Institute
and Faculty
of Actuaries

Life Conference 2022

23–25 November, ACC Liverpool

#LifeConf

Institute and Faculty of Actuaries

SII Reforms: The Risk and Compliance view for Life Insurers

Andy Morris
Marinos Savvides
Humera Muzammil

#LifeConf

Introduction & Agenda

The SII Reforms proposed by HMT suggest wide-reaching impacts on Life Insurers through changes to the Matching Adjustment and Risk Margin.

During the session we will be discussing:

- Three possible implementation scenarios and their likely impacts
- Risk management considerations life insurers will need to be prepared for
- Compliance considerations arising from the above

With the Risk Margin reforms being largely formulaic, and likely to be absorbed by increases in the TMTPs, we have focused our work on the Matching Adjustment reforms as they have a larger scope for interpretation.

mazars

Institute and Faculty of Actuaries

Scenario 1

Increasing the range of liabilities eligible for the Matching Adjustment

“The Government also proposes to extend the range of liabilities eligible for the matching adjustment to include products that insure against morbidity risk, such as income protection products. These have similar characteristics to products currently eligible for the matching adjustment, such as in payment annuities.”

“With-profits annuities and deferred annuities in with profit funds will also become eligible for matching adjustment portfolios, on the basis that part of these annuities are benefits that are contractually guaranteed and may be matched with bond assets. The extent to which such liabilities could be included in a matching adjustment portfolio would need to be consistent with the investment policies and wider financial management and governance arrangements for the with profits funds”

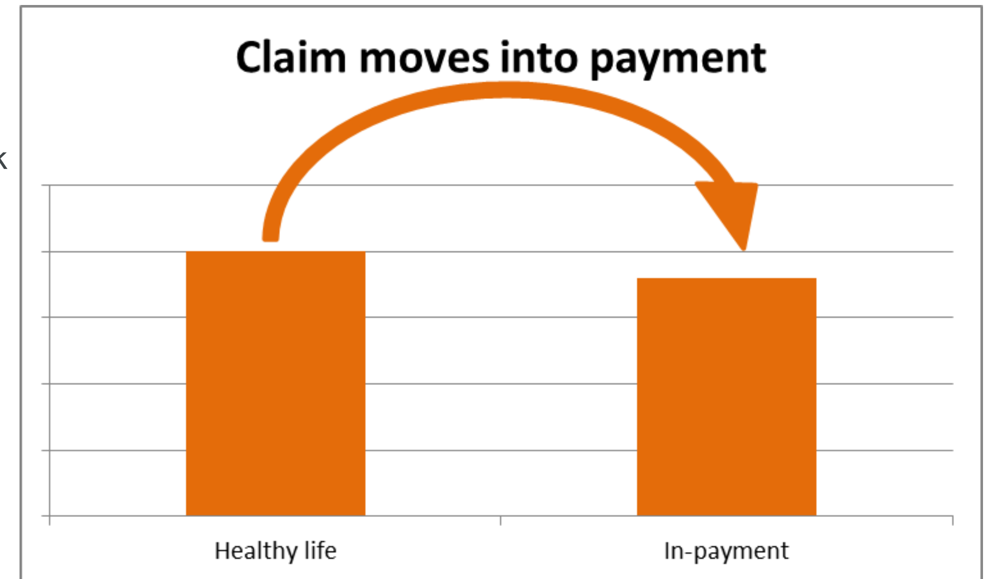
- Source: https://www.gov.uk/government/consultations/solvency-ii-review-consultation

Institute and Faculty of Actuaries

Scenario 1

Income protection

- Volatility of claims
  - Longer duration claims will see most benefit and have most stable termination rates, but will be fewer in number
- Reinsurance
  - Existing reinsurance may make up a large portion of the asset on the back book
  - How could this change reinsurance structures going forwards?
- Valuation approach
  - Pricing versus valuation
  - Valuation when in claim versus when not in claim



mazars LV= Institute and Faculty of Actuaries

Scenario 1

With-profits annuities and deferred annuities

- How will the liability be incorporated?
  - “*part of these annuities are benefits that are contractually guaranteed and may be matched with bond assets*”
  - Questions arise in respect of the remaining non-guaranteed liability

- Investment strategy
  - Is a strategy of backing any fixed cashflows with bonds in line with policyholder expectations?

- Surrender options
  - Currently, policies are permitted in the MA if they contain *“only a surrender option with a surrender value not exceeding the value of the assets ….. covering the insurance or reinsurance obligations at the time the surrender option is exercised”*
  - To what extent will any existing payout calculation basis be compatible with this?

mazars LV= Institute and Faculty of Actuaries

Scenario 2

Broaden the range of assets eligible for the Matching Adjustment Portfolio

“Insurers will be able to include assets with prepayment risk for which the issuer has the option to repay the asset at an earlier date, such as callable bonds, commercial real estate lending, housing association bonds and loans, infrastructure assets and local authority loan portfolios. Policyholder protection will be maintained by combining this easing of restrictions with proportionate actions to ensure risk mitigation”

“The treatment of assets with construction phases will also be amended under these proposals so that firms can recognise penalties and other consequential amounts that may be payable to the insurer if completion is delayed”

- Source: https://www.gov.uk/government/consultations/solvency-ii-review-consultation

Institute and Faculty of Actuaries

Scenario 2

Broaden the range of assets eligible for the Matching Adjustment Portfolio

- Highly predictable cashflows
  - The final consultation response widens the eligibility scope further to include assets with “highly predictable” cashflows.
  - These assets may attract fundamental spread uplifts versus assets with entirely fixed cashflows

- Introducing variability into the cashflows introduces additional risk
  - Reinvestment risk if the cashflow is received earlier than anticipated
  - Liquidity risk if the cashflow is received later than anticipated
  - Unclear at this stage the level of proportionate actions PRA may require in this circumstance

- Investment expertise
  - A wider pool of assets with less vanilla features may require firms to broaden their investment knowledge base

mazars

Institute
and Faculty
of Actuaries

Scenario 3

Adapting to a new framework surrounding the Matching Adjustment

"As set out in the Consultation paper in April 2022, there has been no consensus on the best approach on reform of the fundamental spread. The Government has carefully considered the case for reform … and has decided to leave the design and calibration of the fundamental spread as it stands today. It will, however, increase the risk sensitivity of the current fundamental spread approach to allow different notched allowances to be made within major credit ratings"

"the Government will support the PRA both by ensuring it has the powers necessary to take forward the following additional measures and by being clear that it supports the PRA's use of these measures to hold insurers to account in maintaining safety and soundness and policyholder protection"

- Source: https://www.gov.uk/government/consultations/solvency-ii-review-consultation

Institute and Faculty of Actuaries

Scenario 3

Adapting to a new framework surrounding the Matching Adjustment

- Operational changes
  - Notched ratings will change the way the portfolio reacts to rating changes
  - Asset-specific fundamental spread add-ons
  - Removal of the BBB cliff and its implications

- Attestation process
  - Numerous ways to decompose corporate bond yield into constituents
  - Regulatory expectations may be key
  - Additional part of the approval process for new assets?

Institute and Faculty of Actuaries

Scenario 3

Adapting to a new framework surrounding the Matching Adjustment

- Stability of the regulatory framework
  - Matching Adjustment framework exists to support long term investment
  - Certain elements of the package will be captured in legislation, with other elements captured in the PRA Rulebook
  - 5 year review of the Fundamental Spread calibration

mazars

Institute and Faculty of Actuaries

Product-level risk considerations

With-Profits and Deferred Annuities

Meeting Policyholder’s Reasonable Expectations (PRE)

Asset eligibility rules changing risk PRE on backing assets and returns not being met

Already mixed perception surrounding WP products – can the industry withstand a “scandal”?

Generational Equity

Reforms promise wider asset eligibility with higher returns - need to ensure equity between generations of members, reforms could prove unpopular if later generations are significantly impacted

mazars

Institute and Faculty of Actuaries

Product-level risk considerations

With-Profits and Deferred Annuities

Changing Principles and Practices of Financial Management

Potential for misalignment between current PPFM and portfolios taking advantage of the widened asset eligibility

PPFMs will need to be adjusted from the ground up – early communication to members will be **key**

Knock-on impacts on investment guidelines and monitoring processes, risk of controls environment being inadequate

mazars

Institute
and Faculty
of Actuaries

Product-level risk considerations

Income Protection Claims in Payment

Risks in pricing practices

Widening liability eligibility to morbidity risks for inclusion within MAP – IP Claims in Payment stated as one possibility

Pricing assumption of IP moving to claim in payment will be significant source of risk

- Claims in payment will attract a significantly higher discount rate – the earlier this is assumed to occur, the greater the impact on the premium
- Risk of under-pricing products if assumptions made are too optimistic
- Morbidity already an area of difficulty in determining appropriate assumptions – do we have the data to calibrate appropriately?

There will be a need for revised pricing guidelines and processes – revamping of models could introduce process risk

Capital planning could become (more) complicated

Preparing for the ORSA and Stress Tests

Valuation of a wider pool of assets

Reforms outline an inclusion of infrastructure assets within the MAP, among others

Valuation of these assets and cashflows will either require skillsets not currently available to most Life companies, or reliance on external providers

Communication between valuation and actuarial teams will be key in ensuring the cashflows are well understood, and clarity in how the fundamental spread is calculated

Inclusion in the ORSA and Stress Tests

Determining the cashflow profile for the ORSA, and calibrating appropriate stresses will become more onerous.

Underlying risks will need to be well understood, and may be out of the usual universe of risks actuaries and CROs are used to working with

Inclusion of cashflows introduces complexities within the ORSA process and may necessitate a change in how it is carried out. There will be significant risks involved in the asset/liability interaction over the projection

mazars

Institute and Faculty of Actuaries

Capital planning could become (more) complicated

Adjusting capital requirements and business planning

Volatility introduces complexity

Consultation responses implied a significant element of capital volatility from widened asset portfolios included in the MAP

There are concerns that this indicates higher levels of capital may be required to support portfolios, particularly for SF companies choosing to invest in these assets

Are capital coverage ratios, particularly for bulk annuity providers, robust enough to withstand an increase in capital?

This, along with prior considerations may require a restructuring of functions or hiring of additional resources to redesign the ORSA, Stress Tests and capital calculations

mazars

Institute and Faculty of Actuaries

Reforms necessitate rethinking

Stability of the reforms

The reforms will be implemented, in part, through the PRA Rulebook subject to a 5-year review – considerably shorter than most MA investment time horizons

This allows for flexibility in fine-tuning, but introduces elements of regulatory uncertainty over the stability of the new MA structure

Attestations that the MA only captures liquidity risk may prove to be cumbersome and attract a “voluntary FS add-on”

This could impact the willingness to invest in non-traditional MA assets

Embedding the reforms

Enterprise Risk Management frameworks will need to be amended, or rebuilt from the ground up, to take account of all the above risks and embed the reforms, at a substantial cost to the industry

How we respond to the monitoring and management of these risks may be the balance between the reforms being a success, or hampering the industry

mazars

Institute and Faculty of Actuaries

Why Compliance

"Core to every insurer's business model are the ideas of risk pooling from a large population, leveraging their specialist expertise as long-term investors, making insurance safe and affordable for policyholders and returns attractive to capital providers. Through the provision of long-term finance that is naturally enabled by the long-term liabilities taken on, insurers also play a vital role in supporting risk-taking and growth in the real economy."

- Source: https://www.bankofengland.co.uk/speech/2022/september/charlotte-gerken-speech-bank-of-america

mazars

Institute and Faculty of Actuaries

Compliance with the SII reforms

- Risk Margin – consider impacts on capital projections and pricing strategies

- Fundamental Spread
  - Regular stress testing
  - SMF to attest formally to the PRA

- Matching Adjustment
  - Assets – investment risk appetite and tolerance statements to reflect changes
  - Liabilities – apply for regulatory approval to use the matching adjustment
  - Processes – more streamlined approach

mazars Institute and Faculty of Actuaries

Compliance with the SII reforms

- ‘BBB’ cliff edge – revise investment strategy and risk assessments

- Reduced regulatory burden
  - Removing capital requirements for branches of foreign insurers
  - Increasing SII threshold
  - Reductions or reshuffle for regulatory reporting requirements?
  - More flexibility on internal model requirements

mazars LV= Institute and Faculty of Actuaries

In summary

- Strong governance and risk management processes
  - Evaluate why you are undertaking particular actions
  - Are capital benefits pursued at the cost of policyholders?
- Board responsibility
  - Assess the capabilities in the firm to assess the new investment allowances
  - Ensure expertise are available and utilised – risk, actuarial, modelling and investment team
- Align decisions with your business purpose and risk appetite
- Changes to flow through to the Own Risk Solvency Assessment (ORSA), Solvency and Financial Condition Report (SFCR) and Regular Supervisory Report (RSR)
- Prudent Person Principle – continues to be key for firms and supervisors to mitigate risks
- Investment guidelines will need to reflect new appetite for investments

mazars

Institute and Faculty of Actuaries

Institute
and Faculty
of Actuaries

Thank you

#LifeConf

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.

Institute and Faculty of Actuaries