Speech by John Glen MP, Economic Secretary to the Treasury, to the Association of British Insurers Annual Dinner

Introduction

Good evening, everyone.

It's a pleasure as ever to be here with you all, and a privilege to be able to share some thoughts on the state of play in the industry… and, of course, I'm grateful to the ABI and KPMG for making that possible.

I also want to express my thanks for the consistently constructive role the ABI plays as a voice for the industry… on things like regulatory reform, cyber and 'insurtech', and sustainability.

You're a big part of the reason the UK remains a world leader in insurance…and financial services more widely.

I also want to thank the industry once again for what you've done in the last two years to support customers and businesses, through what has been a very challenging time.

However, it's time now to look to the future… and there's a number of questions that together we will need to answer.

For instance, what lessons can we learn from the pandemic, and take forward?

How do we deliver on the Chancellor's ambition to make the UK the world's first net zero-aligned financial centre?

How do we ensure that even the poorest in our society have access to the insurance products that they need?

How do we address the issue of high buildings insurance premiums for high rise residential buildings in need of remediation?

And how can the industry support the Government's pledge to deliver a world-leading health and social care system across the whole of the UK, developing new market propositions?

All of those are important, live questions.

Reform of Solvency II

But I'm not here to talk about any of that. Tonight, the focus of my remarks is Solvency II – something's that been mentioned to me every week of my almost 50-month tenure as Economic Secretary to the Treasury… the tram lines, if you like, within which you all have to operate… and which I know is a subject of keen interest to every single person in this room.

In the simplest terms, leaving the EU means that the UK can now tailor the prudential regulation of insurers to our unique circumstances.

Put even more bluntly, regulation developed to reconcile insurance markets for 28 different countries in the European Union never worked well for us. Now we’re outside the EU, this Government is determined to fix that.

We have a genuine opportunity… to maintain and grow an innovative and vibrant insurance sector… while protecting policyholders and ensuring the safety and soundness of firms… and making it easier for insurance firms to use long-term capital to unlock growth, something the Prime Minister and Chancellor have rightly been outspoken about.

The Treasury has made excellent progress, in collaboration with the PRA, in developing reforms to Solvency II which we are certain will help do all of that.

And I am delighted, tonight, to be able to tell you more about those reforms… and how we will make them a reality… thereby, we believe, supercharging the opportunities available to this, your industry, in this country.

The headline ambition is as follows: to replace what is an EU-focused, rules-driven, inflexible and burdensome body of regulation… with one that is UK-focused, agile and easily adaptable. A body of regulation which facilitates, not hinders, market developments… which encourages the emergence of new types of assets… which supports the entry of new and innovative firms… and which, importantly, allows the release of meaningful amounts of capital for productive investment.

It’s important this is also understood as part of something much bigger.

As the Prime Minister said a few weeks ago, the UK has made huge strides ‘to capitalise on our newfound freedoms and restore the UK’s status as a sovereign, independent country that can determine its own future.’

There is a real opportunity to unleash what he described as ‘the benefits of Brexit and ensure that businesses can spend more of their money investing, innovating and creating jobs.’

Our new Brexit Freedoms Bill will end the special status of EU law in our legal framework and ensure that we can more easily amend or remove outdated EU law in future. And the Treasury is developing specific proposals in relation to financial services through the Future Regulatory Framework Review.

The question I know you’ll be asking is ‘What do our proposed reforms mean in practice?’

Well, firstly, they will involve a substantial reduction in the risk margin…

including a cut of around 60-70% for long-term life insurers.

Secondly, there will be a reassessment of the fundamental spread used to calculate the matching adjustment, in order to better reflect its sensitivity to credit risk.

Thirdly, we will introduce a significant increase in flexibility to allow more investment in long-term assets such as infrastructure, the hardware which makes economic growth possible.

And, fourthly, we want a major cut in the EU-derived regulations which make up the current reporting and administrative burden.

There's work still to be done to fully estimate the impact of these reforms. But I expect there to be a material capital release… possibly as much as 10% or even 15% of the capital currently held by life insurers… allowing them to put tens of billions of pounds into long-term productive assets, with multiple benefits country-wide.

Very importantly, we're also confident that these reforms will safeguard policyholder protection. The overall level of policyholder protection will remain very strong. Moreover, the PRA already has extensive powers to address individual firm risks, which provide an additional layer of protection against firm failure.

Drilling into the detail of the reform package

I know that's quite a lot to digest. Particularly over dinner. So, let me take those four key reforms in turn and give you a bit more detail about our thinking.

You've told me that the risk margin held on your balance sheets is excessive and brings unnecessary volatility to your balance sheets.

We agree that it exceeds the level needed to properly protect policyholders, especially considering how the risk margin has increased as interest rates fell, whilst the fundamental risk drivers were unchanged. Other protections in Solvency II already ensure that insurers hold sufficient capital to cope with a 1 in 200 shock.

As I've said, we believe there should be a sizeable reduction in the risk margin for long-term life insurers… in the order of 60 to 70%.

Making the UK insurance sector even more dynamic, prosperous and internationally competitive.

At the same time, it'll help you stabilise your balance sheets by reducing pro-cyclicality, which is particularly pronounced in a low interest rate environment.

Finally, it will reduce incentives to reinsure longevity risk offshore.

At the same time, we need to look at alternative methodologies for the fundamental spread, to improve the treatment of credit risk and protect policyholders.

I agree with what the Governor of the Bank of England said in a speech in December… that ‘our essential public policy objectives are the safety and soundness of insurers, and the protection of policyholders.’

I know you all also agree that policyholder protection is a top priority.

Despite the matching of long-term assets and liabilities, an insurance firm remains exposed to some long-term risks… principally the uncertain level of credit defaults over the lifetime of the assets. The fundamental spread measures these retained risks and sizes the value of the matching adjustment benefit accordingly.

Right now, however, according to Solvency II, the fundamental spread doesn’t explicitly allow for uncertainty around defaults and downgrades… and is insufficiently sensitive to differences in risk across asset classes and quality ratings.

So, we’re looking at that too… reviewing the methodology to address those concerns.

The reforms we want to make will help ensure that credit risk is better measured in the fundamental spread… so that its level, and sensitivity, genuinely reflect an asset’s credit risk.

Many of you have been talking to my officials about all of this… and I cannot thank you enough for your engagement.

The things we do as a Government are always better and more effective when they are informed by your ideas and insights. To make this work we need all shoulders to the wheel, and that’s exactly what I’m seeing.

It’s time now to push ahead with this. The Government will publish a full consultation document in April, bringing forward detailed proposals, underpinned in turn by concrete supporting analysis.

What is clear is that any new methodology will need to do a number of things… including boosting incentives to invest in infrastructure and other long-term productive assets, which we think could be a gamechanger…. allowing investment capital to shift, for instance, from bonds to wind farms.

It’s also important that we avoid introducing material volatility on to balance sheets. In particular, the fundamental spread should not be materially, if at all, impacted by short-term fluctuations in market spreads.

We think any new methodology should also mitigate incentives to reinsure credit risk offshore… that it should take into account other tools within the regime to protect policyholders, such as supervisory powers, the prudent person principle, and the ability to impose capital add-ons.… and that it should be phased in.

So, we believe there should be a sizeable reduction in the risk margin for long-term life insurers and a review of the methodology used to determine the fundamental spread.

Crucially, as I have said, the new regime will support firms' ability to invest in long-term productive assets whilst ensuring policyholders are protected…. benefiting firms and this country alike.

There will be other detailed changes too.

We will broaden the range of assets eligible for the matching adjustment portfolio to include assets with the option to change the redemption date.

For example, assets with construction phases and callable bonds will become eligible for matching adjustment portfolios.

We will also broaden the liabilities eligible for the matching adjustment to include income protection products and products that insure against morbidity risk.

We will remove the disproportionately severe treatment of assets whose ratings fall below BBB in matching adjustment portfolios. Although we would still expect firms to comply with the Prudent Person Principle on their investments.

Finally, we want to speed up the assessment and approval of applications for assets to be eligible for the matching adjustment… providing greater flexibility for how assets without historical data are treated, such as new or innovative assets.

There's clearly a lot more detail I could go into, but which I don't have time to cover tonight.

But, as I've said, the Government will formally consult on the package in April.

Please share your thoughts as part of that consultation. There will also be a more detailed technical consultation by the PRA later in the year.

I hope you agree with me that adds up to an ambitious and innovative reform agenda… one which delivers 'Solvency UK'… … a regulatory framework which meets the UK's needs perfectly…supercharging the opportunities available to you and your industry in this country.

But, for all I've said about Solvency II, the message I really want you to hear is this: The Government and I care very much about this industry. We're thinking and working very hard to do everything we can to support you… and we have no doubt that you'll continue to go from strength to strength.

Thank you.

Full list of the proposed Solvency II reforms, including those mentioned in the speech:

Substantial reduction in the risk margin

- A cut of around 60-70% for long-term life insurers.

Reassessment of the fundamental spread used to calculate the matching adjustment

Introduce a significant increase in flexibility to allow more investment in long-term assets such as infrastructure, the hardware which makes economic growth possible

- Broadening the range of assets eligible for the matching adjustment portfolio to include assets with the option to change the redemption date. Such assets will include assets with construction phases and callable bonds.

- Broadening the liabilities eligible for the matching adjustment to include income protection products and products that insure against morbidity risk.

- Removing the disproportionately severe treatment of assets in matching adjustment portfolios whose ratings fall below BBB. Firms would still be expected to comply with the Prudent Person Principle.

- Speeding up matching adjustment eligibility decisions by disconnecting them from the review of valuation, rating and capital issues for less complex assets.

- Introducing a more proportionate approach to matching adjustment breaches.

- Providing greater flexibility for how assets without historical data are treated.

Major reduction in the EU-derived regulations which make up current reporting and administrative burden

- Reducing the number of internal model standards to speed up the approval process, with safeguards to enable the PRA to ensure approved models are still of an acceptable quality.

- Removing requirements for branches of foreign insurers to hold local assets and calculate local capital requirements.

- Doubling the thresholds for the size and complexity of insurers before the Solvency II regime applies, while giving small firms the option to opt in.

- Reforming reporting requirements such as providing reporting exemptions to new insurers and reducing the frequency of some reports and deleting others.

- Introducing a mobilisation regime for new insurers.

- Allowing more than one approach to calculating consolidated group capital requirements.

- Simplifying the calculation of the Solvency II transitional measures to reduce the administrative burden of maintaining legacy systems.