Institute and Faculty of Actuaries

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

18 January 2017

Dear Mr Tyrie

**IFoA evidence to the Treasury Committee Inquiry into Solvency II: Follow-up**

1. The Institute and Faculty of Actuaries (IFoA) thanks the Treasury Committee for inviting us to give oral evidence to the Committee's inquiry into Solvency II, (SII). We hope the Committee found our answers useful, and that they shed some light on the strengths and weaknesses of the SII framework, and the options for its future evolution in the UK.

2. As was requested at the end of the session we have taken the opportunity to summarise the key changes which could be made to SII in the UK, which could be an opportunity to resolve some UK-specific issues. Some of these points are down to the way SII has been implemented in the UK, and are not affected by any need to maintain equivalence or passporting rights. There are potential 'quick wins' that could be made.

3. **Matching Adjustment**, MA: the MA has a material impact on many insurers. However, it incorporates 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. Specific issues include:
   - the need for asset restructuring to achieve MA eligibility; this is particularly relevant to equity release mortgages;
   - ineligibility of other assets which leads to lower levels of funding in the wider economy (e.g. some infrastructure assets);
   - the timescales for new asset approval are too long;
   - inappropriately harsh consequences of breaches in the MA (no matter how minor); and
   - some of the MA requirements could encourage pro-cyclical behaviour under stress.

4. We believe that a framework with more emphasis on insurers' internal governance processes and 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 (such as materiality thresholds) from the PRA.

5. 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.

6. **Risk Margin**: The risk margin calculation can be quite complex and it is often a material and potentially volatile component of an insurer's SII balance sheet. It is peculiarly sensitive to low interest rates.

7. The mechanism and parameters chosen for the risk margin tend to result in excessively high margins that are disproportionately high for long duration business, such as annuities. The risk margin is driving insurer behaviour which might not otherwise be taken.

8. We note that EIOPA is revisiting the risk margin longevity stresses specifically to see if a better and more useful calibration can be used. EIOPA is suggesting quite a few changes and it would be useful for the PRA to be fully engaged if possible with this debate.

9. Some potential modifications which could offer a more realistic approach to the risk margin include:
   - reducing the cost of capital rate from 6% per annum. It could be reduced to 2% / 3%, or 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; and
   - using a higher fixed discount rate for determining the risk margin, rather than the risk free rate.

10. **Volatility Adjustment**, VA: the VA 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 is determined centrally by EIOPA.

11. HMT decided that firms should have to seek regulatory approval before using the VA. However, in some EU states, regulatory approval is not required. Not permitting insurers to use a VA could lead to pro-cyclical behaviour, in which insurers would become forced sellers in an economic downturn.

12. Some European regulators also allow the VA to vary in assumed stressed conditions i.e. treating it as dynamic rather than fixed. This is another area where the UK regulator takes a harder line compared to, for example, the Dutch regulator.

13. We believe it would be appropriate for '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.

14. **Transitional Measures**: 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. 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.

15. 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. However, the process introduced by the PRA to review the reset is somewhat cumbersome and time-consuming, and could give rise to uncertainty.

16. It would be preferable for firms to develop a framework for resets of the transitional measures as a result of changes in economic conditions, with agreement of the PRA. In this way firms could anticipate future resets and smooth out temporary distortions in solvency.

17. **Lack of Discretion:** the SII framework is overly complex and inflexible and there is a lack of space for regulators' discretion; it is less flexible than the prior UK Solvency I (ICAS) regime. The ability to apply discretion is particularly important at times of market stress.

18. Internal model application has been a highly expensive exercise for the industry. 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 makes it harder to take a big-picture view of risk and capital.

19. **Excessive Disclosure Requirements**: There is scope to reduce SII's reporting and differing documentation requirements without diminishing the quality of the regulatory framework. 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.

20. We also believe that there is 'gold-plating' of these requirements within the UK: as well as the reporting 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 in some cases duplicate information. The PRA should consider carefully the necessity to provide them.

21. **Trade-off Between Security/ Value for Money**: Finally, 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?

22. 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. It could be argued that with SII, consumers are being asked to pay for too much security. The question over how much security is appropriate is one for policymakers rather than regulators to decide on.

23. As mentioned in our written evidence, 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.

Should you wish to discuss any of the points raised in further detail please contact Michael Williams, Public Affairs Executive, (public.affairs@actuaries.org.uk / 0207 632 1466) in the first instance.

Yours sincerely

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**Chair, Life Board, Institute and Faculty of Actuaries**