Solvency II reform: a very slow process

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Prudential regimes for insurance traditionally take a long time to develop. Solvency II took 13 years to complete, after Paul Sharma's 2002 report. Nobody can remember how long Solvency I took before it was agreed in 1972, but this author understands that the negotiator jobs had become hereditary appointments.

It is therefore no surprise that the reform of Solvency II is taking a little time. It started with a report by the House of Commons Select Committee in 2017, seen off by the Prudential Regulation Authority (PRA). Reform only really got any traction once Brexit was complete, when the government started casting around for a few benefits of Brexit. It is still bizarre to think that incremental change to the prudential regime for insurance is now touted as one of the foremost benefits of Brexit.

Was this really what the referendum was about? It would, however, be churlish to look a gift horse in the mouth. HM Treasury launched a review of Solvency II alongside a broader review of the powers of the institutions regulating financial services — the Future Regulatory Framework Review.

For the sake of completeness, the author should be clear that this is the UK Solvency II. The EU version of Solvency II, identical to its UK offspring, is also being reformed in Brussels. When both reforms are complete, there will be two different prudential regimes for insurance, both called Solvency II. The Papal Schism is as nothing in comparison.

Ironically, most parties are broadly happy with Solvency II. It is acknowledged to be a sound and sophisticated regime, if cumbersome to administer and over-calibrated for life insurers. Agreement was therefore reached quite quickly on a limited scope for the review. The two main areas are the risk margin and the matching adjustment.

The risk margin

The risk margin is an additional capital buffer, an innovation in Solvency II intended to cover the costs of transferring an insurer's liabilities to another party in the event of failure. When Solvency II came into force, it immediately became clear that the design of the risk margin was flawed.

Nobody had considered the possibility of a long period of historically low interest rates when the method of calculating the new capital buffer was decided. The risk margin was both too volatile and too high. It hit life insurers, with their long liabilities, particularly hard. Even the PRA has always agreed that the risk margin needs adjustment. The question was not whether to reform it, but how.

In fact, the mechanism matters less than the impact on the levels of regulatory capital. The exact mechanism to be used has yet to be finalised, but a speech in February by John Glen, the Treasury minister, suggested that HM Treasury was aiming for a 75% reduction in the risk margin. This would be a good outcome, but whether it happens remains to be seen. The PRA does not like handing back to companies money which could be so much better spent ensuring that PRA staff sleep well at nights.

How should insurers prepare for a reduction in the risk margin? They should not assume that reserves will simply be released on to their balance sheets. They should follow the debate about the mechanism closely, as different methods of calculation will suit different balance sheets.

The matching adjustment

The matching adjustment is a reduction in the capital requirement for long-dated liabilities, intended to reflect the fact that insurers match their assets very closely to their liabilities, and generally buy assets to hold, not to trade. This means that they are not as exposed as other investors to fluctuations in the market value of their assets. The matching adjustment, an adjustment to the discount rate, is designed to reflect this.

The debate regarding the matching adjustment is more complex than the one about the risk margin. The author will at this point try to avoid technicalities, probably without success.

The matching adjustment was written at a time when corporate bonds were considered a rather racy investment class for insurers. Since that time, ultra-low interest rates have led life insurers to raise their holdings of alternative assets such as infrastructure bonds, lifetime mortgages, or rented accommodation of various kinds.

These long duration assets are well-suited to match to long-term liabilities such as annuities, are on a par with corporate bonds as far as investment risk is concerned, and crucially offer annuitants a higher rate of return.

Insurers' charge against the matching adjustment is that the criteria for eligible assets are too narrow, and prevent insurers from investing in socially desirable assets such as the infrastructure projects needed for the transition to a net zero economy.

Regulators have two issues with the matching adjustment:

- First, that it is too generous, and that the adjustment to the discount rate in effect allows insurers an imprudent early release of regulatory capital. There is little empirical evidence on either side of this debate.
- Secondly, that the matching adjustment is not well-suited to assets that are not corporate bonds. This is a fair point. A bond has a maturity date, and a known value at that date, assuming no default. In contrast, rented accommodation, for example, has neither of these features. Regulators also argue that alternative assets are illiquid, with no public market for them, and therefore difficult to turn into cash when required. This is not such a strong point; it assumes that the market for corporate bonds is itself liquid, which is doubtful nowadays. In any event, the point is that illiquid assets such as these are used to back illiquid liabilities such as annuities: there should be no need for unexpected liquidation.

The debate will turn on how best to calculate the notional advantage that insurers get from not being subject to fluctuations in the value of alternative assets. For reasons best known to the technicians, this notional advantage is called the fundamental spread.

How should insurers prepare for the reform of the matching adjustment? Again, it would be wise to follow the technical debate about the fundamental spread closely. There is also very likely to be an expansion in the classes of asset eligible for the matching adjustment. This does not mean that the PRA will declare open season on these assets. The prudent person principle will still apply, and the regulator will expect insurers to demonstrate expertise in these new areas. Insurers would be well-advised to invest in advance in staff with the right experience.

In conclusion, the author referred at the beginning of this article to the Future Regulatory Framework Review. This is significant, because at present the plan is to hand rule-making powers to the regulators, with only the thinnest veneer of political oversight. If this approach is followed, this will be the last public debate about Solvency II, because the PRA will simply change the rules as it sees fit.

The justification is that, in the UK, there is no tradition of detailed political oversight of regulation. It is also the case that, left to their own devices, regulators will always err on the side of caution, and capital levels will only go up. There is no offsetting balance in their objectives to the need for financial security and soundness.

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