HM Treasury

Review of Solvency II

Consultation

RESPONSE FROM:

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To: HM Treasury

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1. Introduction

1. We read the HM Treasury consultation document to which we are responding side by side with the Bank of England Discussion Paper 2/22 – Potential Reforms to Risk Margin and Matching Adjustment within Solvency II.

2. Having done so, we are seriously concerned by the proposals set out in the consultation document.

3. The core proposals from HM Treasury to reduce the risk margin have the potential to significantly increase the risk of insurance companies failing to meet their obligations to policyholders. The tension with the PRA's obligation to protect policyholders is evident from the fact that in response to the Treasury's proposals the PRA is then proposing other regulatory changes to stop policyholder protection being weakened. This does not represent "joined up government" and is not how insurance companies should be regulated.

4. To us, the proposals look like an attempt by Government to "stack" the regulatory provisions so that insurance companies invest more in assets that the Government wishes to favour. The Government seems willing to do that, even at the risk of increased risks to policyholders.

5. It is an essential requirement for a society that believes in economic freedom that insurance companies be able to invest their funds in the best interests of their policyholders (the first priority) and their shareholders (the second priority.) Any attempt by the Government to direct insurance company investments, either by dictat, or by manipulating insurance company regulation, is incompatible with the obligations insurance companies owe to their policyholders and investors.

6. If the Government wishes there to be more investment into the asset classes mentioned in the consultation document, it should change tax policies and the competition / subsidy regimes so that such investments are selected, on their investment merits, by insurance companies and by other investors.

7. We are unable to support them and have given more detail in our responses to the consultation document's questions. These proposals should not be implemented in their current form.

8. We have no objection to a fundamental re-think of insurance company regulation. However, any such re-think should take account of international developments, particularly in the EU and USA, and should not be driven by the domestic political concerns of the Government, as this Treasury proposal seems to us to be.

2. About UKSA

UKSA (United Kingdom Shareholders' Association)

9. UKSA is the oldest shareholder campaigning organisation in the UK, with 14,000 members. We are a not-for-profit company that represents and supports shareholders who invest in the stock market.

10. There are many agents and intermediaries active in financial markets. Unlike them, we are an organisation solely representing people who are investing their own money.

11. UKSA was formed to provide private shareholders with a voice, influence and an opportunity to meet like-minded fellow investors. It is structured as a non-profit making company with annual subscriptions. An elected Chairman and Board of Directors (all volunteers and individuals with a wide range of backgrounds and experience) monitor a regional organisation. Each region benefits from oversight by an elected regional Chairman and Committee.

12. We build relations with regulators, politicians and the media to ensure that the voice of individual shareholders is reflected in the development of law, regulation, and other forms of public policy. See www.uksa.org.uk

3. Answers to your numbered questions

Question 2.1

How would a reduction in the risk margin for long-term life insurers toward the bottom or top of the 60%-70% range impact on:

• policyholders and their level of protection; and

• insurers and their reinsurance, investment and product pricing decisions.

13. Any reduction in the risk margin inevitably increases the risk of insurance companies defaulting on their obligations. That is an inescapable mathematical deduction.

14. If the risk margin is to be reduced, a clear case needs to be made out for the societal benefits of making insurance companies riskier than they are now. Such a case could theoretically be made. Two illustrative examples of cases are set out below.

    14.1. If the insurance industry was unable to attract capital, because its return on capital was too low due to excessive capital buffers and was thereby unable to meet customer demand for insurance due to inadequate provision, then a reduction in the risk margin would be one way of addressing that, while accepting the unavoidable corollary that insurance companies were going to become more risky.

    14.2. If insurance companies were having to charge significantly higher prices for insurance due to large capital buffers being required, and this was causing insurance take-up to be reduced with negative social consequences.

15. The consultation document does not make any such case and supplies no evidence. It does state in paragraph 2.2 *"Observations of the prices at which insurers can transfer longevity risk suggest that the current methodology results in a risk margin that is too high for some life insurers such as annuity writers."*

16. If so, the action to be taken would simply be for the PRA to adjust its detailed methodology for assessing the risk margin used by specific firms. It is not a reason for a government-mandated cut across the board.

17. We have read the Bank of England Discussion Paper 2/22 – Potential Reforms to Risk Margin and Matching Adjustment within Solvency II.

18. We are extremely disturbed by paragraph 43 reproduced below:

> *43. If the risk margin were reduced by 60% or more in isolation, without any change to the current FS, then the PRA's analysis suggests that technical provisions for annuity business would be valued at levels below those implied by the evidence on typical longevity transfer prices. This brings a risk of disorderly failure – a firm in difficulty could find itself unable to secure a transfer to a viable third party, absent an injection of further funds. This would undermine the objectives of safety and soundness and policyholder protection, as well as the concept of Solvency II as a 'going concern' regime.*

19. While the PRA goes on to discuss other regulatory changes that would restore the capital buffers that a risk margin reduction would take away, in our view that is the wrong approach.

20. The risk margin exists specifically to *"ensure that the value of the technical provisions is equivalent to the amount that insurance and reinsurance undertakings would be expected to require in order to take over and meet the insurance and reinsurance obligations."* (Article 77(3) of the Solvency II Directive, which has been quite properly retained in UK law post Brexit.)

21. The PRA's approach would mean that the risk margin, by itself, was not adequate for the purpose it exists for.

Question 2.2

How would a reduction in the risk margin for general insurers of 30% impact on:

• policyholders and their level of protection; and

• insurers and their reinsurance, investment and product pricing decisions.

22. Our response to question 2.1 is equally applicable to this question 2.2.

Question 2.3

Do you agree that a modified cost of capital methodology should be used to calculate the risk margin?

23. From reading DP 2/22, we conclude that the Government has decided that it wants to reduce insurance company capital buffers, and therefore wants to mandate a reduction in the risk margin. We are particularly disturbed to read paragraph 37 of DP 2/22: "Modifying the existing cost-of-capital approach **<u>to the edge of what the PRA's technical analysis supports</u>** could result in a reduction in the risk margin of around 60% for long-term life business under current economic conditions." Emphasis added by us.

24. The PRA is then inevitably left looking around for other ways to stop insurance companies becoming significantly riskier by making other calculation changes.

25. In our view this is not a responsible way of regulating insurance companies and protecting policy holders. We do not support the modifications the Government seems intent on forcing the PRA to make.

Question 2.4

Is there any further information about actual transfer values of insurance risk that should be taken into account when finalising the calibration of the risk margin reforms?

26. No response.

Question 2.5

How could the Government be assured that resource that becomes available following a reduction in the risk margin would not be distributed to shareholders or used to increase remuneration to parties within the insurance firm?

27. As we write in paragraph 14 *"a clear case needs to be made out for the societal benefits of making insurance companies riskier than they are now."* The Government has not provided such a case.

28. We do not see how the Government can be assured that once the regulators say to insurance companies that capital is no longer required, it will not be distributed to shareholders or used to increase remuneration. This is especially an issue if management is remunerated, at least in part, to encourage a high rate of return on capital. Insurance companies basing remuneration on return on capital is an instance where management remuneration approaches are not in line with the wider public interest.

Question 3.1

Taking into account the fundamental spread methodology needing to be sufficiently responsive to changes in investment decisions and reflect long-term exposure to credit risks, do you agree with the above assessment that the current methodology does not:

• sufficiently address the risks associated with assets with the same credit rating but different market measures of retained risks; or

• take account of all the risks associated with holding internally rated or illiquid assets?

29. We have long-standing concerns about the matching adjustment, and its use for both regulatory purposes and accounting purposes. Accordingly, we share the concerns mentioned in this question.

Question 3.2

What is the impact of the fundamental spread including a credit risk premium of 25, 35 or 45% of spreads on life insurers':

• key balance sheet metrics including best estimate liabilities, own funds and the solvency capital requirements;

• incentives to provide annuities;

• annuity prices;

• investment in economic infrastructure, such as clean energy, transport, digital, water and waste;

• investment to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and

• relative incentives to invest in different types of assets, including assets of different credit ratings and different risks, assets with different liquidity, assets that are internally or externally rated, and assets in different sectors?

When answering this question please set out the assumptions you are making, including the size of X and Z.

30. We represent individual investors and not insurance companies, and therefore offer no response except for the point below.

31. We believe that insurance companies should select their investment in the best interests of their shareholders, while ensuring that the investments selected will not impair their ability to fulfil their obligations to their policyholders.

32. Accordingly, we fundamentally object to a dirigiste attempt by Government to direct where insurance companies invest by seeking to manipulate regulatory rules to direct investment in particular ways. The responsibility of Government is to ensure that the tax treatment of *"economic infrastructure, such as clean energy, transport, digital, water and waste"*, the way planning law applies to it, etc, is such as to make insurance companies want to select it on normal commercial grounds.

Question 3.3

What is the threshold for any increase in the fundamental spread above which adverse effects become significant, such as excessive balance sheet volatility or increased reinsurance of risks off-shore?

33. We represent individual investors and not insurance companies, and therefore offer no response except for the point below.

34. Where risks are reinsured, the responsibly of regulators is to ensure that such reinsurance does not increase the risks to policyholders. Beyond that, it should not matter whether the reinsurer is in the UK or overseas; the key test is whether the regulator is satisfied with the reinsurer's ability to meet the obligations it takes on.

Question 3.4

What is the impact on policyholder protection of a credit risk premium of 25, 35 and 45% of spreads, when accompanied by a risk margin reduction for long-term life insurers of 60-70%?

35. No response.

Question 3.5

What is the impact of selecting an averaging period (n) of 0.5, 1, 2, 5, 10 and 30 years?

No response.

Question 3.6

Are there other ways to achieve the same impact that changes to the fundamental spread would have?

36. No response.

Question 4.1

What would be the impact of these reforms on insurers' use of the matching adjustment and investment:

• in economic infrastructure, such as clean energy, transport, digital, water and waste;

• to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and

• in any other asset classes.

37. We are not responding to the first part of this question "*What would be the impact of these reforms on insurers' use of the matching adjustment and investment:"*

38. As far as the bullets are concerned, we refer to our paragraphs 31 and 32 above.

Question 4.2

What are the additional risks that these reforms may pose to policyholder protection?

39. We are deeply disturbed by the entire tenor of this consultation document. The Government appears to have decided to reduce the capital buffers of insurance companies, thereby making them riskier, without offering any justification for making that change. We then see the PRA in DP 2/22 looking for ways to satisfy a government dictat to reduce the risk margin while making other regulatory changes in the opposite direction to preserve policyholder safety.

40. This is no way to regulate an industry.

41. In our opinion, if the Government gets its way and there is an overall reduction of insurance company capital buffers, this will increase the risk to policyholders. No justification has been given for increasing that risk.

Question 4.3

What safeguards are appropriate to protect policyholders from the risks posed by allowing a wider range of assets into matching adjustment portfolios?

42. As previously stated in paragraph 29 we already have concerns about the matching adjustment. These would be magnified if, as consultation document paragraph 4.2 suggests, it is extended to assets which presently would not qualify.

43. The entire tone of paragraphs 4.2 and 4.3 disturbs us. The Government appears to want to direct insurance companies to make particular investments by "stacking" the regulatory provisions to push them in that direction. However,

as far as we can see, there will be no regulatory provisions requiring them to take this consequent direction.

44. Also, as we have mentioned in our paragraphs 31 and 32 above, insurers should select appropriate investments in the interests of their providers of capital and of their policyholder customers and then apply the unchanged regulatory requirements accordingly to ensure its capital adequacy, solvency and long term viability, without interference from governments.

Question 4.4

What impact will these reforms have on insurers providing a greater range and more affordable pricing of products?

45. No response.

Question 4.5

What changes to the matching adjustment approval process are necessary to ensure that applications to use the matching adjustment are approved more quickly?

46. No response.

Question 5.1

What is the impact of these reforms on regulatory costs incurred by insurers?

47. No response.

Question 5.2

What would be the impact of removing capital requirements for branches of foreign insurers operating in the UK, both on existing branches and on the decision to establish new branches?

48. We cannot comment on the impact.

49. However, we are seriously concerned that consultation document paragraph 5.2 is silent about replacement protective measures to counterbalance the increase in risk arising from no longer requiring foreign insurers to calculate branch capital requirements and hold local assets.

Question 5.3

What would be the impact of a new mobilisation regime for insurers and changes to thresholds at which Solvency II applies on:

• businesses currently considering whether to become an authorised insurer; and

• small insurers' ability to expand before Solvency II applies?

50. No response.