Episode 13: Reshaping of the UK's Solvency II and wider changes post-Brexit

KENNY MCIVOR: One of the conclusions it's reached is that there should be an additional secondary objective for the PRA around sustainable growth and international competitiveness, to encourage both of those aspects. And that will complement the primary objective of the PRA, which we mentioned is consistent with one of the objectives of the Solvency II review, which is protection of policyholders and the safety and soundness of firms.

NARRATOR: You're listening to (Re)thinking Insurance, a podcast series from WTW, where we discuss the issues facing P&C, Life, and composite insurers around the globe, as well as exploring the latest tools, techniques, and innovations that will help you rethink insurance.

SINA THIEME: Hello, and welcome to (Re)thinking Insurance. I'm your host, Sina Thieme, and today I am delighted to be joined by my guests, Kenny McIvor and Anthony Plotnek. Welcome, both.

KENNY MCIVOR: Thanks, Sina. Great to be here.

ANTHONY PLOTNEK: Thanks, Sina. Thank you for welcoming us on.

SINA THIEME: In episode six of this podcast series, I spoke to Miroslav Kotaska about the proposed changes to Solvency II for European insurers. And we also touched a bit upon the solvency regime in Europe diverging from the one in the UK.

So in today's episode, we'll focus on proposed reforms to Solvency II in the UK, as set out by the HM Treasury and the Prudential Regulation Authority, the PRA. Kenny, you're a director in Willis Towers Watson's insurance consulting and technology business, with a focus on the bulk purchase annuity market in the UK. And Anthony, you're a director in our insurance investments team, and you lead the private asset proposition. I think prior to joining Willis Towers Watson, you've been at Kilter Finance, Just Group, Canada Life, and EY, and have worked at or consulted life insurers for roughly 17 years.

If you've listened to this podcast before, then you know that I start by googling my guests' names. So Kenny, there is a Kenny McIvor who is a sport injury therapist in Scotland. And I've also found a YouTube video by Kenny McIvor in which he's reviewing a kebab place in Glasgow. Is this the sort of result you wish one would find when googling your name?

KENNY MCIVOR: I'm aware of the sports therapist, but I don't know about the gourmet kebab reviewer. That could possibly be me but I don't think so.

SINA THIEME: He does look remarkably similar, actually.

KENNY MCIVOR: OK.

SINA THIEME: And Anthony, your name seems to be very unique, actually. I could only see actuarial search results, an empty Pinterest page, an empty SoundCloud page with your name. But I think Google knows that you're playing squash. So would that have been your alternative career choice, if the actuarial path hadn't worked out?

ANTHONY PLOTNEK: I mean I'm not sure how lucrative squash is. It hasn't yet even made the Olympics. But perhaps another sport like tennis was in my junior days.

SINA THIEME: Well, I'm glad you are an actuary then. So on the 28th of April 2022, HM Treasury released its consultation on the Solvency II reforms package. And this was accompanied by a discussion paper from the PRA. And you both spend quite a considerable amount of time investigating the key aspects of the current and the proposed regimes. And you described your analysis, in an analytical report which was published on the 21st of July this year, and which is available online. Maybe, Kenny, can you tell us a bit about that?

KENNY MCIVOR: Yeah, no. Absolutely, of course. So yeah, we published that on the 21st of July. And it's been a very important contribution, we hope to the discussion, And this was working alongside the Association of British insurers in the UK. I'd probably be interested in going a little bit further by just giving more context, particularly since you mentioned Miroslav's description of the European process, or at least your podcast with him.

What will happen here in the UK is in October 2020, the UK Treasury kicked off a review, a call for evidence as it were, on Solvency II, looking at many ways to improve it, following the withdrawal from the EU. Now shortly following that, there was a quantitative impact study, a quiz, which we're all familiar with through the Solvency II process many years ago. That was a quiz conducted by the UK's regulator, the PRA, looking at scenarios to gather data for the future reforms.

Now the quiz had two key areas of focus, which was the risk margin and the matching adjustment, hence our work, and indeed the analytical report you referred to, are very much focused on those two areas, and of course very much focused on their implications for the UK and the UK business. Which for those two concepts very, very important to annuity business in the UK, and there's a very growing market there in bulk purchased annuity, an area I work in a lot these days. And that is where annuity business is coming through from the pension regulatory environment into the insurance environment, and that's an area of significant growth, so a really, really key segment of the market.

We produced a first report that went in the public domain on the quiz. So we gathered the quiz data from the life insurers who submitted to the PRA's quiz. And we analyzed that and presented it back to the industry. I believe that was a very helpful contribution to see what was coming out on aggregate. And we also supplemented that with our own analyzes on representative portfolios, and giving some discussion about what was potentially coming through from what we're seeing in the quiz. And there were some serious concerns on behalf of industry back then.

Our analytical report takes up further. It's now following what you mentioned Sina, which was the additional reforms that were set out. There was, in fact, a new proposal that went a different direction from where the quiz went, on one key area of the matching adjustment. So the design of the fundamental spreads had evolved, so we spent a considerable amount of that analytical report looking at that, and what that meant for us, and the industry more generally.

We set out our summary of the results to follow how well the proposed reforms could be meeting Treasury's three objectives, which came in that call for evidence I mentioned earlier. Now those were around firstly the area of international competitiveness for the UK's insurance market. And the second was about protection of policyholders and safety of firms, which also happens to be the regulator's primary objective. So obviously, a very interesting one for the PRA, in particular. And the third Treasury objective was to support firms to provide long-term capital, to drive growth in the UK.

Now there were some serious concerns around how well those would be meeting that objective. In particular, we were seeing winners and losers emerging from the proposals.

SINA THIEME: So Anthony, it's the 17th of August today. And I think things are quite fluid. So as of today, what do you see as the key implications emerging from the current direction of travel?

ANTHONY PLOTNEK: Yeah, no that's obviously a very good question. And if you go back to what were the objectives of Solvency II reform as Kenny outlined the objectives, but primarily the government is looking really for a release of capital from the insurance industry that they've talked about billions of additional funding from the UK insurance industry, and in particular the long-term investors. So it's those that write long-time liabilities primarily, the bulk annuity players, as Kenny described, that transfer pension risk from defined benefit pension schemes historically in the UK, that the insurance industry is seen as the gold standard for holding those liabilities.

And when you hold those liabilities, you need to invest and match those liabilities in the Solvency II regime. And that's what the matching adjustment essentially is designed for. It provides a way of capitalizing the additional liquidity or spread, liquidity premium that you see in these assets relative to your view of the expected cost of default. Because you're a long-term investment, you hold these assets to maturity, to match and pay the annuity liabilities, and therefore the risk you're exposed to is default.

So that's kind of what the matching adjustment was set up in solvency II for. I think there's been in terms of the direction of travel since Solvency II came into effect, and just with the low interest rate environment that we've had in the UK and across Europe for the decade, a big move in the UK into private assets. So these are assets that are not publicly traded. They don't have public valuations or credit ratings. So insurers have to develop that capability themselves. And the regulator is concerned that the current matching adjustment doesn't necessarily consider these assets. So that's why the PRA, as the UK regulator, has come up with proposals to change the matching adjustment significantly alongside a reduction, 60% to 70% in risk margin.

And the Treasury, when they were describing this in their consultation, talked about and envisaged 10% to 15% release in capital across the life industry. So that's where this billions of capital is viewed to come from. But with the PRA's proposals and the testing we did of that in our report, we're seeing that that doesn't materialize. We're more getting a neutral impact overall across the life industry, but a negative impact for the annuity writers.

So that the ones that we would see as the contributors to the objectives around long-term investment and spurring a vibrant and innovative competitive sector, the conflict is with the objective too around protecting policyholders and the soundness of firms. But again, we view that really you need to consider both existing policyholders and future policyholders. That's the future pensioners that currently sit in pension funds that would transfer into the insurance regime, and just whether we're in, as you reach later retirement annuitizing and taking a guaranteed benefit, as rates are arising again, does that mean people start considering annuities more again to obviously reduce, since that was no longer compulsory in the UK as part of pension reforms? That's almost 10 years ago now.

As that chance forms that the UK market to move to more bulk annuities, and that's where the industry is seeing the concerns. But yeah, we have reached this, I suppose, stand off between what the government has set out and what the regulator is proposing, which it says meets the objectives. But within our report, obviously we've challenged some of the assumptions that the regulator had put forward to say that effectively they met that objective. But on a basis, the transitional benefit that is effectively the benefit that was put in to allow a smooth transition from Solvency I into Solvency II, where in particular, the annuity players in the UK have large transitional benefits, because of the risk margin.

This risk margin is now being reduced, but the regulator wants to offset some or all of that reduction essentially, through a significant change to the matching adjustment, which is more unexpected. So in terms of where we do see this going, it's hard to say at the moment. We're in a period of political uncertainty. Obviously, the government here is going through a leadership contest. The industry did meet with the old Chancellor, Rishi Sunak, who is one of the final two just before he resigned, and then set their case to him.

But again, obviously we don't yet know who moves into the roles, or how this potential disagreement in terms of where the [INAUDIBLE] goes between industry and the regulator, how that ends up is still pretty uncertain.

SINA THIEME: Thanks, Anthony. So on that point, I don't know. Kenny, maybe you want to share some of your thoughts as well on what the changing political landscape in the UK could mean for the reform process.

KENNY MCIVOR: Thanks, Sina. Yeah, so Solvency II has been raised by the leadership candidates as an issue to tackle. I should point out here that we're recording this on the 17th of August. So things are still playing out on that contest, of course. What is important here is the government is a very key decision maker. And it's being supported by Treasury and by the Bank of England, and the regulator, the PRA, is part of the Bank of England, to come to an ultimate decision on what is the reform approach to be taken.

So in that chain of command, there's the Chancellor to the Exchequer which has an important oversight role of this area. But indeed, the economic Secretary of the Treasury is probably the most key government individual next in line connected to the Treasury, of course.

The previous Economic Secretary to the Treasury did set a line in the sand shortly after the 2021 quiz that I mentioned. And Anthony spoke about a release of capital, which was being targeted. That was a release that they had been looking for.

Now, the Economic Secretary to the Treasury, of course, at this stage is yet to be reappointed. So that will be an important decision maker also. Industry has been making progress. Anthony mentioned the then Chancellor Rishi Sunak had been in conversation with key senior representatives of industry on this topic. And that appeared to be moving forward as useful discussions for industry. But obviously there's been some significant change.

What is true, of course, is the regulator ultimately does need to regulate this regime and supervise it. So it does have an important role to play, and will ultimately have responsibility over it.

One thing that's currently uncertain is when we will see back the responses from the Treasury's consultation process. So the government guideline period is 12 weeks from the end of the consultation. That was 21, July. So all we see about mid-October, the end of that guideline period. We suspect with the uncertainty on leadership and the need to brief and to understand their position and views on this to move ahead, it's likely and possible that they it will run over that 12-week period before we see clarity on the future direction.

SINA THIEME: Right. There are also more wide-ranging changes afoot in the UK about how regulation is put into practice. Can you summarize a bit how this would work?

KENNY MCIVOR: Yeah. Thank you. So what I'll refer to here is the future regulatory framework consultation, or reviews rather, that run simultaneously to the Solvency II call for evidence I mentioned before. This review is broader than insurance alone. It's for financial services. But it has very important implications for this particular topic. I'd say there's two ones which I should bring out.

The first is what that review, one of the conclusions it's reached is that there should be an additional secondary objective for the PRA around sustainable growth and international competitiveness to encourage both of those aspects. And that says that will complement the primary objective of the PRA, which we mentioned, is consistent with one of the objectives of the Solvency II review which is protection of policyholders and the safety and soundness of firms. And it will also add to other objectives of the PRA, and have regards that the PRA has to work towards achieving.

And secondly on the FRF, the other implication, and this is really quite the substance of the FRF, which is moving rules, the Solvency II rules in particular, into a combination of legislation and the PRA rule-book, the latter of which is designed to give more agility to the regulator, and is also intended to be balanced with appropriate accountability and scrutiny of the regulator on the decisions that go there. But what it means is there's some decisions to be made still about what parts.

First of all, what the reforms would be, but then it will be a question of what parts will sit with the regulator's rule-book, and what parts will sit more firmly within legislation.

SINA THIEME: So with respect to the key topics in the UK review, you mentioned a few pieces here already. What are the different directions that UK and the European Commission are headed now?

KENNY MCIVOR: I mean in the UK, the matching adjustment topic is very key. In the EU, it's only currently Spain jurisdiction which has use of the matching adjustment. So the priorities are very different, it's worth bearing in mind. And even on the risk margin, the other important topic on this UK review, that's given that the UK has a significant amount of annuity business risk margin on that is very high, and interest rate sensitive, as presently designed. So that is some of those issues on the risk margin are more pressing for the UK.

So in the EU review, there's really no material changes proposed to the design of the matching adjustment, which is not a great surprise, given what I said earlier. On the risk margin, however, there is several considerations on that. So the direction appears to be moving towards a tapered cost cap approach, consistent with what is being considered in the UK. So there's consistency there.

The calibration, of course, the strength of it is a different matter where the EU is actually in the EU parliament report in July that calibration has moved down to be a much less onerous risk margin under the calibration for the EU, as compared to where we initially started in the UK, and the quiz. But the UK is intending to move more towards a 60% reduction in risk margin for long term life insurers, which is not too much different from where the EU seems to be getting in that [INAUDIBLE].

SINA THIEME: All right. So Anthony, where do we go from here?

ANTHONY PLOTNEK: Yeah, I mean, as we've kind of touched on it, it's quite a complex issue that there's a number of different views around, in particular, that the matching adjustment reforms and what they might do to the UK sector. Considering obviously the dampening that the has PRA has suggested to the matching adjustment, would make the investment in long-term assets perhaps, compared to today, less of an incentive for the long-term annuity writers. That doesn't obviously fit with the Treasury objectives.

So I think that there's perhaps a few options that might be considered as part of this. And you obviously as Treasury go through their period of understanding of all the responses they've received, the PRA similarly had had their discussion paper, and would have had responses to that. They're asking for further data collection, in particular, around what this might mean to the solvency capital requirements. So the discussion thus far has largely been on the base balance sheet. But if you change the base balance sheet, by definition it may change the 1 in 200 level of capital you need to hold on top of that in the Solvency II regime.

So that gathering exercise would give more information, although firms have been perhaps suggesting that there's very little time over the summer to do that justice. So we're not certain all the information that was asked for will be responded to consistently across those annuity writers, depending on what they've agreed with supervisors directly, as might be possible over the summer. So we've got those things to look at.

But do we have something that is pretty much no change from what we have today? Interest rates have moved quite considerably over the period. We've been discussing and debating this, so the risk margins are actually significantly reduced to what they were at year end '20, when all our analysis and all the quiz data was set at year end '20. But things have changed quite considerably since year end '20. So it may need further analysis in a new interest rate regime, and the Bank of England itself predicting potentially a long recession coming.

So again, this all makes it quite difficult to see how this does pan out. I suppose the second option is to adopt the kind of calibrations that have been put forward by the PRA. But there's clearly quite a bit of reluctance to see that happen in the insurance industry. So further discussion around that, perhaps around in particular, the capital requirements, and what that might mean, and what it might mean in a changing interest rate environment as well.

And then potentially another option where the Treasury or if actually government pays more of a role in influencing the calibration. So it's not yet clear what sits in the powers of the PRA as the regulator, and what would be put in legislation. But might they, having considered the consultation responses, look to perhaps change some of the parameters or indeed change the approach itself. So there's this model that's been put forward in the consultation isn't necessarily one that will be adopted. They could look at alternatives that have been proposed by industry. There are perhaps more extensions of the existing regime, but somewhere around those kind of four options.

Unfortunately, it's hard to predict which of the four we may be at. But yeah, certainly, we'd hope that by October, when we hear the Treasury consultation response, we'll have more detail. We were originally expecting a PRA regulator consultation following that, which was indicated as being before end of the year. Whether the various elements are kind of a bit external to this delay that, so the leadership election, the changing economy, and kind of environment around threat of recession-- that could potentially move this more into next year.

But yeah, certainly lots of track, I think still in terms of understanding when these changes would actually come into effect.

SINA THIEME: Yeah, so it sounds like we're meeting again in the next months to continue this discussion, I think. Thank you so much for your time and your thoughts, Kenny and Anthony.

ANTHONY PLOTNEK: Thank you. And yeah. Yeah, we'd love to speak again.

KENNY MCIVOR: Yeah. Thanks a lot, Sina.

SINA THIEME: Thank you for listening to this episode. And if you found this interesting, then join us on other episodes of (Re)thinking Insurance.

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