



Institute
and Faculty
of Actuaries

Solvency II Inquiry

IFoA response to The Treasury Select Committee

11 November 2016

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.



Rt Hon Andrew Tyrie MP
Chair of the Treasury Committee
House of Commons
London
SW1A 0PW

11 November 2016

Dear Mr Tyrie

IFoA response to the Treasury Committee Inquiry into Solvency II

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Treasury Committee's Inquiry into EU Insurance Regulation.
2. This response has been written by members of the IFoA's Life Insurance, General Insurance and Risk Management Boards. Members of these Boards work in the life and general insurance industries, either employed by insurers or for consultancies advising insurance clients.
3. Many actuaries have been heavily involved in the ongoing development and implementation of Solvency II (SII) in the UK, and also more widely across Europe. In addition, the IFoA has been and continues to be an active participant in discussions on the development of SII, whether these are led by European or UK regulators, through formal or informal consultations, or through ongoing research activity.
4. We therefore believe that the IFoA has an important role to play in the debate on the future of SII in the UK. We would be delighted to discuss our response with the Treasury Committee as and when it gathers oral evidence on this matter.
5. Many aspects of SII are unavoidably technical, including aspects relevant to the questions within the Inquiry Terms of Reference. We would also be happy to explain these points in more detail if that were useful to the Committee.
6. In our response below we have focussed on the impact of SII on the UK insurance industry from a public interest perspective, including the impact on the consumer.

General Comments

7. The IFoA supports the broad aims of SII: to increase the level of harmonisation of insurance regulation across Europe; protect policyholders; introduce Europe-wide capital requirements that are sensitive to the levels of risk being undertaken; and provide appropriate incentives for good risk management and governance.
8. The introduction of SII constitutes the biggest reform in EU insurance regulation ever, and the implementation of a single European regulatory framework applicable across different lines of

insurance has not been straightforward. The early simplicity of concept was distorted in the process of negotiation, both of the original Directive, the amendments under the 'Omnibus II' Directive and in the Commission's Delegated Regulation.

9. SII implementation has led to a range of ongoing practical difficulties, of which some have been exacerbated by market conditions. Difficulties have arisen from:

- elements of SII as agreed at EU level which have caused issues for the UK; and
- issues with the implementation of SII within the UK.

We discuss these points in detail where relevant in answering the questions which follow in the Annex.

10. The IFoA supports taking a pragmatic approach to the future development of SII in the UK. As noted above, we support the high-level principles of SII, and given the effort involved in terms of time and cost to develop and then implement the framework, revisions to the current structure rather than a root and branch replacement would be desirable at this stage. Implementing some revisions could avoid potential consumer detriment.

11. It is worth noting that SII has only recently been implemented after a prolonged gestation period. Although we believe there are some revisions which should be considered in the short to medium term, there is also merit in taking time to learn where the strengths and weaknesses of the new regime lie.

12. It is important for the UK to consider the nature of any insurance solvency capital framework, and determine whether it is in the public interest. Solvency capital frameworks seek to ensure that insurers are capitalised at a level which allows survival of a rare event. However, should they then:

- have sufficient margins allowing them to recapitalise; or
- have sufficient assets to mean a solvent run-off is possible, meeting liabilities as they fall due?

SII adopts the former, more stringent approach. However, the cost of capital is ultimately borne by the consumer and the level of security which they would willingly pay for needs to be taken into account.

13. It is also worth noting that the development of SII was less of a sea-change in insurance regulation for UK insurers than it was for other EU jurisdictions, such as Germany. The UK's ICAS regime was implemented in 2004/5 and was a development of Solvency I (SI) specific to the UK. The 'direction of travel' for UK insurers in moving to SII was similar to that with the introduction of ICAS; ICAS put firms on a journey to a risk based capital framework. While SII was by no means simply a development of ICAS, the gap in moving from SI to SII was narrower for the UK insurance industry than it was in some EU jurisdictions. That said, some aspects of the assessment of liabilities under SII are fundamentally different, particularly for life assurance companies, to that under ICAS; any disadvantages for UK consumers stem from these differences.

14. Paragraph 2 of the Treasury Committee Inquiry Terms of Reference suggests that there are just two options available in terms of the UK insurance regulatory framework: either maintaining SII, or modifying it as the UK sees fit. However, in lieu of maintaining SII in full, the desire for equivalence of insurance regulatory framework may mean that the UK adopts an intermediate framework.

Equivalence could be granted to a regulatory regime if it were considered broadly compliant with SII.

15. The IFoA has commissioned and is currently performing extensive research into various SII topics and this research may also support the work of the Treasury Committee: please let us know if this is of interest. Scope of current ongoing research includes:

- a retrospective of SII against its original aims;
- pro-cyclical elements of regulation;
- impact of SII (and low interest rates) on consumers;
- issues relating to the Matching Adjustment; and
- issues relating to the transitional measures.

Executive Summary of IFoA Response to Questions within Terms of Reference

1. Competitive Implications of Solvency II

16. SII is probably more stringent than many other regulatory frameworks. However, other regimes are looking at their insurance regulatory framework and SII is one of the regulatory models being considered.

2. Development of Solvency II

17. In an ideal world, a number of changes could be made to SII:

- internal model approval is onerous and time consuming, and is driving unnecessary cost into firms, which may ultimately be to the detriment of consumers;
- the Matching Adjustment is over-engineered and unnecessarily constraining. It acts against the public interest by potentially limiting insurers' flexibility to add value through asset selection;
- the Volatility Adjustment is currently of limited effect and artificial. It should be permitted to vary in assumed stressed conditions; and
- the risk margin is very sensitive to long term interest rates, particularly when interest rates are low. This is driving behaviour that might not otherwise be taken, eroding profitability and /or impacting on pricing for consumers.

18. However, despite these and other imperfections, SII is a sound basis for an insurance regulatory framework. If it can be simplified and made less onerous for UK insurers this would be a good outcome. A *significant* change to SII would represent a major burden however, and any change should be carefully thought through.

19. Increasing divergence between SII and any replacement framework in the UK may make achieving SII equivalence more difficult.

3. Implementation of Solvency II

20. SII has encouraged a rules-based and bureaucratic implementation, with the Directive set in stone early on, and underlying text (providing detail) following much later.

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21. However, it has introduced a pan-European insurance regulatory framework covering reserving, governance and reporting that broadly encourages good risk management.

4. Safety and Soundness

22. Although SII has increased the safety and soundness of the UK insurance industry, any improvement arising from SII has not been dramatic when compared to the prior ICAS regime.
23. The SII framework is overly complex, inflexible and there is a lack of space for regulators' discretion. It has however brought higher standards of review and governance.

5. Proportionality

24. Although the development of SII has enhanced many insurers' risk management, there is scope to reduce the reporting and differing documentation requirements without diminishing the quality of the regulatory framework.

6. Financial Reporting

25. The design of SII was intended to be compatible with new accounting standards (IFRS 17). These are not now expected to be implemented until 2021 and although there is likely to be some overlap, the degree of consistency between SII and IFRS 17 will not be fully clear until the design of the latter is finalised.

7. Wider Implications of Solvency II

26. The implementation of SII is likely to lead to a reappraisal of products by insurers, although it is too early to be clear on the outcome. Policyholders will be adversely affected if prices rise due to increased insurer expenses or capital charges, or if access to products reduces. However, in the UK annuity market, the effect of SII is already driving the cost of annuities up for the consumer.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk/ 0207 632 2146) in the first instance.

Yours sincerely



Colin Wilson

President, Institute and Faculty of Actuaries

Annex: IFoA Responses to Questions within Terms of Reference

1. Competitive Implications of Solvency II

Question 1.a) Lord Turnbull suggested in evidence to this Committee that Solvency II makes it more difficult to expand into non-European markets because a European-based and regulated insurance company is at a disadvantage, relative to a Canadian or an American insurance company. What are the competitive implications of Solvency II for UK insurance firms? Please answer within the context of the UK, European and global markets.

1. It is true that Solvency II (SII) is probably more stringent than many other regulatory regimes and it would be harder for UK insurers to compete where local regulators require lower financial resources to provide the same insurance benefits. However, other regimes are looking at their insurance regulatory frameworks and SII is one of the regulatory models being considered.
2. It could be argued that SII could be a competitive advantage, if it were perceived as being a stronger regime, and capital strength were considered desirable. The downside of this is that if SII is viewed as requiring too much capital, multi-national insurers may allocate capital to development in other territories potentially reducing the future competitiveness of the UK and European insurance markets. The higher level of capital may also act as a barrier to entry for new insurance firms or for existing firms developing new products. The potential reduction in the number of insurers and products would also potentially reduce the competitiveness of the UK and European insurance markets.
3. In the main financial and insurance centres of the world, risk and capital regulation has seen significant enhancement in recent years and is likely to continue to do so. This may limit any competitive differential of SII for UK firms, up to the point at which these overseas regimes differ from the implementation of SII in the UK.
4. Were the UK to deviate too far from SII, we may lose equivalence. In reality, UK multinationals would probably have an EU writer in another EU territory out of which they would write their EU business. This could result in a shift of jobs and capital to the EU.

Question 1.b) What impact is Solvency II having on the development of global regulation? Will we see the development of two-tier regulation as firms attempt to move to less rigorous regulatory frameworks either inside or outside their territories, or reinsure risks to other territories?

5. The International Association of Insurance Supervisors (IAIS) is currently developing a global Insurance Capital Standard (ICS), for the largest insurance groups operating on a global basis. SII is seen as one reference point for discussion on questions around these proposed standards. The ICS framework is still subject to consultation and stakeholder testing, and the framework eventually implemented (in 2020) may differ from what is currently being proposed. There are similarities between the ICS proposals and Pillar I of SII.
6. However, there is still considerable doubt as to the direction of travel of ICS here – the recent IAIS consultation document introduced the possibility of a margin similar to SII's risk margin, which was not a feature of some weaker forms of ICAS. This has increased the cost of life assurance products, particularly annuities, and stems from a different philosophy, replacing

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the concept of solvent run-off with the ability to recapitalise through resolution management. The use of the swaps market rather than the Government bond market (rated at say AA or better) to set the risk free rate was in line with the ICAS method but had proven to be flawed. There does not seem to be an ability to arbitrage between the swaps market and the Government bond market creating spuriously low long term risk free interest rates. A method of allowing the higher of the two will allow a more sensible result.

7. At a time when non-EU jurisdictions are in the process of or are considering enhancing their risk and capital supervisory regimes, SII is often considered as one example of a benchmark standard. These overseas regulators are in the beneficial position of, in relation to SII, seeing those aspects of SII that work well and those that work less well. In hindsight, this allows newer risk and capital regimes to learn the lessons of SII, as they seek to implement a fit-for-purpose regime that draws on international best practice and experience.

Question 1.c) Could Solvency II create a potential competitive disadvantage for UK insurance firms in relation to firms from outside the insurance industry (including “disrupters” and companies who are not subject to any form of EU or EEA regulation) who may operate substantially in the same market?

8. It is difficult to see how a firm could operate within the EU and yet outside EU/EEA requirements, as an insurance company would have to be authorised by a relevant body to write insurance. Although a disruptor could seek to circumvent regulation, regulators have a public interest to ensure those operating with the UK/EU are able to pay the claims as they fall due. It is therefore likely that a disruptor would be subject to regulation and capital considerations.
9. The IFoA believes that a strong UK regulatory framework is desirable. We do not want to encourage a ‘rush to the bottom’ approach whereby potential regulatory arbitrage is countered by adopting the least onerous approach in each case.

Question 1.d) What effect has Solvency II had on product innovation and the ability for new entrants to join the market?

10. Early in the development of SII there was concern in respect of product innovation, but in practice, to date this appears to have had relatively little impact. For example, cyber insurance has been growing as a product.

Product impacts are covered under question 7.i) below.

11. In respect of new entrants, these have continued to join the London Market in particular (largely through Lloyd’s of London). This suggests that the market perceives there to be continued opportunities in writing business within UK entities.
12. Conversely, the level of capital required to enter the life assurance market and the time taken to engage with regulators are both unattractive. The retail annuity market has seen both high profile and low profile retreat, reducing competition.
13. The introduction of SII is expected to see an increase in merger and acquisition activity within the insurance industry; a harmonised regime across Europe should make it easier for potential buyers to develop a clear picture of the insurance firm they are investigating buying.

Impacts on market participants are covered under question 5.b) below.

2. Development of Solvency II

Question 2.a) What are the principal developments or adjustments that you would like to see made to Solvency II in an ideal world? Where relevant, please include an indication of timescale, priority, rationale and “real world” constraints.

14. We discuss adjustments to a range of aspects of SII below, including:

- internal model approval and change;
- flexibility over model use;
- the Matching Adjustment;
- the Volatility Adjustment;
- application of discretion; and
- SII Pillar III reporting requirements.

Note that adjustments to the risk margin and transitional measures are also discussed in answer to the specific questions on these topics (questions 2(d) and 3(e) respectively).

Internal Model Approval/Change

15. The capital requirements under SII can be calculated using the standard formula or, subject to regulatory approval, using a full or partial internal model.

16. Under SII any approved internal model is required to meet a stringent set of tests, standards and validation. In our view the process developed by the PRA to review and approve internal models is too onerous and time-consuming, and in turn, this has led to excessive levels of internal model validation within firms. Whilst some validation and review is clearly necessary, we believe the level of validation and documentation required has been excessive and, at the margin, of limited value. This approach does not seem to be sustainable and is driving unnecessary cost into insurers, which may ultimately be to the detriment of consumers.

17. Internal models have also left the regulator very careful and cautious about what it is agreeing to. The PRA is having to signoff on an ongoing model as opposed to a ‘point in time’ capital figure, which then results in them being - understandably - risk averse.

18. Costs of ongoing compliance are also anticipated to remain high. The internal model change process now being operated by the PRA is somewhat cumbersome, time consuming and excessive in its level of review. The PRA are also concerned over internal model ‘drift’, and this results in high costs for the industry and the PRA. It has also ended up with the PRA effectively defining model calibrations via quantitative indicators and crude ratios, to assess the adequacy of far more sophisticated models.

Flexibility over model use

19. Once an internal model has been approved, it is then deemed to be accurate, with a sense that it has to be adhered to rigorously. Given this model reliance, explicit capital ‘add-ons’ are not being allowed, although we understand that add-on capital may in some circumstances be used. However, sophisticated or complex models are only ever an approximation to the real world. Models are also far more likely to be used (the SII ‘use test’) if they produce sensible results in which the insurer has faith.

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20. We believe that model use under SII would be improved if:

- a. a firm could apply to make an explicit capital add-on to the capital outputs of its internal model, recognising (inevitable) model shortcomings; or
- b. the PRA approved amendments to the standard formula methodology and assumptions.

This could then also allow a more proportionate approach to internal model approval in general.

21. It should also be recognised that different models have different uses and may be appropriate for varying purposes. For example, a far more granular model would be necessary for looking at one aspect of one part of the business, compared to a model assessing the overall firm. We think the current approach fails to recognise this because it emphasises the importance of using the (single) capital model for a whole range of purposes, thus demonstrating that model is actually used by the business.

Matching Adjustment

22. The Matching Adjustment (MA) is an adjustment to the risk-free interest rate structure used by insurers to calculate best estimate liabilities under SII, using a portfolio of 'eligible' assets. It is similar to the concept of a liquidity premium used in the UK under SI, but the application of the MA is restricted to certain asset and liability types and the calculation is restricted by specific SII requirements. Under SI there was no established formal framework for using a liquidity premium; arguably SII has added more rigour and consistency to the process for determining the interest rate to value liabilities that was lacking under SI.

23. The MA has a material impact on many insurers, and inclusion of the MA within SII was an important concession won for the UK insurance industry; both HMT and the PRA played a key role in this. However, the MA incorporated stringent restrictions and constraints required by a sceptical non-UK audience designed to prevent it being 'misused'. The consequence of this is that the MA is over-engineered and unnecessarily constraining, which acts against the public interest. It potentially limits firms' flexibility to add value through asset selection, and also excludes the use of assets that would otherwise be considered appropriate.

24. There are a number of practical challenges relating to the ongoing management of the MA, including the:

- unnecessarily onerous approval process for using the MA;
- ineligibility of assets such as Equity Release Mortgages (which are considered to be appropriate assets to back annuity liabilities), or commercial property. This drives firms to put in place artificial constructs to convert the assets to eligible assets;
- ineligibility of some assets that are then excluded from investment mandates which leads to lower levels of funding in the wider economy (e.g. for some infrastructure assets);
- behaviour of the MA eligibility tests which is leading to costly micro-management for UK insurers;
- inappropriately harsh consequences of breaches in the MA (no matter how minor), which could involve losing the right to apply the MA;
- requirement to use allowances for default and downgrade risk set by EIOPA (the 'fundamental spreads'). These can differ from a firm's underlying view of the risk for the assets held;

- application of the MA rules, which typically leads to the need to maintain the matching position within the MA portfolio, whilst also considering cashflow matching risks on a best estimate basis, without the artificial constructs and EIOPA rules. This can compromise asset liability management and increase the complexity and cost of maintaining annuity portfolios. Some of this cost is likely to be reflected in annuity pricing, to the detriment of consumers; and
 - treatment of reinsurance.
25. We believe that a framework that entailed greater control and consistency than existed under the ICAS regime, but without the unnecessary rigid rules and framework imposed by SII would be preferable. This could be supported by appropriate disclosure, supervisory review, external validation and the development of principles and guidance from the PRA.
26. Eligible MA assets and liabilities will not remain static and we support the need for a robust monitoring process given the materiality of the MA to insurers. However, there is scope for a more proportionate approach to be taken when assessing changes to MA asset/ liability portfolios.
27. The MA is particularly relevant for annuity business. Its operation (together with that of the risk margin) is reducing the attractiveness of UK annuity business under SII.

The wider impacts on annuity business are considered under question 7i) below.

Volatility Adjustment

28. A further adjustment is the Volatility Adjustment, (VA). A VA can apply to insurance products which are not eligible for the MA. It is a mechanism, *albeit only of limited effect and artificial in application*, that allows liabilities to be reduced on a prudent basis when asset values are particularly low. It does so by adjusting the risk-free interest rates used in liability calculation. The VA is determined centrally by EIOPA using a published reference portfolio of assets.
29. HMT decided that firms should have to seek regulatory approval before using the VA, since automatic approval might encourage firms to take excessive risks during economic upturns that could turn into losses during economic downturns (pro-cyclical behaviour). While the IFoA did not oppose the need for regulatory approval, we note that not permitting insurers to use a VA could also lead to pro-cyclical behaviour, in which insurers would become forced sellers in an economic downturn. In some EU states, use of a VA does not require regulatory approval.
30. We believe that it would be appropriate for the 'emergency' VA approval to be granted where necessary. There could be circumstances where it would be in the public interest for an insurer to take corrective action quickly, where a significant change of circumstances made this necessary. This could arise if the MA failed, for example, and emergency VA approval may reduce uncertainty for current and prospective policyholders if it mitigated failure.
31. We also believe that the VA should be permitted to vary in assumed stressed conditions i.e. it should be treated as dynamic rather than fixed.

Application of Discretion

32. The degree of regulatory discretion is curtailed with SII effectively being a rules-based rather than a principles-based regulatory regime. SII also constrains insurers and makes discretion/expert judgement hard to apply: there is a requirement for departures from standard protocols to be justified.
33. A key concern with SII is the limited scope for regulatory forbearance in stressed scenarios, i.e. being able to artificially relax/waive a requirement in order to take the 'heat' out of stressed situations. Regulators were very aware of the risk of pro-cyclicality when designing SII, and they sought to address this by building into SII automatic features and formulae to alleviate this, including the VA.
34. However, should these measures not work, there is far less scope to take action, due to the role of EIOPA in rigorously enforcing SII and the greater emphasis on a rules-based culture outside of the UK. In the event that the UK leaves the EU this presumably results in EIOPA having no UK-specific role which may then be an opportunity for the PRA to apply discretion.

Pillar III Reporting

35. The Pillar III reporting requirements under SII represent a sharp increase in the volume, complexity and frequency of reporting (compared with SI) and will lead to increased costs and operational strains. It is not clear what will be done with this great volume of data.

SII Pillar III requirements are considered in more detail under question 5 a) ii.

Other Changes to SII Methodology Pillar III Reporting

36. Other areas where changes in SII methodology might be considered are:
 - removing unnecessary contract boundary limitations;
 - improving the treatment of risks from insurer staff pension schemes;
 - improved rules surrounding Ring Fenced Funds, especially for disclosures;
 - amending the treatment of deferred tax; and
 - addressing the arbitrary exclusion of permanent enhancements to with-profits benefits from SII technical provisions where they have not been added to asset shares – this was a rule specified by the PRA.

Question 2.b) Given the potential increased flexibility that may be available following the UK's exit from the EU, should the UK seek alternatives to Solvency II for insurance regulation (such as a regime similar to the old ICAS regime, or a differentiated regulatory regime which varied according to an insurer's size or customer base)?

37. Since SII has now been fully implemented, a *hasty* change to the UK regulatory framework at this stage would represent a major burden on both the PRA and insurers. Change should be carefully thought through and based upon careful consideration of the purpose and risk management implications. However, it could *potentially* be an opportunity to resolve some UK-specific issues.
38. Changes to the UK regulatory framework would also need to consider the impact of interaction with any Global ICS framework.

39. Even if the UK were not to maintain SII in full, it would be an attraction of any alternative approach if it were capable of being deemed equivalent to SII. Obtaining equivalence status could be key in maintaining the position of the London Market in general insurance.

Question 2.c) Lord Turnbull said in evidence to this Committee that “it will actually help insurance companies if we can leave the [Solvency II] arrangement” which “treats insurance companies as though they were banks”. Should the UK Government seek to withdraw from Solvency II?

40. Despite its imperfections, the IFoA believes that SII is a sound basis for an insurance regulatory framework, and has helped focus attention on risk management across the insurance industry. The difficulty in devising a framework substantially different to SII should not be under-estimated. Nonetheless some of the details could be revisited and simplified. We also believe that more focus on solvency through the run-off of the liabilities rather than resolution would be helpful, and could be of more benefit to policyholders.
41. If achieving SII equivalence status for the UK regulatory framework is considered desirable, then increasing divergence between SII and any replacement framework in the UK may make this more difficult.

Question 2.d) Should the UK seek to amend, or withdraw from, the risk margin, or any other elements of Solvency II?

42. The risk margin is intended to increase the SII technical provisions (liabilities) to the amount that would have to be paid to another insurance company in order for them to take on the insurer's best estimate liability. The risk margin uses a 'cost of capital' approach and is calculated by projecting forward (part of) the SII capital requirement. The calculation can be quite complex and the risk margin is often a material and potentially volatile component of an insurer's SII balance sheet.
43. The previous ICAS regime used a market-consistent approach that reflected the market price for risk. However, it made no allowance for the price a third party would require for accepting uncertainty for non-market risk. The 'cost of capital' risk margin approach for non-hedgeable risk under SII is a proxy to allow for such a factor. However, it should be understood that the approach is one of many that could be adopted as it is merely a proxy and could be simplified.
44. Although the purpose of the risk margin may seem reasonable, the mechanism and parameters chosen tend to result on excessively high risk margins that are disproportionately high for long duration business, such as annuities. We therefore agree that there is merit in revisiting the design of the risk margin.
45. A significant part of the risk margin is more of the nature of an additional capital requirement as opposed to an allowance for the cost of transferring liabilities. It is very sensitive to long-term interest rates, particularly when interest rates are low (as has been the case recently). This can drive behaviour (such as reducing longevity exposure in order to reduce the risk margin) that might not otherwise be taken, as it erodes insurer profitability and/or feeds back into pricing for consumers.

46. In an ideal world, consideration might be given to moving away from the 'cost of capital' concept that underlies the risk margin. Some potential modifications which could offer a more realistic approach include:

- reducing the cost of capital rate from 6% per annum, to 2% or 3%;
- reducing the cost of capital rate by a fixed amount (e.g. 0.5%) over each year of the projection subject to a minimum of 1% say, after 10 years;
- treating longevity risk as hedgeable so that it was excluded from the risk margin. (This might only be acceptable if the best estimates were determined using rates from longevity hedges);
- using a higher fixed discount rate for determining the risk margin, rather than the risk free rate; and
- applying a margin to risk free rates to determine the discount rate (perhaps subject to an upper limit) for determining the risk margin.

47. More generally, it is important for the UK to consider the nature of any insurance solvency capital framework, and determine whether it is in the public interest. Solvency capital frameworks seek to ensure that insurers are capitalised at a level which allows the survival of a rare event. However, should insurers then have sufficient margins to recapitalise, or have sufficient assets to mean a solvent run-off is possible? SII adopts the former more stringent approach, but the cost of capital is ultimately borne by the consumer and the level of security which they would willingly pay for needs to be taken into account.

Question 2.e) Is Solvency II a price worth paying for the passporting of insurance services across the EEA?

The IFoA does not have a particular view on this question.

3. Implementation of Solvency II

Question 3.a) What lessons have we learned from the implementation of Solvency II in the UK?

48. SII has encouraged a rules-based and bureaucratic implementation, partly because of the Lamfalussy process followed: with the Directive set in stone early on, and Level 2 text (providing detail) following much later. This has meant, at times, that decisions have been made in terms of interpreting the Directive text as a rigid truth rather than on the merits of the case; for example, on contract boundaries, especially in relation to reinsurance.

Question 3.b) With the benefit of hindsight, how well has the implementation of Solvency II met its stated objectives?

49. With the implementation of SII, there is now a common, pan-European insurance regulatory framework covering reserving, governance and reporting that broadly encourages good risk management. It has also increased the level of transparency within the insurance industry.

50. Unfortunately, the development of SII has been more model dependent than it should have been. Belief in the benefits of capital models reached a high water mark in 2007-8 when SII was being cast, and although there have been more considered views recently, development has encouraged an excessively rigorous testing of models. There is then an expectation of complete reliance on such models, rather than less exacting testing of models and more flexibility in their use, which may be a better approach.

51. Similarly, development of SII looked to IFRS accounting standards and included several features that were later dropped from that, but then retained within SII.
52. Adherence to a Financial Economic view of the world has at times been too theoretical and dogmatic. All market consistent methods depend for their validity on a deep and liquid market. Experience in 2007-8 and since has shown deep and liquid markets are perhaps the exception rather than the rule. An example is the difference between long term swap rates and government bond rates, which shows a lack of arbitrage in the market. Quantitative Easing exacerbates this, artificially reducing long term yields to the detriment of terms offered to consumers.

Question 3.c) How did the implementation of Solvency II in the UK compare with other European member states, both in overall approach and specific guidance?

53. The development of SII was less of a sea-change in insurance regulation for UK insurers than it was for other EU jurisdictions, such as Germany.
54. The PRA provided more information generally than other territories in a formal way (for example, through policy statements and supervisory statements). This does not in itself necessarily mean that the PRA's requirements have been stricter, but it does reflect the fact that the UK has a significant number of firms which have submitted for (and obtained) internal model approval. However, there is anecdotal evidence (which the Committee might be able to confirm in evidence) that internal models have - contrary to expectations - led to higher levels of capital being required in order to meet the regulator's requirements as well as materially higher costs on the industry.

Question 3.d) Where relevant, please give an indication of the costs of implementation for your firm - both internal (e.g. staff costs) and external (e.g. consultancy costs). [If you would like us to keep this information confidential, producing only aggregated or anonymised data in our Report, please make that clear in the "additional information" box on the website. And if you are content for us to publish the rest of your submission, please send a redacted, publishable, version to treascom@parliament.uk]

This question is not applicable to the IFoA.

Question 3.e) Solvency II has a number of transitional provisions (for up to 16 years in some circumstances). Are these provisions effective, practical and flexible enough?

55. SII includes the use of transitional measures that are designed to smooth in any adverse impact of SII on the balance sheet, to avoid unnecessary disruption of markets and availability of insurance products. This adverse impact principally arises from the use of a risk margin and from differences in discount rates. The transitional measures consist of a deduction applied to technical provisions which is then run off over 16 years.
56. The transitional measures are clearly welcomed by the insurance industry and the sums involved can be material for many insurers. They are subject to approval by the PRA, and they have been of particular focus since 1 January 2016 in the light of prevailing market conditions: many insurers have seen substantial increases in their risk margin given recent low rates of interest.

57. As the transitional measures can be reset, they can act as a hedge to changes in risk margin brought about by changes in interest rates. This is clearly helpful, although the process introduced by the PRA to review the reset of transitional measures is somewhat cumbersome and time-consuming. This can lead to scenarios where the assessed solvency position is temporarily depressed or boosted by changes in the risk margin with the position realigned only once the PRA has approved a reset of transitional measures. This 'saw tooth' pattern for the firm's assessed solvency position is not desirable.
58. It would be preferable for firms to develop a framework for resets of the transitional measures as a result of changes in economic conditions. This would be agreed with the PRA, such that firms could anticipate future resets and smooth out the temporary distortions in solvency.
59. The transitional measures use as an input equivalent solvency calculations under the SI framework. Aside of a question over insurers' continued ability to calculate results on such a basis, the use of SI results may in some circumstances encourage firms to manage their risks on a SI rather than SII basis. For general insurance firms, we would consider this to be a retrograde approach.

4. Safety and Soundness

Question 4.a) How effective has Solvency II been in increasing the safety and soundness of the UK insurance industry?

60. Although SII has increased the safety and soundness of the UK insurance industry, any improvement arising from SII has not been dramatic when compared to the position with the prior ICAS regime.
61. Safety and soundness generally arises from two areas: the retention of suitable capital buffers over and above the sums required to meet future claims, and robust management of risks by the insurer's senior management and the Board.
62. The implementation of SII introduced EU wide the same capital standard as had hitherto obtained in the UK, namely seeking a capital buffer to pay claims in adversity up to extreme situations with only a 0.5% chance of occurring over one year; this 0.5% chance over one year is often referred to as meeting up to a 1 in 200 year event but not beyond. The former ICAS regime used in the UK used a broadly similar approach in terms of setting capital to withstand a 1 in 200 year event. However SII has in many cases (particularly in life assurance) applied this capital standard to a less favourable base balance sheet, and thereby has considerably increased the buffers above the basic requirement to meet claims as they fall due.
63. On capital what SII did do was bring this standard into the reported regulatory returns as a Pillar I measure rather than the prior Pillar II measure of ICAS.
64. SII also imposed an onerous testing and justification of capital models when used by the larger UK groups to support an application to use an internal model rather than the standard default model of the SII rules.
65. SII also provided the standard formula. This has allowed smaller insurers to use a standard set of stresses without needing extensive testing, back testing and validation required of internal models, albeit the standardisation has reduced flexibility. The standard formula has reduced the cost of implementation of SII in a material way.

66. Internal model application has been a highly expensive exercise for the industry, but has brought notably higher standards of review, governance, and documentation. This combination of improved standards for the major players and public disclosure has improved safety and soundness but not dramatically so when compared to the prior ICAS regime, as mentioned above. Certainly the UK's capital models and systems, developed over many years, would not directly need SII to remain in force for them to endure.
67. The implementation of SII has spurred the development of coordinated reporting - the Own Risk and Solvency Assessment (ORSA) - and the formal governance around risk management. The parallel development of the UK's Senior Insurance Managers Regime (SIMR) has also helped in this area. In a similar way to capital modelling, the impact of SII has certainly been to improve formal governance within firms, and the documentation of such governance; it has also brought firms' governance arrangements for large, medium and small firms to a more consistent standard. Conversely, improved Board understanding of, and the seriousness with which they consider, risk management, could never be a matter of just rules (SII or otherwise). It is a more cultural matter that is helped by industry standards, quality of staff, and pressure from the PRA.

Question 4.b) What are its principal strengths, both technically, and in its influence on Boards?

68. Similar points made in the answer to question 4.a) above also apply to this question. There has been a major programme of education for Boards over SII. Partly that has been about Boards becoming able to understand the complexity and terminology of the new regime, rather than the more desirable constant development of Board understanding of risks. As noted elsewhere a complex rules-based system may deliver a finer capture of standard risks but comes with the danger of significant effort being expended on understanding its rules, and how the rules interact with real world events, rather than further considering the real risks faced.
69. SII does place emphasis on the underlying economic reality of risk rather than how to get risk fitting into a rule book; there is a greater awareness of the importance of robust risk management.
70. We believe that the move for Boards to fully understand and authorise their firm's risks has been a major step forward for risk management in the smaller and medium sized firms. This will emerge over the near future as compliance with look-through of assets and analysis of asset holdings increases.
71. SII has also introduced a (broadly) level playing field in terms of insurance regulation across the EU.

Question 4.c) What are its principal limitations?

72. We believe the SII framework is overly complex and inflexible and there is a lack of space for regulators' discretion, other than in a stricter way, such as by refusing consent to the use of the relief mechanisms in the structure. The ability to apply discretion is particularly important at times of market stress.
73. Internal model application has been a highly expensive exercise for the industry, though has brought notably higher standards of review, governance, and documentation.

74. There has been too much focus on having the perfect model, rather than being able to identify limitations and then apply capital adjustments to allow for them in a very transparent and sensible way. This focus on model perfection has a frictional cost and makes it harder to take a big-picture view of risk and capital.
75. SII has its own complexity and detailed application on technical provisions and on the standard capital calculation, and thus its own 'view of the world'. This has driven two sets of management information - one on SII rules and one on a more realistic/less rule based view of the world. Indeed the latter is precisely what is called for by the ORSA. This need to balance two views of capital needs is unhelpful. As an example, mid and smaller insurers face material risk from their staff pension schemes. However, the calculation of capital for the risks of such schemes under SII rules focuses on a particularly artificial measure of the interaction between scheme assets and liabilities. By contrast, a fundamental part of insurers' risk management is to analyse how this interaction affects their firms.

A further concern relates to the issue of pro-cyclicality. We consider this in detail in our answer to question 7 ii) below.

Question 4.d) What are your views on the concept of internal and standard models and does the concept work well in practice? If not, what refinements could be made?

Overview

76. As noted above, the capital requirements under SII can be calculated using the standard formula, or subject to regulatory approval, an internal model. Firms using the standard formula are expected to justify why using the standard formula is appropriate for their business.
77. This aligns well with the prior regime where firms had developed their capital models over long periods of time based on their view of their risks. This interaction between a firm's models and its view of risk is quite crucial to inducing a sound risk culture and only by each challenging and driving the other does a robust culture start to develop.
78. SII allows a reasonable degree of flexibility with firms having the option to use an internal model for all their business, to use the standard formula or to use a partial internal model combining both approaches. SII also allows some flexibility in how firms are able to aggregate standard formula and internal model risks and/or businesses in the calculation of the capital requirements.
79. For general insurance firms the option to use Undertaking Specific Parameters (USPs) also allows firms to adjust the standard formula for their circumstances without necessarily requiring an internal model. However, there is scope to reduce the overhead involved in justifying a USP.

Standard Formula

80. The standard formula approach for determining capital requirements did not exist under the ICAS regime. Some question whether the standard formula is necessary, as it could be argued that it would be preferable to revert to a system where all firms can apply their Internal Models to determine their capital requirements. Conversely, the standard formula has cost attractions for smaller insurers.

81. A standard formula, by its very name is built to cover a very wide diversity of products and risks across the EU. Its application in the UK is good and better than the prior SI 'standard'. The insurer needs to agree that the standard formula does reflect its risk profile.
82. In addition, avoiding the need for expensive back testing and developing of internal models has been crucial in keeping the costs of SII implementation to a reasonable amount for smaller and medium sized firms compared to the costs of internal models.
83. However, there are a number of areas where additional work could be carried to address weaknesses in the current standard formula framework:
- operational risk where the standard formula derives an amount of capital that is (for most firms) inadequate against the real risks run by the firm;
 - it should be extended to include pension scheme longevity risk and pension scheme market risk;
 - sovereign risk should be within scope – it is not currently included within the standard formula;
 - the treatment of participations, and in particular insurance participations, is superficial;
 - there is no allowance for equity volatility risk;
 - allowance for counterparty risk is excessive, especially in relation to reinsurance; and
 - there is a lack of diversification permitted in 'Matching Adjustment' portfolios.

Internal Models

84. Internal models have proved very expensive and time/resource intensive. However, they work well, as with the prior ICAS regime, to foster the interplay between managements' view of risks and the articulation through the internal model of how these risks might develop. Installing such a realistic view of risk into the public reporting should be a boon and help to the larger firms who would be able to focus on one view, and articulation of, risk. Sadly that has not happened as necessarily the PRA has views of how risks should be modelled, minimum scales of stress to be included, and how SII discount rates such as matching adjustment or volatility adjustment should be modelled as flexing in times of stress. The firm in contrast will have its own views on risks driven by its own analysis and built this into its business plans and product pricing.
85. This tension is perhaps inevitable but as SII or any successor beds down it would be very helpful to settle some of these divergences and determine what is a hard regulatory concern, and where the UK regulator is driven by SII rules, or their interpretation. We have already mentioned that there also remain a number of potential practical challenges where a pragmatic and open approach by the regulator would be beneficial, such as avoiding excessive documentation of model changes to models already well-documented. The regulator's basis should be open to public debate and challenge.

The use of capital 'add-ons' in the context of internal models is discussed in the answer to questions 2.a) above.

Question 4.e) Is the new regime flexible enough to withstand another financial crisis?

86. The new regime is far more precise/finer than the previous published regime, but brings its limitations and complexities in its wake. That has proved challenging for the industry during 2016 from the fall in risk free rates and its impact on the cost of capital risk margin.
87. The SII regime is less flexible than the prior ICAS Pillar II regime; the tightness of the SII requirements makes them harder to flex.
88. One practical challenge would be the time taken to put through (and obtain regulatory approval for) internal model changes during a financial or other crisis.

Question 4.f) Can you think of any circumstances where Solvency II would not operate effectively or could increase the risk to the UK insurance industry?

89. The current low interest rates scenario has painfully highlighted that SII can increase strains on the industry in the absence of a real risk. The construction of the risk margin is peculiarly sensitive to low interest rates. This is leading to some very difficult decisions for firms as to how to hedge this SII induced risk, with some perverse impacts on the results from capital models.
90. The PRA has acted to mitigate some of this issue through recalculation of one of the transitional measures under SII. However, that process of itself comes with delay and uncertainty and does not allow straightforward management of the real risks here.
91. With reporting of actual SII results still in its infancy (following the 'go live' date of 1 January 2016), there is a risk that some investment analysts and rating agencies do not yet fully know what to expect when analysing an insurance company's performance. This has already increased the volatility of some insurers' share prices.
92. In the event of a general liquidity crisis in the market, with SII having increased the reliance of insurers on market instruments to mitigate their capital requirements, there may be an increased risk to the industry – i.e. by increasing the systemic connection between insurers and banks.

The membership of the IFoA is well placed to research this and there could be many examples.

5. Proportionality

Question 5.a) Do you consider that the ongoing regulation under Solvency II is cost effective and proportionate with regards to the areas below?

i. Pillars I and II

93. SII Pillar I has required significant cost to develop and implement the internal models and the ability to use them to calculate the capital requirement. The combination of the complexity of the calculations for internal model firms and the ongoing reduction in the timelines to deliver results will continue to drive investment and focus for firms which could otherwise be used for other purposes.
94. This is partially driven by the degree of precision required to calculate something which by definition is an estimate; for many risk categories there is insufficient data to derive the capital requirement 'shock' calculations without the use of expert judgement.

95. The level of documentation and justification required for an internal model application involves firms submitting hundreds of documents and thousands of pages. The rules require similar levels of documentation for future major model change applications and we would hope to see the PRA take a pragmatic approach here in terms of materials which have not changed, with a focus on the relevant model/ capital changes.
96. In the event of a major model change, the timescales to obtain approval are significant with the minimum time likely to be at least 12 months. This covers the identification of the change, development and documentation of the model including initial discussions with the PRA and the six month review period before approval can be granted.
97. This is likely to act as a significant constraint for internal model firms on investing in new asset classes or offering products covering new risks, as insurers will not be able to finalise their business cases until future applications are approved. This is reasonable where firms are seeking first mover advantage but could act to constrain competition where new firms seek to join existing markets.
98. SII Pillar II encompasses the governance requirements for an insurer, together with the Own Risk and Solvency Assessment (ORSA). The governance requirements include the roles and responsibilities of key functions within an insurer, with the insurer's Board having overall responsibility for ongoing compliance with SII; the ORSA requires insurers to assess the entirety of risks they may face, including risks not assessed under Pillar I.
99. The IFoA supports the principles behind Pillar II, including a robust and adequate insurance governance framework and the forward-looking assessment of risks within the ORSA. The development of these has helpfully evolved from the former ICAS approach in terms of making risk management forward looking and linked to business planning, and has thus enhanced the risk management within many firms.
100. However, we believe that there is a risk that the associated Pillar II documentation requirements may be onerous (particularly for smaller firms). These include the requirement not only to justify approaches taken, but also explain why alternative approaches were not taken, particularly where the regulations are strictly applied. We believe there is scope to reduce documentation requirements without diminishing the quality of the regulatory framework.

ii. Pillar III

101. SII Pillar III consists of quantitative and qualitative requirements for public disclosure and private disclosure to the regulator. These are aimed at increasing the level of risk information in the public domain. The disclosure requirements under Pillar III are more extensive than those under SI.
102. The IFoA supports the objective of SII Pillar III to increase the level of transparency over insurers' risk profiles.
103. We believe though that the Pillar III reporting requirements are disproportionate in some areas, and this adds to the cost burden for insurers. It also leads to a sense from firms – fair or otherwise - that the regulator is seeking to obtain everything it can in case there is something to find. More generally this links to the prescriptive nature of SII which has required

the regulator to sign-off on a model (in the case of internal models) and hence lose control of the outcome (the solvency capital requirement generated from this in future).

104. By way of example, the level of required individual asset information is particularly excessive. There is a high chance that the PRA will not be able to 'see the wood for the trees' and will not in practice gain much insight from this information, despite the high costs incurred by the UK insurance and asset management industry.

105. Furthermore, many of the Quantitative Reporting Templates are extremely resource intensive e.g. providing granular details on derivative instruments purchased, including the number of contracts entered into or on the detailed look through of unit fund investments which will lead to marginal changes in the solvency capital calculation. These require significant investment from insurers to provide.

106. We also believe that there is 'gold-plating' of requirements within the UK: as well as the templates required by the SII Directive, the PRA also requires further National Specific Templates to be produced. These are an additional burden to produce and the PRA should consider carefully the necessity to provide them.

107. We would also note the ongoing requirement from the PRA to produce the standard formula capital requirement as one of the measures to identify model 'drift' for internal model firms. We think that differences in movement between standard formula and internal models are a poor indicator of changes in the internal models. These can occur for a wide range of reasons and a better focus would be on the model change logs supplied by firms.

108. A further view is that some of the reporting to supervisors is doubling up on the requirements for other reports: including reporting requirements which seem to be on an 'everything we could possibly want to know' basis rather than effective reporting.

iii. SII's requirements to identify key function holders as implemented in the UK's new SIMR regime.

109. The SII Directive recognises the importance of the actuarial function and as such we require our members in this role to hold the relevant IFoA Practising Certificate. For life insurance actuaries, the role of Chief Actuary has become more tightly- defined, and for general insurance actuaries, an equivalent role was created.

Question 5.b) Has the implementation of Solvency II allowed sufficiently for the different sizes and types of firms?

110. The SII regime allows firms to develop proportionate responses for their business by allowing smaller firms to use the standard formula. The implementation of SII has focused on the larger firms with the PRA applying different levels of scrutiny depending on firm size.

111. SII can place larger, diverse insurance firms and groups at an advantage relative to smaller, more specialist insurers. A large insurer/ insurance group's greater scale means that it is better-placed to absorb the high implementation and ongoing compliance costs associated with SII. Larger insurers may also be more likely to have the resources to develop internal models for their SII capital requirements; using an internal model can often lead to lower capital requirements than via the equivalent standard formula result.

112. Under SII, a well-diversified insurer writing a range of different forms of insurance can correctly receive substantial diversification credit in its capital requirement calculation, with a corresponding benefit to its costs of capital.

113. Conversely, smaller insurers may find the ongoing compliance costs of SII a greater burden, and are less likely to be able to justify the use of an internal model to determine their capital requirements. Smaller insurers, and in particular mono-line insurers writing a limited range of business types are also correctly less likely to benefit from diversification effects in the capital requirements, with consequently higher capital costs. Increased capital and compliance costs are expected to result in increased merger and acquisition activity within the UK insurance industry.
114. However, a smaller insurer following the standard formula route may find their costs have increased (including the costs for audit) but not as much as a large insurer maintaining a complex internal model. Small proportionate reductions in capital requirements may not be as material to smaller insurers.
115. SII has brought in a realistic capital regime to smaller firms in the UK. This has increased capital for some firms but also created a regime that has more flexible technical provisions than the previous published SI regime for changes in market conditions, especially in the allowance for discretionary benefits for with-profits insurers.

Impacts on annuity business is considered in question 7 (i) below.

6. Financial reporting

Question) There are a number of international developments (e.g. IFRS and EEV) attempting to clarify and simplify financial reporting and valuation for insurance entities. How does Solvency II factor in to this debate?

116. The SII framework addresses prudential valuation rules rather than focussing on accounting. However, the design of SII was intended to ensure that the valuation rules would be compatible with international accounting developments (including using the concept of market consistency). The accounting standard IFRS 17 is not now expected to be implemented until 2021. Until its design is finalised, the extent of any consistency between SII and IFRS 17 will not be fully clear.
117. Generally most firms account for insurance based on the SI regime. However, many firms will likely use their SII technical provision as the starting point of assessing their technical provisions for IFRS. Insurer accounting practice between now and 2021 is uncertain, and it is possible a wide range of practices will emerge.
118. The SII Balance Sheet for general insurers includes a number of technical aspects which are inconsistent with the corresponding accounting treatment; these include 'unincurred legal obligations' and 'Events not in Data' (ENIDs). The lack of alignment with accounts in these and other areas increases complexity, reduces transparency and impedes Boards' understanding of the relevant financial reporting.
119. Some insurers have stopped publishing EEV results on the basis that SII is also calculated on a market-consistent basis, such as to make the use of EEV redundant. However, the insurance investment analyst community have suggested that, for life insurers, they do not think that SII on its own provides sufficient information, and the need for

supplementary reporting will likely remain. The European Insurance CFO Forum published updated Market Consistent Embedded Value (MCEV) and EEV Principles in May 2016 to permit greater flexibility in embedded value methodologies and disclosures following the implementation of SII. A number of UK insurers have since reported under this basis.

7. Wider implications of Solvency II.

Question) What are the implications of Solvency II for:

i. UK policyholders;

120. One key aim of SII is to set solvency capital requirements to reflect insurers' risk exposures more appropriately than under SI. A risk-sensitive capital framework was introduced in the UK with the development of the SI ICAS regime. Greater risk sensitivity of capital led to insurers reassessing their product range, and then led to a move away from capital-intensive products with guarantees, to capital-light business. The implementation of SII is likely to lead to a further reappraisal of products by insurers, although it is too early to be clear on the general outcome.
121. The impact on policyholders can be divided into the impact on existing policyholders and the impact on potential new policyholders. The UK population is generally under insured for life and related contingencies, thus the potential policyholders are a significant proportion of the population and the impact of SII on their access to insurance products is important. Policyholders benefit from the greater security of the life insurance companies that are supplying their policy. However since this is in the 1/200 year event scenario, they are unlikely to see this impact ever, nor comprehend what it means.
122. Policyholders will be adversely affected if:
- a. **Prices rise due to increased insurer expenses.** It is likely that there has been an overall increase in expenses of insurers due to SII and thus a detriment to policyholders.
 - b. **Prices rise due to increased capital charges on the insurer,** which are passed on to the policyholder. This varies by policy type but is not thought in general to be a significant impact, although some insurance companies would be more impacted than others, thus a detriment to some policyholders. The net impact might be a reduction in the number of insurance companies thus reducing competition.
 - c. Where investment returns are an important element of the policy, **investment returns on policies reduce** due to SII considerations. There is strong argument that this is the case for large classes of investment policies, particularly those smoothing policyholder returns in the unique way that certain life insurance policies can.
 - d. **Access to products reduces due to reduced** distribution by the insurer, or removal of categories of product that become unsustainable under SII. There is little evidence yet that whole product classes are no longer viable, nor that there has been any decrease in product access by consumers due to SII. While it is likely that internal model approvals, or indeed the capital impact calculations, on new product developments may be more time consuming and more costly than before SII, this is not thought to be a major drag on product innovation.

123. In terms of specific insurance product lines:

- a) **Group insurance policyholders:** consumers who have group life, group critical illness and group income protection insurance benefits through their employer or pension fund will not likely have been impacted by SII at all. It is unlikely that the capital implications under SII of increased capital held for 1/200 year mortality, morbidity or health events would have caused significant increases in group insurance prices. This group insurance tends to be re-priced every two years and operates in a highly competitive market. It is unlikely that prices have increased, access has reduced or security of benefits has changed.
- b) **Individual protection insurance policyholders:** consumers who have existing life and related insurance are unlikely to have seen any impact of SII. Premiums and premium increase patterns are by and large fixed at outset. Any impact of greater capital requirements or constrained investments would impact on the insurer's expenses and profit and not on these policyholders.
- c) **Annuity policyholders:** since policyholders owning annuities have guaranteed annuity payments there will have been no impact on annuity policyholders. New purchasers of annuities will likely have seen an increase in prices. This has happened at the same time as significant legislative change, significant changes in expectations for future mortality improvements and reduction/ volatility in interest rates; therefore the impact of SII is difficult to separate.

It is however likely that SII has had a detrimental impact on new annuity policyholders: solvency capital requirements are higher under SII than previously, operational restrictions regarding the Matching Adjustment and the sensitivity of the risk margin to (currently) low rates of interest are all impacting on the attractiveness of annuity business to UK insurers. The effect of this is to drive the cost of annuities up for the consumer. The consumer is having to pay for use of capital to a degree unlikely to happen, and the cost is high. The effective 'insurance premium' the consumer pays against loss of income, when measured against the former ICAS regime, is such as to make consumers worse off in all but the most extreme circumstances.

- d) **With profits policyholders:** with-profits policies are policies that grow in investment value based on the performance of a with-profits fund's investments. This investment growth is smoothed and reduced by expenses. Where the capital requirements of the company cause an investment mandate constraint, or entail higher expenses, this will be to the detriment of the policyholder. It is highly likely that with-profit funds have experienced both of these detriments due to SII. (The IFoA is in the process of developing a fuller dissertation on this topic to articulate and quantify this impact).
- e) **Unit linked policyholders:** since in unit linked policies, the investment return passes fairly directly to the policyholder, the impact of SII would be in terms of increased expenses, and less so in terms of restricted investment mandates. Capital charges are unlikely to have affected policy benefits.

124. As noted above, the implementation of SII could see an increase in merger and acquisition activity within the UK insurance industry, potentially with some insurers closing to

new business. This could lead to fewer insurers and therefore potentially less consumer choice.

ii. The wider UK business economy; and

125. As long-term investors, life insurance companies should be ideally placed to support the wider UK business economy in two key areas:

- investing to support long-term economic growth, notably in the area of social and wider infrastructure projects such as housing, hospitals and power stations; and
- acting as long-term investors and helping to stabilise markets, reducing volatility and systemic risk, particularly given the post crisis retrenchment of the banking sector's ability to act in this regard.

126. Life insurers typically have long-dated illiquid liabilities, and so long-duration assets that can be held to maturity are an ideal matching investment. The UK Insurance Growth Sector Plan highlighted that 'a stable regulatory framework that actively supports, rather than deters, this long-term investment by insurers is vital'.

127. The UK Coalition Government expressed its desire that UK insurers support the national infrastructure plan, most notably in the 2013 Autumn Statement (<https://www.gov.uk/government/news/new-infrastructure-plan-published-by-government>) and the resulting UK Insurance Growth Sector Plan.

128. A key test for SII from a wider economic perspective is whether it supports or hinders this activity.

Pro-cyclicality

129. At a macro-level, one key implication of SII comes from the expected increase in pro-cyclicality, whereby insurers' investments exacerbates rather than dampens market cycles, and insurers' willingness to bear risk diminishes in periods of stress and economic downturns. (see 'Pro-cyclicality and structural trends in investment allocation by insurance companies and pension funds: A Discussion Paper by the Bank of England and the Pro-cyclicality Working Group').

130. This increased pro-cyclicality comes in part from the very nature of the SII regime, with assets and liabilities marked-to-market and risk-capital held against short-term volatility in market prices. However, this broad framework existed under the UK ICAS regime.

131. The key impact of SII has instead been to impose a standardised framework across the entire EU insurance industry, covering around €10 trillion of assets, meaning that insurers across the EU are likely to react to market events in tandem and reducing the natural offsets that have historically existed between different national systems.

132. A number of key international bodies have highlighted the resulting macro-economic risks, notably the:

- International Monetary Fund in their Financial Stability Report (April 2015, 'Pension funds and insurance companies are less able to play a countercyclical role in financial markets because of tighter requirements to minimise asset-liability mismatches'); and
- Basel Committee on the Global Financial System (Paper No 52, 'Ongoing accounting and regulatory changes ... limit the scope for taking long-term or illiquid assets on balance sheet, particularly during times of elevated market volatility').

133. A key political compromise to facilitate the introduction of SII was the so-called Long-Term Guarantees Package containing various measures to support long-term investment and combat pro-cyclicality, notably the Matching Adjustment (MA) and Volatility Adjustment mentioned already. It will be important that similar mechanisms are maintained (with enhancements) in any successor UK regime.

Infrastructure Investment

134. The MA should in theory incentivise investment in long-term illiquid investments such as social infrastructure. However, again we have some concern about whether this is happening in practice. As discussed under Question 2, the MA as currently implemented in the UK gives rise to a number of practical issues, which can include the need to carry out restructuring of assets to achieve MA eligibility. As with internal models, insurers potentially face the need to submit a revised application for MA approval for material new asset classes.
135. The standard formula capital requirement under SII as originally designed did not reflect the secure nature of high-quality infrastructure investments. However, in September 2015 the European Insurance and Occupational Pensions Authority (EIOPA) published advice proposing a separate asset class to capture high quality infrastructure under the SII Standard Formula. This approach should encourage increased infrastructure investment by reducing risk charges for qualifying investments in both equity and debt.
136. SII also introduces a 'Prudent Person Principle' for insurance company investment, which removes restrictions on investments provided they are prudent and in the interests of policyholders. This could support larger asset allocations to infrastructure and other alternative asset classes.
137. Furthermore, the IFoA believes that UK's insurance regulation framework could promote more infrastructure investment by insurance companies if the liquidity requirements were relaxed. These requirements are appropriate for short-term investments, but infrastructure investments are generally long term in nature, and realistic investors would not demand the same level of liquidity. We recognise that liquidity risk must be controlled, but the need for more investment means that differential treatment for infrastructure is reasonable in our view. We also believe that the PRA should issue guidance designed to encourage these investments (which are natural matches for long term insurance products).

Impact on Equity Investment

138. Regulatory constraints may have unintended consequences for some insurers' investment strategies. Market consistent approaches have discouraged investment in equities other than where the policyholder bears the risk, such as on unit-linked business. This can be both positive and negative:
- it is positive as it discourages firms from giving over-generous guarantees and ensures de-risking can take place at short notice. It has also forced UK insurers to reflect gradually the fall in yield curves and to avoid the need for measures such as the Ultimate Forward Rate, which anticipate a return to higher yields in the future; and
 - it is negative in the sense that it discourages long term investment in risky assets. For example, if the objective is to generate strong real returns with say a 20 year investment

horizon then equities are a good asset as over this time period their returns are likely to be highly correlated with long term inflation impacts. However, SII imposes a one-year horizon for capital and over that time period equity returns may be strongly negatively correlated with inflation.

iii. Regulators?

The IFoA does not have a particular view on this question.