HYMANS # ROBERTSON

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Dive into pensions de-risking

The insurance regulator issues its latest consultation on Solvency UK

On 28 September the Prudential Regulation Authority (PRA) published its long-awaited consultation on the investment aspects of the Solvency II review.

Recap of proposals to date

In November 2022, the government published its response to a consultation regarding UK insurance reforms following Brexit. It announced a new ‘Solvency UK’ regime, with:

- A reduction in the **risk margin**, a component of insurance capital that was introduced with Solvency II and is prominent for annuity business. This change is expected to be incorporated into statute by the end of 2023, allowing insurers to take account of this in year-end solvency calculations.
- Reform of the **matching adjustment** requirements, in particular increased flexibility for eligible assets. This reform is the subject of this consultation.
- Simplifications and **reduced reporting requirements** to ease cost and burden on insurers. This change was the subject of a June 2023 consultation. Proposals are due to be published in early 2024 to come into effect from end-2024.

What’s in this consultation?

Highly predictable cash flows

The change: The ‘matching adjustment’ is a fundamental component of pricing in the bulk annuity market. Without it, the cost of a buy-in or buy-out would be prohibitive to pension schemes. It allows insurers to reflect the asset yield of the investments being used to support the liabilities it takes on less an allowance for credit risk.

The consultation proposes changing the current requirement to match liabilities with fixed and certain asset cash flows to match liabilities with ‘highly predictable’ cash flows. This feature was trailed in the November 2022 proposals, and this consultation says that it will apply to only 10% of the benefit an insurer derives from its matching adjustment portfolio.

The impact on bulk annuities: Insurers are likely to welcome more flexibility, albeit subject to the 10% limit. The 10% limit will apply not just to new assets, but to insurers’ existing portfolios, so its impact may be greater than it seems at first glance. In some instances, these proposals may help insurers take on pension schemes’ illiquid assets, although we expect that many of these assets will still not meet the ‘highly predictable’ requirement.

Attestation requirements

The change: Under the current legislation, insurers use a ‘fundamental spread’ that the PRA provides monthly. This is the yield adjustment on asset return to reflect the cost of default and asset downgrades in calculations. The consultation sets out further details on a proposed attestation requirement for a designated senior manager at the insurer (likely to be the chief finance officer). The designated senior manager will be required to attest that in their view the yield adjustment is materially more certain than best estimate, and increase the fundamental spread accordingly if it's not. They would do so annually or whenever the insurer's risk profile has changed materially. The PRA will also have the power to apply a capital add-on for particular asset classes if it deemed the adjustment was not appropriate. This area of the consultation has come under the most challenge from insurers to date.

The impact on bulk annuities: The attestation is set at a level of being materially more certain than best estimate. In effect, it raises the bar for policyholder security, with corresponding upward pressure on annuity pricing. Furthermore, a significant or complex bulk annuity could constitute a material change in risk profile for an insurer, and so might require an ad hoc attestation. An insurer will need to think carefully about how it responds to pension scheme requests for innovative solutions in these scenarios – particularly in light of the proposed new capital add-on power, which creates a risk for an insurer that returns could be affected after the transaction if not considered carefully.

Increased granularity of credit quality and treatment of sub-investment grade

The change: Assets are currently assessed based on credit quality steps such as AAA, AA, A; no further spread is available for sub-investment grade assets (below BBB). The PRA is proposing to introduce notches to the credit quality steps (such as A+ and A-), as well as an extension to sub-investment grade. The extra credit steps would better reflect the underlying risk profile of the portfolio, while the expansion to sub-investment grade assets could incentivise insurers to broaden their investment strategies, for example in green and digital assets.

The impact on bulk annuities: The expansion to sub-investment grade shouldn't lead to an overall watering down of credit quality in investment portfolios, as a sliding scale of increased capital would continue to apply. Insurers will still be required to invest with the prudent person principle, which will probably mean most of their portfolio will remain investment grade.

Next steps

The consultation period runs until 5 January 2024. The PRA would publish updated rules and policy on the aspects covered in Q2 2024, with an effective date of 30 June 2024. In practice, insurers will be able to take advantage of the investment changes as part of their year-end 2024 disclosures. Next steps depend on the government's legislative timetable, which envisages updated draft legislation being tabled in the coming months to facilitate the future changes.

In summary

The PRA notes in the consultation that the proposals may facilitate modest reduction in the cost of annuities. In our view, this is unlikely, and in isolation these proposals are more likely to give rise to a modest increase in cost. However, taken in the round, along with the risk margin reduction announced in June, the overall impact on pricing and on policyholder security is unlikely to be significant.

The 10% limit relating to new assets may seem low but could still be significant, as it also applies to existing portfolios. The proposed asset flexibilities may help some pension schemes with illiquid assets in the context of buy-in or buy-out, although we don't expect this in isolation to solve this issue.

Get in touch

If you have any questions about anything covered, please don't hesitate to get in touch.

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