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Our thoughts on Sam Woods speech on post-Brexit reforms to **Insurance Regulation**

On 8th July 2022, Sam Woods, the CEO of the Prudential Regulation Authority (PRA), delivered a speech on upcoming changes to the UK regulatory environment. The purpose of the speech was to emphasise the importance of the ongoing post-Brexit Solvency II (SII) review and bring attention to the main areas of contention. In general, Mr Woods reiterated the opportunity the reforms present to the UK insurance sector, where a move towards more bespoke supervision should lead to enhanced competition, investment and policyholder protection.

There is explicit acknowledgement that the proposed reforms could lead to a 'substantial capital release' through adjusting the approach deployed for the risk margin, matching adjustment (MA) and asset eligibility. Despite the risk margin and asset eligibility criteria posing significant questions, special attention was afforded to the MA calculation where the PRA's CEO identified three broad weaknesses:

- *Fundamental spread deduction:* The deduction of fundamental spread in the calculation of the matching adjustment is insufficient. This is because fundamental spreads are based on historical data which may not be a good guide to the future.
- *Basis risk:* The calibration of fundamental spreads is based on historical data of government and corporate bonds. As insurers invest more in other asset classes, the risk profile diverges from assumptions used in calibration of the fundamental spread.
- *Widening of spreads:* The current regime allows insurers to take credit for any widening of spreads as if it arises purely from liquidity concerns, rather than credit risk.

Last year, the PRA conducted a quantitative impact study (QIS) to assess reform options for the MA and other changes. 4most's analysis indicates that these proposals would not only result in a significant reduction in the MA, but also lead to excessively volatile balance sheets. The PRA has since issued a revised set of proposals which have also been met with criticism from the industry.

Currently, HMT is consulting on several changes to SII and 4most has estimated the impact of fundamental spread design options contained in the consultation paper. These proposals represent a refinement to options assessed in QIS, yet we believe it will lead to a material reduction in the MA.

The point about basis risk arising from holdings in assets differing from those used in the underlying calibration of the fundamental spread is interesting. The PRA's proposals for the QIS and the subsequent revised proposals, used same indices for all types of assets with a distinction based on financial and non-financial sectors and credit ratings. This may be because sector-specific indices are not available at a sufficient level of granularity or, as insurers invest more in illiquid assets or private credit, there may be little information available to create any reliable benchmarks. It will be interesting to see how these regulatory challenges are addressed in the forthcoming changes to the regulation.

A valid concern Mr Woods stated in his speech was that the current regulation does not particularly incentivise insurers to invest in productive assets. For example, MA portfolios are tilted more towards ground rents than infrastructure projects.

Other regulatory changes Mr Woods outlined include:

- Speeding up the approval processes and widening the scope of assets in which insurers can invest, e.g., investments with an initial construction phase that may include flexibility on the timing of cashflows
- A significant reduction in the risk margin

The PRA is of the view that the changes to the regulation would free-up billions of pounds capital that insurers can invest in assets that encourage economic growth. We consider that this view may not have factored in any increase in solvency capital requirements (SCR) arising from changes to the MA methodology.