently, PRA requirements demand that firms apply for MA eligibility even if the asset is already approved as MA eligible for another firm. Firms may add new assets to an approved MA portfolio, provided they pass a test demonstrating that they have the same features as existing assets. However, "feature" is not defined, and there are grey areas regarding what constitutes a new feature. Different firms may interpret this differently, creating an uneven playing field where those who take the most aggressive possible interpretation of the regulations are rewarded – a perverse incentive for a well-functioning prudential regime.
- **Enhancing certainty and encouraging innovation:** There is <u>a need to define an asset in terms of its MA features</u>. Under current regulations, firms wishing to introduce a new asset class, or an asset with a new "feature", into their MA portfolios, must go through a lengthy and resource-intensive application process to gain regulatory approval (there is an excessive amount of information required for applications that even goes beyond just the details of the new feature i.e., valuation or credit methodology). In many instances, firms decide this is not cost-effective, and revert to more traditional investments instead. We suggest moving away from the current binary approach (e.g., considering having buckets within limits for 'unapproved' assets).
- A solution could be to allow <u>self-certifying MA application changes</u>, based on the PPP, and allowing a more proportional review of the key parts changing in the MA application. These changes would allow firms to be able to embark on the approval process of more innovative assets with greater certainty about the outcome.
- **Moving away from "Yes/No" decisions:** A more proportionate interpretation of same features to focus on underlying economics and risks (as opposed to a legalistic assessment) and to define an asset in terms of its MA features not its commercial features would contribute to the move away from binary "yes or no" decisions on new features, towards an approach focused on how a firm treats a particular asset class or feature for capital modelling purposes. This could be used as a basis to determine MA eligibility instead. This would also avoid the current issue of putting firms' MA approval at risk or risk technical breaches but boost investments in innovative products as described earlier in this paper.

<u>Overly long and onerous matching adjustment application processes</u>

- Consider a case where there is a precedent for the application – i.e., that firm (or another firm) already has PRA approval for something similar. There is an excessive amount of information required for applications beyond just the details of the new feature (i.e., valuation or credit methodology). Another example is the requirement for an MA pre-application. Alternatively, consider a firm looking to invest in a new asset class. Simple, illiquid credit assets can be privately placed in as little as two weeks, potentially increasing to six months for more complex, bespoke investments. The time required to prepare and submit an MA approval application is therefore likely to exceed the time for which the investment opportunity is available, even before the 6-month approval window the PRA has post-submission. In addition, technical experts responsible for assessing new investment opportunities are now required to divert their focus to the MA application.

- We recommend a mechanism by which asset classes can be pre-approved. The UK Infrastructure Bank (UKIB) and or the British Business Bank (BBB) could agree with the PRA 'pre-stamped' MA approvals for certain assets, significantly expediting investments, especially if minor changes were left to internal governance. There is a limited precedent – the Government's student loan deal was assessed as MA eligible by one of the Big 4 consulting firms, albeit this analysis has never been formally endorsed by the PRA.

Inconsistency and lack of transparency of regulatory expectations between firms.

- Experience indicates that different PRA supervisory teams may have different approaches to MA approvals. Greater certainty in the approval process will incentivise insurers to diversify into a broader range of asset classes, rather than relying on the traditional investments of the past.

Binary nature of eligibility assessments or application of rules more generally

- We concur with HMT's assessment in Paragraph 3.10 of its Call for Evidence that approval decisions for MA applications are currently 'binary yes/no' decisions.
- Binary discussions on new asset 'features' are inadequate. For example, a different FS mapping might be required to allow for better security, or an adjustment to the SCR might be required to account for the particular risk of a given feature. The PRA should explicitly state that it is open to such approaches. As indicated above, greater certainty in the approval process will incentivise insurers to diversify into a broader range of asset classes, rather than relying on traditional past investments.

Lack of pragmatism, and an over-prescriptive implementation of principles

- As highlighted earlier, the PRA appears reluctant to rely on the PPP or on the SMCR (e.g., allowing SMFs to assess MA eligibility and consistency with rules, and be accountable for their decisions). Under Solvency II, regulators are not permitted to require firms to seek pre-approval before they make investments – instead, firms must comply with the PPP, which requires insurers only to invest in assets for which they understand the risks. It follows that firms should be able to consider a wider universe of MA eligible assets, setting suitable risk allowances for asset features that are not an exact fit to current MA rules.

5. Reducing reporting and administrative burdens

Question 5.1

What is the impact of these reforms on regulatory costs incurred by insurers?

Reforms to the Internal Model framework

The ABI's position is that approval processes for new Internal Models and major changes to models are clear examples of overly detailed, complicated and extensive mechanisms, including a lengthy pre-approval stage, which has been imposed by the PRA beyond the expectations of the regulations, making it difficult for firms to operate to an efficient timescale.

We note HMT's proposals to reduce the number and prescriptiveness of Internal Model standards, including those relating to documentation, statistical quality standards, the Use Test, and profit & loss attribution. While these will no doubt be helpful in reducing regulatory costs, some complementary reforms are required in addition.

The ABI recommends significant streamlining of Solvency II Internal Model processes beyond that indicated by HMT in its consultation, to better reflect the unique nature of the UK regime and help towards its competitiveness. This is particularly important as the UK has more firms using approved Internal Models than any EEA member state, and the UK was a major proponent of Internal Models during Solvency II negotiations. Such streamlining could include:

- The application process for approvals for major Internal Model changes can also be lengthy and resource intensive – the PRA will frequently ask for additional information throughout the process. Routine internal model implementation and major change approvals could be completed to a 3 month deadline; for more complex approvals a maximum of 6 months, ideally less could be aimed for.
- Firms are often incentivised (perversely) to put needed minor model changes on hold until the next model change cycle, so as not to exceed the threshold for accumulated minor changes requiring such a major change. Greater flexibility from the PRA in allowing higher thresholds for such accumulated minor model changes requiring a major change application would allow firms to adapt models dynamically to the continuously evolving reality. We would also propose the removal of the PRA imposed limit of one major model change application per year.
- The process should focus on the key elements describing the change in outputs and the change in modelling with an overall template that the firm completes, rather than requiring firms to submit many documents that they must produce exclusively for the regulator. On discrete changes, these could be made on a continuous basis rather than requiring all to be submitted annually.
- We recommend the abolition of the requirement for standard formula SCR reporting for firms operating PRA approved Solvency II Internal Models for the sole purpose of monitoring 'model drift'. By definition, the Standard Formula does not capture an Internal Model firm's risk profile appropriately, and since it is not updated frequently, fails to provide an appropriate comparison. We are not aware of any evidence from the PRA that demonstrates there is widespread 'model drift' in the insurance sector – if there was, the Standard Formula would likely not identify model drift anyway.

We also note HMT's proposal for the residual limitations with models to be mitigated by the use of safeguards such as approval conditions, capital add-ons and exposure limits. While we welcome HMT's apparent desire for a closer and more collaborative relationship between the regulator and the firm, and the avoidance of protracted discussions on detailed technical modelling issues, we would note the following:

- We would ask HMT to specify what these new "approval conditions" are. It would be unfortunate if streamlining elsewhere in the process were to be offset by new approval conditions restoring the complexity and delay we currently see.
- Solvency II rules are appropriately restrictive on the circumstances under which the regulator can apply capital add-ons. We would want to see no loosening of these as part of a revised approach to Solvency II Internal Model approval.
- Under Solvency II, the regulator does not set formal exposure limits – instead, the PRA uses 'soft' powers to effectively ensure exposure limits on firms. The PRA also ensures that firms are compliant with the PPP, which stipulates that insurers may only invest in assets and instruments whose risks they can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs. We would want to see no additional powers for the regulator to set exposure limits, or any weakening of reliance on the PPP, as part of a revised approach to Solvency II Internal Model approval. Such

powers would be unnecessary and would be inconsistent with the PPP and risk management requirements under Solvency II.

<u>Increasing the thresholds before Solvency II applies</u>

Proportionality is an important concept in Solvency II and one we support. Hence, we are supportive of the proposal to double the thresholds for the size and complexity of insurers before the Solvency II regime applies. We would note that a similar proposal has been made in the EU; hence this reform is necessary to ensure the continuing competitiveness of smaller UK insurers and new UK start-ups.

Furthermore, HMT should consider changing the thresholds methodology by incorporating annual inflation while limiting volatility, for this methodology to remain proportionate over time.

The current regulation includes a provision allowing a firm to continue to be authorised under Solvency II, even if it were to no longer meet the size requirements of being in scope. This would give firms the option of regulatory continuity, if being reclassified as a non-directive insurance firm would have costs that outweighed the benefits.

<u>Reforming reporting requirements</u>

It is generally acknowledged that regulatory reporting costs have increased substantially since the Solvency II implementation. There was a substantial increase in the level of regulatory reporting introduced under Solvency II compared to the previous UK regime, although there is no evidence that the UK regulator thought the prior volume of reporting was insufficient.

The ABI estimates that reporting requirements are between 4 and 8 times greater than prior to Solvency II, depending on the size of the firm and the nature of the business model, mainly to facilitate consistent treatment across the European single market. The scope for improvement now that the UK has left the EU is therefore considerable and should be taken during Phase 2 of the current review later this year.

Current requirements are both onerous and costly to an extent that cannot be justified by their supervisory use and are detrimental to overall market efficiency. The ABI estimates that aggregate compliance costs for Solvency II are in excess of £200m per year greater than under the previous regulatory regime, and the majority of this is due to reporting. We stand by the principle that only information that is genuinely needed by both firms and the regulator should be reported – if this goal is achieved, the regulatory costs savings for UK insurers will be considerable.

We agree with the need to focus on enhancing proportionality in the Solvency II reporting framework – QRTs, SFCR and RSR are examples where the requirements are out of proportion with the value to stakeholders. We would note the following about HMT's plans by which this could be achieved:

- Simplifying particularly complex templates – Industry would favour changes that remove unnecessary reporting templates in their entirety, rather than making incremental changes to existing templates, or moving data requests from one template to another. Even where such incremental changes reduce the overall volume of reporting, or the overall number of templates, the one-off systems changes required will usually more than offset any long-term benefit. Our view is that elimination of templates or data is always preferable to modification, which may incur significant change costs to source data and reporting systems. As a principle, the PRA should recognise that even minor changes to a single template often brings significant implementation costs.

- Reducing the reporting frequency of some templates and deleting others – There is considerable scope for this now that UK insurers are no longer subject to European regulatory reporting requirements. As part of our engagement with the PRA in Q1 2022, industry has already provided the PRA with a detailed 'Master Document' roadmap demonstrating how such streamlining could be achieved.
- Making other templates more appropriate for the needs of the UK market - It is essential that reporting requirements reflect data and information used internally by firms – they should not be generating data solely to comply with a regulatory requirement. A Use Test assessment should be made before the introduction of any new reporting requirement. We would also emphasise that where data is available to the PRA from alternative sources (IFRS 17 and UK GAAP data being an obvious example) there should be no need for additional, duplicative regulatory reporting requirements. We encourage the PRA and FCA to work in a co-ordinated manner, to ensure there are no multiple requests for similar data, albeit in a different format.

We note the PRA's assertion that its Phase 1 December 2021 reforms (set out in policy statement PS29/21) will lead to a reduction in the number of templates – which does not necessarily reflect the number of values to be entered in that template, nor the amount of effort required in determining and entering the information in that template - that firms need to complete of around 15%, and in some cases 40%. However, we do not recognise this very optimistic view of the benefits of the Phase 1 process, which consisted of the limited number of template deletions (in many cases little-used templates) plus a (welcome) extension to the availability of quarterly reporting waivers.

Most firms will see a negligible reduction in reporting requirements as a consequence of Phase 1. It is important that Phase 2 of this process (on which we expect the PRA to consult in late summer of 2022) is far more ambitious.

Allow more than one approach to calculating consolidated group capital requirements

We support the proposals to allow the temporary use of multiple Internal Models in the consolidated group SCR calculation following an acquisition or merger. We also support the proposal for acquired firms no longer being required to temporarily hold additional capital post-acquisition, while legacy models are combined with those of the acquiring insurer.

We do not expect there to be significant reductions in regulatory costs from an operational perspective as a consequence of these reforms; however, it will be possible for firms to avoid an unnecessary and temporary strain on their balance sheets while incorporating legacy models into their organisation.

We would expect any conditions relating to this temporary use of multiple Internal Models to be transparent, for example any rules about the maximum period of use.

Simplification of the calculation of Solvency II transitional measures to reduce the administrative burden of maintaining legacy systems

The Transitional Measure on Technical Provisions (TMTP) as it is currently applied has very high operational costs for both firms and regulators, particularly associated with the maintenance of legacy systems, which we do not believe are justified and could be significantly reduced, resulting in savings being passed onto customers.

Appropriate TMTP reform would relieve operational and technical capacity, including IT systems and staff; this would allow insurers to redirect these resources into more worthwhile areas of risk management, which we think would be a benefit to the safety and soundness of firms.

HMT has not indicated the nature of its intended simplifications in its consultation paper. The following should be considered:

- To reduce the costs of maintaining legacy systems, firms should be allowed to significantly simplify the methods used to determine the pre-Solvency II position and expand the use of expert judgement. It can be readily demonstrated that there is a lack of real value in maintaining such legacy systems so long after Solvency II implementation.
- The process by which firms must apply for TMTP should be simplified and streamlined. Currently, firms' TMTP calculations and the resulting deductions from capital requirements must be overseen by the firm's Audit Committee. In our view, this requirement is excessive, given that this is the only part of the balance sheet that must follow this process.
- Firms can currently only apply for recalculations of the TMTP either once every two years or after a material change in risk profile. Allowing greater flexibility through calculation of the TMTP on a fully dynamic basis would allow firms to apply a TMTP that matches the movement of Technical Provisions on their balance sheets. This would help ensure that firms are not forced to act in a procyclical manner, which could have a negative impact on UK financial stability.
- The Financial Resources Requirement (FRR) cap is a significant source of complication within the TMTP regime and firms are in favour of removing it. This might have been necessary at the start of Solvency II, but it is now 2022 and the need for it is much reduced. Removing this cap would significantly reduce the effort required to recalculate the TMTP.
- The regulations for TMTP require both that the TMTP reflects the current risk profile of firms (SS6/16, 3.2) and that firms maintain a consistent Solvency I approach which would have applied prior to Solvency II implementation (PS25/19, 2.7). Significant expert judgment is needed to balance these two requirements, and this may lead to spurious results. Balancing the different TMTP regulatory requirements is becoming increasingly difficult as time passes since business decisions are made based on Solvency II. This can lead to artificial impacts on the TMTP due to the application of Solvency II to changes in the business which may have been implemented differently under Solvency I.
- A simpler approach to TMTP would have significant benefits to firms' capital management, enhancing stress & scenario testing capabilities. This will enable firms to manage their balance sheets & solvency positions more effectively.

We would emphasise that any reform of the TMTP needs to be considered in the context of the overall, and final, design of the Solvency II regulations, particularly those critical elements relating to the Risk Margin and MA.

Under a scenario where the Risk Margin has been adequately reformed, and appropriate refinements to the MA around MA eligibility criteria and BBB cliff have been made, we would propose a significant simplification of the pre-Solvency II models and legacy systems used to calculate the TMTP in a way that avoids additional complexity for firms.

This is industry's preferred outcome. A more significant simplification of legacy systems would allow firms to cut the costs associated with their maintenance. This more meaningful reduction in operational costs could then be passed onto customers via reduced product fees and expense loadings.

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?

The ABI believes that the capital requirements for foreign branches should take into account the level of risk that each branch brings to the UK market, and the outsourced nature of their activities.

Third-country branches operating in the UK with head offices in the EEA and Switzerland, robustly regulated under Solvency II, or those in any jurisdiction with a solvency and supervisory regime that is of a similar strength and sophistication to that in the UK should be exempt from any branch capital requirements for the business done in the UK and recognised as fully prepared to meet the claims of UK policyholders. However, we expect controls on branches to persist - it is crucial that the UK regulatory regime remains an even playing field for UK firms and foreign branches and avoid overseas firms using more generous MA rules. We would ask HMT if it is its intention to exempt all third-country branches, or only those in jurisdictions with a similar strength and sophistication – the consultation paper is unclear on this point.

With regard to the requirement to localise assets in the UK to cover the capital requirements of the insurance branch, we consider these represent a constraint on capitalisation. Removing this requirement would boost the competitiveness of the UK market and ensure it remains a global hub for insurance and reinsurance.

Furthermore, lighter reporting requirements for branches would represent a significant step towards improving the attractiveness and proportionality of the regime. Many branch reporting requirements provide limited benefit, are duplicative of what is produced at legal entity level and entail high implementation and process costs. We believe that a large portion of the current reporting requirements for third country branches, both quantitative and narrative, should be removed.

We note some recent comments in a 14 June 2022 speech *'Competitiveness and productive investment: What parts do they play in the reform of insurance regulation?'* in which the PRA set out its view that firms need to consider their capacity to recapture risk ceded offshore in the event of a counterparty failure, especially in the event of reinsurance market tightening or even closure, where re-ceding risk another reinsurer may not be possible.

We consider this view to be contradictory to the goal of achieving greater openness and competitiveness in the UK insurance market. We support the view that primary insurers must fully understand reinsurance counterparty risk. However, should they also be required to retain the capacity to recapture reinsured risk, this could have the (likely unintended) effect of undermining the value of reinsurance; the benefits it can bring to the UK economy; and the attractiveness of the UK market to international reinsurers.

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?**

We note HMT's proposal to enable the PRA to introduce a new mobilisation regime for insurers, consistent with that used for the credit institutions sector. This would include modified entry requirements such as a lower capital floor, lower expectations for key personnel and governance structures, and exemptions from some reporting requirements.

The contrast between the recent growth in innovative and disruptive challengers within the banking industry, and the relative lack of new insurers authorised by the PRA since its formation in 2013, shows that more needs to be done to enable new entrants.

HMT's proposals on a new mobilisation regime and increased Solvency II thresholds are steps in the right direction; however, the need for such a regime should be understood as an indicator that the regime as a whole is too rigid.

Besides HMT proposals, we also believe that some complementary reforms are required. The PRA should review its approach to authorising new firms, to ensure that the authorisation process is more streamlined and faster, and to ensure that firms do not face a cliff edge of new requirements, but rather a smooth glide path to allow them to grow and develop.

In order to guarantee some certainty for insurers that are on the edge of the thresholds, firms should be in scope of the Solvency II regime only after three years of being above the thresholds. This would be more proportionate than under current requirements, providing a more encouraging framework for start-up insurance firms, as long as additional appropriate safeguards are in place to maintain firms' solvency, protect policyholders and financial stability.