End-state Market Update

November
2021

In 2016 the pan-European insurance regulatory regime, commonly known as Solvency II, was introduced.

The life insurance industry in the UK has enjoyed a sustained period of expansion since the introduction of the regime. Today insurers are helping finance areas of the economy that have historically been associated with banks. And these trends look set to continue with the Government pushing to have an 'Investment Big Bang' that supports its 'levelling up' agenda. The trends could be further supported by Brexit, which gives the UK the option to diverge from parameters set by the European regulator, EIOPA.

Our new update:

- **highlights key trends that have shaped the bulk annuity market since the introduction of Solvency II; and**
- **considers the implications these trends could have on the protection provided by insurers in the future.**

We focus on the residual covenant and counterparty risk embedded in the design of the Solvency II regime. This is a lens that has historically received limited attention from the pensions community in the UK in stark contrast to other geographies where more recent insurer failures have propelled counterparty risk to the forefront of insurer selection criteria.

This update comes at a timely juncture: the Prudential Regulation Authority (PRA) and HM Treasury are currently running the first ever comprehensive review of the Solvency II regime. The review will include a recalibration of features of the Solvency II regime that have the potential to reverberate on the affordability of these products and the counterparty risk posed by market participants. We examine a handful of the possible changes in this update.

At the same time, insurance risk-transfer products have become the default choice of many Defined Benefit (DB) pension schemes seeking to set and achieve their long-term objectives. This means that changes to affordability and the counterparties active in the market can have a direct impact on pension schemes' long-term strategies. In that context, it has never been more important for trustees and the Pensions Regulator (TPR) to keep a watchful eye on changes to the insurance regime.

Change is a constant feature in any modern financial system. Insurers are not immune to this. This update seeks to take a step towards bridging the knowledge gap that currently exists across the pensions and insurance communities.

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Policy review update

Solvency II review in the UK

In October 2020, the UK Government issued a Call for Evidence setting out three objectives for the Solvency II review, namely to:

- spur a vibrant, innovative and internationally competitive insurance sector;
- protect policyholders and ensure the safety and soundness of firms; and
- support insurance firms to provide long-term capital to underpin growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the Government's climate change objectives.

As part of the review, the Government asked the PRA to model different options to better understand which combination of reforms would best meet the Government's objectives and assess the aggregate impact of such reforms. In July 2021, the PRA launched a Quantitative Impact Study (QIS) to gather the necessary data from providers. Responses have now been sent to the PRA.

Statements from the PRA suggest that the QIS data will inform a policy package that will be put to consultation which we now expect to take place next year next year. So, we expect the pensions community will have an opportunity to actively engage with the first review of the Solvency II regime.

"We expect the pensions community will have an opportunity to actively engage with the first review of the Solvency II regime in 2022"

Solvency II review in the EU

On 22 September 2021, the European Commission announced proposals to reform Solvency II. It noted that "the overall aim is to ensure that insurers and reinsurers in the EU keep investing, and support the political priorities of the EU"[1]. The changes are expected to reduce the industry's capital requirements by €90bn ($106bn) in the short-term.

The Commission's proposals will now be scrutinised by the European Council and Parliament. The changes are expected to come into effect by 2024 at the earliest.

1 Source: Insurance rules' review: encouraging solid and reliable insurers to invest in Europe's recovery

Growth trends

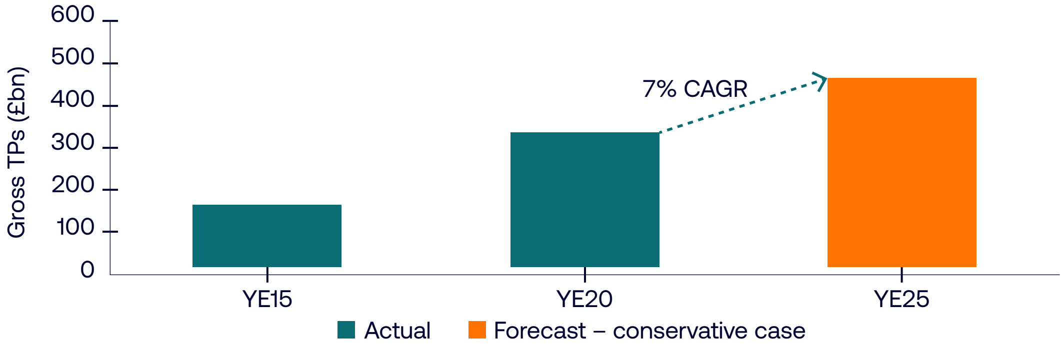
The UK has one of the most developed life insurance markets in the world. At the moment, eight insurers actively write new business in the bulk purchase annuity (BPA) market, with combined annuity books of c.£330bn[2].

The BPA market is not standing still. There has been a wave of consolidation, including: Phoenix's acquisition of Standard Life's insurance business, which included a c.£16bn annuity book, and Rothesay's acquisition of the Prudential's c.£12bn annuity book. Organic growth has also picked up; in 2019 alone, c.£44bn of new business premiums were written, setting an all-time record for the bulk purchase annuity market. Before the introduction of the Solvency II regime, the same eight insurers had an annuity book of c.£164bn - that is a c.2x growth in only five years[3]!

Meaningful organic growth for insurance solutions is set to continue. Demand is being supported by a range of structural drivers, including:

- as the DB pension schemes mature, their liabilities start to look like a closed book of immediate annuities;
- as the regulatory regime becomes more stringent, more corporate sponsors and trustees are looking to transfer the risk to third parties; and
- Solvency II has allowed pricing to remain attractive notwithstanding reduced credit spreads (insurers invest premiums in credit instruments).

Should the level of new business written in 2020 (c.£32bn) materialise over the coming years, the market will increase by c.40% by YE2025. In practice, this looks set to be a conservative projection.



Across a market that manages £2.4trn of DB pension liabilities, funding levels for DB schemes on an insurance-style solvency basis have improved from c.58% in 2016 to c.72% in 2020[4]. So, there is a distinct possibility that the demand could outstrip the current capacity of annuity providers. While the gradual running-off of insurers' back books could provide some additional capacity as capital is released, the anticipated new business would likely dwarf the impact of the decline in in-force policies. With this scale of demand in mind, the trustees and corporate sponsors have a vested interest in having access to a growing and stable annuity market.

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2 Technical provisions (TP) classed as other life insurance as at YE2020
3 A part of the growth also reflects lower yields
4 The Purple Book 2020 published by the Pension Protection Fund

Growing pains

It is likely that further innovation and/or new market participants will be required to keep up with increased demand over the next decade. Pensions superfunds could have a role to play here, albeit progress to date on their regulatory framework has been slow with only one provider having been approved by TPR as at the date of this report. Alternatively (or in parallel), politicians could be tempted to relax the Solvency II regime to create scope for existing insurers to meet the growing demand. The Government is attracted by the prospect of an 'Investment Big Bang' that gets life insurers (and pensions trustees) to redeploy more proceeds into real economy to support its 'levelling up' agenda[5].

The Association of British Insurers (ABI) considers that the current review of the Solvency II regime has a material role to play. Its analysis suggests that changes could lead to a one-off £95bn release of capital. This would be achieved by broadening the scope of assets eligible for matching adjustment and by reducing the level of capital buffer insurers are required to hold.

The PRA has been quick to push back on this scenario, but it will be aware of the political reality of the moment. Insurers have more recently also downplayed the prospect of a drastic change in the Solvency II regime, knowing that their ambitious business plans can largely be achieved within the existing regulatory framework and a regulator who has greater latitude to adapt policy along the way in a post-Brexit environment. Given that backdrop, there will be fear among some that the review of the Solvency II regime ends up clamping down on those provisions that have enabled the rapid expansion of insurers in this market over the last decade.

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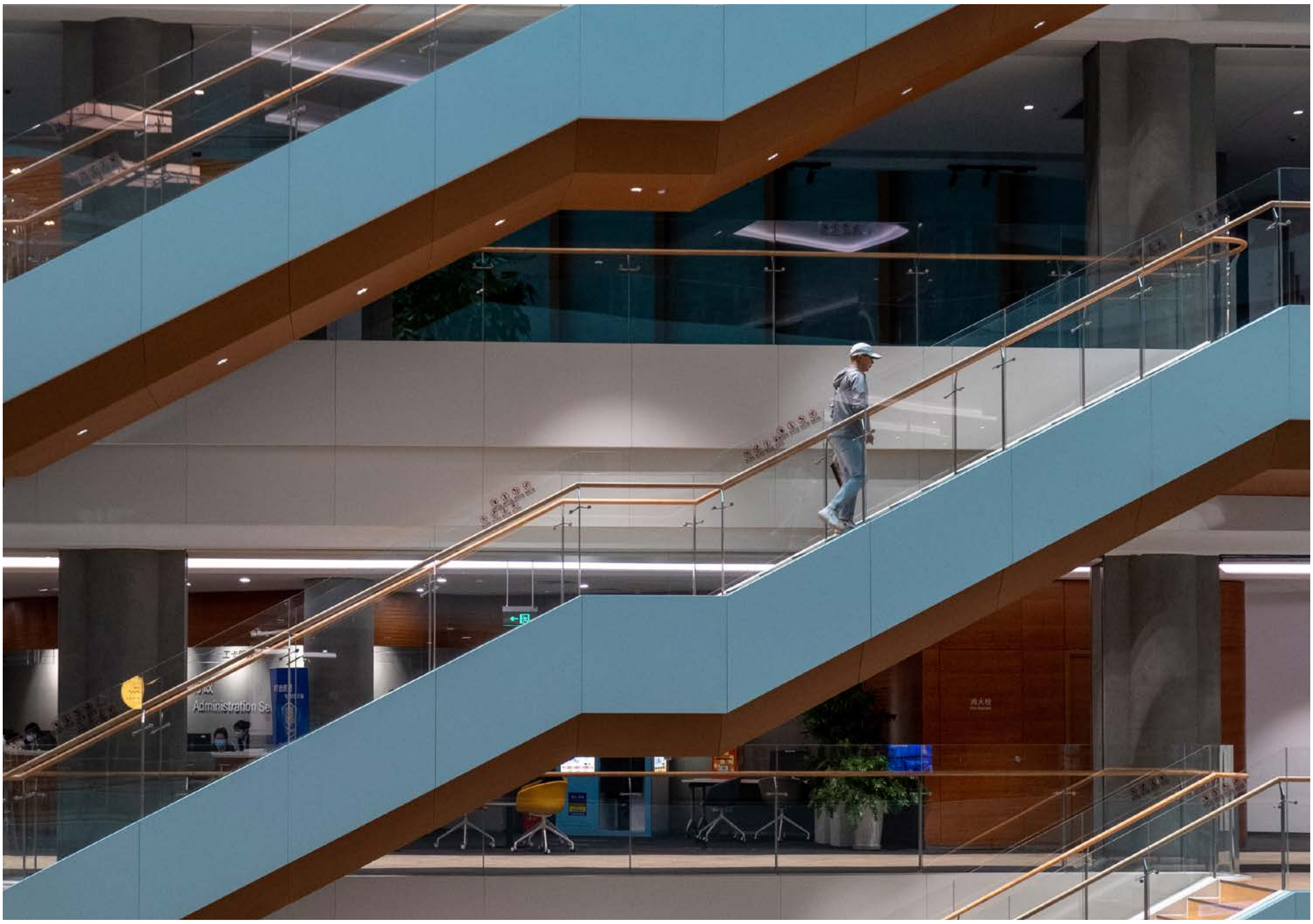
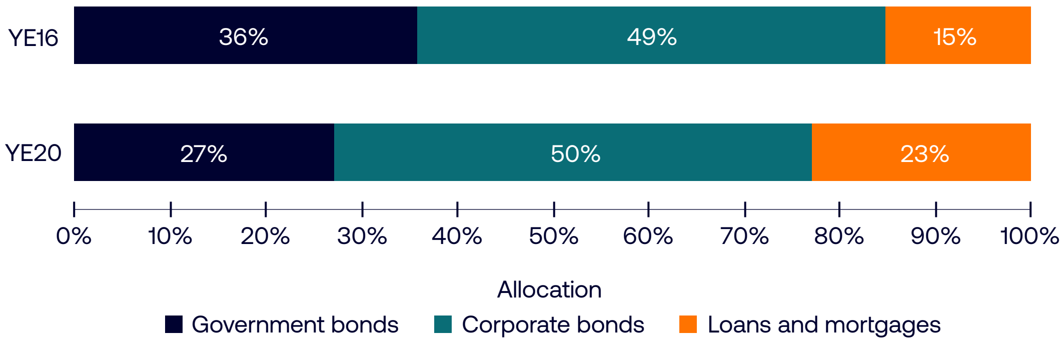


5 Source: A_Challenge_Letter_from_the_Prime_Minister_and_Chancellor_to_institution__1_.pdf (publishing.service.gov.uk)

Investment strategies - a quiet revolution

Insurers must invest the premiums paid by pension trustees to generate enough resources to meet committed obligations and make a return for shareholders. Historically, annuity providers primarily invested in government bonds and investment grade corporate bonds. Yet, the introduction of Solvency II and, in particular, the Matching Adjustment mechanism represented a paradigm shift, which has been dramatically changing insurer balance sheets.



As reflected above, insurers are now making higher allocations to alternative assets. Between YE2016 and YE2020 the allocation to loans and mortgages has increased by over seven percentage points. In absolute £ terms, this has meant a 186% increase in this category which stood at over £80bn at YE2020. **This staggering increase in alternative assets has come almost entirely at the expense of the allocation to government bonds where the proportional allocation has reduced by over eight percentage points.**

These new asset classes, which include equity release mortgages, commercial mortgages and infrastructure loans, offer features that are not readily available in more traditional investments including:

- higher yields;
- better terms, including more stringent financial covenants; and/or
- longer dated, making them a better match for long dated annuities.

The PRA expects the overall allocation to 'illiquid assets' to increase to 40%[5] as insurers continue to optimise their balance sheets to the incentives introduced by Solvency II. That means the snapshot we see at year-end is not necessarily representative of how an insurer's portfolio will look in five, let alone next year. But, as ever, there are trade-offs that could have meaningful implications on the health of the Solvency II framework.

5 Source: 'An annuity is a very serious business' – Speech by David Rule, Executive Director of Insurance Supervision (26 April 2018)

Investment trade-offs

Insurers are increasingly shifting their investment strategies from traditional credit assets (e.g. gilts and corporate bonds) to alternatives which tend to be higher yielding, offer longer durations and usually improved terms. However, there are a handful of trade-offs implicit in this transformation that are important to the health of the overall insurer regime.

"Too high an allocation to alternative assets could strain an insurer's liquidity position"

- **Liquidity:** Alternative asset classes tend to have less active secondary markets. Too high an allocation to alternative assets could strain an insurer's liquidity position. This is what we saw in Q1 2020 when at least one of the insurers became a forced seller to meet a margin call following increased market volatility in the wake of the first Covid 19 lockdown. As the allocation to loans and mortgages increases, liquidity considerations are set to become a more important gauge of the health of the insurance industry.

- **Material ancillary risks:** Alternative assets carry more than the corporate credit and interest rate risks that Solvency II was explicitly designed to manage. Balance sheets are now exposed to ancillary risks including residential property prices and pre-payment. These are the type of risks that in the past would have been associated with specialised underwriting teams at commercial banks, not insurers. But, Solvency II is allowing insurers to venture into segments of the economy it has never been before.

- **Complexity:** In the absence of a more fundamental rethink, the PRA and insurers have had to rely on complex structures to adapt that original vision of the Solvency II regime to the new range of investments insurers are taking on. In our view, the resulting structures are inefficient and too often leaves the insurer exposed to the same (if not more, given the added complexity) overall level of risk. The securitisation requirements on equity release mortgages are a prime example.

Ensuring that the above factors do not translate into higher risk is fundamental. Already, 75% of all the capital requirement on the industry is met by the upfront recognition of investment returns that will take decades to be realised. This is an average figure. In practice, the capital base of some insurers is already wholly reliant on the current calibration of the Matching Adjustment mechanism. This is one of the reasons why a handful of critics point to the Matching Adjustment mechanism as a potential source of systemic risk for the industry.

Even before accounting for possible changes to the Solvency II regime, the insurance industry's reliance on Matching Adjustment is set to increase given to previously mentioned shift to alternative assets. Recommendations made by the ABI as part of the review of the Solvency II framework would see an acceleration of this trend.

However, more recent statements from the PRA have left the door open to a strengthening of certain aspects of the Matching Adjustment mechanism. The PRA's views on this aspect of the regulatory framework could become one of the most important topics covered by the current review of the Solvency II regime.

Matching Adjustment

Matching Adjustment ("MA") allows insurers to take upfront credit for investment returns that will take decades to be realised. Its impact can be vast when applied to long-dated obligations such as pensions. On a typical book of bulk annuities, a 100bps increase in the discount rate could result in a >15% reduction in the value of the liabilities. A meaningful portion of this reduction would translate into an attractive day 1 profit!

Unsurprisingly then, the PRA had the following to say about the importance of the Matching Adjustment mechanism to the insurance industry:

> "the MA is very valuable to the insurance sector. As at the end of 2020, it resulted in an improvement to UK firms' solvency positions worth £81bn. To put that figure into context, at the same date the entire UK insurance industry had a total capital requirement of £116bn. The integrity of its value is therefore critical as a significant driver both of policyholder protection and of the investment choices firms make."

The Matching Adjustment mechanism relies on the assumption that those future returns can be predicted with almost certainty over several decades. That is a monumental task in a world that is constantly changing.

In the previous article, we highlighted some of the trade-offs involved in increasing insurers' reliance on the Matching Adjustment mechanism. The PRA appears to be catching up. In a recent publication, it recognised some of these shortcomings (see below). Whether or not it is prepared to take action remains to be seen.

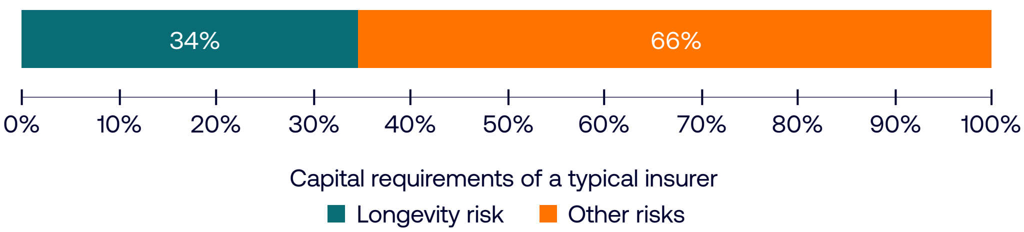
> "Solvency II rules split the spread of an MA-eligible asset into two components: the fundamental spread (FS) represents compensation for retained risks around credit losses, and the MA represents a liquidity premium. Setting aside the case where the asset rating changes, almost any change in spread is treated as a change in liquidity. This means that insurers may not recognise a change in credit risk contained in the credit spreads, because the FS for any given rating is based on 30-year long-term averages, and therefore is extremely slow to change."

> **"The dependence on credit ratings and insensitivity to the signals contained in spreads is an issue for two reasons. First, credit rating changes are a lagging indicator of risk. Second, many MA-eligible assets are assigned ratings by insurers themselves and are therefore subject to less external scrutiny than external ratings."**

Changing attitudes to longevity risk management

The review of Solvency II introduces has the potential to change how insurers manage longevity risk. For any annuity provider, one of its biggest risk exposures is longevity risk – i.e. the risk that policyholders live longer than assumed. Since the implementation of Solvency II in 2016, it has been more capital efficient for insurers to transfer a significant proportion (i.e. often at least 80%) of longevity risk in relation to new business to third parties (e.g. reinsurers), typically via longevity swap arrangements, rather than hold the unhedged risk on their own balance sheets.

The market for longevity reinsurance offers a number of security features that serve to protect member benefits. It includes highly rated reinsurer counterparties, sophisticated collateral structures and, in several cases, providers that hold long-dated mortality risk which can serve as a natural hedge to longevity risk.



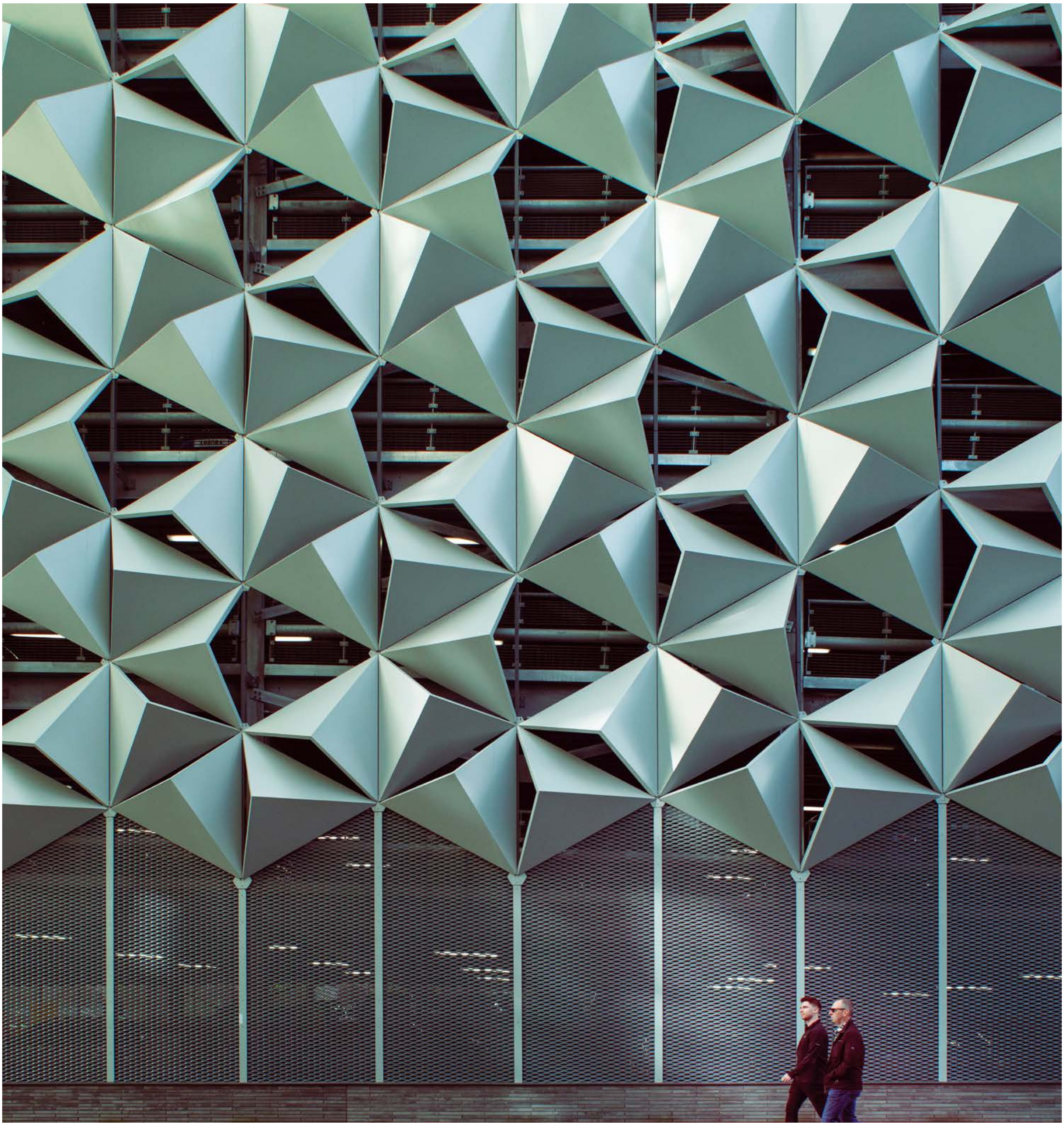
One of the key drivers behind the desire to transfer longevity risk lies in the Solvency II risk margin, which is a prescribed level of additional capital that insurers have to hold to back annuity obligations. If left unmitigated, longevity risk can be one of the key contributing components to the risk margin and to an insurer's overall capital requirements (as reflected in the chart above). The transfer of longevity risk therefore results in a reduction to an insurer's longevity risk exposure, its risk margin and therefore its overall solvency capital requirements.

The margin for longevity has been challenged as being too big and too volatile. We agree with the aim of tackling these aspects of the risk margin. These changes could result in a more accurate reflection of the economic risks carried by insurers as well as a more stable balance sheet that is better able to weather temporary periods of market strain.

Another important potential impact will be on the appetite for deferred buy-ins and buy-outs. Historically, non-pensioner members have been more expensive to insure than pensioners due to, among other factors, the increased exposure to longevity risk, which is 'expensive' for an insurer to take on. If the risk margin is reduced, pricing for deferred buy-ins could meaningfully reduce, placing more schemes within reach of securing benefits and accelerating their journey plan of delivering member benefits. Indeed, questions within the PRA's Quantitative Impact Study suggest that a review and reform of the risk margin may well be on the cards.

However, a dramatic reduction in the risk margin could lead to lower levels of longevity reinsurance. By reducing transfers of longevity risk to the reinsurance market, the risk profile of insurers would become more unbalanced, dominated by low likelihood, but high impact events. Presumably, insurers would have to manage the added risk by making multi-decade longevity projections rather than relying on the more natural 'mortality' hedge available through the reinsurance market.

As the actuarial profession has learned in the past two decades, changes in longevity risk and trends can take many years to materialise. The current review of the Solvency II framework looks set to reduce the volatility of the risk margin, but it remains to be seen if changes are sufficiently material to drive insurers away from the reinsurance market.



Our Covenant Risk Solutions team

We are a leading provider of Covenant Risk Solutions in the UK pensions market through our specialist team. We offer independent, high-quality insurer due diligence advice to support many of the most pivotal decisions taken by trustees and sponsors of occupational DB pension schemes.

We have advised on over £32bn of pensions risk-transfer transactions since 2014, including buy-ins, buy-outs and longevity swaps. We have advised on transactions of all sizes, ranging from £3m to almost £4bn, with sponsors operating across a wide range of industries.

Our specialist Covenant Risk Solutions advisory and analysis team incorporates a wide range of relevant skillsets and experiences, including actuarial, investment banking, corporate finance and accounting.

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