WILLKIE FARR & GALLAGHER LLP

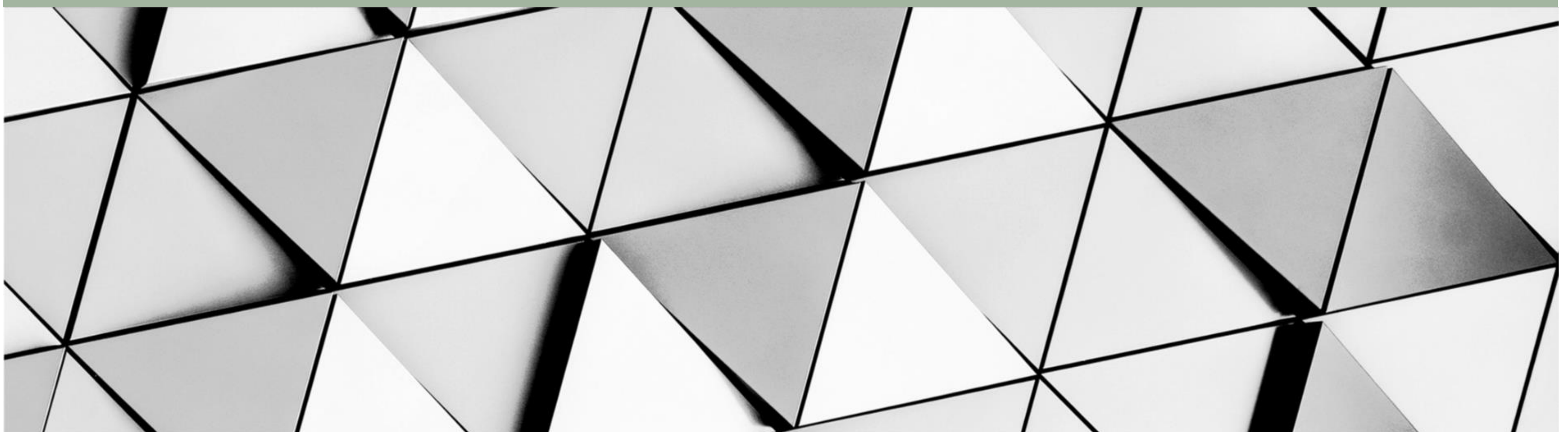
BRUSSELS CHICAGO FRANKFURT HOUSTON LONDON LOS ANGELES MILAN NEW YORK PALO ALTO PARIS ROME SAN FRANCISCO WASHINGTON

Longevity 17 Conference

Solvency II Reforms – an overview and impact on the pension risk transfer market

Kirsty Maclean

12 September 2022

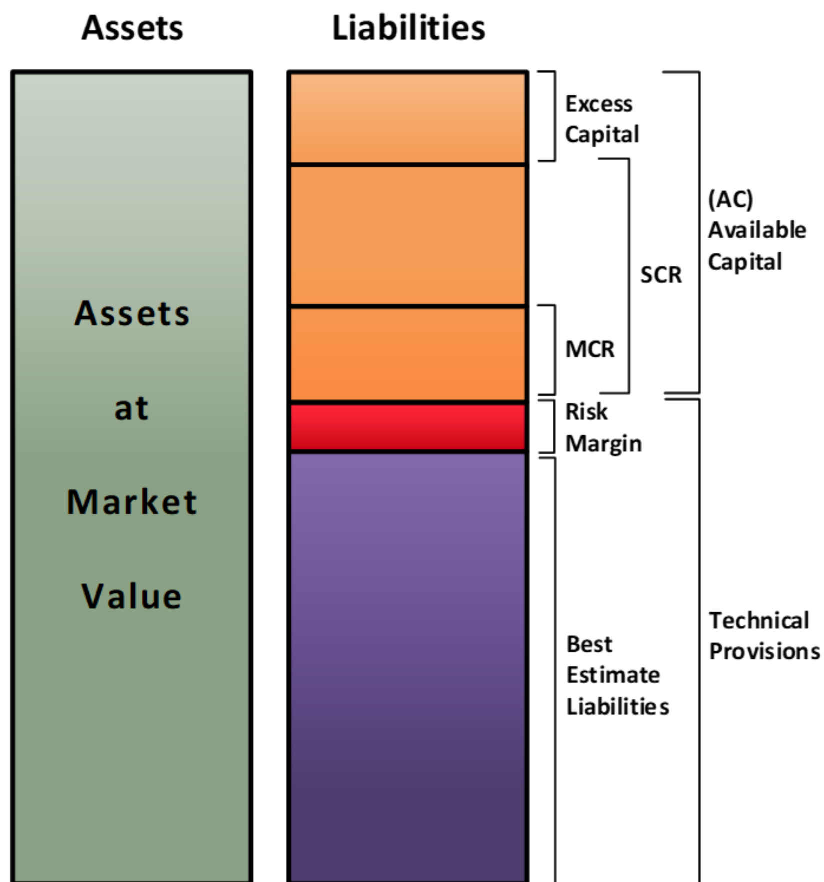


Copyright © 2022 by Willkie Farr & Gallagher LLP. All Rights Reserved. These course materials may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP.

Solvency II reform - how did we get here?

31 March 2015	Deadline to transpose Solvency II into domestic law
1 January 2016	Solvency II goes live in the UK
23 June 2016	Brexit vote: UK votes to leave the EU
23 June 2020	UK government announces it would review certain features of Solvency II
19 October 2020	HM Treasury (HMT) publishes review of Solvency II: Call for Evidence
31 January 2020	Exit day: UK leaves the EU
31 December 2020	Brexit transition period ends
1 July 2021	HMT publishes Response to the Call for Evidence
20 July 2021	Bank of England (PRA) launches Quantitative Impact Study
21 February 2022	Speech by John Glen, MP at ABI dinner
28 April 2022	HMT Consultation on Solvency II reform
28 April 2022	PRA Statement and Discussion Paper DP 2/22
7 July 2022	Boris Johnson, head of the UK Conservative Party and Prime Minister, resigns
21 July 2022	ABI published response to HMT Consultation (and consultations close)
6 September 2022	Liz Truss assumes role as new UK Prime Minister
TBD	UK government to publish a response and proposed legislative changes

The Risk Margin



WILLKIE FARR & GALLAGHER LLP

The Risk Margin (continued)

- Technical Provisions (TP) = Best Estimate Liabilities (BEL) + Risk Margin (RM)
- Best Estimate Liabilities
  - Present value of future liabilities payable to an insurer's policyholders, discounted using a risk-free yield curve
- Technical Provisions are intended to be market-consistent
- Risk Margin defined as amount on top of BEL that an insurer would have to pay to transfer risks to another solvent insurer
  - Covering more realistic costs associated with insurance business / "unhedgeable risks"
  - Risk Margin determined using a proxy method under Solvency II
    - cost-of-capital method
    - standard 6% rate
- What are the criticisms?
  - Too sensitive to interest rate movements
  - Too high when interest rates are low
- What is being proposed as part of the reform?
  - New method of calculation, still based on cost-of-capital method but with tapering
  - Could result in a reduction to the Risk Margin of 60 – 70%

The Matching Adjustment

- Favourable capital treatment for long term assets matching long term liabilities
- Achieved through an adjustment to the discount rate
- Estimated £85 billion of benefit to UK bulk annuity insurers
- The issue with the Matching Adjustment relates to the Fundamental Spread
  - the allowance made for risks retained by the insurer
  - downgrade, credit and other retained risks
- What are the criticisms? The PRA believes that:
  - the Fundamental Spread does not appropriately allow for these retained risks
  - the Matching Adjustment is too high, running the risk that insurers can't meet liabilities
- What is being proposed as part of the reform?
  - Adding a credit risk premium / CRP
  - PRA says that whatever the solution is it should deliver an outcome equivalent to at least 35% of credit spreads

Investment Flexibility

- Cashflows generated by assets eligible for Matching Adjustment portfolios are required to be fixed in terms of timing and amount
- Justified by policyholder protection
- What are the criticisms?
  - The PRA recognises that fixed cashflows create inflexibility for insurers
  - Changes to the Fundamental Spread could allow some additional flexibility
- What is being proposed as part of the reform?
  - Proposal is to ease the requirement by allowing insurers to include additional assets, such as:
    - Assets with pre-payment risk for which the issuer has the option to repay the asset at an earlier date
      - i.e. callable bonds, commercial real estate lending, housing association bonds and loans, infrastructure assets and local authority loan portfolios
    - Ability to recognise penalties and other amounts payable to a firm if completion is delayed on investments with construction phases
  - Still with limits to maintain prudence for policyholder protection

Impact of Reforms on the Pension Risk Transfer Market

- Risk Margin
  - Market generally happy with proposal given it does result in a reduction
  - Won’t feel the full 60-70% relief in real terms for some time given transitional measures on technical provisions are still in play for business written prior to Solvency II go-live
  - However, benefit could be offset by Matching Adjustment reforms
- Matching Adjustment
  - Reduction to the benefit, resulting in increase to best estimate liabilities
  - Balance sheet volatility
- Investment Flexibility
  - Increase in UK investment in more diverse investments welcomed
- Net effect?
  - Unlikely to reach the quoted 10-15% capital reduction
  - Economic and societal benefits
  - Striking right balance between capital relief and policyholder protection
  - Impact on pricing and reinsurance?
- Demand > Capacity
  - Solutions?