Four Rs: Creating the conditions for long-term sustainable growth in the life annuity sector – speech by Charlotte Gerken

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Speech

Introduction

Thank you for your introduction, and for inviting me back to the Bulk Purchase Annuities Conference. There is never a shortage of material to cover at this event given the challenges and, of course, opportunities that annuity business creates for the management of very long-term assets and liabilities. This year I am going to focus on the conditions for sustainable growth in the Bulk Purchase Annuity (BPA) sector – the Four Rs referred to in the title – **Responsibility of the Board, Risk Management, Resilience and Regulation.** Like last year, I will share insights we have gained from our supervisory analysis of the asset-related risks that annuity writers face. As you will be aware credit risk and its effective management continues to be one of the Prudential Regulation Authority's (PRA's) top priorities for the sector and – through the Matching Adjustment (MA) - it is also a topic of focus of the Solvency II reform[1] work. Today, I will also share some of our developing views on the form that regulation and supervision may take in light of our work on Solvency II reform. This reform is expected to have implications for all insurers but is particularly important for annuity writers given the areas under consideration.

I would like to start by thanking those of you here today who have been providing both input and feedback on the areas for Solvency II reform. The UK life insurance sector is vital to the security of millions of policyholders' income, and important to the wider economy via its long-term investment; so the direction that the industry and its regulation takes matters.

Your engagement is an essential part of making the right choices as we reform the regulation of the UK life sector. Regulation is unsurprisingly one of my Rs today; but first I'll recap on the growth of the BPA sector in recent years and its potential trajectory. Then I will talk about the foundations for sustainable growth on which regulation needs to be based. So let me begin with what the BPA market looks like today and how we got here.

[1] https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/solvency-ii

Bulk Pension Annuity market developments

Starting with growth, Chart 1 of the slides (in the Annex) shows the growth in the BPA market over the last decade or so, highlighting that insurers have taken on around £200bn of pension scheme liabilities over that period.

Chart 2 shows that the BPA market is projected to have opportunity to grow at significant pace over the next ten years. The decline of Defined Benefit (DB) pensions and the desire to secure future scheme member benefits continues to create demand from DB pension scheme sponsors and trustees for de-risking or exit solutions. These should provide their members with a well-managed and cost-effective delivery of their outstanding pension benefits as they fall due over the coming decades – some extending more than 50 years into the future. Life insurers also have the capability to use the relatively stable and long-term annuitant liabilities entrusted to them, to invest in productive assets for the benefit of future generations, including in the transition to net-zero carbon.

While I talk about growth, overall this is really a transfer of promises - specifically promises made by a large number of employers converted to promises made by a smaller set of insurers. It is important to remember that this is not all new investment or credit creation. But in making this transfer there is a change in investment strategy that backs those promises. And, given there is still a much larger pool of DB pension liabilities potentially available, as prudential regulator we need to know that the right package of incentives – and constraints – are in place for this transfer to be soundly managed in both the short and longer term.

Conditions for long-term sustainable growth

The recent history of the UK life sector has shown us conditions that were not supportive of sustainable growth – or indeed policyholder protection. We need only cast our minds back a couple of decades to the existential challenges faced by some with-profits firms and the impact this had on benefits paid to policyholders. These challenges resulted from the inadequate capital resources supporting the promises they had made (or were deemed to have made) to their policyholders. Whilst BPA balance sheets look very different, this nonetheless underlines our strong motivation for and expectations of effective governance, risk management and resilience, underpinned by a robust, transparent and risk-sensitive solvency system for long-term business.

We see these elements as necessary conditions for success and for the purposes of today, I’ve boiled them down to four Rs:

- **Responsibility of the Board**
- **Risk management**
- **Resilience; and**
- **Regulation**

Fundamentally, the PRA and BPA firms should be aligned in their interest in the growth of the sector happening in a sustainable way. And there is more agreement than not on the conditions needed for success. As we move from the fundamentals and start delving into the detail, differences of views emerge between BPA firms and the PRA on the extent, nature and relative importance of these conditions; not unexpected given our respective objectives. Having worked with financial firms to improve their risk management and resilience over a quarter of a century, I remain, perhaps surprisingly, optimistic that we will be able to work through the differences, although I will be the first to acknowledge that there are no easy answers.

The four Rs each prompt a more detailed question that take us to the main issues we need to resolve in the coming months in order to make sure regulatory reforms (reforms being a bonus R) are geared to enhancing the prospects for success:

- First, thinking about the governance and management needed for success: how do **Boards take responsibility** for the particularly long-term nature of BPA business?

- Second, what does effective **risk management look** like for BPA firms today, given the continuing evolution of MA asset portfolios and exposure to long-term economic uncertainty?

- Third, in aligning **resilience** to risk taking, what roles do balance sheet valuation and capital requirements each play in a going concern regime?

- And finally, in designing and maintaining a **regulatory regime** that has robust and risk-sensitive qualities, what package of Solvency II reforms will support the risks being taken now and for the long term?

Responsibility of the Board

Let me start with the inherent challenge of making decisions for the long-term. Imagine that instead of packing a suitcase for our 2022 summer holiday, we are instead asked to pack all of the suitcases we will need for every holiday over the next 30 years. No additional suitcases will be provided and it will never be possible to completely refresh the contents of any of them. Oh – and you have to look after them, as any loss or damage will be a cost to you.

Such a situation may sound rather fanciful but it is not too dissimilar to the BPA business model. It relies on a single premium upfront to fund liabilities far into the future, and the ability to change strategy or de-risk may be constrained by a number of factors. These factors include the illiquid or complex nature of the investments and the financial resilience of the balance sheet. In relation to security of benefits, once the pension scheme is bought out, there is no possibility of further scheme sponsor contributions to meet any member benefit payments. Boards' ability to make decisions now, that carefully balance a long-term view against the pressure of short-term performance measures, is therefore critical to the future health of individual firms and to confidence in the sector as a whole.

The events of the last two to three years, let alone last three or four decades, remind us that over the life of the liabilities taken on today, there will more likely than not be big changes; and the uncertainty inherent in long-term business needs to remain front of mind. The PRA is therefore keen to continue to work with Boards to consider important questions around:

- Which of the incentives for management encourage the sustainable performance of the business over the long term; and which may favour shorter term?

- What could happen in the future and how resilient is the business to these risks?
- How easily could the business transfer from open to closed status if this became necessary?
- On what terms could the liabilities be transferred to a third party in a range of different market conditions?

We have observed over the relatively short time Solvency II has been in force, that investment strategies for annuity business have been influenced by the up-front MA benefit that certain assets attract. The Prudent Person Principle[2] is part of our rules around investment and we expect Boards to challenge, approve and control the continuing appropriateness of the investment strategy.

Risk management

Moving from the challenges that Boards face in respect of BPA business to risk management challenges associated with investing for the long-term. Here success is about achieving a sustainable balance between investing safely for the long-term whilst also taking opportunities to diversify asset holdings, including into assets that have wider benefits for the economy as a whole. The PRA recognises that the increasingly diverse range of features associated with MA assets may have a significant bearing on the level of risk and uncertainty around the future long-term business plan. Specialised features of these assets affect both how easily they can be sold or re-structured, and how attractive they may be to other market participants. Bespoke and sometimes innovative features of some of these assets may increase uncertainty around this.

Since Solvency II was implemented, the range of asset types in MA portfolios has expanded substantially, including increased investments in a wide variety of illiquid loans and other forms of private credit. We estimate that annuity firms' holdings of assets other than corporate or UK government debt has grown, from around 15% of assets backing annuities at the end of 2014, to around 45% of MA portfolios at the

[2] Supervisory Statement 1/20 Solvency II: Prudent Person Principle, section 2.3 (SS1/20 Solvency II: Prudent Person Principle (bankofengland.co.uk))

end of 2020[3]. The PRA is attuned to the merits of these investments, both in terms of risk diversification for firms, and for the real economy of the UK.

It is in that spirit that the PRA has worked with the BPA sector over the last six years or so to support the safe growth of more diverse MA portfolios than was the case when the MA requirements were drafted.

Indeed, there is now a very wide range of assets in firms' MA portfolios as shown in Chart 3.

However, all assets are not equal in terms of the MA they generate with, for example, Chart 4 indicates that current investments in student accommodation benefit from almost double the MA of current infrastructure holdings. Whilst we would not expect all assets to achieve the same MA, these disparities do give rise to questions as to the extent to which MA benefit is excessively influencing investment choices: and whether those behaviours are prudent and delivering the best outcome for the UK economy.

Furthermore – Chart 5 shows a relatively small proportion of firms' asset holdings are driving the majority of their MA benefit4. Whilst firms are expected have a diverse range of assets matching their liabilities, this raises the question of whether the current MA framework adequately captures the risks and uncertainties associated with the unique and innovative assets that tend to be the most MA-efficient.

Naturally, investment in new asset types with some bespoke and novel features raises new and important questions for the prudential regulator:

- Do firms have the right risk management capabilities and the governance to apply them rigorously and robustly?
- Is the regulatory solvency regime suitable for them or is a square peg being forced to fit a round hole?

[3] PRA calculations using annual returns data for year-end 2014 and Matching Adjustment (MA) Asset & Liability Data submissions by firms as at year-end 2020.
[4] This refers only to assets in Component A of firms' MA portfolios. See paragraph 4.5 of Supervisory Statement 7/18 for a definition of Component A. (Supervisory Statement 7/18 'Solvency II: Matching adjustment' (bankofengland.co.uk))

The PRA has always focused on ensuring that investments in these new asset types do not break the link between risk exposures and their valuation and capital requirements. The most notable example of this is the extensive work we have undertaken on Equity Release Mortgages. The assessment of valuation and risk in assets with more bespoke features inherently requires more judgement, and relies much more on firms' own internal assumptions and much less on public information. Firms argue that they are good at making these assessments. However, given the uncertainty inherent in assessing future performance of long-term assets, it is particularly important that the regulatory regime does not allow firms to over-anticipate future profits on these assets, before it is clear whether the profits will truly be earned.

In the reform process, we are challenging ourselves to consider the extent to which the existing Solvency II regulations are unduly constraining diversity and innovation in firms' MA portfolios. And we are contemplating changes that we consider will loosen requirements in a few key areas. To materially expand MA portfolios in the absence of a sound quantitative basis is again likely to be detrimental to policyholders and could also threaten the resilience of the BPA sector. This is why any work to further extend MA eligibility needs to be coupled with firms having effective risk management and a reassessment of the appropriateness of the quantification of the MA.

Resilience

As noted earlier, for very long-term business – with liabilities that can stretch several decades into the future – it is critical to make appropriate assumptions when undertaking balance sheet valuations and when calculating the amount of capital that is required now to support that business. This brings us to the third R, which is resilience. In this context, it is important to recognise that balance sheet valuations and capital requirements play different roles in Solvency II and they are not substitutes for each other:

- The balance sheet valuation assesses whether the firm has sufficient assets to be able to meet the potential costs of transferring its business to a third party should the need arise.

- The Solvency Capital Requirement (SCR) is intended to cover the impact of a 1 in 200 year stress on the balance sheet over the next year.

The ability to transfer the business after a stress event provides a critical 'bridge' between the one-year Value at Risk methodology that underpins the SCR and the long-term risk profile of insurance business. Therefore, if Solvency II is truly to be a 'going concern' capital regime then it is essential that the calibration of the Fundamental Spread (FS) – the allowance for risks retained by firms in respect of their investments - be aligned with this. In particular the FS should sufficiently capture the retained risk for which a third party would seek compensation in any transfer price. Without this – the resilience of the Solvency II balance sheet is undermined and firms may struggle to de-risk in times of stress.

The PRA is supportive of the MA as a concept that reflects the nature of the risks arising from a portfolio of well-matched, long-term illiquid assets and liabilities. However, it does not imply a departure from Solvency II's near-term transfer value discipline. When evaluating possible packages of quantitative reform, an important validation point for the PRA is whether the resultant liability values, including the risk margin, are adequate relative to the transfer values implied by actual buy-out transactions. If current liability valuations were to be insufficient to fund these observable transfer costs, then the balance sheet would lack the resilience that it would be expected to have under Solvency II and a key safeguard of policyholder protection would be put at risk. In other words, we could no longer be confident enough that if an insurer failed in the future, its liabilities could be safely transferred to a third party. The long-term security of policyholder benefits would then be in question.

The PRA is continuing its work to assess the extent to which different reform combinations lead to an adequate transfer value being achieved and see this as a key validation tool when assessing the merits of any package.

Regulation

I now come to the final R – regulation – and want to focus remarks today specifically on the work to reform the existing regulatory framework for insurers – Solvency II. The interlinkages between the first three Rs I have covered help explain why such regulatory reform needs to be considered as a package: changes in one part of our regulatory and supervisory framework have consequences for others. While the PRA has not yet consulted on a reform package, it has recently published a Discussion Paper[5] seeking views on a range of areas that are likely to be key in forming such a package. Our intent lies in finding a set of reforms that protects policyholders and enables even greater investment flexibility than we have seen already, whilst reducing any misaligned investment incentives.

To achieve this intent, the Solvency II reform package we develop must address the two significant deficiencies in the current regime: a risk margin calibration that is overly sensitive to interest rates; and an allowance for retained risk – the FS - that varies very little, if at all, as credit risk premia vary across assets and over time.

The risk margin is currently pulling more than its weight in the current Solvency II construct – the resulting incentive being for insurers to reduce the insurance risk they are taking. However, the MA as currently formulated rewards taking certain non-insurance risks, potentially in significant quantum, and with a set of incentives that may be misaligned. We therefore see quantitative reform of both the risk margin and Matching Adjustment, as integral to any package.

The PRA seeks a calibration package that is better able to capture how liability transfer values are likely to be impacted by the assets held to back the business. Such a package should also take account of different financial and economic conditions that might pertain at the point that a transfer became necessary, including times of stress. These properties would provide supporting evidence of the economic reasonableness of the calibration. And it would provide assurance that the package is serving its policyholder protection purpose. In particular, as MA portfolios become more diverse then a question arises as to whether the assets currently backing a book of business are assets that another party would be able and willing to take as funding.

To achieve a material reduction in the level and sensitivity of the current risk margin, the PRA considers it necessary for the design of the MA to appropriately reflect

[5] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2022/solvency-ii-review-matching-adjustment-and-reforms-to-the-fundamental-spread

uncertainty around future credit risk experience that would likely be reflected in any transfer price. The FS is the key determinant as to the amount of any expected future investment profit firms can recognise upfront. A calibration of the FS that is too low exposes firms to risk that this future investment profit does not emerge in practice and the associated implications this would have on their ability to meet their liabilities as they fall due.

A successful outcome of the Solvency II review will be DB scheme members, trustees and insurance policyholders having long-term confidence in the resilience of the insurance sector, and in the security of their benefits.

Conclusions and next steps

Solvency II has only been in force for around six years, but we have already learnt a lot. Particularly in respect of the relationship between the regulatory framework and firms' business models. This makes approaching reform both complex and sensitive at the industry level, and for the various and varied individual players. But reform is necessary, to put in place a regime for the UK that provides the right level of resilience and investment incentives into the long-term. This regime will build on the experience and unexpected shocks we have seen in recent years, and create the capacity to deal with whatever else the future might bring. Returning to my suitcase analogy, who would have thought in 2019, never mind 1990, that those carefully packed clothes for a 2020 holiday in the Caribbean would need to instead serve a staycation in the UK. Things change and the ability of MA portfolios to adapt to this is key.

On the Solvency II review, we have been open with the possible reform options we've been developing in the pre-consultation phase of the review. This has had the benefit of generating a lot of feedback, particularly in the months since our quantitative and qualitative information requests. As mentioned, we recently published a Discussion Paper[6] alongside HM Treasury's Consultation Document. We are now arranging further meetings to hear reactions to that Discussion Paper

[6] PRA Discussion Paper 2/22 (DP2/22 – Potential Reforms to Risk Margin and Matching Adjustment within Solvency II | Bank of England)

and will engage with all material provided to us. We will be asking many of you for more information in the next few weeks and months, because we need to explore further the areas that are important to us and the areas that you've said are important to you. This includes the impacts of any reforms to the balance sheet on capital requirements.

We will listen and engage with all the information we receive. I don't expect that we will agree with everything we hear – but the healthy tension and particularly the case study or experience backed arguments are going to help us to a better solution overall.

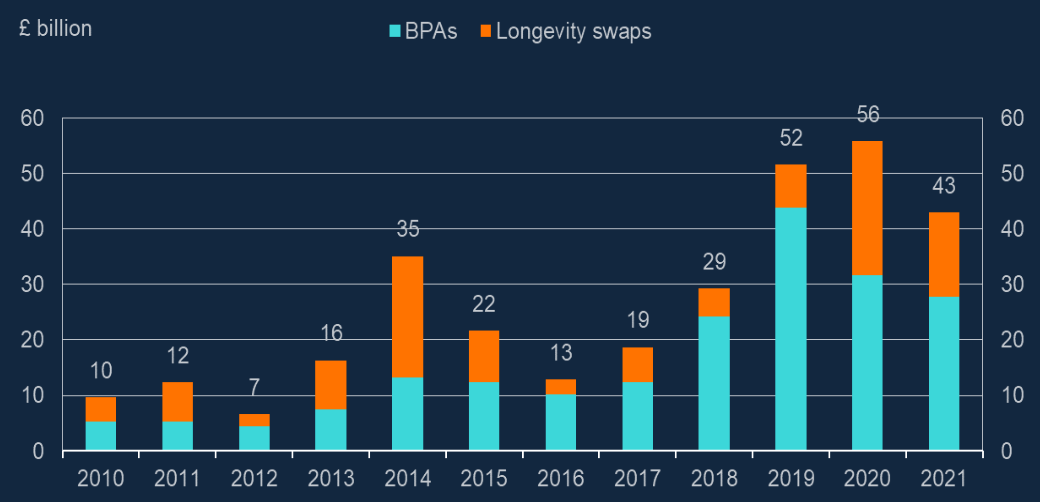
The PRA is keen to see the BPA sector develop in a way that allows it to safely and sustainably deliver on promises made to its long-term policyholders. As my discussion of the four Rs shows – relying on regulation, in isolation, to ensure security of policyholder benefits is not enough. Boards must be responsible for running their businesses prudently, consistent with safety and soundness; firms need to invest in the right risk expertise to take on and manage the assets selected to back their long-term obligations to policyholders; and resilience must be appropriate for the risks being run. We, as regulator, are keen to work with firms to create the conditions necessary for success now, and for the long-term.

I am grateful to Craig Turnbull, Jemima Ayton, Miranda Hewkin-Smith, Alan Sheppard, Shamir Patel, Laurienne Sherriff, Giles Woodruff, Philip Grundeu, Anooj Dodhia and Wendy Fu for their assistance in helping me prepare this speech.

Thank you.

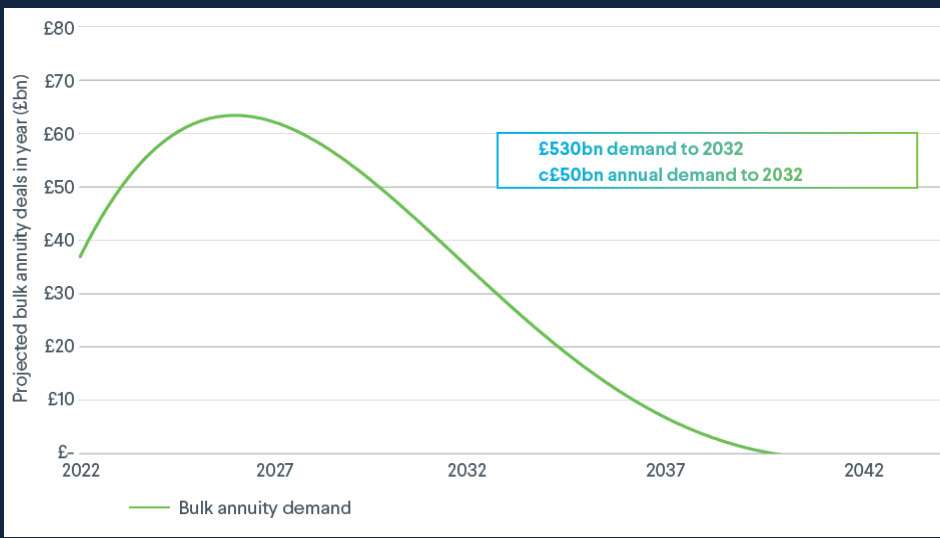
Annex

Chart 1: Bulk Purchase Annuities (BPAs) and longevity swap transactions (£ billion) since 2010



Source: Lane Clark & Peacock

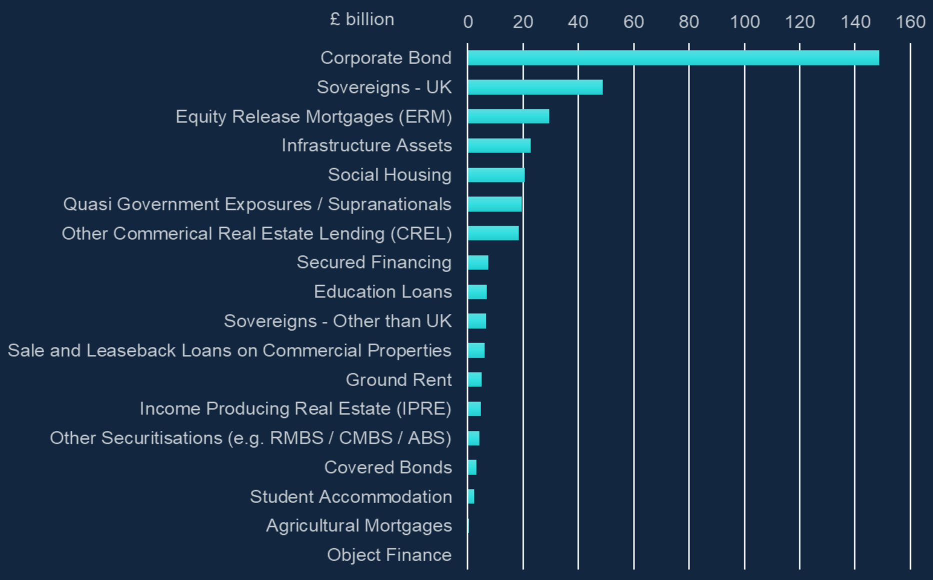
Chart 2: Projected bulk annuity demand



Source: Hymans Robertson – Risk Transfer Report 2022

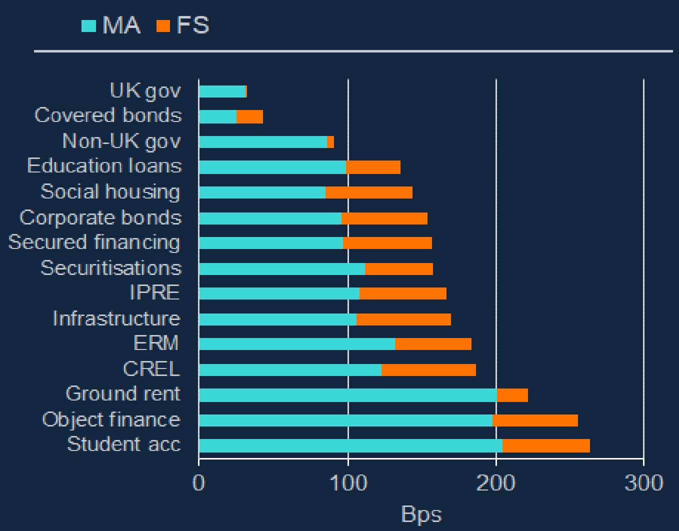
Demand is expected to ramp up as the majority of over £2 trillion of Defined Benefit liabilities looks to find a home in the insurance market over the next 20 or so years. Projected demand averages c. £50bn per annum over the next 10 years, compared to a record £44bn in 2019.

Chart 3: Assets held in insurance firms' Matching Adjustment (MA) portfolios at year-end 2020 (£ billion)



Source: PRA analysis of Matching Adjustment (MA) Asset & Liability Data submissions by firms as at year-end 2020.

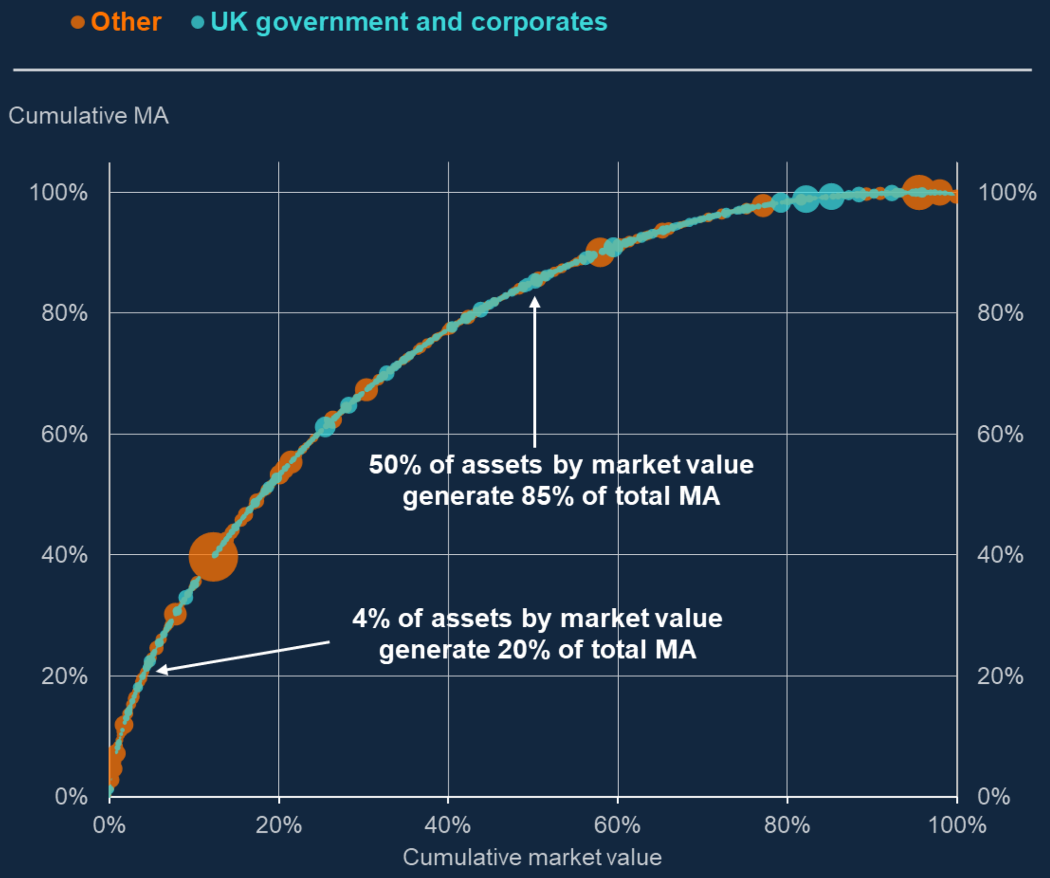
Chart 4: Matching Adjustment (MA) benefit by asset class at year-end 2020 (basis points)



Source: PRA analysis of Matching Adjustment (MA) Asset & Liability Data submissions by firms as at year-end 2020 .

Ranked by spread in basis points (lowest to highest) and does not show asset classes where there are limited holdings across the industry.

Chart 5: Matching Adjustment (MA) versus Market Value



Source: PRA analysis of Matching Adjustment (MA) Asset & Liability Data submissions by firms as at year-end 2020.

Note: Assets shown are those in Component A of insurance firms' Matching Adjustment (MA) portfolios only. See Paragraph 4.5 of Supervisory Statement 7/18 for further details.