So long, farewell, auf Wiedersehen, goodbye!

The Government has published a response to its 2022 consultation on reforms to UK insurance regulation, bidding farewell to Solvency II and heralding the introduction of a new regime, Solvency UK. This includes some substantial changes to the original consultation. We summarise in this note the Government's conclusions, as well as considering what they may mean for pension scheme de-risking.

Background and key conclusions

In April 2022, HM Treasury and the Prudential Regulatory Authority ("PRA") issued consultations regarding UK insurance reforms following Brexit, as until now, the UK regulatory regime for insurers has remained aligned with the European Solvency II regime. The Government published its response to the consultation on 17 November, announcing a new "Solvency UK" regime to replace Solvency II. The key take-aways are:

- Reduction in the risk margin, a component of insurance capital that was introduced with Solvency II and is prominent for annuity business.
- Reform of the matching adjustment requirements, in particular increased flexibility for eligible assets.

These reforms are largely in line with the original consultation, with one notable exception in respect of the matching adjustment, discussed further below.

Investment freedoms

Insurers typically seek enhanced returns through the use of matching assets such as corporate bonds, infrastructure and social housing, but unlike a pension scheme, they have to hold capital to protect against the credit risk inherent in these assets – the risk that the issuer of the bond doesn't repay the insurer. If the insurer's assets provide cashflows that are fixed and closely matched with their liabilities, the insurer can then discount their liabilities using the asset yield, less an allowance for default risk. This feature, known as the "matching adjustment", is critical for a functioning buy-in and buy-out market, as without it, costs would be prohibitive to pension schemes.

The reforms will make the matching adjustment simpler to operate, in particular expanding the universe of acceptable assets, and replacing the requirement for cashflows to be fixed with a need for them to be highly predictable. This will make it somewhat easier for bulk annuity insurers to find assets to support new buy-in and buy-out business, and should be marginally more efficient, as there will be less need for them to re-structure assets to make them matching adjustment friendly. For some

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schemes who hold illiquid assets that are proving a stumbling block to de-risking, it may be worth revisiting whether insurers are interested in these due to the expanded list of acceptable assets.

Proposed changes to make the allowance for default risk more sensitive to credit spreads have now been dropped – this will be a particular source of relief for insurers, and possibly for pension schemes too, as it had the potential to increase capital requirements and therefore pricing for buy-ins and buy-outs. Instead of these changes, the Government will introduce various protections in this area, including requiring insurers to participate in regular stress tests and extending the PRA's powers so that they can increase the default allowance in specific instances. Although not part of the consultation earlier this year, the Government had separately discussed an intervention power that would allow the Treasury to amend PRA rules if it didn't like them – this has now been scrapped, which will retain the PRA's independence from Government.

10 to 15% drop in capital?

The original consultation highlighted a potential capital release of 10-15%, though these figures are conspicuous by their absence this time around. As we previously wrote[1], this 10 to 15% seemed unrealistic in a bulk annuity context, and perhaps the Government has come to realise this. While the Government expects its proposed changes to cut the risk margin by 65%, this will be lower in practice for two reasons – firstly, insurers typically use reinsurance to reduce the risk margin, and secondly, recent higher interest rates are likely to dilute the figure. Still, we expect to see a modest reduction in some instances in the capital that insurers need to hold to back new buy-in and buy-out business, which in these instances may mean slightly improved pricing.

In summary

For pension schemes looking at buy-in and buy-out, regulatory changes are a fine art. Make things too hard for insurers and you push up the price of de-risking, but make things too easy and you weaken the security of the regime. Overall the Government seems to have struck a reasonable balance here. Pension schemes should not expect dramatic changes to the buy-in and buy-out market, though they may see some modest price improvements in some instances, along with a corresponding small reduction in capital levels.

Get in touch

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

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[1] Insurance reforms - what might they mean for pension schemes? (June update)

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