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End-state Market Update

August 2022

Introduction

2022 began with the hope of reduced market uncertainty: COVID-19 has been on the decline, and a general pick-up in economic activity has been observed. In practice, the year is being shaped by macroeconomic and geopolitical headwinds, and against the prospect of stagflation over the horizon.

In the meantime, the UK insurance sector is grappling with an added layer of complexity: the first ever reform of the Solvency II regulatory regime. For a highly regulated ecosystem, the stakes are high.

In our H1 2022 End-state Market Update, we focus on the following aspects:

1. **Potential implications of the Solvency II review; and**
2. **Implications of the current macroeconomic environment on UK insurers.**

Solvency II is changing – what does this mean?

On 28 April 2022, the UK government (the Government) published its much-anticipated consultation paper on its proposed reforms to the Solvency II regulatory framework and its applicability for UK insurers. Alongside this, the insurance regulator in the UK, the Prudential Regulation Authority (the PRA), published its own statement and a discussion document. Reading the documents in tandem, it is easy to spot the tension between the Government of the day and the watchdog.

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On the political front, the reform of the Solvency II regime has captured the imagination of a post-Brexit Britain that is nimbler and more competitive outside the EU. The Government sees the loosening of certain provisions of the existing framework as an opportunity to channel greater investment (through the insurance industry) to the real economy, to support, among other initiatives, the 'levelling up' agenda. While the objective is commendable, the pace of change has already frustrated both politicians and providers, with the EU's own review into Solvency II already well ahead of the review process in the UK.

Meanwhile, the PRA finds itself in an unenviable position. Having historically prided itself on independence, technical prowess and focus on the protection of policyholders, it is increasingly challenged across all three fronts. New objectives have expanded its mandate to include competitiveness, while the new Financial Services bill holds the prospect of more inquisitive government ministers. At stake is the long-term implications of the Solvency II reforms on the security of policyholders, which increasingly include defined benefit pensions members.

State of play and the most debated aspect of the Solvency II reform

Interestingly, there is already a consensus over most of the proposed changes to Solvency II, which look to:

1. Reduce the volatility of insurers' balance sheets by reforming 'risk margin' provisions;
2. Reassess the 'fundamental spread' (i.e. the expected cost of default and downgrade of assets) used in the calculation of the Matching Adjustment (MA);
3. Increase investment flexibility, allowing insurers to invest in a wider range of asset classes; and
4. Reduce reporting and administrative burden on the insurers.

The debate centres on one aspect of the reform - the valuation mechanism commonly referred to as the Matching Adjustment (MA), which allows insurers to take credit today for investment returns they may realise many years from now. Since its introduction in 2016, MA has become an integral feature of the life insurance industry in the UK, shaping business plans and driving insurance pricing. At the end of 2021 (YE21), MA already represented 71% of the entire capital base of the UK life insurance sector and, in a handful of instances, it represented all of the capital resources available to insurers[1]. Part of the challenge facing the PRA is that even modest changes to MA can have an outsized impact on providers.

"This draws into question the headline claim published by the Treasury that the Solvency II reform would result in a 10-15% reduction in capital requirements. "

The PRA has been quick to point out that it is **not** looking to do away with the MA (reminding commentators that the mechanism remains controversial in some academic circles), but to address its shortcomings (notably its calculation using historical data, insensitivity to market signals and inability to capture certain risks). The PRA proposes to use at least some of the capital released as a result of the reform of the risk margin provisions to address these weaknesses. This objective, coupled with the active use of reinsurance among annuity providers, draws into question the headline claim published by the Treasury that the Solvency II reform would result in a 10-15% reduction in capital requirements.

Does the PRA have a point?

A careful examination of MA mechanism validates many of the concerns raised by the PRA in the consultation document:

- MA is currently underpinned by backward looking default statistics, which may not be an appropriate guide for the future;
- MA is too slow to pick up market signals, with any material increase in credit spreads treated as additional return rather than an indication that underlying credit risk has increased; and
- MA does not capture ancillary risks (e.g. property) that are embedded in the investments made by insurers which now include much more than just corporate debt and government bonds.

"We have sympathy with the PRA's view that the shortcomings of MA could in time prove costly to policyholders and UK taxpayers."

The above echoes the concerns raised in our YE21 End-state Market Update. Experience since the introduction of the MA has been positive, allowing insurers to diversify, improve pricing and become a force for good. However, MA remains untested since its relatively recent introduction in 2016. This period has been characterised by historic, low levels of corporate defaults, coupled with significant quantitative easing implemented by central banks. Left unaddressed, we have sympathy with the PRA's view that the shortcomings of MA could, in time, prove costly to policyholders and UK taxpayers through the Financial Services Compensation Scheme (the security net for insurers).

1 Source: Solvency II: Striking the balance – speech by Sam Woods, 8 July 2022

However, we have some reservations with the way the PRA is proposing to address these shortcomings. Getting MA to respond to market signals is a step in the right direction, but careful consideration will need to be given to the implications the change would have on, for example, attractive assets (those that offer a predictable yield and support economic growth) that happen to trade in less liquid markets. In extremis, the PRA's proposal could start to unwind some of the diversification benefits that followed the implementation of Solvency II. Similarly, the changes should not incentivise insurers to pursue structured solutions as a way to circumvent the new regulatory rules. As we saw with equity release mortgages, the added complexity can sometimes end up creating problems for the future.

What is the impact on the annuity market?

Should the narrative from the Government prevail, the expectation is that there will be increased capacity in the annuity market, with a marginal improvement in pricing. However, the post-reform Solvency II regime would then increase the risk of insurer failure. The PRA has stated that this increase would only be acceptable if MA gets reformed as well.

Given the central role played by MA, it is still not clear if the reform will indeed reduce pricing for insurers; nor if it will truly lead to the 'Big Bang' investment drive the Government is hoping for. At face value, the PRA's MA proposals have the potential to result in 'winners' and 'losers' within the Bulk Purchase Annuity (BPA) market, with monoline annuity providers most impacted by the changes.

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Against this backdrop, trustees and sponsors will need to increase their focus on insurer strength when selecting a counterparty for their annuity policy.

How would any capital released be used by the insurers?

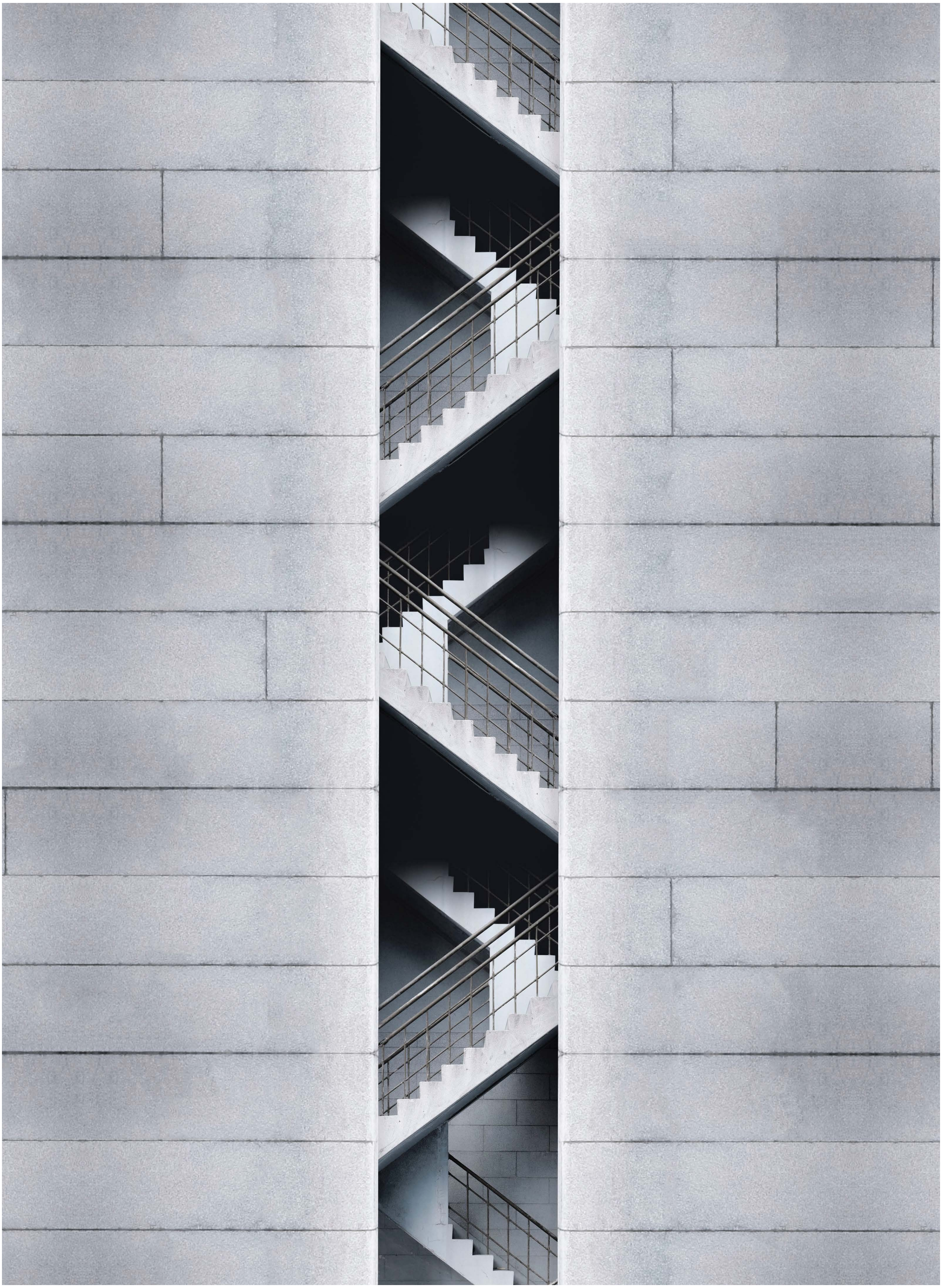
The answer to this question remains one of the key drivers of the review, and the Government has posed this question as part of the consultation (Question 2.5): *"how could the Government be assured that resource that becomes available following a reduction in the risk margin would not be distributed to shareholders or used to increase remuneration to parties within the insurance firm?"*

Although the Government would want to present any reduction in capital requirements as enabling more investments in the real economy, there is a distinct possibility that the reform spurs higher distributions to shareholders (after all, insurers are already well capitalised).

At this stage, there is no suggestion that the Government would put restrictions or otherwise mandate the uses of capital released through the Solvency II reform.

What is next?

The consultation closed on 21 July 2022, but the Government has not yet provided a firm timeframe for its subsequent response. A more detailed technical consultation by the PRA is expected later in the year, which will inform the overall package of reforms.



Stakeholder perspectives

Government proposal

1 Substantial reduction in risk margin	• At YE2021, the risk margin for life insurance business in the UK (including the eight BPA providers) was in excess of £32bn[2]. A substantial reduction in the risk margin is proposed, including a reduction of c60%-70% for long-term life insurers. Insurers actively using reinsurance would see a much smaller reduction • A higher risk margin increases the cost to insurers of writing new business and leads to a sub-optimal allocation of capital resources. **A lower risk margin would release capital, reduce balance sheet volatility and reduce the incentive to reinsure longevity risk**
2 Reassessment of the fundamental spread used in the calculation of MA	• At YE2021, UK life insurers' balance sheets benefited by £80bn from MA[3] • The Government has noted that there are several indicators to suggest that the current fundamental spread does not properly capture retained risks (e.g. risk of credit downgrade and default) • These risk exposures may be heightened given the observed trend in recent years that has seen a steady increase in the proportion of assets in MA portfolios that are illiquid[4] (such as private placements, property-backed investments, etc.). **A final decision on calibration has not been reached at this stage**
3 Increase in investment flexibility	• The range of assets eligible for the MA portfolio is proposed to be broadened to include assets such as callable bonds, commercial real estate lending, housing association bonds and loans, infrastructure assets, local authority loan portfolios and the treatment of assets with construction phases • The Government has also proposed the removal of 'the disproportionately severe treatment' of sub-investment grade assets (i.e. credit rating below BBB) in the MA portfolios, arguing that removing the cap on the MA benefit for sub-investment grade assets reduces the likelihood that insurers would be incentivised to sell BBB assets in a market downturn and encourage insurers to diversify into a wider range of assets
4 Reducing reporting and administrative burdens	• The proposals include reforms to the internal model framework and reporting requirements under Solvency II • These changes are intended to enhance the attractiveness of the UK to foreign insurers and increase competition, encourage growth and reduce the administrative burden and cost associated with Solvency II

2 Source: PRA
3 Source: PRA
4 Source: PRA. The proportion of assets invested in less liquid asset classes has increased from around 31% in 2018 to around 41% in 2021

What has the PRA said?

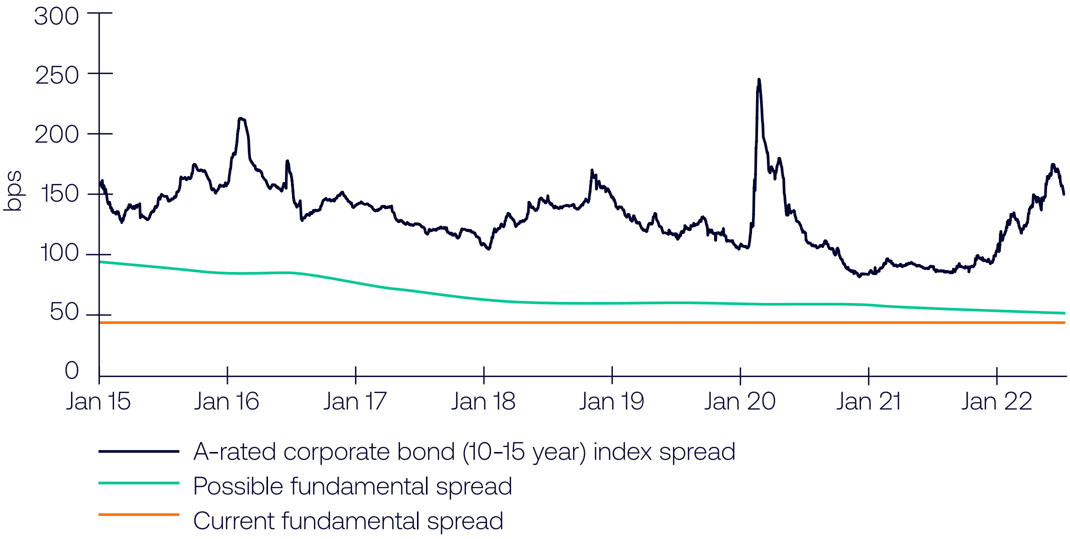
The PRA believes that any reforms need to ensure the long-term safety and soundness of the UK insurance industry and deliver an appropriate degree of policyholder protection. Through its discussion document, the PRA has set out its position on the Government's proposals, in particular risk margin, MA and the fundamental spread (being calculated using Government and corporate bonds, and based on historical returns).

The PRA agrees that the risk margin should be reformed to deal with concerns that it is too sensitive to movements in interest rates and too high when interest rates are low.

However, the PRA considers that the current fundamental spread design does not appropriately reflect the risks retained by insurers because it does not:

- Fully and explicitly allow for uncertainty over future credit losses; and
- Explicitly take account of the range and nature of assets held in insurers' MA portfolios.

The PRA believes the fundamental spread should include an explicit allowance for a credit risk premium (CRP). To ensure that retained risks are adequately captured, the CRP needs to be calibrated to deliver an outcome equivalent to at least 35% of credit spreads on average through the cycle.



The above chart[5] reflects the limited impact credit spread movements have on the current fundamental spread. The PRA's preferred approach (in green) goes some way toward addressing this limitation. This lack of market sensitivity, however, is one of the key aspects that allows insurers to write new business at the most affordable terms in an environment when most other capital providers are operating on a 'risk-averse' mode. The PRA considers a CRP of 35% of credit spreads to be appropriate but, as noted above, the Government has not reached a final decision on calibration at this stage.

If this outcome is achieved, the PRA believes the risk margin could be recalibrated to reduce by around 60% for life insurers, while continuing to ensure that the UK regime provides an appropriate level of safety and soundness and, ultimately, policyholder protection. While at the edge of what their analysis supports, these levels are within the ranges noted in the consultation.

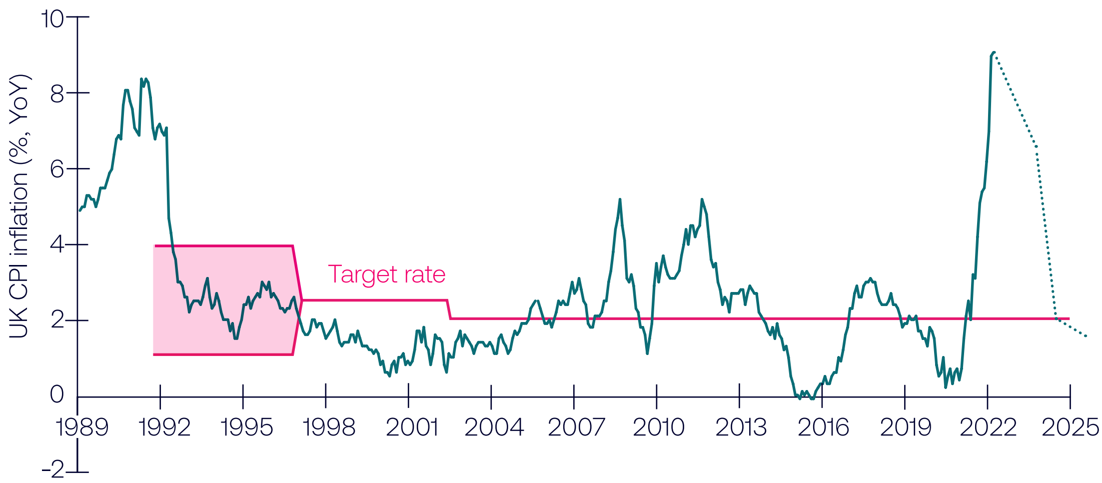
The PRA has noted that whilst the above combination of reforms would involve (by definition) an increase in the risk of insurer failure compared to the current position, the reforms would still ensure that the UK continues to operate a going concern regime.

5 Source: Eikon, the PRA

Current macroeconomic environment and potential implications on insurers

Record high inflation and looming stagflation risk

The UK economy is currently in a state that has not been experienced in over 40 years. Consumer Price Index (CPI) inflation in the UK rose to 9.1 in the 12 months to May 2022, a level last seen in 1982. The chart below[6] shows the latest forecast published by the Monetary Policy Committee, which indicates that inflation in the UK may not return to the current target level of 2% before Q2 2024.



High inflation, coupled with recent Gross Domestic Product contraction and a bleak growth outlook, means that the UK may be heading into 'stagflation' – a difficult to navigate macroeconomic environment where both high inflation and low economic growth prevail.

If that is the environment we end up in, it may result in deterioration in insurers' invested asset quality through increased credit downgrades and defaults. While the Solvency II regime aims to be robust with capital buffers calibrated to withstand a 1-in-200 risk event, the relative immaturity of the regulations means that it has not yet been tested through a full business cycle.

"If we end up in a stagflation environment, insurers could see the quality of their investments deteriorate through increased credit downgrades and defaults."

Liquidity crunch

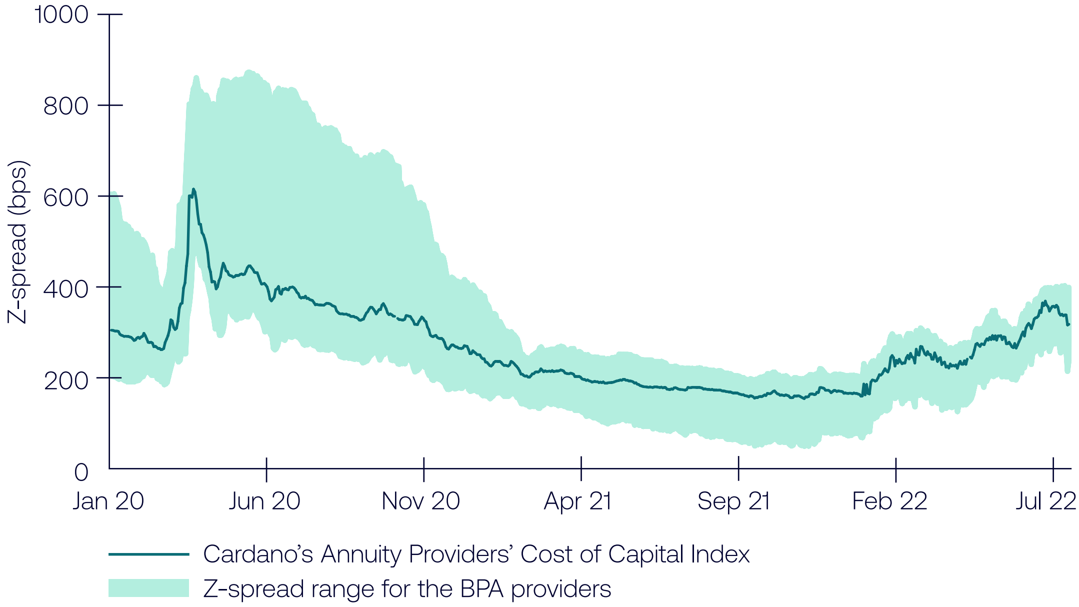
As the market adapts to this fast-evolving environment, there is likely to be added pressure on liquidity management for insurers. For instance, an increase in volatility in the interest rate and credit markets could lead to collateral calls on the derivatives used by insurers – we saw this dynamic in H1 2020 following the first COVID-19 lockdown.

This is particularly relevant for insurers that have a smaller allocation to more liquid assets such as government bonds and cash.

6 Source: Refinitiv Eikon. Inflation target until 2003 was based on RPI. Since 2003, the target is based on CPI.

Increasing cost of capital

The cost of capital for UK BPA insurers is increasing. This means that while capital has not been constrained for insurers over the last few years, the situation could quickly change. The chart below shows the Z-spread of select Tier 2 instruments for the BPA insurers in the UK, which is inching closer to levels observed during the initial aftermath of the COVID-19 outbreak.



To some extent, the risk is mitigated by the recent rounds of capital raising undertaken by UK insurers in the wake of lockdowns when interest rates were lower. As such, we believe that new business will continue to be prioritised until the real economy is impacted. However, should capital buffers exhaust, insurers may again need to approach the capital markets, albeit at a substantially higher cost.

Whilst insurers are well-capitalised today, navigating through the current environment will be tricky. Any insurers that get the balance wrong could end up facing significant challenges in raising additional capital.

Adoption of IFRS 17 accounting principles

In May 2022, the UK Endorsement Board (UKEB) approved the adoption of the International Accounting Standards Board's (IASB) IFRS 17 (Insurance Contracts) for use by UK insurers.

What are the changes?

Under the current accounting standards, insurers recognise a significant profit upon the signing of an annuity contract, followed by smaller and declining gains over the remainder of the contract's lifetime. IFRS 17 seeks to spread the profit recognition over the duration of the contract.

There were concerns around the implementation of IFRS 17 for annuity contracts as their lifetime is uncertain, and determining the 'service' provided by insurers is not apparent. An IFRS Interpretations Committee concluded in March 2022 that the service is considered as the periodic payments a policyholder receives for 'surviving' each period, an approach least favoured by insurers as it would materially delay the recognition of accounting profits.

In addition to profit recognition, there are other impacts anticipated due to IFRS 17 (e.g. leverage) which currently remain highly uncertain. We are likely to get more clarity once the insurers publish their half year 2022 results.

Market reaction

Some insurers (e.g. Legal & General) have voiced their disagreement with the IFRS Interpretations Committee's analysis, arguing that this approach *"would materially misrepresent the balance sheet and income statement for one of the most material insurance product lines in the UK market".*

The effective date for the implementation of IFRS 17 is 1 January 2023, and the accounting standard will be reviewed for any potential reforms in January 2028.

Trustees looking to transact with an insurer over the near-term will want to understand the implications of IFRS 17 on the insurer's strategy and investor base.

Our Covenant Risk Solutions team

We are a leading provider of risk transfer / end game advice in the UK pensions market through our specialist Covenant Risk Solutions team. We offer independent, high-quality advice around insurer counterparty risk to support many of the most pivotal decisions taken by trustees and sponsors of occupational DB pension schemes.

We have advised on over £48bn of pensions risk transfer transactions since 2014, including buy-ins, buy-outs and longevity swaps. We have advised on transactions of all sizes, ranging from £3m to almost £4bn, with sponsors operating across a wide range of industries.

Our specialist Covenant Risk Solutions team incorporates a wide range of relevant skillsets and experiences, including actuarial, investment banking, corporate finance and accounting.

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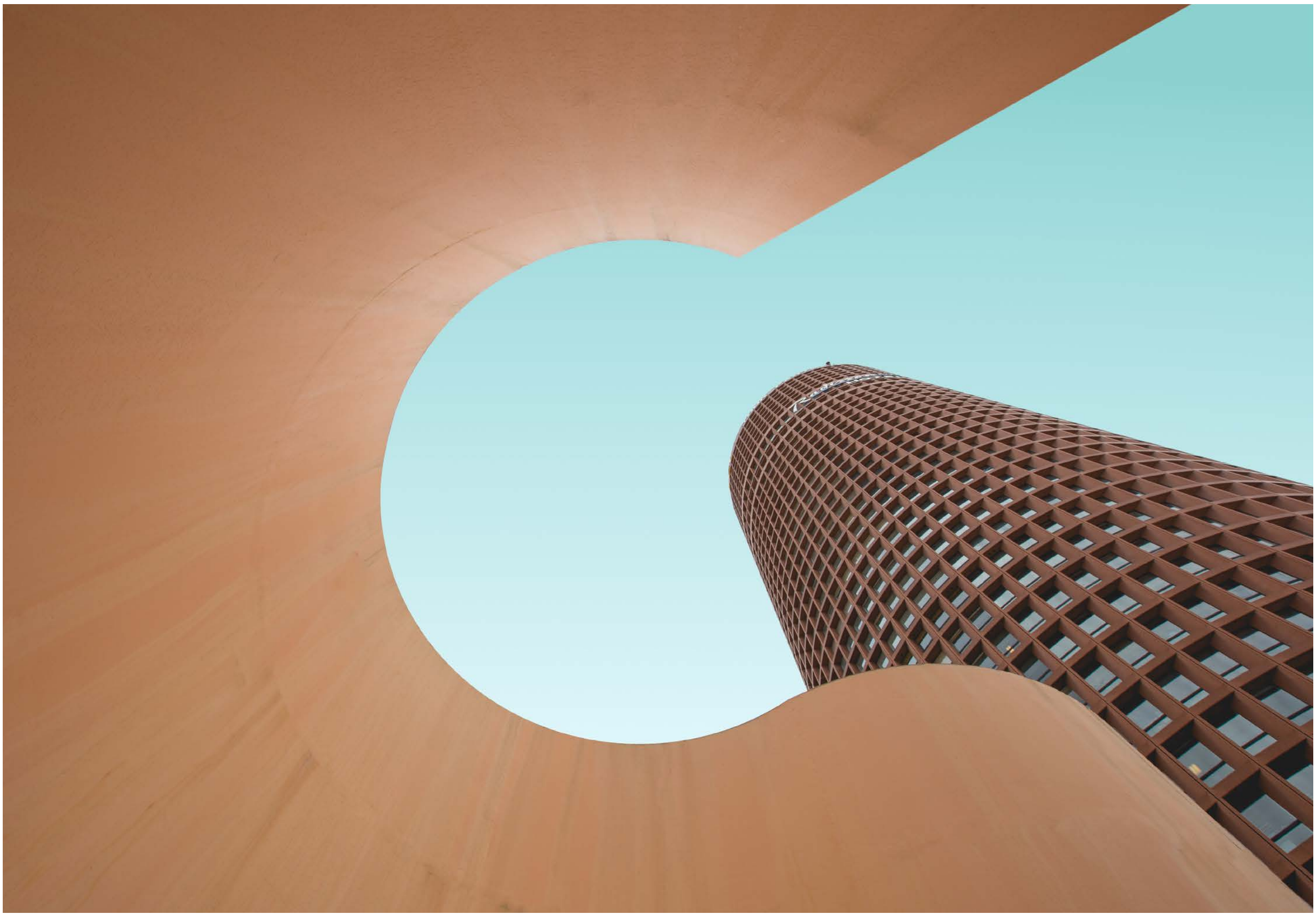

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