

## **PRA Discussion Paper DP2/22 – Potential Reforms to Risk Margin and Matching Adjustment within Solvency II**

### **Response from the Association of British Insurers (ABI)**

**21 July 2022**

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

*The Association of British Insurers 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 over £1.9 trillion, pays over £16 billion 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 the PRA.*

*We would also draw your attention to our parallel response to HM Treasury on its Solvency II review, and an independent report from WTW commissioned by the ABI, which sets out an analysis of certain aspects of the proposed designs and calibrations of the PRA’s proposals in DP2/22. The analysis contained in WTW’s report is based on year-end 2020 QIS data that WTW has not independently audited or verified. This data will not reflect the material changes on insurers’ balance sheets that will have resulted from the significant rises in risk-free rates (c200bps) since that date.*

*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.*

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

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## 1. Executive Summary

1. We welcome the opportunity to respond to the PRA's discussion paper DP2/22. The intention of this document is to set out industry's consensus view that material changes to the current Fundamental Spread (FS) are not necessary to ensure the maintenance of policyholder protection, and conversely, the PRA's 'index spread' proposal will be detrimental to all three of the Government's objectives for Solvency II reform.
2. We would welcome the opportunity to discuss the content of this response in further detail with any interested stakeholders and propose to share with HMT and the PRA, WTW's report analysing the impact of DP 2/22 proposals which is referenced above and at various points in this response.

### Overall Impact of Reform

3. The current PRA reform proposals for the Matching Adjustment (MA) FS and Risk Margin will not meet the explicit target for reform set by the Government to release 10 – 15% of capital currently held by life insurers. This is critical because long term life insurers, and not non-life insurers, are responsible for most of the long-term investment activity which the Government seeks.
4. The calculations and methodologies within the PRA's DP 2/22 discussion paper assume that the transitional measure for technical provisions (TMTP) has fully run off. As outlined recently in a speech titled "Solvency II - striking the balance" by PRA CEO and Deputy Governor for Prudential Regulation Sam Woods, PRA calculations also assume that insurers only reinsure 50% of longevity risk. Neither of these assumptions reflect current reality as on average life insurers reinsure over 80% of new longevity risk and TMTP, which we note the PRA considers to be real capital, does not run off until 2032.
5. Considering the above assumptions, it is the ABI's view that proposals to introduce an index spread model to calculate the MA FS would for the majority of UK annuity providers reduce, and not increase, own funds. This point is considered in an independent WTW report commissioned by the ABI to analyse the impact of the PRA's DP2/22 proposals (see Section 2 below).
6. New business (which doesn't have TMTP) will not experience a capital release as firms are likely to continue to cede longevity risk offshore. For specialist annuity writers an increase in the FS will necessitate a capital injection to restore levels of solvency coverage, unless offset by a reduction in the Solvency Capital Requirement (SCR).
7. The PRA has stated (Annex Paragraph 104) that its proposed changes will not necessarily lead to material changes in the level of SCR capital held by firms (see also Section 4 of the WTW report). We disagree; this is contrary to HM Treasury objectives for the review.
8. The PRA has stated that the two key elements covered in DP2/22 (the Risk Margin and the MA) need to be treated as a package. If life insurers do not see a large enough reduction in the Risk Margin (and therefore retain some of its volatility and continue to be incentivised to cede longevity risk offshore), and if the MA is made more procyclical and volatile, then the package could result in increased risk for insurers'

business models and adverse customer outcomes. These two elements have different economic substance; therefore, the PRA should approach each on their own merits.

## Fundamental Spread Reform

9. We welcome the PRA's comments in support of the MA in concept both in DP 2/22 and in various communications since Solvency II implementation.
10. The crux of the ABI's position on MA FS reform is that the current framework and mechanisms are fit for purpose and calibrated well above the level of Expected Defaults, which implicitly provides an allowance for uncertainty. We acknowledge PRA concerns about the current FS, but we do not agree with its supporting rationale for reforms of this nature and consider its specific proposals counterproductive for industry and policyholders and contrary to HM Treasury's objectives.
11. Academic research cited by the PRA to support its calls for FS reform represent only a small proportion of the total research done in this area and are predominantly based on U.S. markets. There appears to be no consensus on a 'correct' approach from this academic research, and the PRA appears to have favoured those studies that support its case. It is questionable whether the PRA's chosen papers provide evidence to support its reform proposals as they are not representative of the long-term risk associated with default and downgrades, and not always relevant to the UK market.
12. We are concerned that the proposed index spread model would create significant levels of balance sheet volatility and procyclicality. We consider this an unacceptably high price to pay, given there are credible alternatives that would properly address the PRA's concerns.
13. Notwithstanding the above and with the aim to secure meaningful reform that meets HM Treasury'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.

## Risk Margin Reform

14. We agree that the Risk Margin should be reformed to deal with concerns that it is too sensitive to movements in interest rates, and too high when interest rates are low. We are pleased to see the PRA considering inclusion of a time-dependent parameter ( $\lambda$ ) – the ABI has consistently called for this to be introduced, and has previously presented evidence that it should be calibrated in the range  $\lambda = 0.8 - 0.9$  with no floor.
15. We note that the PRA concludes that  $\lambda$  should not be lower than 1 for non-life insurance risks but we are unclear about the reasons behind this or how it intends to identify precisely which risks should and should not have a  $\lambda$  lower than 1 applied. There are strong arguments for a  $\lambda$  parameter, and we consider it should apply to all insurance business.
16. We also agree with the PRA that there is a case for lowering the CoC rate to below 6%. The ABI has previously presented evidence that the calibration should be in the range CoC rate = 2% – 3%. It is noteworthy that in Europe the European Commission overrode EIOPA's proposal with a more ambitious reduction to the Risk Margin – reducing the Cost of Capital rate from 6% to 5%. The European Parliament proposes

to go even further with a reduction to the Cost of Capital, from 5% to 4%, 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 the Risk Margin.

17. However, we would note that the PRA has missed an opportunity to explore ways to fully or partially remove (demonstrably hedgeable) longevity risk from the Risk Margin calculation.

## 2. Independent Analysis of PRA proposals

### Important notice

18. The ABI commissioned WTW to produce an independent report using previously collected member QIS data as at year end 2020 (covering >75% of the UK insurance market) to analyse the impact of the PRA's DP 2/22 and data collection exercise (DCE) proposals and calibrations.
19. We set out below an ABI summary of the WTW report and also make references to this work elsewhere in our response. While we believe that the views expressed in this response are consistent with the views expressed in the WTW report, **we would emphasise that this response sets out the views of the ABI, which are not necessarily those of WTW.** 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.

### ABI summary of the independent report

20. PRA proposals would see some annuity writers with lower available capital. Proposals will not provide the types of release indicated to meet HM Treasury's Solvency II review objectives, and indeed, would see some annuity writers with lower available capital. For firms focussed on writing material volumes of bulk purchase annuity business, a 60-70% Risk Margin reduction for long-term life insurers combined with the proposed significant reduction to the MA benefit, **does not provide the 10-15% level of capital release from UK life insurers that is expected by the Government.** This is important because long-term annuity writers are the long-term investors capable of supporting the growth of the UK economy following the UK's withdrawal from the EU.
21. As HM Treasury's three key objectives for the Solvency II review interact with each other, they need not conflict with each other, if considered collectively. Objective 2 (protection of policyholders and the safety and soundness of firms), if considered standalone and narrowly, could be detrimental to the other two objectives and to the prices future policyholders pay. A narrow interpretation of "policyholder protection" does not necessarily lead to an appropriate degree of protection for policyholders; an excessive focus on prudence has cost implications that impact the prices and availability of products that future policyholders may rely on for security in retirement. PRA proposals would introduce unnecessary prudence in the MA to the detriment of best delivering Objectives 1 and 3. WTW's analysis, based on the year-end 2020 QIS data, shows that the net balance sheet effect for annuity firms of the PRA's proposals **is negative in aggregate (lower Own Funds "OF")** with the exact effects depending upon how the proposals are calibrated. This does not allow for the recent large rises in risk-free rates, which will have significantly reduced the benefit of RM changes but not significantly changed the adverse MA impact. Credit spreads have increased over this period as well, making the FS impact more severe. **As such the overall impact, in**

**conditions prevailing at the time of writing, on annuity firms' OF could be significantly worse than that shown by the QIS data.**

22. We consider below the impact of reform proposals on each of the Treasury's Solvency II review objectives:

### **Objective 1: Spur a vibrant, innovative and internationally competitive insurance sector**

23. Under the existing proposals the Government's envisaged overall 10% to 15% release of capital is unlikely to be achieved. The PRA's estimate of capital impacts makes no allowance for the offsetting effects of transitional measures on technical provisions (TMTP) which apply over a 16-year period and remain substantial (**£21.7 billion** as at year-end 2020 across firms in WTW's QIS dataset). Nor do they take into account significant changes in the macroeconomic environment that have occurred since year-end 2020. **Therefore, the 10-15% estimate of the release of capital does not apply in practice for many insurers and proposals see almost no change in OF (WTW estimates a 0.02% decrease in OF based on the QIS data as at year-end 2020) allowing for TMTP.**
24. WTW's analysis using QIS data as at year-end 2020 indicates that the reform proposals would have generally led to specialist annuity firms **requiring capital injections to restore existing levels of solvency coverage unless there was an offsetting reduction in SCR which the PRA indicates in DP2/22 is not its expectation.** This is based on an aggregate estimated **5.9% decrease in OF** for annuity specialists.

### **Objective 2: Protect policyholders and ensure the safety and soundness of firms**

25. **A significant margin (allowance for uncertainty) exists between the current Solvency II FS allowance and both historical average default losses and actual default losses experienced by insurers since the MA was introduced.** The Solvency II SCR additionally allows for significant credit capital to protect against the risk of defaults in extreme circumstances. PRA supervisory statement SS8/18 specifically expects firms to benchmark their tail transition event to the 1930s – it states the calibration of the MA used to calculate insurers' Technical Provisions ("TP") is of sufficient strength to cover the most extreme decade in historic data (the 1930s experience). The PRA indicates (Annex Paragraph 104) an expectation that the SCR will not reduce. It appears that the PRA expects insurers to withstand a 1930s style credit shock twice – once on the base balance sheet and once more in the SCR. We consider that this goes far beyond an "appropriate" level of protection for current and future policyholders, and implies a double counting of tail risk. This would put annuity business out of kilter with other business, as other lines would still be valued at best estimate with their unexpected deviations captured in the SCR.
26. Having a risk adjustment that would be sufficient to withstand the worst decade in history for transitions on the base balance sheet does not appear to be aligned to the requirements of Solvency II. It is unclear why such a prudent margin for the allowance for uncertainty is considered to be appropriate by the PRA. **The existing FS already allows for considerable uncertainty and is set at a multiple of c3 times historic default losses.** The PRA's DCE calibration would increase this multiple to circa five times based upon our sample portfolio. Increasing insurers' financial resource requirements (the total of Best Estimate Liabilities, RM and SCR capital) will increase prices and increase barriers to customers' access to the insurance sector, resulting in

less secure alternatives becoming more attractive, adversely impacting customers and the competitiveness of the insurance market.

27. The PRA's 'index spread' proposals on the FS would introduce volatility and procyclicality into the framework, increasing both the likelihood of stress events occurring, and the adverse impact on firms as a result of those events. These will have significant knock-on impacts on policyholder protection.
28. We would note that capital is just one of a raft of measures under Solvency II and beyond intended to provide protection to policyholders, such as the regulatory ladder of intervention and the strict risk management and governance requirements under Pillar 2.

### **Objective 3: Support firms to provide long-term capital to drive growth consistent with the Government's climate change and productive finance objectives**

29. Current proposals do not incentivise capital investment. **Instead, the reforms create obstacles for the insurers participating in the growing pension buyout market which provides security for millions of vulnerable UK pensioners and whose retirement income relies on a thriving insurance sector.** For insurers whose business focusses on annuities, the significant dampening of the MA benefit indicated in DP2/22 will more than offset any release offered by the Risk Margin reduction. Additional spread volatility created in the balance sheet will further act as a constraint on investment.
30. **New aspects of the MA design (the Z-term of the CRP is a prime example) are overly complex and lack detailed specification** making them challenging to implement and difficult to fully assess, particularly for private asset holdings. In particular the reference indices (which were only specified in an update to the PRA's 2022 Data Collection Exercise) do not reflect the term structure of credit spreads, and are only for £ sterling.
31. **The significant proposed changes to the MA do not align with the objective of driving growth consistent with the Government's climate change and productive finance objectives.** Additionally, proposals appear overly penal for those assets where firms might currently be rewarded by earning higher spreads than equivalently rated UK corporate bond assets. By seemingly attempting to narrow the range of MA benefit possible across the range of investments within the asset universe, the Index Spread approach artificially reduces the returns achieved on some highly secure, well-collateralised cashflow matching assets in sectors such as student accommodation, housing associations, certain types of infrastructure (including productive finance), property related / ground rent backed debt, and other private placements such as local authority and university loans. Some assets are inherently more illiquid and more costly to originate and manage, with supply and demand factors also coming into play.
32. The significant change in the capital strain of different asset classes or sub-classes will have material consequences on firms' investment approaches and allocations. If the additional risk mitigants achieved when originating the types of assets underlying this objective are no longer recognised, **firms may struggle to justify investment in key asset classes the government is targeting.**
33. Some assets have high investment management expenses (IME), which are reserved for elsewhere in the Technical Provisions, whereas public corporate bonds in the index have much lower IME. The PRA's index-spread approach cannot see IME, and

therefore mistakenly treats spread to compensate for higher IME as relating to credit risk.

### ABI's Conclusion

34. It is the ABI's view that it is detrimental to the UK economy and future policyholders to have overly prudent protection for existing policyholders (this point is also echoed in HM Treasury's consultation paper) as this will **drive up future prices and reduce the capital for UK Government climate change and productive finance objectives**. We also consider that critically, to provide an outcome closer to the Government's target of a 10% to 15% release of capital currently held by life insurers, a more balanced package of reforms is required which avoids significant change to the level and volatility of MA and results in a less polarised outcome for different types of insurers.

### 3. Reform of the Matching Adjustment

35. We welcome the PRA's comments (DP2/22 Paragraphs 12-14) that inclusion of the MA in the solvency framework is justified, and it should not be calibrated such that the level of policyholder security is excessive in relation to the risks faced by insurers in respect of their MA portfolios. We also note the strong support the PRA has expressed for the MA framework in various communications since Solvency II implementation.
36. The PRA considers (DP2/22 Paragraph 16 and PRA Rulebook Technical Provisions 2.2) 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.
37. Market consistent valuation is not appropriate when there is no active market for some assets and liabilities, especially where these carry bespoke features and risks. Further, the concept of a transfer value is both unobservable and circular. It follows that we do not accept the PRA's line of reasoning as set out above. It 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. We would also note these important points about the concept of transfer value
- a) Circularity – the presence of the Risk Margin in the regime itself affects the transfer values that would be observed, so current transfer values cannot be used to calibrate the Risk Margin or MA directly
  - b) Relevance – the transfer should be to an insurer with an MA approval who is economically able to capture risk premia via the combination of a buy-and-hold strategy and investing in fixed-income assets that benefit from the pull-to-par effect. Under those assumptions, risk premia demanded by short-term credit investors are irrelevant to the transfer value.

### The current MA design

38. The core of the ABI's position is that the current FS is fit for purpose, and more than prudent enough to account for any reasonable changes in investment decisions that

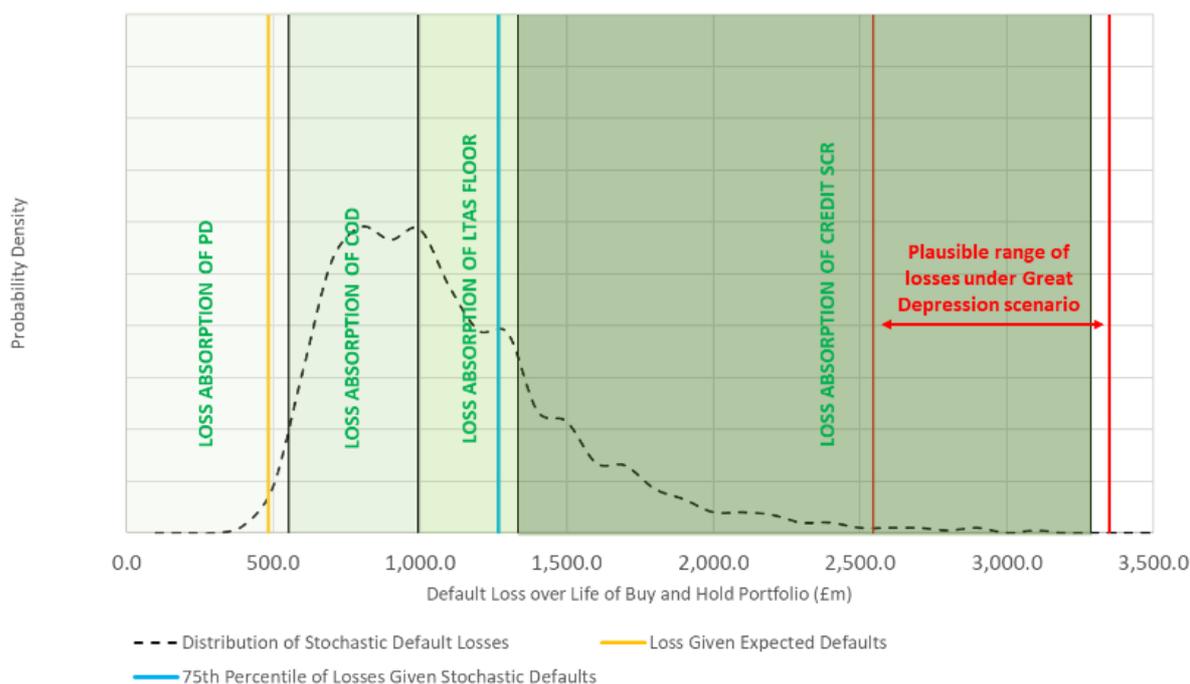
may be made by long-term insurers, and a reasonable and appropriate view of long-term uncertainty in credit risk associated with those decisions. Furthermore, and as we demonstrate later in this response, we consider that the current FS is calibrated well above the level of Expected Defaults, which implicitly provides an allowance for uncertainty, largely through the Long-Term Average Spread (LTAS) underpin.

39. No evidence has been put forward to suggest that insurers are unlikely to earn the MA benefit they claim, or that insufficient allowance for losses due to credit default and downgrade is being made. Conversely, EIOPA has set out evidence that UK insurers do not obtain undue capital benefit from their application of an MA (see “The role of the MA in financial resilience” section below). We do not consider that the Bank of England has provided credible justification for its proposals to introduce a credit risk premium into the calculation.
40. However, whilst we acknowledge PRA concerns about the sensitivity of the current FS element of the Solvency II MA framework to credit risk, and the extent to which it reflects uncertainty around defaults and downgrades, we do not agree with the PRA’s supporting rationale for change or its proposal for an “index spread” model proposed in discussion paper DP2/22. We are concerned that PRA proposals would create significant levels of balance sheet volatility and procyclicality, and would have additional negative impacts elsewhere.
41. Therefore, in this response we set out what we believe to be a compelling case that: (1) no change to the current FS methodology is needed; and (2) the ‘index spread’ model proposed by the PRA is flawed and will not allow the Government to realise its objectives for Solvency II reform. We accept that there are (inevitably) some flaws with the current approach, but we consider these flaws to be acceptable in the face of the level of prudence that is applied, and insufficiently material to warrant a complete overhaul of the approach. However, and notwithstanding the above with the aim to secure meaningful reform that meets HM Treasury’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**.

### **Prudence in the current MA design**

42. As we alluded to above, we can demonstrate using a multi-year stochastic transitions projection (calibrated to the 1930s style credit shock) that the current FS contains enough allowance to cover a substantial portion of the distribution of cumulative default losses over 20 years.
43. 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:

Expected credit losses over life of buy and hold portfolio versus loss coverage provided by the SII balance sheet



44. The losses given expected defaults (yellow line) and the 75<sup>th</sup> percentile of losses given stochastic defaults (blue line) are included for illustrative purposes. We consider that this chart 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 stronger FS would not provide any additional policyholder protection, as there are no ‘gaps’ to fill.
45. However, any such stronger 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.
46. 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”; it is not designed to cover extreme adverse events, as the 1 in 200 year SCR is also available to absorb unexpected loss (the entire area shaded in green above). This area is calculated by starting with the t=0 undiversified credit SCR as a capital buffer, which is called on to absorb losses over the run-off period of the portfolio.
47. The PRA notes (Annex Paragraph 9) that the rationale for the specific percentage (35% for non-government bonds) for the LTAS floor chosen by the European Commission is unclear. Nevertheless, we consider that this represents a very prudent floor incorporating an allowance for uncertainty above expected defaults – which we are prepared to accept as remaining within the current MA framework.
48. The PRA notes (Annex Paragraph 11) that for sub-investment grade assets there is a further addition to the FS in order to limit the MA on those assets to that achievable on

an equivalent investment grade asset. We consider this 'BBB cap' to be a weakness of the current framework and welcome proposals for its removal.

### The role of the MA in financial resilience

49. We note the PRA's comments (Annex Paragraph 16) that the calibration of the MA requires balance. It should not be calibrated such that the level of policyholder security is excessive; it should result in a competitive annuity market and incentivise firms to invest in a wide range of long-term, illiquid assets that can also provide wider economic benefits. We agree with this analysis and believe that the evidence since Solvency II implementation demonstrates that the current MA framework provides exactly these outcomes.
50. The PRA notes (Annex Paragraph 17) that an appropriate degree of policyholder protection includes the ability to transfer the business to another insurer (if necessary) immediately following a severe stress. It is important to recognise to whom the transfer is being made – insurers are not expected to hold a Risk Margin to transfer assets to a bank, but to another insurer who will be subject to the same rules.
51. We would draw the PRA's attention to EIOPA's 2019 report 'Solvency II Long-Term Guarantee (LTG) Measures and Measures on Equity Risk'. This made an assessment of the use of the MA in Europe (i.e. within the UK and Spain), and concluded the following:
  - a) National supervisors reported there were no specific cases where undue capital relief was observed for an undertaking due to the application of the broader LTG measures. Hence, we can conclude that the UK supervisor took no issue with the quantum of capital benefit arising from the use of the MA by UK firms at the time, and considered the LTG package to be appropriate for the UK.
  - b) National supervisors observed no trends in investment behaviour that could be clearly linked to the use of LTG measures. Most of the identified trends related to search-for-yield behaviour in the context of a low interest rate environment.

## 4. The Fundamental Spread – PRA concerns

52. The ABI agrees with the PRA view (Annex Paragraph 19) that the MA is not intended to cover the compensation for retained credit risk to which firms remain exposed. However, the PRA has not put forward any evidence to suggest that insurers are unlikely to earn the MA benefit they claim, or that insufficient allowance for losses due to credit default and downgrade is being made. We would note that Technical Provisions are not expected to cover all possible losses – the SCR has sufficient loss absorbency to cover stress movements, and the FS is stressed at all future points.
53. The PRA puts forward (DP2/22 Paragraph 18) its view of the sources of retained credit risk to which firms' MA assets are exposed: (i) expected loss due to default (EL); and (ii) uncertainty around that EL for which a willing arm's length third party would demand a 'credit risk premium (CRP)' for taking on the risk. We consider this to be a reasonable conceptual breakdown of the issue, akin to option pricing. **However, this does not automatically imply a need to adopt a spread-based model for calculating the FS.** Solvency II internal model firms will have distributions for transition risk which can be leveraged to measure uncertainty around credit losses directly. The key point is that annuity writers are long-term buy and hold investors and market spreads, which are strongly influenced by short-term behaviour, should not

play a role in the quantification of the FS unless they are averaged over a sufficiently long (30 years +) period.

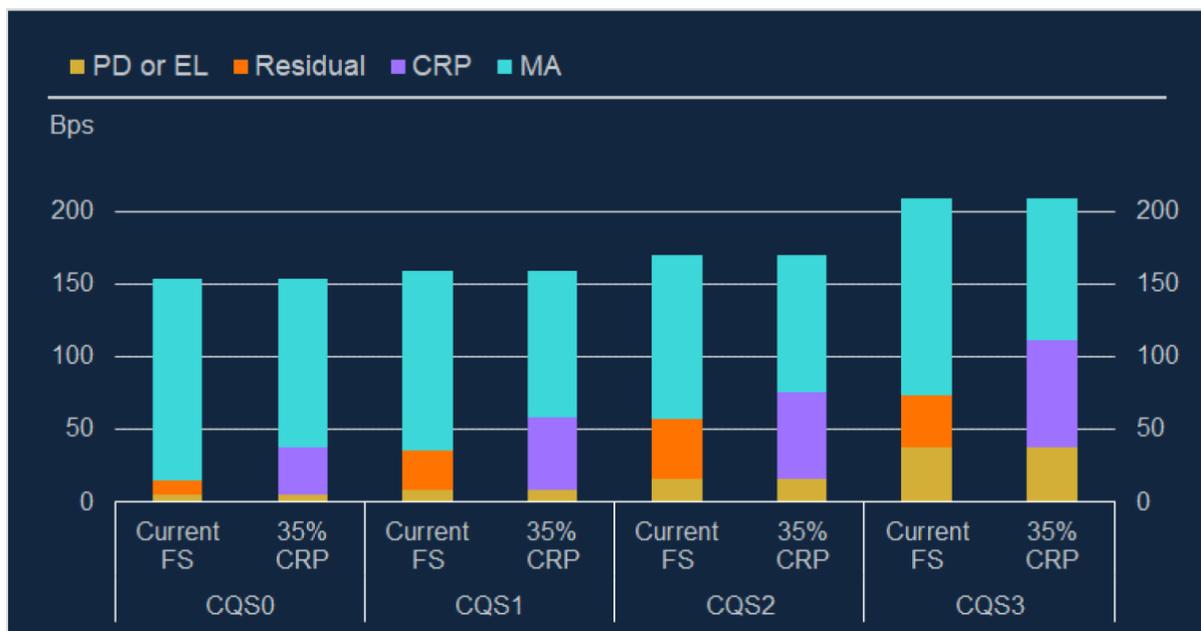
54. The PRA acknowledges that this decomposition is not observable, which leads to challenges in the quantitative measurement of an appropriate allowance for retained risk. Significant expert judgement is required to make such a measurement – the key judgement being how much compensation an informed market participant should demand for taking on the uncertainty around the default losses. We also note that long-term, buy-to-hold investors are not directly exposed to the volatility in asset pricing that the CRP captures.
55. We would reiterate that the views expressed in this section, and for the avoidance of doubt, throughout this document, are those of the ABI. 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.

### **PRA concern (1) – Level of the FS**

56. The PRA states (Annex Paragraph 23) that the FS does not capture all the retained risks which insurers face, and as such its level (in basis points) is generally too low. We do not accept this assertion, and do not consider that the PRA has provided evidence for it.
57. The PRA considers (Annex Paragraph 29) that the existing Probability of Default (PD) element of the MA design is an appropriate methodology for the calibration of the EL element of the FS. We agree with this position; the PD is very prudent given the very low recovery assumption used.
58. The PRA's proposed new CRP will replace the cost of downgrade, LTAS floor, and sub-investment grade cap components in the current methodology. The PRA considers that the CRP should incorporate a range of factors including expected and unexpected downgrades. While we accept that some allowance consistent with the strength of other base balance sheet elements is justifiable, as any market participant would want compensation for uncertainty, we believe that the unexpected element is duplicated in the SCR, leading to double-counting. This is also implied by the academic papers looking at the CRP, where the models suggest traders are seeking compensation for the risk of a market crash through the CRP. We consider that the CRP as devised by the PRA is trying to do too much, meaning that it is not possible to calibrate in a meaningful way.
59. The PRA states that the CRP is likely to change more quickly than the EL, as it is intended to signal increased uncertainty and potential concerns around future credit experience. This may be true, but we do not consider that long-term buy-to-hold investors are exposed to this volatility in asset prices. It is not clear that the increase in CRP reflects an increase in long-term expected defaults. In our view, for the MA to operate as intended, the FS should be stable over time and linked to long-term changes in underlying risk, not short-term pricing movements. This is not merely a desirable outcome, but reasonable in its own terms, because long-term life insurers are "buy-and-hold" investors. Further, the industry has built investment, ALM and business models around the expectation of such a stable framework.
60. The PRA asserts that the current Solvency II approach to the cost of downgrade based on average transitions and fixed 'RC factors' or spreads for each rating is unlikely to represent an adequate allowance for the potential loss from downgrades, taking

uncertainty into account. It also asserts that even where the LTAS floor is biting, it is not clear that this has taken the source of uncertainty into account. We do not accept these assertions, and consider that the evidence shows the opposite to be the case – the current approach does take full account of the cost of downgrade.

61. However, the PRA’s own figures (Annex Chart 2, shown below) demonstrate that under the current approach, the FS is calibrated well above the level of expected loss (EL, yellow bars) as there is a material “residual” (orange bars) above it. Industry’s view is that the combination of EL + residual already provides adequate allowance for uncertainty, and the PRA’s CRP (purple bars) represents unnecessary additional prudence and undesirable additional volatility.



62. Firms using the MA with a Solvency II Internal Model are required by the PRA to be capitalised such that they could withstand a default and downgrade event equivalent to (or even stronger than) the Great Depression of the 1930s. However, we consider that excessive protection will ultimately be to the detriment of the industry’s investment capacity as well as of consumers in terms of the price of insurance.
63. Since its establishment, the MA has performed as intended, including during the peak of the Covid-19 crisis, mainly due to its counter-cyclicality – in other words, it avoids insurers being forced into selling assets (in order to improve their solvency positions) into a falling market, at a price lower than purchased. The PRA’s proposals would introduce volatility and procyclicality into an element of the Solvency II framework precisely designed to avoid that.
64. It could be argued that had defaults over and above those covered by the FS occurred during the Covid-19 crisis, there would be greater strain on insurers’ balance sheets. However, had such defaults happened it is the role of capital buffers and *in extremis* the SCR to absorb the losses, not the FS. Even in the actual scenario, if an insurer were to transfer the business, the SCR can cover some of the cost of transfer as it would not be expected to fund both the technical provisions and the SCR of the purchasing firm.

## Evidence from independent academic research

65. The PRA has carried out a review of academic literature that uses data relevant to the UK life insurance market and identified a plausible range in which the FS could fall. While it recognises (Annex Paragraph 37) there is no 'definitive' academic work, these studies suggest a CRP calibrated at between 35% and 55% of the credit spread to be an appropriate allowance for uncertainty around expected loss for corporate bond assets.
66. However, the PRA has decided (Annex Paragraph 40) not to accept the analyses contained in academic papers to which its attention has been drawn that do not support its proposed CRP calibration. Some of these support the argument that corporate bond markets can be subject to over-reaction, leading to short-term volatility in spreads that are not reflective of credit fundamentals.
67. The PRA has also looked at evidence (Annex Paragraph 43) from the credit default swap (CDS) market, which suggests that the cost of purchasing credit protection contains a sizeable risk premium, which can vary from 1 to 10 times the size of the expected loss. The PRA believes that a CRP calibrated at 35% of spreads equates to c2-3 times the size of the expected loss and is therefore consistent with the CDS market. However, note that we believe that a CRP calibrated at 35% of spreads is closer to c5 times the size of the expected loss – this point is considered in WTW's independent report.
68. We are not comfortable with the PRA's analysis above. CDSs are traded instruments; however, the CDS market is not deep and liquid, with no significant volumes outside the 5-year tenor, so any conclusions need to be treated with great care. CDSs contain illiquidity and mark-to-market volatility risk premia; the presence of these risk premia confounds any attempt to use CDS pricing to inform the FS. Since CDS prices overstate buy-to-hold credit risk, benchmarking the CRP to CDS prices will also overstate retained credit risk, so the comparison is self-defeating. We would also note that the span of outcomes from 1 to 10 times the size of the expected loss should be an indicator that this is not a very useful reference point – with such a wide range in CDS, the pricing does not seem to be driven by the level of EL.
69. WTW's independent view as outlined in its report analysing the impact of PRA proposals using member QIS data as at year end 2020 highlights the much wider body of research in this area which has so far failed to reach a consensus on linking future defaults to spreads and using current spread levels to quantify future expected losses. The report goes on to state that the papers the PRA has selected represent only a small proportion of the total research done and are predominantly based on U.S. markets, analysing only corporate bonds and employing structural models which are typically used for the purposes of pricing rather than to establish a prudent level of real world credit losses for a buy and hold investor. It adds that the PRA does not set out why the chosen papers are representative of the long-term risk associated with default and downgrades and therefore should be used as the basis on which the FS is determined. It concluded that it may therefore not be appropriate to draw conclusions directly from the PRA's selected academic papers.
70. We would also observe that if the same academic analyses were repeated on more recent data, they might suggest a different CRP to be relevant today. This is demonstrated in one of the academic papers referenced, which suggests a lower CRP for AAA, AA and A rated assets. This raises questions about the stability of the PRA's

proposed regime – if the CRP itself is so volatile that it will require frequent recalibration, then this will have adverse financial stability implications.

### **Validation based on historical credit losses**

71. The PRA states (Annex Paragraph 44) that historical credit loss data cannot be used to estimate the CRP, as (among other reasons) this data ignores downgrades that increase credit risk on a forward-looking basis but do not lead to increased defaults. Hence a comparison with historic data is not intended to derive the CRP, but rather to assess the extent to which credit losses sustained by a firm during a credit crisis would be covered by the FS. This appears to be double counting of capital in both the FS and the SCR. Further, the academic papers the PRA relies on to determine an appropriate range for the CRP rely on historical credit loss data to calibrate this CRP, which appears to contradict the PRA's statement at the top of this paragraph.
72. The PRA notes (Annex Paragraph 46) that the variation in historic defaults has previously been dampened by actions taken by central banks, governments and others, and the CRP would need to reflect uncertainty around the extent to which those actors would be willing and able to absorb losses that would otherwise have resulted in increased realised defaults. However, insurers are not taking data and then adjusting it for the possibility of Government intervention. The capital they hold refers back to a credit event (the 1930s without Government intervention) which is prudent by modern standards, and this distorts the distribution of losses. This covers up to the 80th percentile of credit experience, and the SCR covers the rest, so overall the amount of capital does not assume Government intervention.
73. The PRA considers (Annex Paragraph 47) the 1930s default and downgrade experience, relatively undistorted by significant government action, to be the most useful reference point available. We would argue that if the SCR is to be calibrated to the 1930s experience, the base balance sheet should not be at the same level of confidence, and still less double counted against the SCR. Further, we would challenge whether the 1930s experience (almost a century ago, in a very different, pre-war world, with relatively limited data, a much more limited set of asset classes, an equity market that was much more concentrated by sector, geography and company, a bond market in its infancy, a much less diverse global debt market, very different insurance sector composition, and much weaker regulation and risk management) genuinely remains an appropriate reference point for the setting of a modern FS (the PRA itself acknowledges that the 1930s experience may no longer be relevant to today's market conditions in footnote 12 on page 18 of the Annex). The PRA estimates that a FS calculated using a CRP of 35% to 55% of the credit spread gives a credible coverage of the 1930s experience.
74. The PRA notes (Annex Paragraph 49) that the FS is expressly not designed to cover a particular percentile of credit loss (although it has made references to the need to cover the 99.5th percentile of loss). We agree that it is instead intended to be used in the calculation of an appropriate discount rate for eligible liabilities.
75. In conclusion, we consider that there is no historical credit loss evidence to suggest that the current FS framework, which covers up to the 80th percentile of credit experience (with the SCR covering the remainder) is inadequate.

## Impact of the CRP and its calibration on the level of the FS

76. The PRA states (Annex Paragraph 53) that *“it is clearly the case that the larger the MA on any given portfolio of assets, the greater the risk that sufficient future investment returns equal to the size of the MA are not achieved”*. We do not accept that this statement is relevant in terms of the objective of calibrating an appropriate level of FS. Instead, we would argue that the risk of the MA not being earned is entirely a function of the correctness of the calibration of the FS, and the mapping from asset to FS.
77. The PRA has framed its view of the CRP calibration (Annex Paragraph 54) as a percentage of the asset spread, rather than as an absolute level of basis points in its own right. However, we consider this to be a mistake. The FS should be calculated based on the risks retained by a buy-and-hold investor, which are not the same as the risks compensated for by credit spreads, or the spot spreads associated with a particular asset class, or the spreads observed in a “relevant” index.
78. We note that from Chart 2 that the MA will reduce significantly across all CQSs from its current level if an approach using a CRP calibrated based on 35% of spreads is introduced. We do not consider that the PRA has demonstrated that such across the board reductions in the MA are justified. In particular, we would note that the current FS is likely overestimating the risk on AAA, AA and A-rated assets.

## PRA concern (2) – Risk sensitivity of the FS to differences across asset classes

79. The PRA states (Annex Paragraph 23) that the FS is not sensitive to differences in risks across asset classes for a given currency, sector and CQS. It believes that this incentivises firms to hold high spread-for rating assets, as credit is taken upfront in the form of the MA for all of the excess spread, so creating Tier 1 capital. However, the PRA has provided no evidence that firms do this to an inappropriate extent, given that they are subject to regulations such as the Prudent Person Principle (PPP), internal issuer level risk analysis, etc. There are good reasons why assets would have the same ratings but different spreads, and firms should not be penalised for seeking better value for money on their investments – for example, assets from the same counterparty listed on different exchanges.
80. The PRA’s own chart (shown below) from Charlotte Gerken’s 14 June speech *‘Competitiveness and productive investment: What parts do they play in the reform of insurance regulation?’* demonstrates that UK insurers do not chase high spreads at the expense of prudence. The majority of assets in MA portfolios do not generate high levels of MA – insurers hold significant amounts of sovereign assets for risk management purposes, which generate little to no MA.

**Chart 1: Assets held in firms' MA portfolios at year-end 2020 (£ billion)**



Source: PRA analysis of MA Asset & Liability Data submissions by firms as at YE20<sup>1</sup>

81. We acknowledge that there is a lack of granularity in the current CQS framework; however, we do not accept that this issue should be seen as a major weakness – the FS as currently calibrated works as intended. In trying to find common ground with the PRA, we have proposed a solution to address this concern (the “notching” approach, see Section 6.2.1 below). However, the PRA has dismissed this proposal (Annex Paragraph 108), arguing that it does not go far enough in allowing for uncertainty around credit risk, and discards up-to-date signals in market spread data.
82. The PRA notes (Annex Paragraphs 4 and 57) that since the implementation of Solvency II, insurers' MA portfolios have included an increasingly diverse range of assets, including high-yielding and illiquid assets such as student accommodation, housing associations, certain types of infrastructure (including productive finance), property related / ground rent backed debt, and other private placements such as local authority and university loans. These are precisely the kind of investments in which the Government wants UK insurers to invest, and for which it has established one of its 3 key objectives for the Solvency II review.
83. However, we are concerned that comments from the PRA in DP2/22 and elsewhere give the impression that the PRA considers such investments to be inappropriate for long-term insurers. Examples include:
  - a) The PRA states (Annex Paragraph 58) that for more “idiosyncratic” assets, there is a greater risk that the MA calibration does not appropriately capture the inherent credit risk. 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, especially when additional credit mitigants on illiquid assets are taken into account relative to the unsecured liquid credit underlying the FS. We consider that rating agencies are able to effectively rate a wide range of assets, so that the FS, which is dictated by rating, is appropriate. It is our view that the current FS already provides an excess of prudence, and further adjustments should not be required.

- b) A 26 May 2022 speech from the PRA '*Creating the conditions for long-term sustainable growth in the life annuity sector*' included the observation that as MA portfolios become more diverse, a question arises as to whether the assets would be acceptable to a third party as funding as part of any transfer. There is an implicit suggestion here that more complex and less liquid assets may have less appeal to a third party than more traditional gilts and bonds. However, other annuity providers could be comfortable with acquiring a wider range of assets, as they are comfortable that the firm that owns them has been meeting the robust regulatory requirements for backing annuity liabilities in the UK. Further, instead of charging capital for this risk – with all its negative consequences – the PRA could mitigate this risk to policyholders by being clearer about the MA eligibility of assets. It's not that insurers do not want to take assets *in-specie*, it's that they do not want an MA ineligible asset.

84. We consider that the PRA's proposed 'index spread' approach would limit the industry's capacity to allocate long-term capital to illiquids to underpin growth, in line with Government objectives. We have the following concerns:
- a) If the MA is reduced such that it is lower than the cost of capital required to hold that asset, insurers will have less incentive to absorb the opportunity costs of giving up liquidity, and their appetite for illiquid assets may reduce – even though such assets will continue to offer attractive yields.
  - b) Further, the proposals will add considerable extra complexity and cost, as well as operational risk and model risk. This is an area that would require further consideration as there are not comparable reference indices for all asset types, i.e. the illiquid assets the government would like to boost investment. Further, 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 costs 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. Firms that have spent significant sums of money on Solvency II Internal Models based on credit ratings will now have to reflect this change in their models. This will also take supervisory time to approve and work through.
85. 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) some extremely prudent treatments for how illiquid assets should be treated in stress – these go beyond the requirements of the PRA Rulebook and the onshored Solvency II Directive.
86. 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. There are robust assurance processes in place, including external credit assessment institutions (ECAI) validation of internal ratings, the existence of credit risk teams, and the high level of supervisory scrutiny. We consider that credit rating information is best placed to determine an appropriate FS.

87. Irrelevant information only impacting on short-term market prices should be absent from the calculation as it does not impact the ability of a buy-to-hold investor to back long-term liabilities. Prices are mostly driven by participants holding credit trading books who are exposed to the risk of spreads changing, and so spreads contain a risk premium for future changes in spreads. This will be inherently more volatile than the risk premium for long term default risk.
88. The PRA introduces (Annex Paragraph 58) a concept of “MA efficiency” – the level of MA generated for a given credit rating. It notes in Chart 3 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/reward profile of such assets. We do not agree that this conclusion necessarily follows – differences in “MA efficiency” (or liquidity), differences in IME levels, and differences in supply/demand dynamics that are unrelated to credit risk are to be expected for different assets classes contained within wide ranging CQS buckets.
89. Chart 4 shows a wide dispersion in spreads across assets in ratings bucket CQS 3; Chart 5 shows a similar wide dispersion in spreads across ratings buckets CQS 0-6. Again, this is to be expected given the wide ranges of the CQS buckets, and the differences in liquidity, funding and term features of the different assets and asset classes within those buckets. If the PRA 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’ (see Section 6.2.1 below).
90. The PRA states (Annex Paragraph 62) that there is a question as to whether a transferee firm would take ‘bespoke exposures’ on their existing valuation without a material delay in order to conduct the necessary due diligence. While this may be true in certain circumstances, we do not consider this to be a compelling argument for an increase in the FS.
91. The PRA also states (Annex Paragraph 63) that any delay in realising the value of collateral diminishes the certainty that can be attributed to the resulting MA – hence collateral cannot be used to justify a lower FS. We consider that the PRA is unduly concerned with this point about speed of recovery – collateral can only increase the probability of being able to meet policyholder liabilities in extreme adverse scenarios. Firms manage their MA portfolios at portfolio level, not asset level. So as long as they have enough liquid resources to cover a reasonable level of missing cash flow from assets in default, there is no issue with waiting to receive the recovery. The existing FS is sufficiently prudent to cover this timing risk on collateral enforcement.
92. The PRA believes (Annex Paragraphs 64-65) that private lending presents additional challenges for firms in terms of both asset valuation and the identification and monitoring of risks. We welcome the PRA’s acknowledgement of the work insurers have done to develop and maintain specific expertise in these areas.
93. The PRA notes (Annex Paragraph 67) that in just under 1% of cases by market value, the MA benefit (£) exceeds the market value of the asset, raising the potential concern that the MA may be inappropriately generous at longer durations. While we acknowledge that the optics of this may be unfortunate, it is not justifiable to use this

as an argument that the MA is simply “too big”. It is perfectly possible for this situation to arise on long-dated assets, and not intrinsically unreasonable. We would also note that the SCR is dwarfed by the total size of best estimate liabilities, but this should not be used as an argument that the SCR is “too small”.

94. The MA is related to the expected cash flows expected from an asset over its lifetime, not its market value. If a credit risky asset can be shown to provide a certain return over risk-free, and if the insurer can demonstrate that it has made appropriate allowance for credit default and downgrade, then it should be able to take the appropriate level of MA – regardless of how that compares with the spot price of the asset. We would also note that MA portfolios contain significant quantities of gilts and low-risk assets, some of which have negative MA benefit, but which are included for matching, diversification or PPP reasons.
95. The PRA has previously used false equivalence arguments to emphasise the size of the MA – for example, by pointing out the comparative level of the aggregate UK MA benefit and the SCR. This is not a meaningful comparison – the MA and the SCR are entirely different elements of the Solvency II balance sheet, performing entirely different functions.
96. The PRA states (Annex Paragraph 68) that it needs to consider whether any further adjustments are needed to reflect idiosyncratic risks in respect of non-corporate bond assets. We consider that the current FS is already sufficiently prudent. The PRA’s proposed calibration of the FS to a level equivalent to 35% of current spreads would provide an excess of prudence and is not required.

### **PRA concern (3) – Risk sensitivity of the FS to structural shifts in credit conditions**

97. The PRA states (Annex Paragraph 23) that the FS does not adjust to reflect structural shifts in the credit environment over time, unless there are actual defaults or downgrades. This is correct – but this is an intentional part of its design, not a problem to be solved.
98. Chart 6 shows the FS as currently formulated is highly risk insensitive to any change in credit spreads over time, including during the financial crisis of 2008 and the Covid-19 pandemic of 2020. It was precisely this risk insensitivity that allowed insurers to ride out the latter of these two spread spikes, and not be forced into procyclical fire sales of assets into a falling market – with all the financial stability implications of that course of action.
99. The FS was never intended to reflect spot spreads – Recital (31) of the Omnibus II Directive states that firms should be allowed to “*avoid changes of asset spreads from impacting on the amount of Own Funds*”.
100. The PRA considers (Annex Paragraph 70) that ratings downgrades and widening credit spreads are both potential indicators of changes in the level of, and uncertainty around, future credit losses. However, it has not demonstrated that spread movements are a better lead indicator of credit default than credit ratings and the current CQS framework. It is not reasonable to assume that structural shifts in the credit environment will be ignored by credit rating agencies and although they may lag to a certain extent, these lags are temporary and very brief in the context of multi-decade liabilities. There is a very heavy price to be paid (in volatility and pro-

cyclicality) for linking the framework to spreads, which are very reactive, prone to fear/greed dynamics, and are reflective of risks simply not faced by annuity writers.

101. The PRA states (Annex Paragraph 72) that ignoring risk signals in current spreads is equivalent to taking an over-optimistic view that low default experiences of the immediate past will continue into the future, and any future credit market deterioration will be mitigated by the actions of public authorities. We do not accept this analysis. As already pointed out, there is already a significant allowance for uncertainty around future credit risk experience within the existing framework, and any deterioration will be reflected in revised credit ratings. We do not consider that the case has been made for incorporating a CRP as the PRA intends.
102. The PRA has acknowledged (Annex Paragraph 73) that its proposals will require significant smoothing in order to minimise undue volatility and filter out noise as much as possible. The ABI view is that the most sensible approach is to maintain the current level of smoothing provided by the LTAS, rather than unnecessarily introducing credit spread as a further risk indicator.

## **5. The Fundamental Spread – PRA proposals**

### **Proposed FS / MA design and implementation considerations**

103. From the discussion paper (Annex Paragraph 74):
  - a) The PRA considers that the FS should increase from its current level in order to reflect uncertainty in respect of expected future default losses. We do not accept this analysis. As already pointed out, there is already a significant allowance for uncertainty around future credit risk experience within the existing framework, arising implicitly from the COD and LTAS floor rather than being explicitly identified.
  - b) The PRA considers that the FS should capture 'basis risk' reflecting that there are differences in risk between assets of the same rating, and that this can in part be informed by the size of the spread on assets. However, basis risk is offset by collateral, and secured assets should attract a lower capital charge, not a higher one. To obtain greater sensitivity, the most appropriate solution would be to make the CQS framework more granular by the introduction of 'notching'.
  - c) The PRA considers that the FS should be more sensitive to structural changes in credit conditions but should not introduce excessive volatility on to the balance sheet. We welcome the PRA's acknowledgement (Annex Paragraph 76) that the QIS parameters introduced an unacceptable degree of volatility into the Solvency II balance sheet. We remain of the view that the most sensible approach is simply not to introduce such volatility in the first place, by not unnecessarily introducing credit spreads into the FS calculation.
104. The PRA notes (Annex Paragraph 75) that investment behaviour incentives need to be considered in the design of the FS and MA. We agree wholeheartedly. However, we consider that the PRA's 'index spread' approach will not permit the Government to achieve its objective of supporting insurance firms to provide long-term capital to underpin growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the Government's climate change objectives.

105. We support the PRA's intention (Annex Paragraph 78) not to introduce an explicit Valuation Uncertainty (VU) adjustment into the design of the FS, as this adds undue complexity to the design and has the potential to disincentivise investment in high-quality illiquid assets.

### **Potential formulations of the CRP – the 'index spread' approach**

106. We note the PRA's proposed definition of the CRP (Annex Paragraph 83):

$$\text{CRP} = X * (\text{average spread of reference index over n-years}) + Z * (\text{difference between spread of asset and that of the same reference index})$$

107. The parameters X, Z and n would be calibrated to achieve an allowance equivalent to a minimum of 35% of spreads through the cycle. However, we reiterate our view that the PRA has not justified the need for the inclusion of the CRP in the FS calculation, and also failed to justify why a 35% calibration would be appropriate.
108. If the PRA's proposed 'index-spread' framework were to be implemented as policy, it would represent a fundamental shift in the view of risk, away from ratings towards asset spreads and indexes. This would have major impacts both on firms and the PRA:
- a) Firms would need to reconsider their investment strategies, asset-liability management and other areas of risk management, pricing, and many other areas of the financial management of their businesses.
  - b) There will then necessarily be approvals required from the PRA for MA applications and major model changes (it is hard to see how a change of this nature could not be treated as a major model change for firms with Solvency II Internal Models for credit risk). These would require significant resource and time from any firm seeking such approvals, and also from the PRA. It is unclear if this situation has been fully considered or how it would be addressed – the PRA will need to resource itself to cover a wave of simultaneous applications from firms, in the same way (and to a similar scale) as it did at the outset of Solvency II.
  - c) The PRA would also need to develop (or at the very least review) the Solvency II standard formula treatment of the FS, and some of its Supervisory Statements (for example SS3/17, SS7/18 and SS8/18). These changes would need to be in place prior to firms considering the major model changes that would be necessary.
109. The PRA has not demonstrated that the CRP is a risk to which firms are exposed. It relies on a transfer value argument to justify the CRP, but insurers are not currently required to hold a transfer value after a 1 in 200 year event, and do not need to reflect a transfer value to a non-insurer. The PRA's argument is circular – if it forces insurers to recognise the CRP, then firms will charge for the CRP in the transfer. The uncertainty of defaults is otherwise reflected in the FS.
110. Put simply, these proposals are not a modest evolution of the existing regime, but fundamental changes to a very significant part of the original Solvency II framework. It is therefore unsurprising that the impact would be very substantial indeed, both to firms and to the PRA.

## Considerations for 'X'

111. The PRA notes (Annex Paragraph 85) that the X term is similar to one of the QIS components and is intended primarily to address the concern that the level of the current FS is too low as it does not take account of uncertainty around future expected default losses – a conclusion we do not accept. The X term is intended to respond if there is a structural shift in credit conditions, although a cap and floor will be applied to constrain this term during times of extreme spread levels.

## Considerations for the choice of reference index

112. The choice of reference index is a key determinant of the size of the FS using the PRA's 'index spread' approach. We note the PRA's suggestion (Annex Paragraph 90) that current corporate bond indices could be used as reference indices, given they already underlie the FS calibration, and given that they have the advantage of simplicity and clarity. However, we would also note that there is little choice about this – there are no illiquid bond indices.
113. We therefore consider that this absence of appropriate reference indices makes the PRA's proposed CRP approach unviable. We would question whether any indices exist that would be appropriate for the more complex, illiquid assets that already form a significant proportion of MA portfolios, and the additional asset classes that need to be introduced to meet Government objectives for insurers to invest in long-term productive finance. It is difficult to see how there could be public reference indices on privately held assets.
114. The only practical choice would be to use corporate bond indices, but this will lead to significant differences that (1) should not be assumed to be credit risk without evidence; and (2) will lead to significant noise on illiquids given that the basis between illiquids and liquids can move for all manner of reasons (for example, corporate QE, issuance patterns, supply and demand factors, etc). We would also note that until now there has been no consideration of the term structure which should be incorporated into the indices, no consideration of currency variation, and no allowance for sectoral differences below the level of financial and non-financial. The QIS and DCE exercises both had very simplified index values, and a number of important considerations were ignored.
115. Lastly, we would also note that the index return on corporate bonds could be expected to be structurally lower than that on illiquid assets, so using a corporate bond index return could unfairly penalise higher spread assets.

## Considerations for the averaging period 'n'

116. As the PRA notes (Annex Paragraph 79) 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.
117. We also agree that (as pointed out in Annex Paragraph 94) a shorter (1-year) averaging period is more prone to pick up "noise" rather than "signal", and could result in excessive balance sheet volatility. We believe that this problem would be further exacerbated by any averaging period shorter than 1 year, up to and including the logical end point, which is a reliance on current spreads.

118. We believe that it is necessary to average over a number of credit cycles, in order to obtain a reasonable long-term average. While 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. The independent WTW report submitted alongside this document considers different averaging periods, which show that 20 years is the point at which it stabilises significantly. For these reasons, the ABI does not consider the PRA's proposed value of 5 years to be useful or appropriate. Five years is also similar to business planning time horizons, increasing the risk of pro-cyclical behaviour as firms seek to manage results over this horizon.
119. 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 (Annex Chart 7) 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 on insurers' balance sheets at this point, and potentially harming the economy during what should have been 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.
120. 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. If the averaging period is too short, then this reduces the benefit of diversification, as the FS on all assets would move in a similar way.

### **Considerations for 'Z'**

121. The PRA notes (Annex Paragraph 85) that the Z term is intended primarily to address the concern that the current regime overly incentivises investments in assets with high spreads for a given rating. It is intended to remain stable unless the idiosyncratic risks on a specific asset move differently to an appropriate reference index. However – we do not consider the Z term to be an appropriate element of the FS framework for a number of reasons – chief among these being the additional volatility and procyclicality it will introduce, and the lack of suitable reference indices to use in its calculation.
122. The PRA also notes (Annex Paragraph 95) that Chart 8 is based on the assumption that the Z term of the CRP is stable over time, and it would welcome input from industry as to what extent this assumption is reasonable in practice. We are unconvinced by this assumption. The proportion of spread attributable to illiquidity must move over time as liquidity in the market changes – this is obvious from first principles. As liquidity changes the proportion of spread attributable to illiquidity must change (unless all of the other elements change at exactly the same rate). Therefore, any stable calibration of Z is impossible.
123. We would note that the use of spot spreads will inevitably introduce unwarranted volatility into the framework, where asset values do not move in line with the index, setting a restriction on how stable the Z term will be over time. It makes little sense for the FS on an illiquid asset to move simply because the corporate bond index has moved. Further, the difficulty of finding appropriate reference indices (as set out above) will introduce additional uncertainty into the Z term.
124. The PRA notes (Annex Paragraph 96) that the Z term of the CRP would largely cancel out for an investor in the constituents of the reference index. This assumes that the

index is representative of the universe of potential investments, which it would not be if it is based on credit spreads. We would note that this would stifle innovation and create a risk of ‘herding’ – firms may be incentivised to invest in the index in order to keep the Z term close to zero and stable. This perverse incentive would lead to a reduction in diversification and increased annuity prices.

## 6. The Fundamental Spread – Other considerations

### The SCR

125. The PRA considers (Annex Paragraph 102) that the 1930s credit default experience can be a useful historic reference point when assessing the appropriateness of any SCR calibration for the FS in stress. It appears that the PRA expects insurers to withstand a 1930s style credit shock twice – once on the base balance sheet and once more in the SCR. We consider that this goes far beyond an “appropriate” level of protection for current and future policyholders.
126. The PRA is correct (Annex Paragraph 103) that the methodology and calibration used to determine the SCR will need to be revisited if any change is made to the FS design.
127. The PRA’s position is that the base FS and the FS assumed in stress must be considered in terms of whether they are each meeting their own objectives – we agree. They two serve different functions – the base FS is used to value liabilities, the stressed FS is used in the calculation of the SCR. However, the following should be noted:
  - a) The PRA’s preferred method for calculating the stressed FS, as set out in supervisory statement SS8/18, is highly complex, and a strong candidate for streamlining.
  - b) The fact that the PRA did not consider the SCR impact of its proposals as part of last year’s QIS exercise, and has still not properly addressed the impact in DP2/22, is a major weakness in its approach. Before any reform of the current approach to the calculation of the FS is proposed, it is essential that the impact on the SCR is properly considered.
  - c) We do not accept the PRA’s expectation (Annex Paragraph 104) that its proposals will not necessarily lead to a material change in the level of SCR held by firms – we do not consider that sufficient analysis has been performed to date to make such a determination. The FS is a key part of the risk profile of annuity writers. Making major changes to it is bound to have a substantial effect on the design and calibration of Solvency II internal models. We would question whether the PRA is adequately resourced to deal with multiple simultaneous Internal Model change applications that are positively required by the regulations or by firms’ own internal model change policies. The PRA also needs to consider refreshing its guidance in (for example) supervisory statement SS8/18, and what changes it would need to make to the standard formula SCR under the new framework. It should be noted that there will be significant time and effort required by industry to amend Solvency II Internal Models to reflect the new FS; this will distract management from managing real risk exposures.
128. To eliminate the double counting between the base and SCR, it might be appropriate for any increase in the FS to reduce the SCR, as more of the risk which was being covered by the SCR is being covered by the FS. Similarly, if the FS were to increase

as spreads widened, this could cause the SCR to fall as spreads widened – this is not something that is necessarily a feature of Internal Models currently.

### **Other possible changes suggested to the FS design**

129. As we alluded to earlier in our response, we have demonstrated a willingness to discuss credible alternative methodologies that do not have the downsides of the PRA's proposed index spread model, which HM Treasury could consider for implementation. We remain willing to continue this dialogue on options. We have already communicated some of these alternatives, such as the use of rating modifiers (notching) to address the regulator's concerns around FS risk sensitivity, and the merits of a greater reliance on Pillar 2 of Solvency II and using a firm's own view of risk. We reiterate some of these options below. We remain open and would welcome the opportunity to discuss alternative approaches even further as we are currently actively formulating an option to include in the FS an explicit recognition of the current implicit allowance for unexpected defaults.

### **Use of rating modifiers ('notches')**

130. Calibrating Fundamental Spreads at (notched) rating rather than CQS level would improve the risk-sensitivity. The decision to group ratings into CQS bands represents a trade-off between model simplicity and accuracy. Therefore, any adjustment to the FS regime which attempts to correct for this trade-off indirectly will be less accurate than changing the granularity of the calibration.
131. However, to address PRA concerns around the lack of granularity in the current FS framework, HM Treasury could consider specifying the FS at the level of notches or small letter ratings (not rating bands) to better reflect the risk information inherent at this level. This would provide the framework with greater sensitivity, and more appropriately recognise the risk characteristics of individual assets.
132. This should be relatively straightforward to implement, although it will not be cost-free – there will be some work in redesigning models and data systems. As the PRA points out (Annex Paragraph 107), there will be a material increase in the number of FS tables that are published on a monthly basis. However, the approach will improve risk-sensitivity, promoting good risk management.
133. We consider that such an approach has the following advantages:
- a) The proposal is for the change to act symmetrically such that minus ratings would experience an uplift in FS but plus ratings would experience a decrease in FS. The overall change in FS would therefore depend on the specifics of each firm's portfolio.
  - b) While the PRA has expressed its concern that the FS is too low in all circumstances, we believe the proposal would at least partially mitigate, as lower rated assets within a rating band will see an increase in FS. We consider this explicit link to the risk profile of the asset is more justifiable than a blanket increase to the FS.
  - c) This proposal improves the risk-sensitivity of the FS both between assets with different notches of rating in the same large letter category, and to notch movements in ratings over time.

- d) We propose this would apply to internally rated assets as well as externally ECAI rated assets. This may require some firms to develop internal rating methodologies to set notch level ratings. We see this as a reasonable risk management improvement that would be required under the revised framework.
- e) The PRA acknowledges (Annex Paragraph 108) that this approach does go some way to mitigating the issues around the FS risk sensitivity and its overall level. Furthermore, whilst the PRA suggests that this approach would create added operational complexity by creating a need to publish more granular rating tables, we are of the view that this complexity would be far less onerous than the additional costs and complexity introduced by the PRA's index spread model – and more importantly, **it would not make the inappropriate allowance for risk that we would expect to see from the index spread model.** It should also be noted that the WTW report considers a simple approach of interpolating the current full-letter FS to include + and - notched assets; to aid simplicity, the PRA also has the option to specify that firms take a similar approach. It would then only need to publish the same tables as currently.

134. We consider that this approach would have the following impact:

- a) The proposal will increase the volatility of firms' capital positions, but in reaction to rating agency activity and genuine changes in long-term risk (for example, a downgrade or upgrade) rather than short-term changes in market sentiment or risk premiums driven by those market participants who actively trade bonds.
- b) By reacting only to changes in long-term default risk as expressed via ratings, rather than short-term changes in market sentiment expressed via spreads, the proposal better supports the Government's objective to allow insurers to provide long-term investment capital to support growth.

135. The PRA states (Annex Paragraph 100) that its proposed Z term in the CRP would automatically pick up basis risk arising from concentrations in particular notches within a credit rating, and hence more granular FS tables may not be necessary. We would note that having the Z term capture notches (in addition to other factors) does not make it a desirable element, and also makes its calibration that much harder. But, as pointed out above, the Z term would introduce irrelevant aspects and greater volatility into the MA framework, which the introduction of notching would not. Notching goes directly to the risks that matter for long-term investors.

### **Greater reliance on firms' own view of risk and solvency assessment**

136. Pillar 2 of Solvency II introduced some key protections around risk management and governance (such as the ORSA), which industry considers are working as intended and should be maintained. As the PRA points out (Annex Paragraph 116), risk management systems are already in place to pick up various credit risk signals that go beyond the credit rating.

137. The PRA states (Annex Paragraph 118) that it is unwise for the regulatory framework to place reliance on the successful operation of Pillar 2 measures across firms to address material deficiencies in the Pillar 1 requirements. We agree that Pillar 2 has been a successful aspect of Solvency II, which exists precisely because it is not possible to solve every problem in a quantitative way. Pillars 1 and 2 of Solvency II should operate in a complementary way, and are not intended to offset weaknesses in each other. Where we differ with the PRA is in its (in our view, incorrect) assertion that

there are deficiencies in the current FS design that require a solely spread based Pillar 1 solution such as the index spread model. We would also note that the PRA appears to be going against its own principle, by seeking to put an allowance into Pillar 1 (a stronger FS) to account for perceived deficiencies in Pillar 2 (the robustness of internal ratings).

## 7. Reform of the Risk Margin

138. We agree with the PRA's statement (DP2/22 Paragraph 30) that the Risk Margin should be reformed to deal with concerns that it is too sensitive to movements in interest rates, and too high when interest rates are low. We would also note that the current Risk Margin framework has demonstrated that it is not fit for purpose for long-term business typical in the UK, such as annuity business.
139. We are pleased to see the PRA considering (Annex Paragraph 33) inclusion of a time-dependent parameter ( $\lambda$ ) – the ABI has consistently called for this to be introduced, and has previously presented evidence that it should be calibrated in the range  $\lambda = 0.8 - 0.9$  with no floor.
140. We note that the PRA concludes (DP2/22 Paragraph 34) 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.
141. We note the PRA's statement (DP2/22 Paragraph 35) that there is a case for lowering the CoC rate from its current level of 6%. We agree – the ABI has previously presented evidence that the calibration should be in the range CoC rate = 2% – 3%.
142. It is noteworthy that in Europe, the European Commission overrode EIOPA's proposal with a more ambitious reduction to the Risk Margin – reducing the Cost of Capital rate from 6% to 5%. The European Parliament is proposing a further reduction to the Cost of Capital, 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 Risk Margin reduction.

## 8. Validating reform packages against observed transfer values for long-term business

143. The PRA correctly notes (DP2/22 Paragraph 39) that transfers of insurance business are relatively infrequent, and their pricing reflects many idiosyncratic factors. Hence, we would point out that such data may not be of value in calibrating the level of Technical Provisions. We would also reiterate the issue of circularity – the presence of the Risk Margin in the regime itself affects the transfer values that would be observed, so current transfer values cannot be used to calibrate the Risk Margin or MA directly.
144. Nevertheless, we agree that prices in the active market for transferring longevity risk suggest that the current Risk Margin is too high, particularly for annuity business – a position noted by numerous respondents to HM Treasury's Call for Evidence (DP2/22 Paragraph 39).
145. We also agree (DP2/22 Paragraph 41) that the pricing data from the longevity risk transfer market is a useful input to help validate the potential outcome of Risk Margin

reform, particularly for annuity business. However, we would dispute that the ABI's preferred option of a reduction of the Risk Margin by >> 60% in isolation, without any change to the current FS, would result in Technical Provisions valued at levels below that implied by longevity transfer price evidence.

## 9. Impact of reforms on overall capital levels, safety and soundness and investments

146. There is a consensus view in industry that the PRA's proposed reforms to the FS framework will create shifting volatility to spread movements, uncertainty in insurers' business models (perhaps impacting shareholder attractiveness) and higher operational costs. We do not consider that the reforms will advance any of the Government's objectives for Solvency II reform.
147. We note the PRA's definition (DP2/22 Paragraph 45) of 'percentage change in capital' as the reduction in regulatory capital requirements from the reforms, expressed as a percentage of current life industry OF.
148. We also note that this calculation has been performed assuming the reforms are fully phased-in, and any existing transitionals have run off in full. As was made clear in a recent speech called "*Solvency II - striking the balance*" by PRA CEO and Deputy Governor of Prudential Regulation Sam Woods, it also appears to assume that only 50% of longevity risk is ceded offshore. Neither of these assumptions reflect the real world.
149. As a consequence of this, there would be no 'capital release' on Day 1 were the PRA's proposed reforms to be implemented, and possibly for many years thereafter. We are concerned that the PRA's decision for the purposes of this definition to ignore the TMTP raises questions as to whether the PRA continues to view the TMTP as 'real capital'. We are also concerned about the PRA's claim that only 50% of UK insurers' **total** longevity risk on their balance sheets is ceded offshore, whereas our understanding (from the PRA's own figures) is that 80-90% of **new** longevity risk is ceded in this way. Assuming too low a level for this percentage could result in a material over-statement in the benefit of a reduction in the Risk Margin.
150. The PRA states (DP2/22 Paragraphs 46-47) that a package of c60% reduction in the Risk Margin (for life business) and a FS calibrated to include a CRP equivalent to 35% of credit spreads over the cycle would release between 10-15% of capital from the life sector in current economic conditions. However, as pointed out above, this capital release would not be released for many years after implementation of this package, if at all. The PRA also states that this package could support between £45bn and £90bn of new business, and therefore investment from the insurance sector. We do not recognise these figures, and would ask the PRA to set out how they have been derived.
151. The PRA states (DP2/22 Paragraph 47) that some of this released capital could be returned to shareholders "*as noted by the ABI in its February 2021 report on Solvency II reform*". In fact, this is similar to a comment from an independent February 2021 report commissioned from KPMG by the ABI, which stated that any benefits "*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*". We consider that the high level of competition for pricing bulk annuity transfers will limit the amount of

release paid out to shareholders as dividends. The more likely outcome is that it will supplement future shareholder investment and thereby support new business growth.

152. The PRA states (DP2/22 Paragraph 49) that reforms that reduce overall capital levels from their starting position will inevitably lead to some reduction in financial resilience. We do not accept this simplistic assessment. We consider 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 '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 policyholders. Additionally, it is not correct to say that a more fit for purpose Risk Margin automatically equates to lower policyholder protection – even if that means if it is set at a lower level. Reducing the level of the Risk Margin to the point where it makes the decision marginal on whether to cede longevity risk offshore or not has no impact on policyholder protection; the policyholder protection is just moving from being provided by the capital the reinsurer is holding to the capital the cedant is holding. We consider that a reformed, fit for purpose Risk Margin, combined with the existing FS framework (which has already demonstrated its prudence), will ultimately provide greater security to policyholders, and a wider range of more attractively priced retirement products.