December 2021

Solvency II

Bank of England
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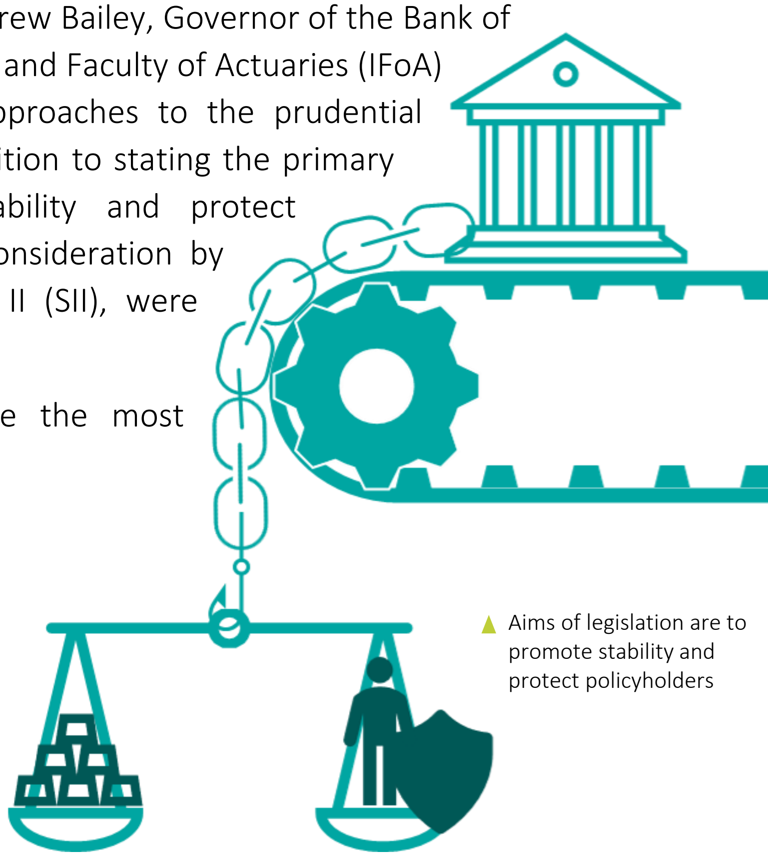
Regulatory Update

Wednesday 1st December 2021 saw Andrew Bailey, Governor of the Bank of England, deliver a speech to the Institute and Faculty of Actuaries (IFoA) reflecting on current and proposed approaches to the prudential regulation of UK insurance firms. In addition to stating the primary aims of legislation (to promote stability and protect policyholders), policy reforms, under consideration by the PRA's ongoing review of Solvency II (SII), were discussed.

The 4most Insurance team summarise the most pertinent points from the speech.



Aims of legislation are to promote stability and protect policyholders

Post-Brexit Opportunities

The UK's exit from the European Union gives rise to an opportunity for the PRA to review the regulatory framework in the UK financial services industry. At the point of transition, EU regulation was simply transferred, unchanged, to the jurisdiction of an independent regulatory authority.

The PRA recognises the need to adapt regulation for an evolving UK market. Unsurprisingly, a solvency directive intended to steer insurers across all member states can be amended to better suit the needs of any one country. The (now independent) UK market contains unique features such as, having a high exposure to annuity products, that must be recognised under a more dynamic structure.

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The Governor recognises there are likely to be prevailing public interest matters to contemplate when assessing the suitability of current regulation.

Items Under Review

At present, the PRA are reviewing two main areas of the SII framework:

- The Risk Margin (RM)
- The Matching Adjustment (MA)

Risk Margin

It is acknowledged that, presently, the RM calculation is too susceptible to interest rate movements, particularly in a low-rate environment where the RM is often too high. The PRA appreciates there are valid arguments for reducing it under such circumstances, although methodology nuances must be accounted for when suggesting an alternate approach.

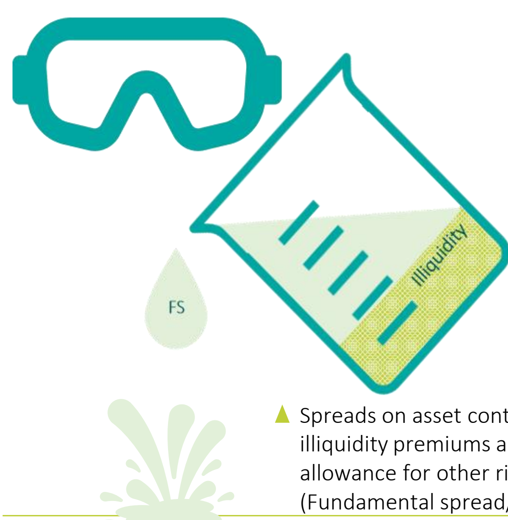
Matching Adjustment

The inherent benefit of the MA is realised through granting permission to insurers to recognise illiquidity premiums. By increasing discount rates for well-matched long-term liabilities, present values of liabilities are reduced, and balance sheet volatility is smoothed. Given this is a significant advantage for firms with large annuity portfolios, the PRA emphasises the significance of the MA in the UK insurance market.

In essence, the MA works to ensure that asset and liability cashflows are well matched enough that, changes driven by unstable spreads are dampened, and recognition is afforded to insurers for reduced exposure to liquidity risk caused by an enforced sale.

The spread on any asset sitting inside a MA portfolio can be split into two components:

1. an illiquidity premium – the MA
2. an allowance for other risk (e.g. credit risk) – the Fundamental Spread (FS)



Spreads on asset contain an illiquidity premiums and an allowance for other risks (Fundamental spread/ FS)

At present, the PRA are concerned that the MA calculation is flawed in some areas:

- The FS does not explicitly allow for the risk posed by asset default or downgrade and academic literature suggests that its recognition of credit risk is historically low.

- The FS does not sufficiently respond to changes in credit markets over time. Consequently, any spread widening, not combined by a corresponding rating downgrade, is presumed to be driven purely by an increase in the illiquidity premium which can be credited by a larger MA.

- The FS is unaffected by varying levels of spread or risk posed within a single asset class. As a result, assets which offer higher spread but are assigned the same rating will produce a higher MA, regardless of whether they carry higher perceived credit risk.

The Governor stressed that the PRA are striving to address identified deficiencies and are working actively with the industry to produce meaningful reforms which are within the public interest - for example, broadening the range of assets eligible for MA benefit.

Further Considerations

The speech concluded with a clear statement of intent from the BoE. They accept that SII, in its current state, is not optimal for the UK insurance market – there is work to do to reverse the lack of flexibility innate to a standard purposely designed to increase harmonisation across EU member states. It is undeniable that work is needed to address current levels of ill-fitting prescription which limit the level of judgement applied and can, if managed carefully, benefit market participants. Firstly, through enhanced policyholder protection and secondly, by creating a regulatory environment which encourages insurer investment and economic growth.

Finally, the Governor reiterated his belief that reform of SII is essential to safeguarding the future suitability of the standard in a rapidly developing world. The unwieldy practical nature of SII, alongside the high associated operational cost, also presents a challenge. Nevertheless, refining the current shape of SII should be an aim which is motivated by a common good.

[Reforming Solvency II: Delivering policyholder protection - speech by Andrew Bailey | Bank of England]

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