BANK OF ENGLAND

Speech

Speech given by

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Introduction

Talking to parliamentarians about key regulatory issues is an important part of ensuring the transparency, openness and accountability of the regulator. So I welcome the opportunity to set out our views on recent developments in the prudential supervision of insurance.

The two most significant events affecting the life insurance industry in the last year have been:

- Firstly, the Budget announcement reforming the at-retirement market - which had a major impact on annuities; and
- Secondly, the political agreement over Solvency II reached in November. European legislators have taken an important step forward, and we welcome the certainty on timescales that the agreement provides to industry and regulators alike.

Post Budget changes to the at-retirement market

The changes to annuities announced in the Budget are the biggest changes to affect the life insurance industry in many years. I must emphasise that the Prudential Regulation Authority's interest, and so the subject of my remarks, is on the potential impact of these changes on individual life insurers rather than looking at the wider social impacts.

Prior to the Budget annuities dominated the retirement income product market in the UK; UK insurers had c£240bn of net annuity liabilities at end 2012, with the market having grown by 13% that year alone. This is in contrast to static or falling sales in other traditional life insurance products: life insurance premiums in 2012 were £165bn, but claims and benefits paid, at £196bn, were significantly greater. Indeed, our analysis of the returns made to us by life insurers indicates that there have been net outflows from the life insurance sector in every year since 2008. So, with With-Profits books in run off, and protection business offers limited growth prospects and under margin pressure, annuities remained in many respects the life industry's unique selling point and a key source of differentiation from other asset managers.

Therefore, while the impact of the 2014 Budget announcements on the annuity market is still unclear, the effect is clearly likely to be significant. While there has been some retreat from the projections of a 90% decline that were floated by market commentators and in the press immediately following the budget, many firms have reported falls of up to 50% in annuity sales in the short time since the changes were announced and some are still talking of perhaps a 75% long term decline in volumes.

It is likely that this situation will stabilise as the implications of the changes become clearer but it is likely that annuity sales will be permanently and significantly reduced as many customers choose either to take their money or move into alternative drawdown products. Insurers face an increasingly competitive landscape. Cash released from pension pots may find its way into new ISAs, or the new NS&I Pensioner Bonds, or on to platforms by way of drawdown products; alternatively, people may want to move money away from financial services products and invest in buy to let properties or simply spend some or all of their accumulated pot. The choices that individuals make at retirement will be very specific to their individual circumstances and it will be for FCA, as conduct regulator, to determine what form any guidance around this should take.

Insurers and the PRA are currently assessing the likely impact of the changes – we are having many conversations with insurers on this. It is a commercial matter for firms to determine whether they will change their business mix and the extent to which product innovation is needed. However, such changes will undoubtedly give rise to a fresh set of prudential regulatory issues and so we will be considering how the changed environment will affect firms and what actions are needed to mitigate the risks that arise. Significant potential issues include:

- Whether the viability of existing business models will be affected by the changes;

- Increased competition for the reduced pool of annuities, for drawdown business and in other business segments (to compensate for the decline in annuity business) and the impact of these on margins and profitability across the industry;

- The potential for industry consolidation which may give rise to risks from the integration of different cultures and systems;

- Product innovation which, while welcome in principle, places a clear onus on firms to ensure that they are not becoming exposed to unexpected or poorly understood risks.

Solvency II

For many life companies reacting to a new and fundamentally altered strategic and business landscape will be the key challenge over the next few years. At the same time, they will have to adjust to the introduction of Solvency II. In that context I want to comment briefly on what has become an issue of particular significance recently. That is the position of insurance regulation in general, and Solvency II specifically, in relation to the scope for the insurance industry to provide long term financing for infrastructure. The Government's Insurance Action Growth Plan has given a particular salience to this topic.

In setting out the PRA's intent and approach when implementing Solvency II, I would like to address two main issues:

- Firstly the PRA's attitude and approach towards insurers' investments; and secondly
- how Solvency II helps the PRA ensure that policyholders are appropriately protected in relation to insurers' investment risks.

So if I turn firstly to the PRA's attitude to insurers' investment strategies, let me highlight two key features of a traditional annuity in the UK. Firstly, once the annuity has been purchased – or "vested" in the jargon – by a policyholder, there is a long term obligation on the insurer to make regular pension payments to the policyholder; this obligation will be for as long as the annuitant, and in some cases their partner, lives and so the cash payments to be made by the insurer may stretch over 30 years or more. At the same time, once purchased and unless it is for a defined contractual maturity, the policy cannot be surrendered or otherwise cashed in. It therefore represents a long term illiquid liability. This is a very important point and is a crucial difference from the liquidity risks inherent in the liabilities of the banking sector. Annuity writers typically look to match their assets and liabilities as closely as possible. They therefore need long term assets yielding predictable cash flows; but because they do not have the liquidity risks of banks they can afford to invest in relatively illiquid assets. And in its calibration of capital, the insurance capital regime in the UK has always recognised, and given a benefit to, what is technically termed this "liquidity premium" inherent in annuity writers' business models. Under Solvency II, the matching adjustment seeks to do exactly the same and has been something the UK has advocated strongly in the Solvency II negotiations.

Conceptually, the PRA recognises that investment in long term infrastructure assets, if managed appropriately, can hold out significant advantages for annuity writers. But from a supervisory perspective the most important point to emphasise is that, as long as insurers are able to understand and control the risks, and hold capital commensurate with those risks, the PRA does not take a view about the intrinsic and relative merits of individual asset classes. That is separate from substantial concentrations in particular asset classes, which is a legitimate area for prudential review.

What a firm invests in is for that's firm's management to decide; the PRA does not promote one asset class over another. What is important from the PRA's perspective is that a firm holds sufficient capital against the risks of its investments and that it has the right expertise, information and systems to be able to manage the risks of those investments both at the underwriting stage and in its subsequent monitoring of the exposure. In this regard, infrastructure is treated the same as any other asset class. It is treated that way under the current regulation, the UK's 'ICAS' regime. And it will be treated that way under the future regulatory regime, Solvency II.

That said, I should highlight that direct financing of infrastructure projects has not typically been a major constituent of UK insurers' investment portfolios. In the PRA's view that has not been a result of regulatory barriers or initiatives.

Finally, I'd like to turn briefly to consider Solvency II specifically, and how this will influence the PRA's activities and the requirements for firms as it relates to their investment strategies.

One of the major planks of the Insurance Action Growth Plan was that the agreement of the matching adjustment within Solvency II would actively promote insurers investing in infrastructure or other longer term projects. In relation to that I'd like to make two points.

The PRA is, and has always been very supportive of the matching adjustment. We think it right that it was included in the political agreement of Omnibus II. The PRA supports the matching adjustment principle because it recognises the illiquidity of certain liabilities and encourages the prudent risk management strategy of closely matching assets and liability cash-flows. We have long welcomed the recognition within the Solvency II negotiation process that insurers whose assets can closely match predictable liabilities face a reduced level of spread risk which should be reflected in turn in a correspondingly reduced capital requirement.

In all discussions about the Matching Adjustment, it is important to remember that the adjustment is not designed to favour particular asset classes, such as infrastructure. The matching adjustment is recognition of the beneficial effects of insurers ‘closely matching assets and liabilities in terms of duration and liquidity profile. In the PRA’s view, Solvency II will not be the material factor in investment decision making except in so far as it helps to ensure that insurers recognise the full extent of the risks that they face.

Indeed, in this regard Solvency II moves the regulatory regime more explicitly to a neutral approach to investment allocation. Gone are the old quantitative investment limits for certain asset classes of Solvency I, to be replaced by the prudent person principle. This gives much more freedom in insurers’ investment choices and portfolio construction. This higher freedom needs to be balanced with adequate policyholder protection safeguards. To achieve this Solvency II, whose core purpose is of course the protection of policyholders, is much clearer about the system of governance that is required to ensure a high level of responsibility, accountability and ability to manage risks. These are welcome developments. They create a more risk sensitive and sophisticated approach to the treatment of asset risk within insurance regulation.

I’d like to finish these remarks by stressing that Solvency II and the PRA will require appropriate risk management of all an insurers’ investments, not just those in infrastructure, because ultimately it is the performance and risk management of these assets that will underpin such critical payments as pensions. Ultimately we are responsible for promoting the safety and soundness of insurers and contributing to the protection of policyholders. And to do that we shall, in line with our public commitments, continue to apply a forward-looking, risk based and proportionate approach to prudential insurance supervision.