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Solvency UK - One Step Closer

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Disclaimer

Views

The views expressed by the presenters do not necessarily reflect the views of their employers.

Purpose

This presentation has been prepared for general information purposes only and does not purport to be and is not a substitute for specific professional advice. While the matters identified are believed to be generally correct, the authors do not warrant the accuracy, adequacy or completeness of this information, and expressly disclaim liability for any errors or omissions. As such, any party placing reliance on these materials does so entirely at its own risk.

Limitations

Some of the summarised material within this presentation has been prepared based on HM Treasury's Consultation Paper and the PRA Discussion Paper on the review of Solvency II published on 28 April 2022, the PRA's subsequent Consultation Papers CP12/23 and CP19/23 published 29 June 2023 and 28 September 2023 respectively, and HM Treasury's Consultation Response and Subject expert group meeting summaries from February to July 2023 published by the Bank of England. The material within this presentation focusses on the issues relating to life insurers and annuity providers in particular.

Agenda

- Overview of reforms timeline and key developments
- Potential implications of key developments
- Big picture considerations
- Q&A

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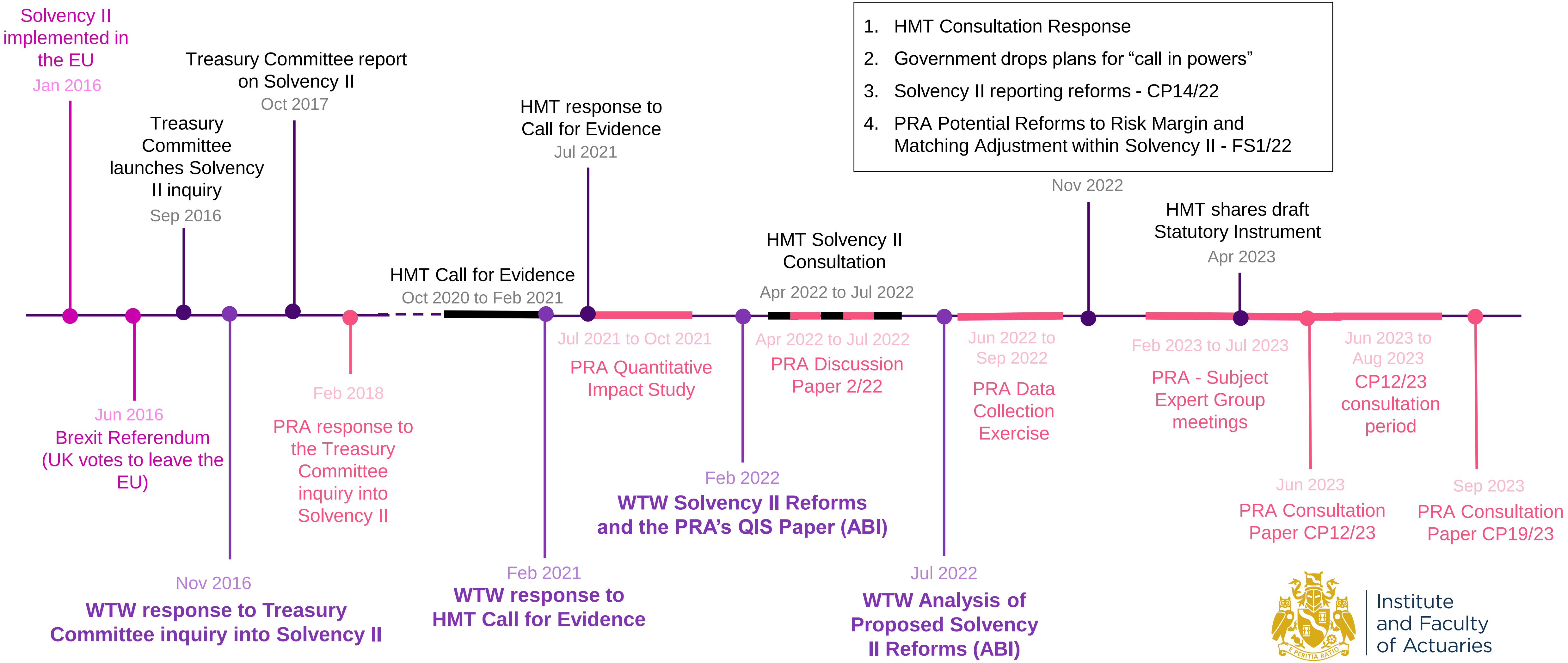
Overview of reforms timeline and key developments

Key
WTW
HMT/Government
PRA

An overview of the Solvency II reforms timeline



Key
WTW
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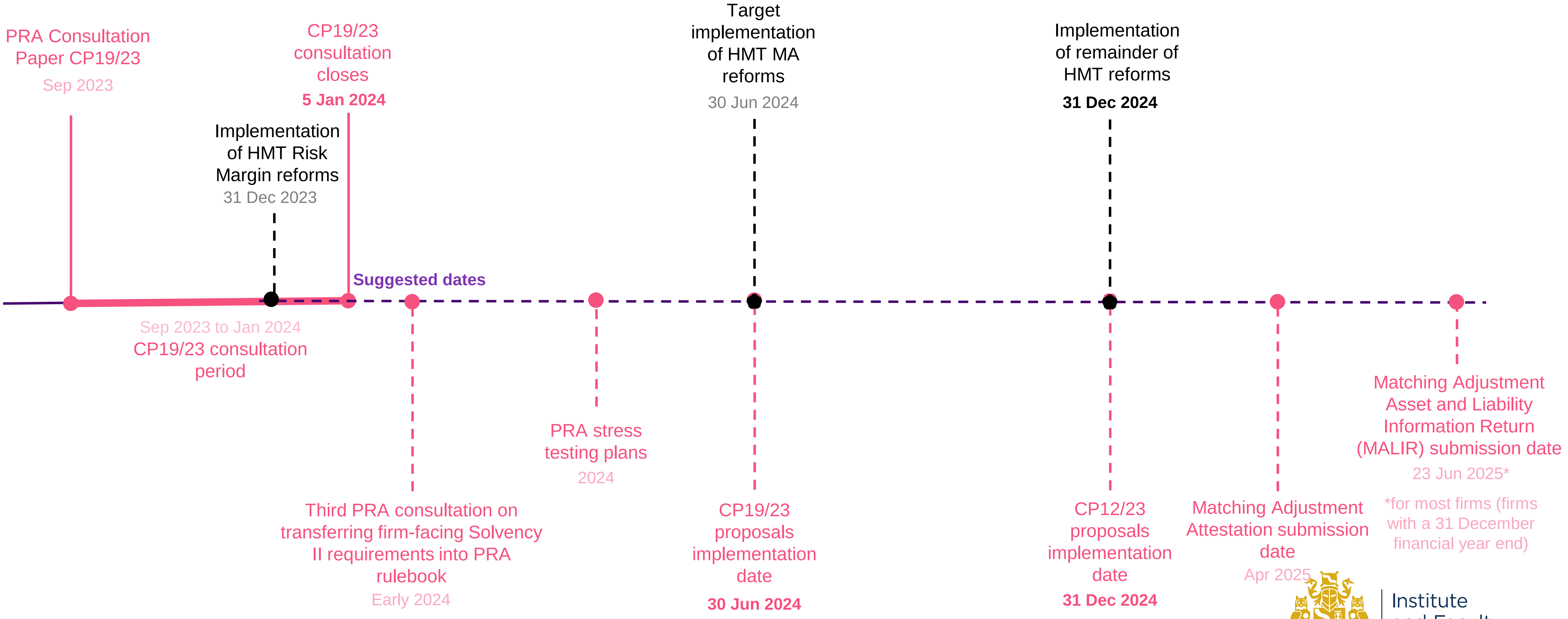
There is still more to come…



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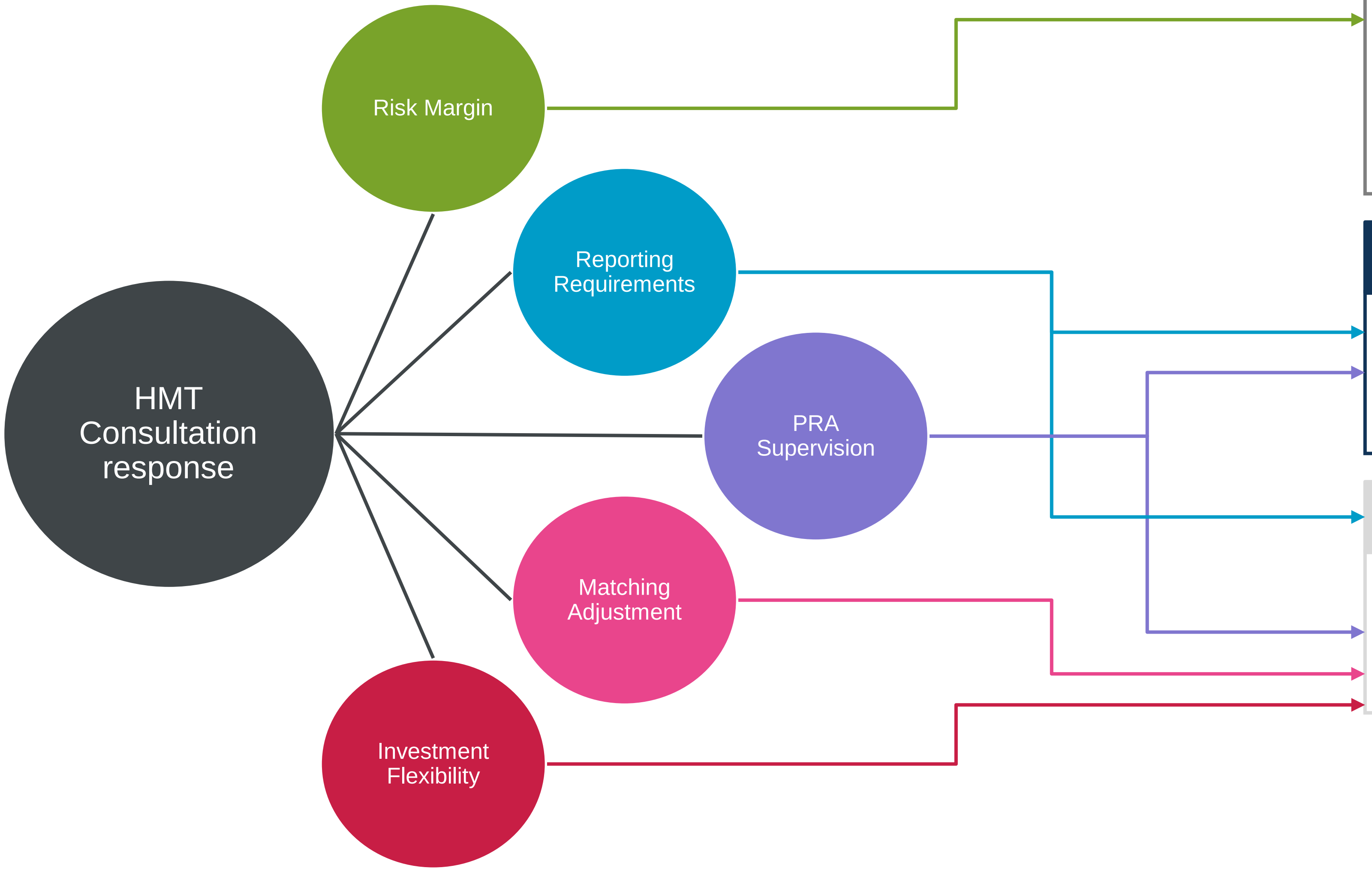
HMT Consultation response mapping



HMT Statutory Instrument

- Includes the new proposed formula and parameters for the Risk Margin calculation:

$$RM = CoC * \sum_{t \geq 0} \frac{SCR_t * \max(\lambda^t, \lambda_{floor})}{(1 + r_{t+1})^{t+1}}$$

$$cost\ of\ capital\ (CoC) = 4\%$$
$$risk\ tapering\ factor\ (\lambda) = 0.9$$
$$floor\ of\ risk\ tapering\ factor\ (\lambda_{floor}) = 0.25$$

- The proposed changes to the calculation are consistent with previous comments from the government which indicated a sizable reduction in RM for long term insurers (60% – 70%).

PRA CP12/23 - Review of Solvency II: Adapting to the UK insurance market

- Consultation issued on 29 June 2023 with response deadline of 1 September 2023.
- Proposals intended to simplify some Solvency II requirements, allow improved flexibility for others, and encourage entry into the UK insurance market.

PRA CP19/23 - Review of Solvency II: Reform of the Matching Adjustment

- Consultation issued on 28 September 2023 with response deadline of 5 January 2024.
- Proposals intended to improve the way that the MA supports investment and maintain a high level of prudential standards and policyholder protection.

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Consultation Paper 12/23

Transitional Measures on Technical Provisions (TMTP)

- Introduction of a simplified new default method (the TMTP method)
- Ability to use legacy approach subject to approvals and conditions
- Removal of FRR test
- Removal of PRA approval for recalculations
- Chief Actuary to oversee TMTP

Internal models (IM)

- PRA grant “permission” to use an IM
- Permission to use IM with residual model limitations (RML) may be granted
- Introduction of formal Internal Model Ongoing Review framework
- Annual CRO attestation on IM
- Changes to IM Tests and Standards

Overview of CP12/23

- Introduction of new RML CAO to potentially speed up IM permission
- Statement of Policy for CAOs broadly aligned to retained EU law
- Methodologies to calculating CAOs
- Review of CAOs on “regular basis” by the PRA rather than annual
- Aggregate report summarising use of CAOs at industry level

Capital add-ons (CAOs)

- New templates, removed templates and template changes
- Regulatory Supervisory Report removed
- Introduction of SCR Analysis of Change for IM firms to replace P&LA
- Group SCR calculation changes and branch requirement removal
- Threshold increases, administrative amendments and mobilisation regime

Reporting, disclosures and other matters

Source: PRA Consultation Paper 12/23, 29 June 2023

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Consultation Paper 19/23

Investment flexibility

- Matching Adjustment (MA) asset eligibility widened beyond fixed requirements, so assets with ‘Highly Predictable’ (HP) cashflows can be included subject to meeting a set of criteria
- Controls on quality of matching for MA portfolios to be extended to limit the material new risk potentially introduced by assets with HP cash flows

Liability eligibility

- Restatement of existing MA liability conditions
- Expanded liability eligibility to include:
  - In-payment income protection claims
  - Guaranteed element of with-profits (WP) annuities

Credit ratings under MA

- Removal of MA benefit cap on sub-investment grade (SIG) assets
- Requirement to consider appropriateness of SIG MA cap in Internal Model (IM)

MA permissions, breaches and rule changes

- Firms to include evidence in MA applications of assets being managed in line with Prudent Person Principle
- MA benefit reduced in staggered manner where MA conditions not restored within a 2-month period
- Streamlined MA application approach to allow for decisions in 6 months

Notching

- Mandatory application of a notched FS through linear interpolation, but some discretion in application
- Notched FS only applied for assets which are not Central Government and Central Banks, and are mapped to Credit Quality Steps 1 to 5
- Differences in granularity of credit quality between Technical Provisions and IM should be justified, with likely capital add-ons if model developments are required

Assumptions underlying the MA

- MA assumptions (both conceptual and technical) set out in one place to provide clarity on expectations
- Conceptual assumptions – setting out the logical underpinning of the MA
- Technical assumptions – setting out the policy requirements in relation to the technical information published by the PRA for the MA calculation

MALIR

- More formal data collection exercise for MA, with a separate Matching Adjustment Asset and Liability Information Request (MALIR) submission for each MA portfolio
- Builds upon YE22 ad hoc information collection template, with tightened areas of inconsistency and new fields largely related to HP assets
- Waiver process if the annual MALIR requirement is disproportionate given the size of the firm or its MA portfolio

MA Attestation

- Firms required to formally attest to the PRA on the sufficiency of the FS and the quality of the resulting MA
- Firms should identify sources of anticipated returns and judge whether a proportion of these should be recognised in the MA, with more focus on assets with a high level of MA

Source: PRA Consultation Paper 19/23, 28 September 2023

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Potential implications of key developments

Solvency II reforms mini-polls

Following the release of CP12/23 in June 2023 and CP19/23 in September 2023, WTW has hosted breakfast roundtables with participants from UK life insurers to discuss the consultations.

To support the discussion, mini-polls have been carried out with firms providing views and sentiment on the consultations overall as well as key topics contained in each of the consultations. A summary of participation is provided in the table on the right.

The roundtables, mini-polls, discussion with individual firms and additional analysis support the information contained within the subsequent slides.

Summary of participation	CP12/23 mini-poll (July 2023)			CP19/23 mini-poll (October 2023)		
	Internal / Partial Internal Model	Standard Formula	Total	Internal / Partial Internal Model	Standard Formula	Total
Matching Adjustment	11	2	**13**	11	2	**13**
Non-Matching Adjustment	1	7	**8**	2	0	**2**
Total	**12**	**9**	**21**	**13**	**2**	**15**

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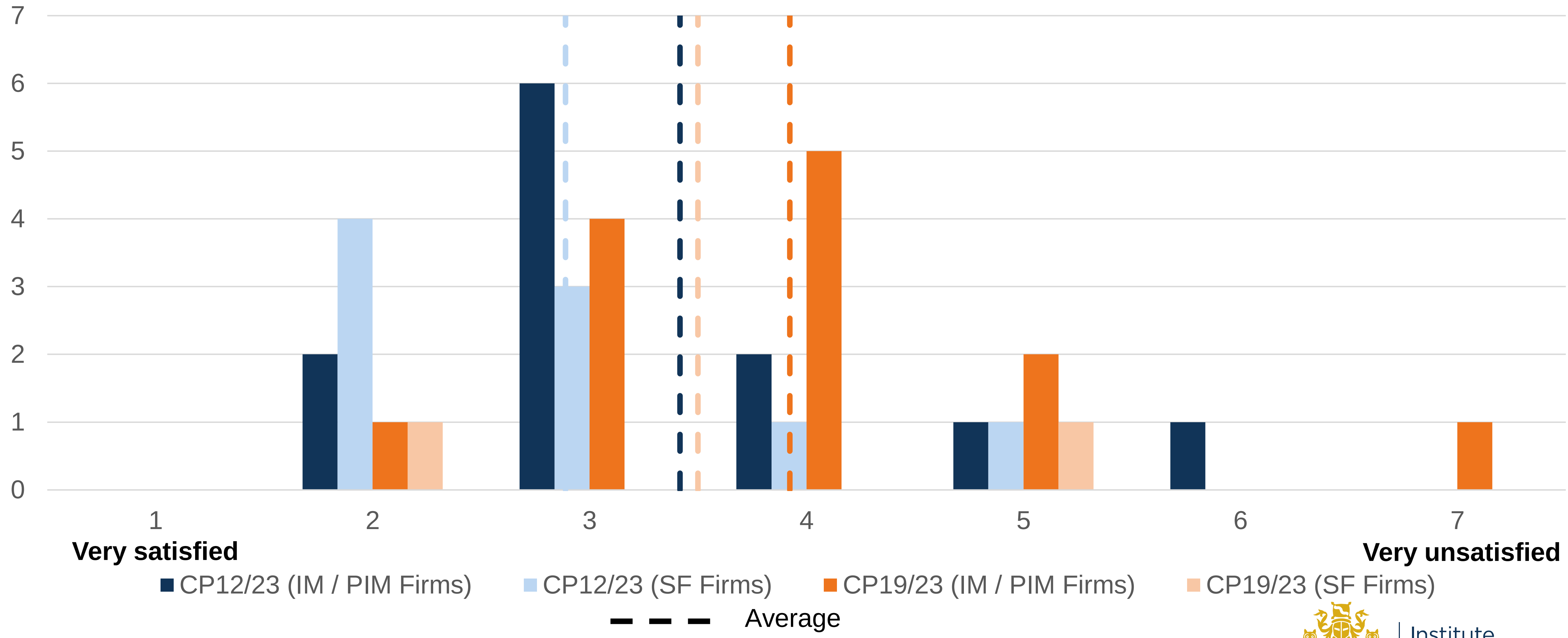
Industry reaction to the PRA Consultation Papers



Source: WTW Breakfast Roundtable Mini-Polls on CP12/23 and CP19/23, July and October 2023

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CP12/23 – Benefits and drawbacks

Benefits

- Reduction in risk margin
- TMTP simplification
- Removal of RSR
- Reduction in reporting requirements

Drawbacks

- Volume of changes
- Residual Model Limitation Capital Add-Ons
- Ongoing IM maintenance unchanged
- Changes to existing reporting templates

Source: WTW Breakfast Roundtable Mini-Poll on CP12/23, July 2023

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CP19/23 – Benefits and drawbacks

Benefits

- Removal of sub-IG cap
- Liability expansion
- Degree of certainty
- Allowance for assets with HP cashflows
- MA application streamlining

Drawbacks

- HP cashflow criteria
- 10% MA benefit limit on assets with HP cashflows
- Onerous nature of MA attestation
- Treatment in stress
- External assurance on ratings

Source: WTW Breakfast Roundtable Mini-Poll on CP19/23, October 2023

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Insights from PRA CP19/23 Roundtables

Whole of asset with both fixed and HP cashflows counts towards 10% HP limit

ERM unlikely to be HP in current form but product design may change this in future

Assets currently held in MA portfolios, unless in error, can continue to be held as 'fixed'

Pragmatism for new assets where no rating agency methodology exists

Attestation at portfolio level but PRA expecting more granular analysis

Potential PRA guidance issued following first attestation to support consistency

PRA view that MA attestation proportionate to size, complexity and asset risk profile change

Implementation approach to be determined based on final policy

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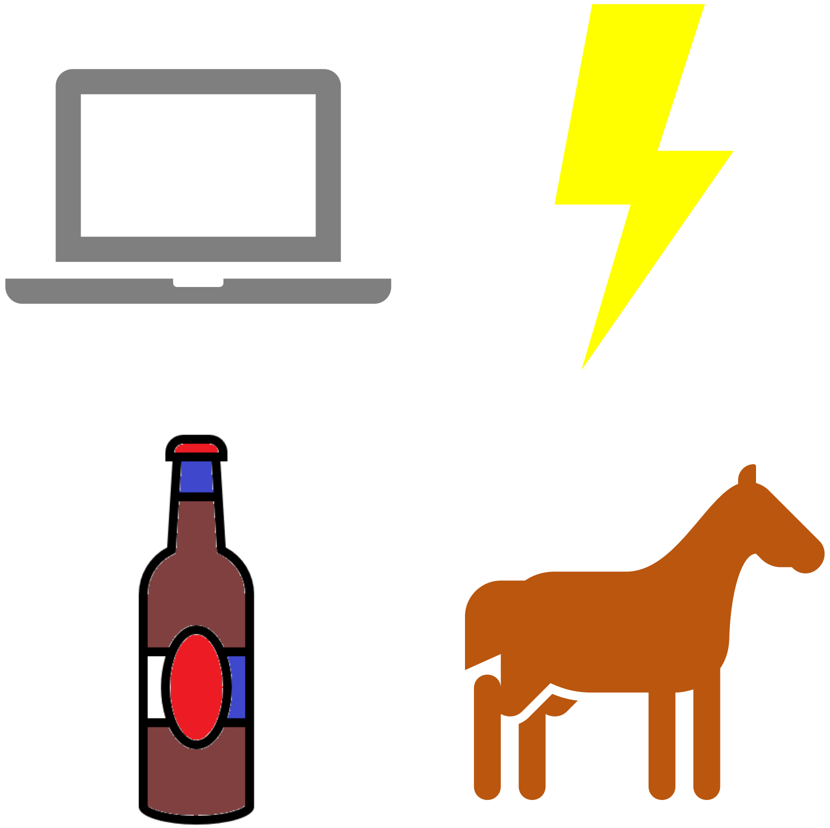
The hunt for HP

While CP19/23 permits assets with HP cashflows to be held in the MA portfolio (subject to limits and additional requirements), firms are currently exploring new and existing investment opportunities to identify whether these could be included in the MA portfolio.

Assets with HP cashflows are likely to fall into one of the following three categories:

1. Traded credit (e.g. callable bonds, CLOs, RMBS)
2. Direct private investment with features that may not fit into existing MA rules (e.g. construction phase infrastructure)
3. Elements of internally structured assets (e.g. mezzanine notes of LTMs)

While some firms may already hold some of these assets in their MA portfolio under the existing ‘fixed’ rules, they may want to consider whether holding such assets under the ‘HP’ rules is more beneficial.



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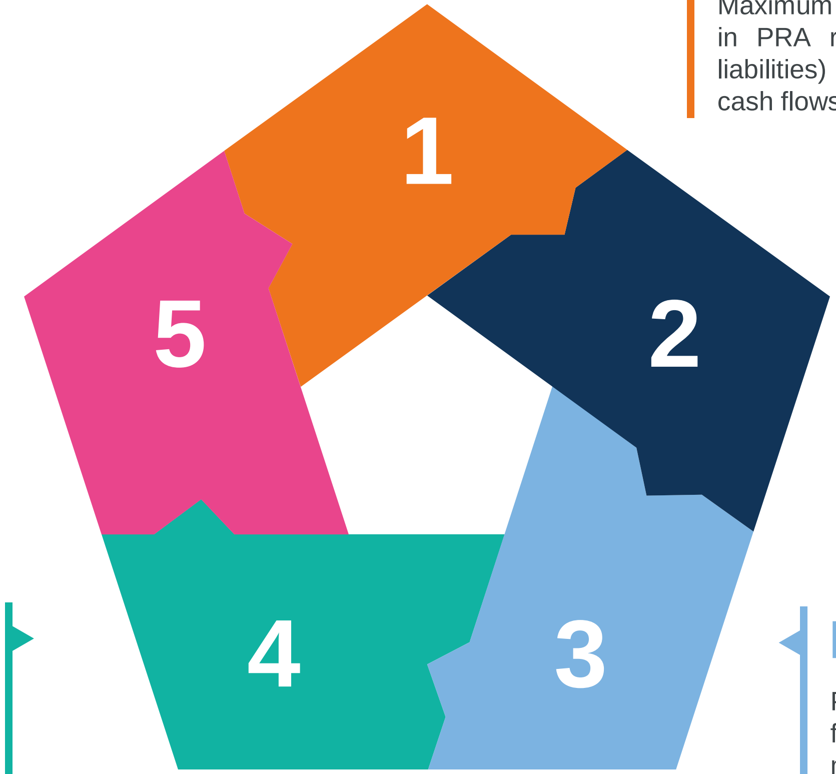
Specific requirements for HP cash flow assets



10% of total MA benefit

Maximum of 10% of the total MA benefit (defined in PRA rulebook as impact on best estimate liabilities) to be generated from assets with HP cash flows.

PRA Matching Tests 4 and 5

Introduction of two matching tests to consider reinvestment and liquidity risk where HP cash flows are not received as expected.

Minimum 10 bps FS add-on

Proposed minimum FS add-on of 10 bps as an estimate for reinvestment and/or rebalancing costs under normal market conditions based on PRA analysis.

Best estimate cash flows

Default approach of probability-weighted average of future cash flows but deterministic or median approach when greater reliance on expert judgement.

HP under stress

Consistency with approach used in the best estimate but consideration must be given to how the FS add-on may change under stress.

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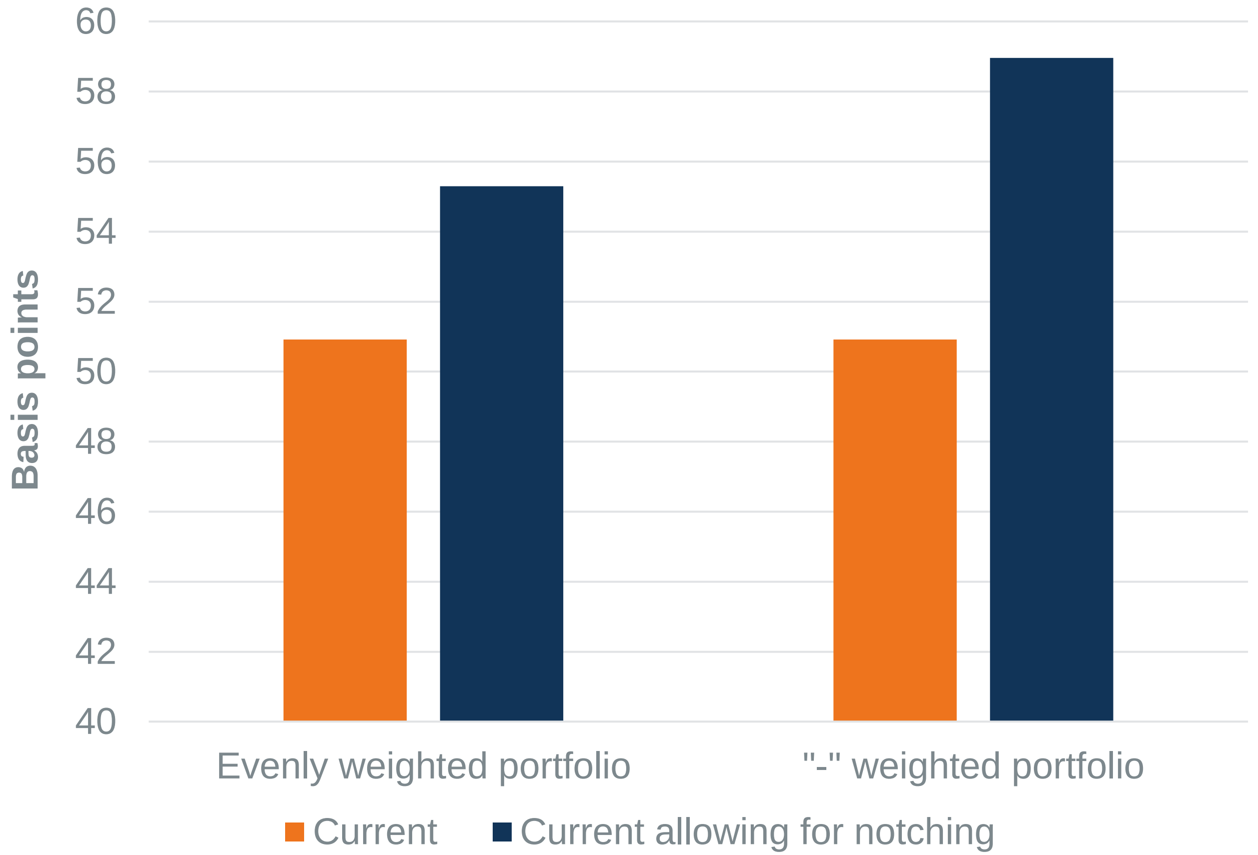
Allowance for notched ratings

- The graph on the right sets out the potential impact on FS from applying notching.
- The base FS of 51 bps is calculated using an illustrative portfolio with a typical asset allocation for MA portfolios, with average term to maturity at 10 to 15 years.
- We have used the approach of linearly interpolating the current full-letter FS to include + and – notched assets.
- We have shown the impact of notching in two scenarios:
  - An evenly split portfolio with 33% of asset in each notch
  - A “–“ weighted portfolio with 50% of the assets “–“ rated, 25% of the assets “+” rated and 25% of the assets in the exact letter rating.
- As expected, the “–” weighted portfolio which is biased receives a higher increase in the FS from notching.



Source: WTW Analysis of Proposed Solvency II Reforms, 21 July 2022 (Figure 5.3)

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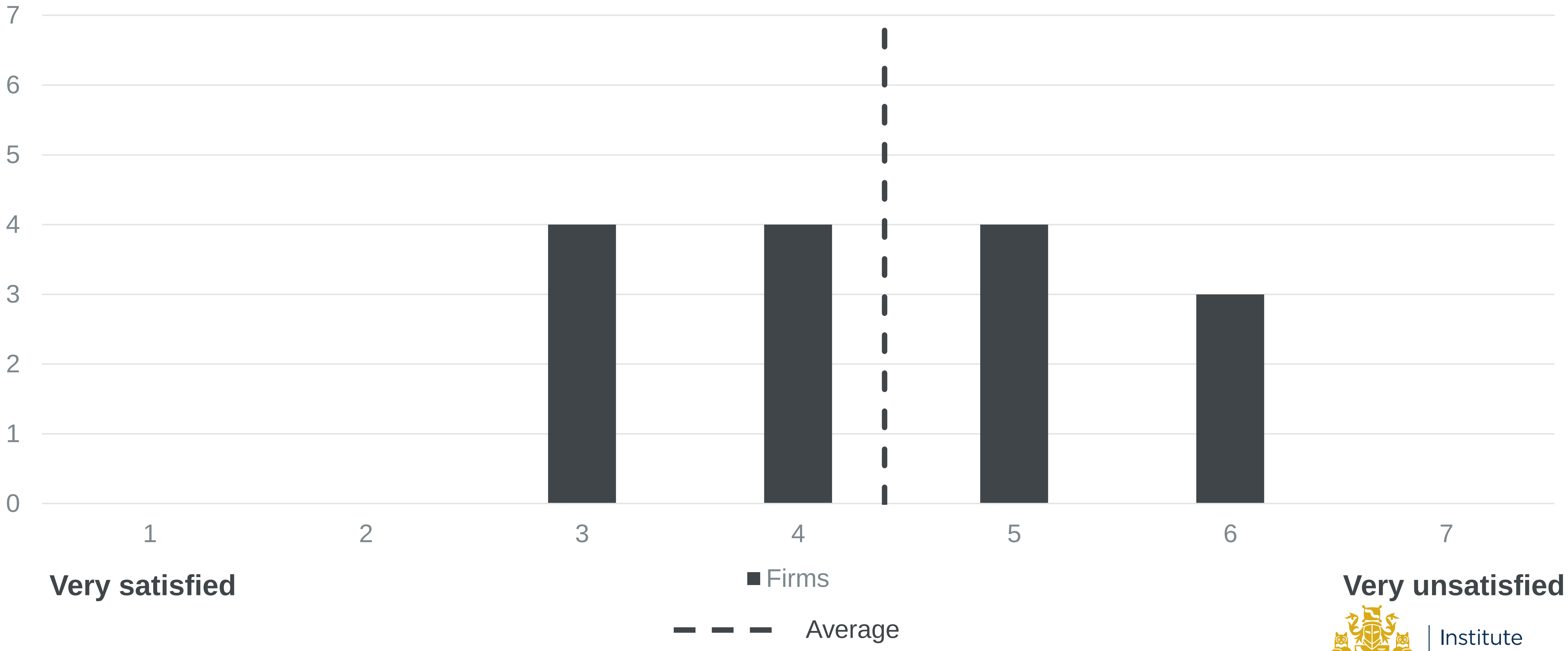
Industry reaction to the MA attestation proposals



Source: WTW Breakfast Roundtable Mini-Poll on CP19/23, October 2023

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Sufficiency of the FS for corporate bonds

MA Attestation Requirements

- Under CP19/23, the PRA proposes that firms attest the sufficiency of the FS and the quality of the resulting MA.
- The PRA sets out a 3 step approach to the attestation in the updates to SS7/18. Steps 1 and 2 consider the sufficiency of the FS while step 3 considers the appropriateness of the MA.
- In particular, step 1 considers assets with a risk profile consistent with the assumptions underlying the MA and step 2 considers assets with a risk profile that is not consistent with the assumptions underlying the MA.

PD + CoD vs LTAS floor approach for Step 1

- One potential approach that could be considered to support Step 1 is a comparison of the Probability of Default (PD) plus Cost of Downgrade (CoD) against the Long-Term Average Spread (LTAS).
- The FS is determined using the greater of PD+COD or LTAS with the LTAS floor biting for a number of credit ratings and terms.
- The difference between the LTAS floor and PD+COD can be considered as a buffer for uncertainty.

WTW Credit Calibrator

- We have leveraged the WTW Credit Calibrator to project corporate credit PD and CoD to compare against the LTAS floor to evaluate the buffer for uncertainty.
- **WTW's Credit Calibrator** is an **accelerator tool** designed to assist our clients with the challenge of meeting Solvency II requirements for the calibration and / or validation of the matching adjustment under stress (MAuS).

Overview of approach

FS sufficiency for corporate bonds (MA attestation step 1)

Data Uncertainty

The data used to calibrate the FS may not adequately capture certain risks (e.g. idiosyncratic or climate).

Data Uncertainty PD + CoD vs LTAS floor approach

Assuming that the rating used in determining the FS is appropriate, we analyse the term at which the LTAS floor no longer bites at different ratings (i.e. there is no longer a buffer against PD + COD).

Rating Uncertainty

The ratings used in determining the FS may be inappropriate or inaccurate.

Rating Uncertainty PD + CoD vs LTAS floor approach

By considering notched changes to the rating, we analyse the term at which the LTAS floor for the original rating no longer exceeds the PD + CoD for the new rating.

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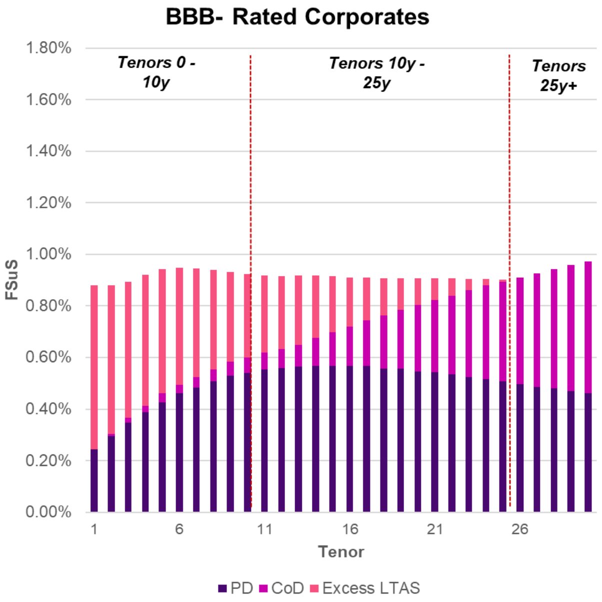
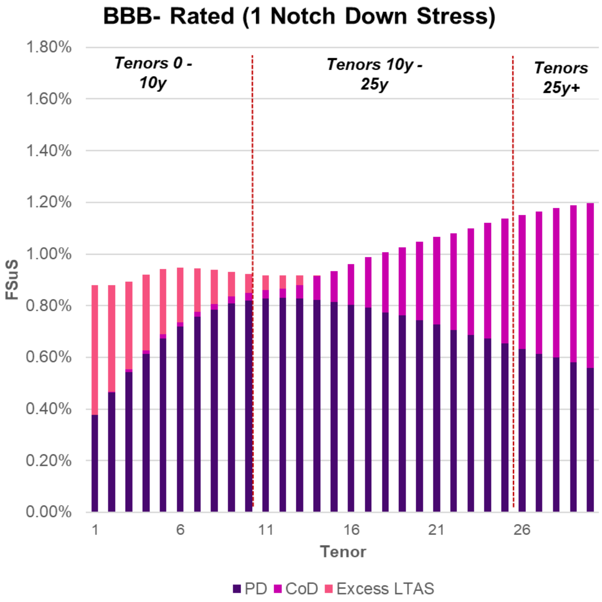
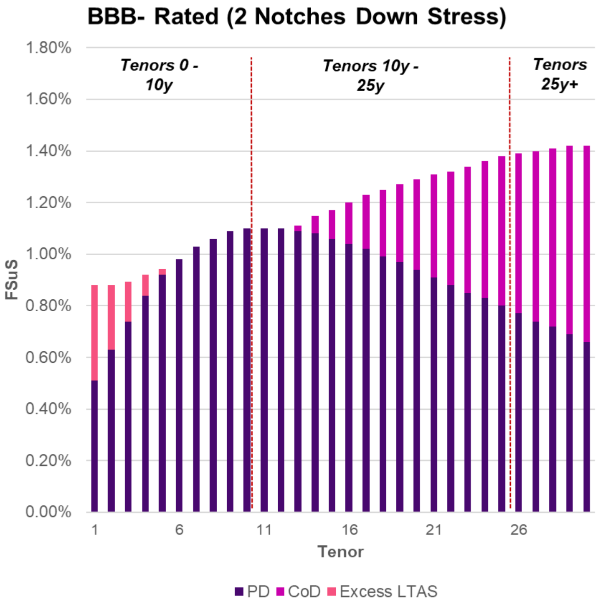
PD + CoD vs LTAS floor analysis







- The charts above illustrate how PD, CoD and excess LTAS vary by term with excess LTAS generally beginning to fall away at higher terms. These may be the points at which the FS sufficiency may need to be considered.
- The table on the right sets out the terms at which PD+CoD exceeds the LTAS floor. We note that linear interpolation for notching also leads to some unintuitive outcomes (e.g. BBB vs BBB- results)

Tenor at which PD+CoD exceeds LTAS floor			
Original Rating	**Data Uncertainty**	**Rating Uncertainty**	
Rating (Non-Fin)	**No change**	**1-notch down**	**2-notches down**
A	17	16	15
A-	18	18	17
BBB+	20	19	7
BBB	22	10	2
BBB-	26	15	6

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Big picture considerations

Objectives of the reforms

1. *Spur a vibrant, innovative and internationally competitive insurance sector*
2. *Protect policyholders and ensure the safety and soundness of firms*
3. *Support firms to provide long-term capital to drive growth consistent with the Government's climate change and productive finance objectives*

HM Treasury

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Aspirations

"City chiefs to **unleash £80bn** Brexit 'Big Bang' as ministers scrap EU red tape

- The Telegraph following John Glenn ABI Annual Dinner speech

"**Phoenix** plans to **invest £40-50bn** in illiquid assets and sustainable investments over the next five years to support house building, green energy, and local communities across the country without compromising policyholder protection in any way.

- Andy Briggs following the 2022 Autumn Statement

"This is a very welcome boost for UK investment. We estimate reforms to Solvency 2 will allow **Aviva** to **invest at least £25 billion** over the next ten years across the UK, including in critical areas such as social housing, schools, hospitals and green energy projects

- Amanda Blanc following the 2022 Autumn Statement

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Potential impacts of proposed investment flexibility

£100bn

Intended level of investment unlocked by Solvency UK

HM Treasury Press Release, 29 June 2023

£32bn

Own funds MA benefit to UK annuity insurers at YE22

Paragraph 6.37 of CP19/23

£290bn

Approximate total market value of assets backing annuity liabilities within the MA

Paragraph 10.6 (Footnote 29) of CP19/23

10%

Proportion of MA benefit (BEL only*) arising from assets with HP cashflows

Paragraph 2.21 of CP19/23 and Appendix 2 Annex B Paragraph 5.5

›

£3.2bn

MA benefit from assets with HP cashflows and potential lower bound on market value*

10% to 20%

Typical range of MA benefit as a proportion of market value of assets backing annuities within the MA

›

£16bn to £32bn

Potential range of market value of assets with HP cashflows**

Further investment may arise from inclusion of additional liabilities in the MA portfolio, new bulk annuity transactions and the reduction in the risk margin.

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*Paragraph 5.5 of Appendix 2 Annex B to CP19/23 sets out that matching adjustment benefit in the context of the 10% limit is ‘an amount equal to the impact on its best estimate’
**Assuming all UK insurers use 10% limit from assets with HP cashflows

Reality?

“ As things stand, the revision of the rules would have a negative impact on **L&G's** solvency ratio of 5 percentage points, according to UBS.

- UBS prior to the 2022 Autumn Statement

“ It estimated the reform to the risk margin would increase the group's solvency ratio by 3-4 percentage points.

- **Aviva** rose 1.7%,
- **L&G** jumped 4.2% and
- **Phoenix** advanced 3.2%.

- Barclays following the 2022 Autumn Statement

Investment Delivery Forum

The insurance and long-term savings industry invests billions in green and good infrastructure.

Solvency UK regulatory reforms will allow us to channel £100bn more into such projects over the next 10 years, with the Forum on hand to ensure investment happens swiftly, keeping us on track to net zero.

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Oversight

The Sub-committee will review the impact of the PRA's policies in relation to the
insurance sector insofar as they affect regulated firms, individuals and markets, responding and providing feedback to the PRA at an appropriate stage of the policy development process

- Sub-committee membership – as at March 2022:

  Representatives from ABI (Chair), IFOA, IRLA, AFM, Lloyd's, IUA,

  + Helen Pickford, UK CFO, Zurich – ABI-elected
  + Andrew Stoker, CFO, Rothesay – ABI-elected

- Sub-committee membership – as at March 2023:

  + Andrew Stoker, CFO, Rothesay – ABI-elected (Chair)
  + Charlotte Jones, Group CFO, Aviva – ABI-elected
  + Rakesh Thakrar, CFO, Phoenix – ABI-elected

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Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

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Thank you