Sam Woods: Adapting to Solvency

Speech by Mr Sam Woods, Executive Director of Insurance Supervision of the Bank of England, to the Association of British Insurers, London, 9 July 2015.

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It is a great pleasure to speak to you today.

I plan to give another speech in a few months' time, focussed on the history of insurance regulation and supervision here in the UK. But today I will talk about my immediate priority, which is getting Solvency II over the line for go-live on 1 January 2016.

The industry has made a tremendous effort to make the transition a successful one. The circumstances have been difficult, with a delay to political agreement on important aspects of the new regime compressing the time that the industry has had to prepare. The delay has also added to the costs of implementation. However, the time has not been wasted and firms have used it to make important improvements to their Own Risk and Solvency Assessments, as well as their internal model applications.

Today I want to make sure that investors and insurance firms understand the approach the Bank of England will take to capital under Solvency II.

First, I would like to bust two myths:

- the idea that there is some kind of plan within the Bank to use Solvency II to increase required capital across the insurance sector; and
- a suspicion that we will somehow keep the current 'ICAS' regime alive after 1 January 2016, rather than embracing the new regime.

Second, I want to make it absolutely clear that we will give firms plenty of time to adjust to the new regime, and that those firms who wish to make use of transitional measures will be given the freedom to do so.

Myth-busting

I have heard from some a concern that we will use Solvency II to increase levels of capitalisation across the sector, or that we are seeking to load the sector with more capital now so that it is baked into the new regime once operational.

Let me state very simply: there is no such plan within the Bank of England. The reason for this is also simple: we think that our current regime secures an appropriate level of capitalisation for the insurance sector and puts us in a good position to make the shift to Solvency II. The ICAS regime was introduced in 2004 as a response to the stock market falls and subsequent problems faced by UK firms in the early part of the decade. It is based on sound principles, such as market-consistent valuation of the balance sheet and a risk-sensitive approach to determining capital – many of which are embedded within Solvency II. The success of these principles was demonstrated by the resilience of the sector during 2008 But Solvency II moves beyond our current regime. So although there has been no change in our view of the type of risks that firms are exposed to, and we do not intend to use Solvency II to increase the aggregate level of required capital across the industry, this is not the same as saying that the surplus capital positions of individual firms will not change with the arrival of Solvency II. It is a different regime, with a different shape to ICAS. Firms will therefore see movements in their regulatory capital positions. For some firms these positions will be tighter, for others looser.

This brings me to the second myth: that we intend to re-create the ICAS regime under the guise of Solvency II. Let me be clear: Solvency II will be the foundation of our supervisory approach and we will fully embrace the change that accompanies it. Although Solvency II incorporates many of the features of ICAS, the shape of the new regime is different. The EU is moving to a harmonised, risk-based, transparent, and "going concern" regime. This means some significant changes to the shape of the balance sheet and our assessment of financial resources. For the UK in particular, the move to a going concern regime represents a fundamental departure from the current set-up, in which a firm is required to calculate financial requirements under the assumption that, following a stress, it writes no new business and instead "runs off" its existing business over time. Solvency II looks at the insurance industry through a different lens and views insurers as "going concerns", such that it is assumed that insurers will continue to operate after a stress. To achieve this, Solvency II introduces the concept of the "risk margin" which is intended to capture the cost of transferring a set of liabilities from one insurer to another. The risk margin is a fundamentally new component of our regulatory framework and we will ensure that firms meet it.[1.]

This is a source of some tension at the moment, because the construction of the risk margin is such that, in particular for life business, it becomes much larger when risk-free rates fall. So the current environment of low rates means that the risk margin is large – and when and if rates rise, it will become smaller. Reasonable people can debate whether or not it is sensible for this element of provisions to be so sensitive to risk-free rates, and it may be that once we are into a Solvency II world some firms will choose to hedge this exposure. However, that debate is for another day: the risk margin and its calculation are part of the law and our job is to implement it. More specifically, the directive is clear that the Solvency Capital Requirement (SCR) and the risk margin are separate concepts: put simply, firms have to survive a 1-in-200 stress, using the capital held to meet their SCR, and then have the risk margin available to provide for the costs incurred in an orderly transfer of liabilities. It is obvious that in this respect Solvency II is more demanding than the ICAS regime, even if other elements of the regime are not.

A related source of tension is our use of the Quantitative Indicator (QI) framework as part of our assessment of internal model applications. This framework describes a set of judgements, based on evidence and analysis that provide an assessment of the most common risks faced by UK insurers, such as longevity risk for life insurers, and how they relate to each other. Many of the areas covered by the framework involve a significant degree of judgement, and accordingly we are flexible in how we use the framework and consider it just one input into our consideration of whether firms' models meet the tests and standards for approval under Solvency II. The way we use the QI framework has also been, and continues to be, informed by evidence and practices presented to us by firms. However, it would be odd indeed if a regulator (or a firm for that matter) were to change their view of conditions in the real world because of a change in regulatory regime. Clearly, despite the lofty ambitions of European legislators, the move from Solvency I to Solvency II doesn't change how long people will live for, or the probability of a North American windstorm. So our beliefs about the nature of the risks to which insurance companies are exposed will persist as we move into the new regime. But the regime requirements are different, and we will embrace that change. People should not confuse these two things.

Adapting to the new regime

Solvency II introduces some important reforms to modernise the regulatory regime for insurers in the UK. But a sudden implementation of these changes by firms, and particularly on the life side given the introduction of the risk margin, is unlikely to promote either of the PRA's objectives of safety and soundness and policyholder protection. We believe the opposite – that an orderly transition should support those objectives, because much life insurance business (and particularly those lines of business most impacted by the risk

[1] Fuller explanation of the new ***Solvency II regime***

margin) is long-term in nature. This business will continue to exist – and will therefore be regulated – under the new regime, despite having been priced on a set of assumptions derived under the existing regulatory regime. Further, the long-term nature of much life insurance business should reduce some of the risks associated with resolving financial institutions, and therefore elements of a going concern regime can be phased in more slowly than would otherwise be the case.

At the same time, an orderly transition will promote financial stability. Recent changes in the microstructure of some financial markets have reduced liquidity and made them more susceptible to disorderly trading even in response to small shocks. It is not yet clear how much impact Solvency II will have on the asset side of insurers' balance sheets, but given that UK insurance firms manage in the region of £2 trillion in assets, it would seem wise to implement the new regime carefully. In my view there is only one serious argument which could push us in the other direction. If the sector was undercapitalised under the current regime, then allowing a gradual transition to the new standard would present a risk. This was exactly the position we found ourselves in with the banking sector when implementing CRDIV, the European vehicle for Basel III. The financial crisis had made it abundantly clear that our capital regime for banks was wholly inadequate. So we decided to move quickly, to promote safety and soundness and financial stability. We are in a different place with insurance: we consider that the levels of capitalisation secured under the current regime are consistent with our objectives, and therefore, unlike in the banking case, we see a low risk to those objectives in allowing firms plenty of time to adapt to the new standard.

European legislators foresaw this and therefore (very sensibly in my view) included within the Directive transitional measures which allow firms significant breathing space as they adapt to the new regime. As a safeguard, the benefit from the transitional deduction from technical provisions (TDTP) is capped to make sure financial resources cannot drop below those required under the current UK regime as a result of using the transitional. The practical expression of the stance I have just described is therefore that the Bank will allow full use of transitional measures by those firms that qualify to use them, and that the transitional asset created by the TDTP will qualify as Tier 1 capital. This is consistent with the approach being taken across Europe, and I was glad to see Gabriel Bernardino's recent comments on this topic. He said:

"It is also fundamental that market analysts and investors understand that Solvency II adjustments and transitional measures are a legitimate part of the regime. Transitional measures do not distort the solvency reality: they are designed to ensure a smooth transition to the new regime, avoiding disruptions in the market and allowing a certain period for companies to fully recognise the impact on old books of contracts that have been underwritten in a different regulatory framework".[2]

I agree.

For the benefit of investors, let me be crystal clear: when we consider whether or not firms are in a position to pay dividends, one of the main quantitative yardsticks we will use is capital levels after the benefit of transitionals. Now, investors taking a close interest may be concerned about the capital strain firms using the TDTP may face as the transitional benefit unwinds over 16 years. They are right to have an eye to that, but I would like to point out that there will be some off-setting benefit in the form of the release of the risk margin as the back book rolls off – it will be up to firms to set out this picture for analysts and investors, but it is the net adjustment we should be focussed on. For transitional measures to achieve their purpose there needs to be a shared understanding on some of the important practical details about how they will operate. We will be working with firms to make sure these expectations are clear, and will also ensure that the way in which the transitionals apply is transparent to

[2] Full version of the speech ***"Milestones of preparation for Solvency II"***

all market participants. This includes how transitional measures might apply to books of business that are subject to a Part VII transfer, and the frequency with which some of the transitional measures need to be re-calculated. The cap on the level of benefit firms can derive from the technical provisions transitional presents a practical challenge, given that it will require firms to be able to produce estimates of their solvency position on an ICAS basis for a period after the end of that regime. Clearly it would be unreasonable and unrealistic to expect ICAS models to be maintained and run once Solvency II has been implemented. Therefore we will be exploring with firms ways in which they might be able to satisfy the requirement to approximate ICAS solvency positions in a cost-effective and efficient way.

Conclusion

I will add a very quick word on the process of internal model approvals before summing up. I consider it vital that our approval process is entirely consistent across firms, and that the timing and communication of our decisions is consistent with orderly markets. It is therefore my intention that, following a thorough and consistent review of firms' applications, we make final decisions on all models for firms for which we are the home supervisor in early December, and communicate those decisions to firms simultaneously at that point. Firms that do not have an internal model will, of course, enter the regime on the standard formula.

In conclusion, we will faithfully implement Solvency II here in the UK. We will be proportionate, and we will be robust in the pursuit of our objectives. And in doing this:

- we will not use Solvency II to increase capital requirements across the insurance sector;
- we will not keep the ICAS regime alive; and
- we will give firms plenty of time to adapt to the new regime.

Thank you.