Solvency II

Summary

- The government released its consultation response on Solvency II reform in November 2022.
- Insurers will be able to invest in a wider range of assets to support UK growth.
- Impact on buy-in and buyout preparation is likely to be minimal.

Good for pensions, good for Britain?

Will new Solvency II proposals help insurers cope with the buyout big-bang of the next few years and invest in UK growth? Maggie Williams explores

HM Treasury's 17 November 2022 consultation response on UK-specific reforms to Solvency II was positive news for insurers and pension schemes, even if it didn't pack the same media punch as other aspects of the Autumn Statement, delivered the same day.

Since its launch in April 2022 by then-Chancellor Rishi Sunak, the review of Solvency II has been the poster child for post-Brexit UK-specific rule-making. The government says that it aims to create a "vibrant, innovative and internationally competitive" insurance sector, enabling insurers to access a wider range of assets and to help ignite then-Prime Minister Boris Johnson's promised 'investment big-bang'.

Since then, debate on rule changes has been the subject of frustration from Johnson, caution from the Prudential Regulation Authority (PRA), nervousness from insurers – and confusion for pension schemes waiting to see how the regulations might affect future buy-in and buyout transactions.

The November consultation response will have provided more certainty for insurers and trustees alike, although it could still be some time before the new regulations come into force. The government hasn't yet set out a timetable for implementation, and the proposed regime changes will require primary regulation. All in all, it could be 2024 before the new rules are in place.

Perhaps the good news is that, despite the disagreements and frustrations while the regulations have taken shape, the impact on buy-in and buyout is likely to be minimal *[see our boxout for more detail on two key aspects of the proposals and how they will affect pension schemes]*.

"Trustees will no doubt have been keeping a close eye on developments, but we do not expect the proposed reforms to impact the plans for schemes preparing for buyout," says Standard Life senior business development manager, Kieran Mistry.

Hymans Robertson partner and risk transfer specialist, Michael Abramson, is also upbeat about the new proposals: "These changes will help buyout insurers to invest more broadly and with less frictional cost. They will cut some of the existing Solvency II red tape, and reduce some of the capital requirements – in particular for longevity risk."

The details of the government's consultation response will also help to provide more certainty about deal pricing and allay fears that the reforms would undermine security for policyholders. On the first of these, Abramson says there could even be a little good news: "We expect the reforms to bring a marginal improvement to pricing in some cases, though this is likely to be lost in the noise of market movements."

Security for policyholders will be monitored through extra powers given to the PRA, which regulates the insurance sector, including additional stress tests.

LCP partner, Charlie Finch concludes: "There are some aspects of the proposals that are materially helpful, both around how deals are structured and also greater flexibility. This will help insurers to cope with the significant rise in volumes of buyout deals that we expect to see over the next two to three years."

Being able to support higher volumes of deals will be particularly important over the next five to 10 years. Barnett Waddingham's End Gauge index for November showed that the average time for a FTSE 350 scheme to reach its buyout funding level is now just six years. The gilt yield volatility that we saw in the second half of 2022 may also have prompted even more schemes to see buyout as a viable destination.

How will the new rules affect buyout insurers?

Given the long road ahead until the reforms are finalised and become law, schemes that are planning to transact a buyout in the short or medium term will see little or no impact on their plans.

For those that are at an earlier stage in the de-risking process, Mistry expects the flexibility in asset allocation proposed by the new rules *[see boxout]* to help insurers cope with intense periods of activity in the future. "Enabling insurers to source from a wider pool of assets should provide some additional comfort in the market's ability to service the expected rise in demand," he says.

That additional flexibility may also mean that, in the future, schemes could transfer illiquid assets that qualify for matching adjustment to insurers as part of a premium payment. This would reduce one of the more complex and time-consuming steps in de-risking preparation.

The new response also includes a more nuanced approach to reserving rules related to the risk profile of an asset. "Insurer reserving requirements will change more smoothly between assets of different credit ratings, which will add greater precision to the current rules," explains Finch.

But will more flexible asset allocation options drive the hoped-for 'investment big-bang'? Royal London director of policy and external affairs, Jamie Jenkins, believes so. He says the proposed rules will "allow the industry's capital to be used more effectively", helping insurers to "invest in the infrastructure the UK needs to drive future growth and deliver on the country's net-zero ambitions". Mistry says new approaches could include support for "house building, green energy and local communities across the country".

Mistry adds that this could help trustees align their scheme's ESG principles with buyout goals. "Schemes can continue to have confidence that insurers will invest for the good of wider society," he adds.

What do the reforms mean for buy-in and buyout?
There are two key areas where the proposed Solvency II reforms will affect pensions buy-ins and buyouts.

1. Asset flexibility
What's the change? The new rules would broaden the range of assets that insurers can hold within matching adjustment portfolios. Matching adjustment enables insurers to recognise a part of the excess returns from eligible assets above the risk-free benchmark in their reserving calculations. This is a significant benefit for them – in 2020, insurers' balance sheets were boosted by £81 billion through matching adjustments.

To qualify for matching adjustment under the proposed new regulations, assets will need to provide 'highly predictable' cashflows. This is an important change of wording from the 'fixed' cashflows required by the current Solvency II legislation (which effectively restricts matching adjustments to bond-like assets), and opens up a wider potential range of investments.

What does it mean for buy-in and buyout? "This change should widen the asset pool available to insurers and help them to price competitively for a larger number of schemes," says LCP partner, Charlie Finch. Matching adjustments enable insurers to price annuities competitively, offering a benefit to pension schemes as well as the insurers.

2. Risk margin reduction
What's the change? The risk margin for long-term life insurance business will be reduced by 65 per cent.

What does it mean for buy-in and buyout? The risk margin reflects the cost of transferring liabilities that the insurer cannot hedge, to a third party. For buyouts, this mostly applies to longevity risk. Insurers add the risk margin to their best estimate of the liabilities.

The new proposed approach would reduce the capital required to cover the risk margin by 65 per cent. While that sounds like a significant drop, in practice, "it will result in a relatively limited reduction in capital requirements for buy-ins and buyouts for most insurers, depending on their approach to managing and reinsuring longevity risk. We still expect this to be an important part of insurers' risk management", says Finch.

"Schemes should not put their de-risking plans on hold as a result of these reforms"

What impact will it have on schemes?
"Schemes should not put their de-risking plans on hold as a result of these reforms," says Abramson. "We do not expect the changes to fundamentally shift pricing or the security of the insurance regime."

Mistry says: "Speaking to consultancies and trustees, it appears there's no slowdown in sight, with many more schemes preparing in earnest to approach the market early in 2023." Abramson adds that the same principles of good buyout planning – such as data cleansing and preparing benefits specification – will remain as important as ever. "Now more than ever, there is a need to be well prepared before approaching insurers to maximise market engagement," he says.

While the government works out the finer details and passes the legislation needed to bring Solvency II reforms into force, for schemes aiming to complete buy-ins and buyouts now or in the future, it remains business as usual.

Written by Maggie Williams, a freelance journalist