What's Next? Bulk Annuity Insurers – Regulatory Developments – speech by Lisa Leaman

Given at Westminster and City's 21st Annual Conference on Bulk Annuities

25 April 2024

Speech

Introduction

Good morning. I am delighted to be speaking at the Bulk Purchase Annuities Conference for the first time.

The bulk purchase annuities (BPA) sector faces a very different environment now than it did two years ago. Demand is growing even more rapidly than before, thanks to the greatly improved funding positions of defined benefit pension schemes. The sector is also set to benefit from substantial regulatory reforms that have followed the UK's exit from the EU and the Government's review of Solvency II, some of which have already been implemented.

Our reform package will support the industry in meeting its commitment on UK productive investment. It will enhance accountability and improve transparency while maintaining the high standards of policyholder protection that consumers, the industry and Government expect. We are delivering this at pace and in close consultation with the industry and Government.

We are adapting the insurance regulatory regime to be more flexible and responsive for the UK. 'What's next' for us – and the industry – is to implement the reforms effectively, and for the industry to use this opportunity to make further investments that benefit both their policyholders and the UK economy.

Today, I will start by talking about recent developments that we in the PRA see in the sector. I will go on to explain how we plan to implement regulatory reforms in a way that will facilitate investment and be responsive to both opportunities and risks in the sector. I will then look at the challenges of implementation of the regulatory reforms with a particular focus – and this is probably one of the very few audiences where this will make me popular – on the matching adjustment (MA).

I will conclude by discussing the actions we are taking to respond to emerging risks as the market grows and changes – in particular the risks from the rapid growth of funded reinsurance (Funded Re).

Growth and diversification

In preparing these remarks, I looked back at speeches that PRA colleagues have delivered at Westminster and City Bulk Purchase Annuity conferences in previous years.

In 2018 David Rule gave a speech titled ‘An annuity is a very serious business’. I couldn’t agree more.

At the time of David’s speech, volumes of bulk annuity transactions were around £10bn a year. Contrast that with the position now: in 2023, BPA volumes were £50bn[1] and are expected to remain at or even above that level for some years to come.

This growth in activity is not surprising. Volumes have been steadily increasing since 2018. Higher interest rates have improved scheme funding levels, more or less across the board, fuelling demand. Existing bulk annuity writers have put to work the capital released by risk margin reform and there appears to be no shortage of capital keen to enter the market to meet this demand. Commentators expect transaction volumes to remain high over the coming decade.

The structure of transactions is also evolving to meet demand. Complexity is increasing as some transactions now feature long price locks, deferred premiums and in specie premiums. These features can bring additional sensitivities to a firm’s balance sheet and risk management challenges. In our 2023 review work we observed some good practice around the risk management of complex deal features and the setting of clear limits for more complex exposures; and we are looking to all firms to ensure that their risk management frameworks keep pace with changes in business practice.

Alongside capital, and operational capacity, sourcing MA-eligible assets is a critical driver of the current market, influencing pricing and supply of insurance solutions for those schemes that choose to transact.

David touched on asset allocation in firms’ MA portfolios in his 2018 speech. At the time, corporate bonds and gilts made up around 75% of assets backing annuities, and analysis of firms’ business plans suggested this proportion might decrease to around 60% by 2020.

The pace of change has exceeded this prediction. We estimate that corporate bonds and gilts accounted for around 55% of assets backing annuities at the end of 2020; and 52% by the end of 2022. Corporate bonds nonetheless remain the largest single component of MA portfolios (Chart 1).

Other asset classes make material contributions to firms’ MA portfolio assets – for example, infrastructure, equity release mortgages, social housing and commercial real estate loans are some of the key investments that insurers make to back their annuity liabilities.

[1] **Buyins and buyouts hit a record £50 billion in 2023**

The MA provides a significant benefit to annuity firms. In aggregate, the MA contributed around 40% of eligible own funds at end 2022 for firms with permission to apply the MA; this figure has not changed materially since end 2020.

However, a small proportion of firms' asset holdings still dominate in terms of the amount of MA benefit they generate. Collectively, property-related assets generate about a quarter of the aggregate MA benefit.

The proportion of assets rated internally (rather than by external credit rating agencies) is increasing – by market value from nearly 33% in 2020 to about 38% in 2022. Internally rated assets continue to provide more MA benefit than externally rated assets[2].

As you would expect, our focus in supervision has adapted to reflect these changes. Firms' approaches to rating their assets, validating the adequacy of their internal rating processes and risk management has been at the forefront of our supervisory attention.

What comes next through the implementation of regulatory reforms that will create the Solvency UK regime has the potential to further accelerate the change in firms' asset exposures. We and the industry are preparing for that.

Solvency UK – the new insurance regulatory regime

The package of Solvency UK reforms proposes changes to some aspects of the EU regime that were over-calibrated or overly prescriptive, or less well adapted to the UK. The reforms are being implemented through a combination of the Government legislating directly for some parts of the overall package, and the PRA making changes to its rules and policy materials for other parts.

So far, the Government has implemented reforms to the risk margin which have reduced capital from the existing stock of annuity liabilities: capital that can now be used to support new business alongside a reduced new business capital strain. The PRA has published near-final rules and policy materials that streamline the approval of internal models, and changes to them, and create a new 'mobilisation' regime to facilitate entry and expansion for new insurers[3]. We have also already simplified the calculation of transitional measures (or TMTP as it is obscurely known) that eased the introduction of Solvency II.

At the heart of the package, at least as far as the BPA sector is concerned, are reforms to the MA. The PRA is currently considering feedback to its consultation on proposed reforms to the MA and is on track to publish a policy statement, including final rules, in early June, with an effective date for changes of 30 June 2024.

[2] As measured by the MA benefit in bps by asset class.
[3] **PS2/24 – Review of Solvency II: Adapting to the UK insurance market | Bank of England**

There are big benefits to adapting the MA rules to enable the life insurance sector to play a bigger role in productive investment in the economy. As at year end 2022, life insurers held around £250bn in assets to back their long-term liabilities[4]. This figure is increasing and if external projections are correct about the likely future growth in the BPA sector, it could easily double over the coming decade (Chart 2). And the industry has said that the Solvency UK reform package will enable significant further investment into the UK economy and has committed to investing £100bn in UK productive assets[5].

In June the PRA will finalise rules to give firms greater flexibility over what they invest in within the MA portfolio. The Government's reforms allow a proportion of the MA benefit to be earned from assets with 'highly predictable' cashflows. Newly eligible assets will include assets like bonds where interest payments are linked to construction phases, rental lease payments, or to meeting environmental impact targets. We have proposed rules to enable firms to have up to 10% of their MA benefit being generated by these new assets, with scope to use the full allowance through changing market conditions.

The PRA has proposed to remove the cap on MA benefit for sub-investment grade assets, consistent with Government legislation on the calculation of the MA. The current cap disincentivises firms from investing in assets still in construction phase, and from financing emerging technologies, particularly those that will contribute to achieving net zero goals. That is because such assets may not initially have an investment grade credit rating, but they do generate long-term cash flows that may be suitable to back annuity liabilities. Removal of the cap should facilitate investment in these assets, although I should say that firms must continue to comply with the Prudent Person Principle. We do not expect a wholesale expansion of direct investment in sub-investment grade assets in MA portfolios, but firms should no longer be inhibited from investing in BBB, and particularly BBB- rated assets, due to the previously severe capital consequences of rating downgrade.

We recognise that firms can also be held back from new investment opportunities by slow and bureaucratic regulatory processes. So, the reform package also proposes to simplify the approval process for a large proportion of MA applications. This will enable firms to move more quickly when investment opportunities arise. In addition, we propose to remove the current cliff edge effect of a loss of MA benefit if a breach is not rectified within 2 months, and instead introduce a gradual tapering in MA benefit to give firms greater confidence in taking advantage of the new investment flexibility.

We would like to thank stakeholders for engaging with us in our development of the proposals under Solvency UK through participation in the various Subject Expert Groups and in responses to our consultation papers. This has been invaluable in informing our proposals, highlighting potential unintended consequences or ambiguity in our proposals,

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[4] PRA calculation from year-end 2022 MA data collection excluding cash, derivatives, and reinsurance.
[5] **Solvency UK: Cross-sector co-operation to drive £100bn investment into UK projects | ABI**

as well as potential alternative approaches. We are carefully considering the evidence and arguments provided in response to our consultation papers and will make changes to our proposed rules and policy materials where necessary.

Developing this complex package of reforms has been a significant challenge. Implementation will pose challenges too. Respondents to the consultation on MA reforms have sought clarification on aspects of implementation where they feel they will have to devote resources now to prepare for possible outcomes in the final rules. At the PRA we are anxious to avoid diversion of industry resources that could be dedicated to preparing for new productive investment for the benefit of the UK. Therefore, we published a statement[6] on 15 April that responded to industry's implementation questions.

Implementation of the MA reforms

Firstly, I should make clear that the PRA does not expect that firms will be required to reapply for permission to apply the MA under the Solvency UK regime where permission has already been granted under the Solvency II regime.

Secondly, there have been concerns that PRA proposals were intended to require the reclassification of some existing assets in MA portfolios as having highly predictable cash flows. Examples include assets where the timing of cashflows is not strictly fixed but is bounded such that the most prudent timing can be assumed for the purpose of the MA calculation.

I can confirm this was not within scope of the proposals the PRA consulted on, which were only intended to broaden the MA eligibility criteria to go beyond allowing assets with fixed cash flows. The proposals were not intended to change the PRA's policy on where assets are considered to have 'fixed' cash flows.

As we finalise policy and rules on the MA, the PRA will consider changes to clarify that its policy on what is 'fixed' was not within the scope of the consultation, and to ensure there are no unintended changes to the PRA's policy on assets which are considered to have 'fixed' cash flows.

Finally, we understand that the implementation date of 30 June 2024 for the MA reforms may pose practical challenges to firms in some areas. The PRA will communicate, as part of the policy statement, the date(s) on which new requirements will take effect, and whether early adoption will be possible on a voluntary basis.

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[6] **Solvency II Review – Matching adjustment reform implementation considerations for 30 June 2024 | Bank of England**

The PRA's 15 April statement also seeks to provide clarity on implementation of specific proposals: the MA attestation, triggers for variation of MA permissions, voluntary fundamental spread additions, notching of the fundamental spread, and the removal of the sub-investment grade MA cap. On the last two requirements, I can confirm that the PRA does not expect that firms will be required to submit a new MA application to document compliance with the new regime at the point of implementation, unless it is coupled with other changes to the MA portfolio.

The PRA is actively working through the practicalities of the reformed regime and will provide more materials in due course to help firms understand how it will work – including updated supplementary information forms to reflect changes to the relevant legislation and PRA policy, and to help firms and the PRA focus on what is required during an application review against the eligibility criteria.

We have been in active discussions with insurers for some time around the likely flow of MA applications in the early days of the new regime to ensure that we are ready to handle applications and can be responsive.

We want to improve the experience of firms in the process. We are looking at ways to make the MA application process more efficient, both in advance of application and during the PRA review and decision-making stage. The PRA is now setting up a dedicated team of specialists to handle these applications. We will monitor how well the process is running, and report publicly on this. This does also need action from firms to make sure that applications we receive are comprehensive enough for us to move quickly through our analysis – we will each need to play our part.

"Sandboxes"

A topic that has come up through our engagement with industry which I would like to draw attention to is sandboxes. Sandboxes mean different things to different people but in this context, I mean creating an environment to explore, learn and develop assets for MA eligibility without obtaining full approval.

Sandboxes are new proposals which were not considered in the PRA's consultation on MA reforms. One proposed model is to use a sandbox to obtain MA benefit for assets that a firm considers to be MA eligible, but for which the streamlined application process might be either too slow or too costly given the size of the exposure. Another, complementary suggestion is a way to explore future eligibility for assets that are currently ineligible for the MA but which the firm nevertheless considers suitable to back annuity liabilities.

We have already seen a range of views on these sandbox ideas, but there is no consensus on whether they should be allowed or what form they should take. Moreover, our immediate priority is to deliver the substantial benefits promised by current reforms.

We are open to new ideas, and we agree that it is important to think about how we could bridge any gap that might emerge in future between what is allowed by the form of prudential regulation, and those financing needs of the UK economy that can best be met from the life insurance sector.

However, before making any decision on sandboxes, we would need to carefully consider what additional benefits these would bring beyond those delivered by the current set of reforms, and whether these are likely to add value to insurers' ability to invest productively in the UK economy without introducing unacceptable prudential risk.

To move this forward without distracting from implementation of the current reforms and the substantial benefits that those can bring, we have convened a new Subject Expert Group with a panel of insurers. The purpose of the group is to explore industry's suggestions about how to potentially develop proposals for which there could be a strong additional benefits case and which we could be confident would attract broad take-up across industry. This is an essential first step before we consider further reforms.

Accountability, Resilience, and Transparency

There are two more aspects to cover to complete our discussion of MA. Our proposed policy changes will hold firms more accountable for risk management by requiring senior managers to attest that the MA being claimed can be earned with a high degree of confidence and that the fundamental spread reflects compensation for *all* retained risks, enabling firms to reflect their own risk profile, where necessary, by making additions to the fundamental spread.

The Solvency UK regime will also deliver greater transparency around the financial strength of the industry through an enhanced life insurance stress test. This will give more information to the providers of capital and more insight for investors and counterparties into the resilience of the industry overall, focussed on firms participating in the BPA sector.

For the first time, we will introduce publication of individual firm results, a key part of the Government's MA reform package. The disclosure will cover insurer portfolios behaviour in stress along with insights into the resilience of individual firms and dependencies on management actions in potentially uncertain market conditions. In turn, publishing individual firm results should strengthen market discipline and provide greater protection to policyholders and the wider financial system.

The enhanced disclosures will provide clarity on the resilience of the life insurance sector and individual firms in this market. It will support pension scheme trustees and their advisors in seeking de-risking insurance solutions which maximise their member outcome.

We have engaged with stakeholders through our stress-testing Subject Expert Groups and workshops throughout 2023 and this year – not just affected firms but also potential users of these disclosures, from equity analysts to the pension fund trustee community; thank you to those who have supported this work. Your input has helped the team shape the approach to the 2025 Life Insurance Stress Test (LIST). An approach document, guidelines and instructions are due to be published in June.

The 2025 LIST will include new exploratory features – one of which is a sector-wide stress of firms' use of Funded Re. Funded Re is the transfer of all the material risks of a BPA transaction – both investment and insurance risks – to counterparties typically based outside of the UK. One motivation for these transactions is to invest in a wider range of assets, which may not be eligible for MA. This creates potential risks and capital strain on recapture if the collateral is not eligible for the MA. There is also additional risk if reinsurers in these transactions have large, concentrated exposures similar to those of the insurer ceding the risk.

Our stress test will assess the ability of firms to measure the risks associated with the recapture of a Funded Re arrangement in stressed conditions. As this scenario is exploratory, the conclusions will only be published at the aggregate sector level. We will continue to monitor the volume and the increase in complexity of Funded Re arrangements, as the product develops. This will inform our views on the publication of individual firm-level results of the Funded Re stress in future LIST exercises.

While Funded Re is not a new concept, its growth alongside a material expansion in BPA transactions does pose risks to our objectives; and we have been responsive to this emerging risk. We issued a consultation paper on new expectations for risk management of these transactions last November[7], and are now considering the responses received.

We are grateful for firms' responses and engagement, and we intend to publish our final policy in July. At the same time, we are developing the Funded Re features of LIST in a consistent way with the expectations in the draft supervisory statement.

Conclusion

I have explained today how we are adapting the regulatory regime to be more flexible and responsive, better suiting the needs of the UK. There is more to do, including publishing our policy statement on MA reforms in early June and continuing to develop our approach to stress testing for 2025. And we are continuing to work on our own internal operations to ensure the implementation of all the reforms goes smoothly, including streamlining our approach to MA applications.

[7] CP24/23 – Funded reinsurance | Bank of England

The changes will simplify the UK insurance regulatory regime, improve scope for flexibility and judgement, and support firms in meeting the commitment they have made to invest more in the UK economy.

Five years from now the Government will be assessing the extent to which reforms and firms' responses to the reforms – in particular the industry's productive investment commitment – have delivered on the objectives for the Solvency II review.

What will the BPA sector look like in 5 years' time? I anticipate several positive developments. A far larger sector with insurers providing sound, efficient and effective management of defined benefit liabilities as they run off. More transparency, as market discipline will be enhanced by the disclosures from our Life Insurance Stress Tests. Enhanced accountability, with firms taking greater responsibility for the prudence of the MA through the new attestations that they will make. A sector investing productively in the UK, supported by the substantial reforms to investment flexibility that we are finalising now, and facilitated by responsive and agile processes at the PRA. Through this significant period of growth and change we will continue with our intensive supervisory focus on the sector to ensure that policyholders will continue to enjoy the appropriate degree of protection that they rightly expect.

I hope that the PRA will be delivering a speech at the Bulk Annuities Conference in 5 years celebrating the successes of these changes.

I would like to thank Esi Porter-Davison and Casper Davidson for their assistance in preparing these remarks. I am also grateful to the following colleagues for their helpful comments: Alwin Luchmaya, Nimra Mahmood, John Mayor, Anu Ralhan, Alan Sheppard and Mathieu Vital.

Thank you.

Annex

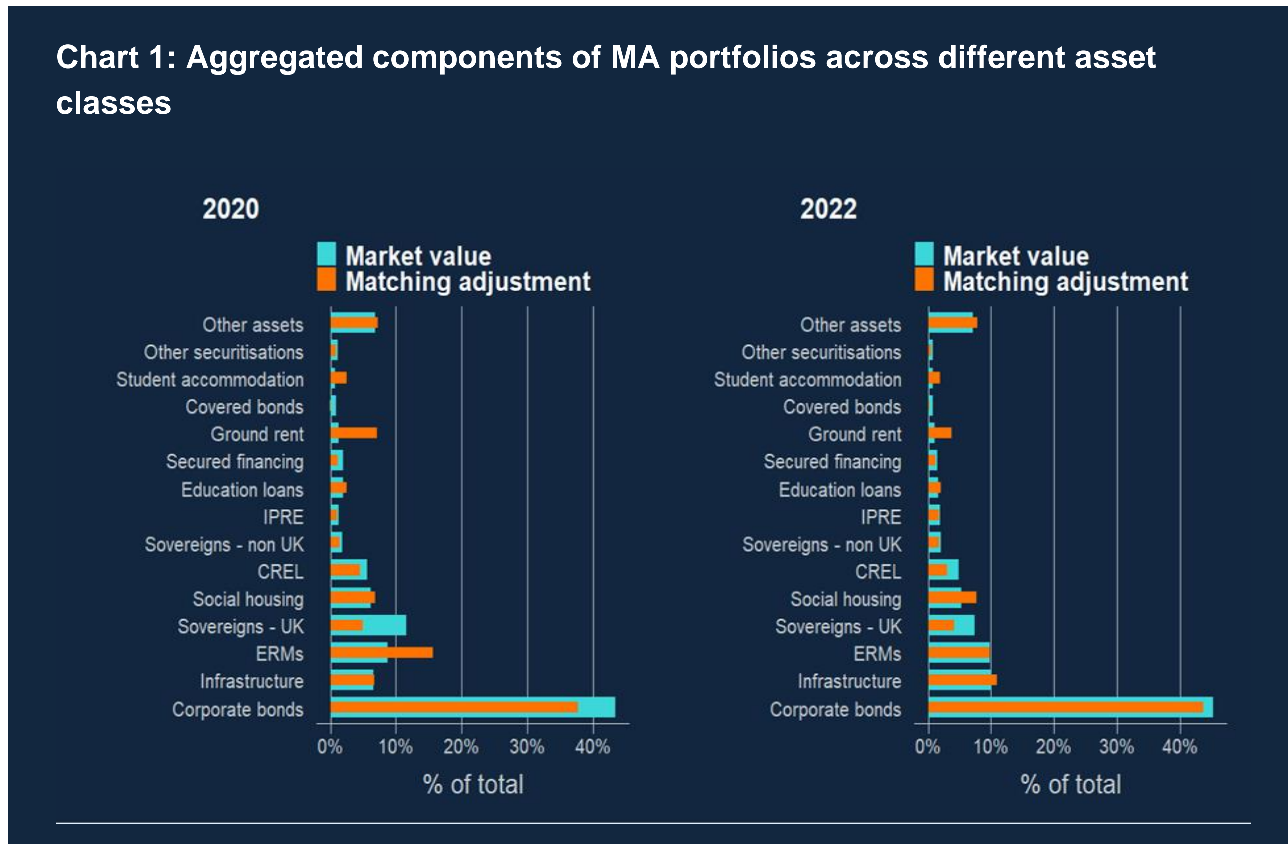

Chart 1: Aggregated components of MA portfolios across different asset classes

Source: PRA calculations from MA data collection exercises at year-ends 2020 and 2022. Assets classified as ‘Derivatives’, ‘Cash’ and ‘Reinsurance’ have been excluded. ‘Corporate bonds’ shown in are as reported. However, other asset classes, such as ‘Social housing’ also include some corporate bonds alongside loans.

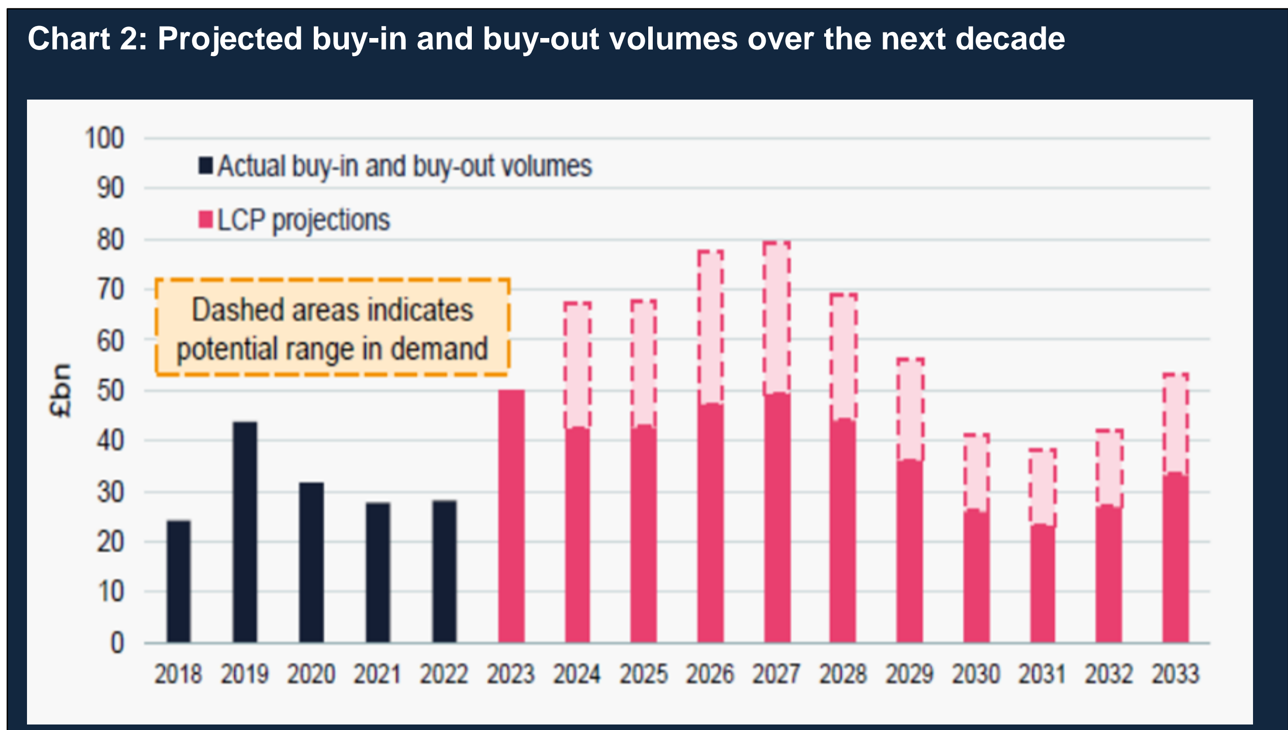

Chart 2: Projected buy-in and buy-out volumes over the next decade

Source: [LCP analysis of projected buy-in and buy-out volumes over the next decade]