BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Dear CEO,

Gathering data for the Solvency II Review

I am writing to you on the launch today of our Quantitative Impact Study (QIS) for the Solvency II review.[1] On Thursday 1 July, the Government published its response to its 'Call for Evidence' for the Solvency II review.[2] As part of that response it asked the Prudential Regulation Authority (PRA) 'to model different options to better understand which combination of reforms would best meet the Government's objectives and what the aggregate impact would be'. The QIS exercise will gather the data that we need to carry out this modelling. A further set of qualitative questions will be sent to participants next month.

The Solvency II review is an opportunity to tailor the UK prudential regime for insurers to achieve three objectives the Government has set. In order to advance the policy making process, we need high quality data from QIS participants and under fairly tight timescales. We are writing to a number of firms through the Bank of England Electronic Data Submission (BEEDS) portal, inviting them to participate in the exercise to ensure that we have an appropriate breadth and level of coverage across the industry. If you receive this invitation, I would ask that you prioritise resource to complete the exercise to the standard needed to inform policy making. We welcome responses from all other UK regulated firms should they wish to participate.

In order to give us a sufficiently comprehensive dataset, we are collecting information covering a range of economic scenarios and potential policy outcomes. I would like to be very clear that nothing in this exercise should be taken as a signal that we have reached any settled policy decisions. We are gathering data, not testing specific proposals.

This letter recaps on the objectives of the Solvency II review, sets out the scope of the QIS and explains the thinking on two key areas being assessed under it – the risk margin and the matching adjustment (MA).

1 https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/solvency-ii/solvency-ii-reform-quantitative-impact-survey.
2 https://www.gov.uk/government/publications/solvency-ii-review-call-for-evidence.

The Solvency II Review

On Monday 19 October 2020, the Government issued a Call for Evidence setting out three objectives for the Solvency II Review:[3]

- to spur a vibrant, innovative and internationally competitive insurance sector;
- to protect policyholders and ensure the safety and soundness of firms; and
- to support insurance firms to provide long-term capital to underpin growth.

We see a close interaction between these three objectives, with resilience playing a vital role in supporting innovation, competitiveness and insurers' ability to provide long-term capital to invest in assets that underpin growth for the UK economy. On this last point, the Call for Evidence response outlined a number of areas that could impede insurers' ability to fully play their part in supporting the economy. Many of the processes, for example around internal model applications, are overly cumbersome. We are also aware that some MA requirements can appear arbitrary and unhelpful for firms, and may result in sub-optimal treatment of assets, including those which would underpin long-term growth. The Review provides an opportunity to reform these areas and pursue our primary and secondary objectives.

Scope of the QIS within the Solvency II review

The QIS we are launching today focuses on three key structural components of the balance sheet that we believe need serious consideration in the review: the risk margin, the MA, and the transitional measure on technical provisions. We are gathering data in these areas to help us model potential policy options, and to understand how the drivers of the transitional measure on technical provisions may change as a consequence of changes to other parts of the balance sheet.

Early next month, we will also release a series of qualitative questions to inform our thinking about Solvency II reform. Example areas covered include the eligibility criteria for assets in the MA portfolio, regulatory processes around internal model and MA approvals, and the costs of implementing reforms. The qualitative questions will also explore how potential changes to the balance sheet may affect a firm's risk appetite, business plans, reinsurance, and investments.

You will note that the QIS does not cover the standard formula. This is because, in agreement with HM Treasury, we have decided to prioritise consideration of changes to the risk margin, MA, and the internal model regime.

The Solvency II review also covers a number of other areas that are not included in the QIS, either via quantitative or qualitative questions. These include: reforms to reporting requirements, a mobilisation regime for new insurers, the thresholds for regulation under Solvency II, capital requirements for branches of foreign insurers, and the methods for calculating the consolidated group Solvency Capital Requirement (SCR). We are considering whether additional evidence is required to develop reform proposals in any of these areas, and will engage with you and other interested parties as appropriate. On Thursday 8 July, we also launched a consultation on the first phase of reforms to Solvency II reporting requirements.[4]

Risk margin

The risk margin plays an important role by ensuring liabilities are held on the balance sheet at the value for which they could be transferred to another business. This is an important contributor to policyholder protection, particularly in a situation where a firm gets into difficulty. There is broad consensus between the Government, the PRA and respondents to the Call for Evidence that the risk margin as it stands is too

3 https://www.gov.uk/government/publications/solvency-ii-review-call-for-evidence.
4 https://www.bankofengland.co.uk/prudential-regulation/publication/2021/july/review-of-solvency-ii-reporting-phase-1.

volatile and that, in the current low interest-rate environment, it is too high. This has unintended distortive and procyclical effects.

There is a strong case for making the risk margin less sensitive to interest rates – but there are still decisions to make about how a reformed version should be designed and calibrated. Most respondents to the Call for Evidence did not express a preference on design, and the PRA does not have a settled view on the relative merits of different reform options.

Because of the range of responses, the QIS takes an open-minded approach. It asks firms to provide us with some 'input data' so that we can do our own modelling of a range of possible designs and calibrations. It also asks firms to provide balance sheet data based on two alternative risk margin structures. These two structures have been chosen for the QIS because they are two of the most prominent candidates for a reformed risk margin, rather than because the PRA or Government are closed to other possible approaches. We have also specified calibrations for these structures for the purposes of gathering data, but our choices here are not indicative in any way of policy decisions; there is no settled view on where the calibration should come out. We are also gathering data under different economic scenarios to help us model future potential policy options through the cycle. The data from these two specifications will provide relevant evidence against which possible designs and calibrations can be compared, and our own modelling can be validated.

Matching Adjustment (MA)

The MA is an important part of the regime which facilitates an effective market for annuity products, helps to stabilise the balance sheet, and provides a strong incentive for insurers to invest in certain long-term assets. It requires insurance companies to match the cash flows they expect to receive from their assets with the cash flows they will need to pay out to policyholders. This means that insurers can ride out temporary market turbulence as the market value of those matched assets goes up and down.

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 £81 billion.[5] To put that figure into context, at the same date the entire UK insurance industry had a total capital requirement of £116 billion. The integrity of its value is therefore critical as a significant driver both of policyholder protection and of the investment choices firms make. For this reason it must be calibrated carefully and appropriately. An appropriate calibration of the MA is also necessary for any reforms to the range of MA-eligible assets.

The Solvency II calibration of the MA assumes that the majority of any asset spreads on matched assets that exceed an expected credit-loss provision are a reward for tying up funds (a 'liquidity premium'). It then allows insurance companies to recognise upfront all of that 'excess' spread as capital that is of the same quality as cash.

The PRA is concerned about the risk that some of the returns treated as a liquidity premium might be, instead, compensation for variability around future credit losses. Even long-term, matched investors are exposed to this variability. Therefore, the current MA design risks allowing insurers to recognise upfront, as capital, future returns that may not materialise. As noted above, it is important for policyholder protection that firms' technical provisions are sufficient to enable the insurance liabilities to be transferred to another business. For this reason, they must reflect the risks retained by firms and not just expected losses (noting that no risk margin is held for market or credit risks). The MA should only include the component of asset spreads that reflects compensation for risks to which firms are not exposed by virtue of being long-term investors.

Solvency II was designed as a Europe-wide 'one-size-fits-all' regime and has therefore only ever had a partial fit for the UK market. Furthermore, the UK market has changed substantially since the regime was

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5 PRA calculation based on data from 2020 annual returns.

designed. Before Solvency II, annuity writers tended to hold a narrower range of assets, focused on corporate debt, which is the asset class that was used to calibrate the MA. In 2014, when details of the MA framework were being agreed, around 65% of the assets backing UK annuity business were corporate bonds, 20% were sovereigns, and 15% were mortgages and loans. Insurers now hold a broader range of assets, and in recent years we have observed a steady growth in investments in alternative assets that tend to be illiquid in nature. By year-end 2020, we estimate that the proportion of illiquid assets in MA portfolios had reached almost 40%.[6] Additionally, the MA calculation is heavily reliant on each asset's credit rating, which brings risks, including of inconsistencies and inappropriate risk mappings given the increasing reliance being placed on firms' internal ratings.

We think it sensible to consider addressing these issues as part of the Review in order to safeguard policyholder protection and to enable other changes to take place – in particular to ensure that the MA provides an appropriately solid foundation upon which to make changes that can enhance the capacity of the sector to invest in assets that underpin long-term growth. Respondents to the Call for Evidence identified a number of such changes which we believe could be considered. These may include: removing the automatic restriction on the MA benefit that can be earned from sub-investment grade assets, reforming the asset eligibility rules, reforming the MA approval process, and rebalancing some of the incentives in the current rules, for example to allow a more beneficial treatment for assets with call and prepayment features, and infrastructure assets with a construction phase.

For these reasons we see a case to explore reforms to the MA. In the QIS, we are gathering data on two alternative possible design variations. These variations would recognise more explicitly the risk profile of individual assets, and make more allowance for the credit risk premium within asset returns, while still recognising the aim of the MA and preserving its valuable stabilising effects. We have not yet reached a view on which of these designs, if either, is preferable, or how any design should be calibrated. Through the QIS exercise, we are gathering data on different possible calibrations, and also across a broad spectrum of economic scenarios. With this data in place, we will be able to model potential policy options, and understand how they are likely to perform through the cycle, to ensure the MA delivers an appropriate level of benefit.

Conclusion and next steps

We expect that the calibrations against which we are gathering data are likely to produce a wide range of potential outcomes. Observers should not draw any inferences from the fact that we are testing calibrations across this wide range of scenarios. The calibrations included in the QIS exercise have been chosen to ensure that there is a comprehensive set of data on which to build a policy package for consultation, and to inform policy decisions which will arise following that consultation.

The QIS exercise is very important but its content does not represent the full scope or ambition of the Solvency II review. There are important changes to the regime that do not lend themselves to quantitative analysis in the QIS, but which will be key to addressing barriers to firms playing a complete role in supporting the UK economy, and we will cover some of these through a set of qualitative questions. In the meantime no decisions have yet been taken on the shape of any final package of reforms, or how the different elements can best be balanced against each other.

Thank you again for your efforts to respond to the QIS over the coming months and for committing the resource that this will need.

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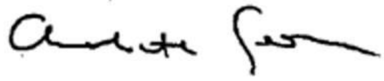
[6] See Chart 4 in the Appendix to the April 2021 speech 'Developments in the PRA's supervision of annuity providers', available at https://www.bankofengland.co.uk/speech/2021/april/charlotte-gerken-pre-recorded-18th-bulk-annuities-conference.

Yours faithfully



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