Dive into pensions de-risking

Insurance reforms – what might they mean for pension schemes?

JUNE UPDATE

The Government and the PRA have published further details regarding reforms to UK insurance regulation. These appear to support the previous headlines of a 10-15% cut in capital for life insurers, but our questioning of the PRA suggests otherwise. What does all this mean for pension schemes who have or are considering securing a buy-in or buy-out?

What has happened since our February update[1]

HM Treasury ("HMT") issued a consultation paper regarding the reforms at the end of April, and the Prudential Regulatory Authority ("PRA") published a related discussion paper at the same time[2]. The Treasury consultation seems to support the headlines that we reported in our last update, specifically:

- Substantial cut in the risk margin[3], c60-70% for long-term life insurers (the buy-in/out insurers)
- Review of the matching adjustment[4] requirements, including increased flexibility for eligible assets
- A cut in reporting and administrative burden for insurers

The Treasury noted that "the reforms could result in a material release of possibly as much as 10% or even 15% of the capital currently held by life insurers". This sort of reduction in capital requirements could in theory lead to lower buy-in/out pricing, though at the expense of a lower level of policyholder security.

PRA vs Treasury views

The tone of the PRA's paper was somewhat more reserved than HMT's, perhaps to be expected given their respective roles, but the PRA did seem supportive of a reduction to the risk margin of around 60%, so long as this was considered in the round with an adjustment to the calculation of the matching adjustment that will generally work to increase levels of capital held. The implication of the PRA's paper was that the reduction in the risk margin could outweigh the change in matching adjustment, as they noted that a combination of reforms along these lines could indeed release capital of the order of 10-15%.

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[1] Insurance reforms - what might they mean for pension schemes?
[2] For a more detailed summary, please see the recent Newsflash issued by Hymans Robertson's Insurance & Financial Services team.
[3] A component of insurance reserves that was introduced with Solvency II and is prominent for annuity business.
[4] Matching adjustment eligibility ensures that assets are capital efficient – broadly, for assets to be eligible for matching adjustment treatment, they need to have certainty of timing and amount of cashflow income and be a close match to liabilities.

On closer inspection

The trouble is, the maths didn't seem to stack up. Insurers generally reinsure longevity risk, which greatly reduces the risk margin they have to hold in practice, so it was hard to see how a 60% reduction would lead to a 10-15% release in capital when the offsetting changes to the matching adjustment are factored in.

On 26 May Charlotte Gerken, the PRA's co-lead of insurance regulation, gave a speech regarding these reforms[5], after which I took the opportunity to ask about this mathematical puzzle. The response provides some insight into how the headline numbers have been calculated – specifically that the PRA's modelling was done with no allowance for reinsurance[6]. So while the 10-15% figure might apply at an industry wide level before the industry chooses to reinsure (which the PRA noted is an insurer-specific management decision), it seems unlikely that it will apply to bulk annuity insurers in reality – simply because, as we have already noted, these insurers are currently widely making use of longevity reinsurance.

What might this mean for pension scheme buy-ins and buy-outs?

In short, perhaps not a lot! Whereas previously it may have been expected that the reforms would bring additional capacity for buy-ins and buy-outs and possibly lower pricing, though at the expense of a lower level of policyholder security, these latest revelations suggest that this is less likely to be the case.

These latest developments may be of comfort to pension scheme trustees, especially those who already have buy-ins, as they may not need to contend with a lower level of security for their members.

We should raise the possibility that overall the reforms actually *increase* the level of capital required for some insurers, which would increase both pricing and member security. This will vary from insurer to insurer, noting that for new business, insurers may be able to amend their investment strategies in order to avoid any increase in pricing.

Next steps

The consultation process closes on 21 July 2022. The PRA and HMT will continue to work closely on the reforms, and the PRA will need to consult on changes to its regulatory rules. We will of course keep you updated as and when more details emerge.

Get in touch

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

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[5] Four Rs: Creating the conditions for long-term sustainable growth in the life annuity sector – speech by Charlotte Gerken

[6] Ms Gerken also noted that the PRA's modelling assumed that the grandfathering aspect of Solvency II ("transitional relief", which runs off until 2032) had run off – depending on the details of the PRA's modelling, this may also serve to dampen the 10-15% at an insurer by insurer level.