Current issues

Insurance Investment & ALM Panel Discussion: Will the UK Solvency II reforms make it more attractive to invest in illiquid assets?

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As part of our 8th Insurance & Financial Services Seminar held in London on 6th October, we hosted an industry panel session to discuss the UK's potential Solvency II reforms and how these might impact insurers' investment strategies and their appetite to invest in illiquid assets.

The panellists were:

- **Marc Storan** – Chair of the panel
- **Max Cawthorn** – Senior Strategy Manager at Pension Insurance Corporation Capital
- **Sam Tufts** – Head of New Assets at Phoenix Group
- **Nick Ford** – Head of Risk & Capital at Hymans Robertson

Key takeaways from the discussion included:

1. Whilst there was strong acknowledgment that there was still uncertainty of where the reforms would land, the panel felt the overall reform package would fall short of the positive reforms the industry wanted to see.
2. The panel highlighted the lack of detail to date in the proposed reforms regarding the current asset eligibility rules, and that the current rigidity was stifling even greater insurance investments in UK productive assets.
3. There were concerns that the potential revisions to the MA calibration may prove to have the opposite effect of the HM Treasury's' overall objectives aligned to the reforms.

The following section provides the questions which were put to the panel and a summary of the discussion which took place.

On 8th July PRA's Sam Woods suggested that changes in asset eligibility "*may prove to be the part of the reform package which does most to promote investment*". Do you agree or disagree with this statement?

It was discussed that the proposed reductions to the risk margin could potentially release capital from insurer's balance sheet which may be deployed to support further investments in UK assets. The panel noted the helpful granular details provided by the PRA to reform the size and interest rate sensitivity of the risk margin, but questioned whether this was now solving a problem that we have started to move away from as interest rates rise.

On the MA calibration, the panel cautioned against the potential volatility that may be introduced in the MA and they were in agreement that the proposed changes to the MA calibration could lead to some illiquid assets becoming relatively less attractive.

In contrast to the detailed proposals for the changes to the risk margin and the MA calibration, the panel noted the lack of commensurate detail that has been put an area on asset eligibility rules where the panel were hoping for more practical rules and removal of some rigidity in the current prescribed rules to better support insurance investments in the UK economy and society.

Is the new Truss Government a game changer in this reform journey and what changes are needed?

A few weeks ago, the UK Government (at the time of speaking) announced its ‘Growth Plan’, aiming to kickstart growth in the UK economy. Reflecting the recent UK politics, an idea that remains is the potential introduction of ‘Investment Zones’ that benefit from tax incentives and looser planning regulations that aim to accelerate housing development. Although these are sitting outside of the Solvency II reform remit, the panel highlighted they were also another component of the wider changes needed to ease the sourcing of certain investments and reduce associated planning times in certain property backed investments. The panel also noted that wider changes are needed to increase investment in areas such as affordable housing, for example, simplifying the current planning system by replacing Section 106 of the Town and Country Planning Act 1990 and creating more public-private procurement models.

As the UK continues its overhaul of the financial regulatory framework post-Brexit, the HMT has set three objectives regarding the Solvency II reforms:

1. Competitive insurance sector
2. Investment to support growth
3. Policyholder protection

The proposed Financial Services and Markets Bill aims to address some of these HMT’s objectives, but the panel felt there ought to be better direct alignment with these objectives and reformed Solvency II technical rules to reduce the subjectivity in how these objectives are interrupted and achieved. The panel also called for a wider set of reforms, for example on planning law, to allow for a better investment framework.

What are the current regulatory barriers preventing insurers from investing?

The panel gave its views focusing on the current Matching Adjustment framework and the criteria for asset eligibility:

- The panel noted that the current rules requiring fixed asset cashflows disincentivises insurers from investing in certain asset classes such as project finance with material construction phases.
    - while also highlighting that the liability cashflows that these assets back are not fixed themselves.
- Considering the complexity, effort and costs associated with structuring assets such as Lifetime Mortgages the panel questioned the need for such restructuring to meet the ‘fixed cashflows’ requirements when the insurers’ balance sheets exposures are still very similar to the underlying assets.
- The panel called for a less cumbersome asset approval process from the regulator.
- Overall, less rigidity in the eligibility rules and more prominence on managing any associated risks of asset-liability mismatch.
- The proposed removal of the BBB cliff-edge could benefit insurers by allowing them to invest in sub-investment grade assets, manage any downgrades more effectively or help investing in assets with construction phase.

Assuming the UK Government delivers on removing the above regulatory barriers, where are you thinking of investing in the UK economy that is different from today?

The panel spoke about two key beneficial changes to the UK economy and UK productive assets that this could bring:

1. Create more opportunities in new types of insurance investments such as battery storage and EV charging points which could help UK energy security and its path to Net Zero emissions.

2. Open up for more and wider sub-sector investments across areas such as social housing and infrastructure assets.

Outside of the MA portfolios, the panel was also keen to see greater allocations to equity investments in infrastructure, new technologies and start-ups that will help accelerate growth in the UK economy.

Does the panel expect more use of funded reinsurance after the reforms?

HMT has previously signalled its appetite to review the use of reinsurance in the UK market following its increasing use. In a recent speech by Charlotte Gerken, the PRA has said that "We intend to strengthen our monitoring of funded reinsurance, for example analysing structures and the risks that they pose in detail". As volumes from the pension risk transfer market show no signs of abating and as a result of the recent market shifts, more schemes may be in a stronger position and have a greater desire for buy-out. A more competitive PRT market may lead to higher demand for funded reinsurance as insurers may find capital or asset sourcing starts to become a constraint on increasing PRT volumes further. The panel noted some unintended consequences of funded reinsurance with investment potentially being directed overseas, but that we needed to see the Government's and PRA's final review of Solvency II to fully assess how the use of reinsurance will evolve further.

Conclusion

The industry expects a further update on the Solvency II Review from the PRA before the end of the year, and potentially further guidance from the UK Government.

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