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Dear Solvency II Review Team,

RE: Investment Association Response to HMT consultation on reform of Solvency II

The Investment Association[1] (IA) welcomes the opportunity to respond to HMT's consultation on potential reforms to Solvency II. Our members manage just under £1 trillion of assets on behalf of UK insurance companies globally[2], providing these clients with expertise in investment and risk management tailored to the regulatory and economic circumstances that insurers operate under. A number of our members also operate insurance companies for the sole purpose of manufacturing unit-linked investment products, which are commonly distributed in the UK retail and pensions markets.

Solvency II has had a significant impact on the relationship between insurers and investment managers, with a greater emphasis on the former to demonstrate their understanding and control over their asset management arrangements. This includes detailed reporting requirements at an asset class level on insurers' portfolios for the purposes of calculating their Solvency Capital Requirements (SCR) under Solvency II. In order to help investment managers assist their insurance clients with meeting their regulatory obligations under Solvency II, the IA has helped develop a Europe-wide industry standard template[3] for Solvency II portfolio reporting.

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[1] The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage over £9.4trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. That is 13% of the £75 trillion global assets under management.
[2] Investment Management in the UK 2020-21, IA. See chapter 4 for further detail on the UK institutional market.
[3] Solvency II Tripartite Template. Available to download at https://findatex.eu/

While insurance companies and their representatives are best placed to comment on the detail of the specific proposals being consulted on, we have views in two areas: (i) the overarching impact of the proposals on insurers' investments in their matching adjustment portfolios; and (ii) the opportunity to safely simplify existing reporting requirements for asset management operated life insurance companies that manufacture unit-linked investment products.

<u>1. Impact on insurance company investment in matching adjustment portfolios:</u> From an investment perspective, we are supportive of the government's overall goals for Solvency II reform: freeing up insurers to invest more of their resources instead of holding them as capital and widening the range of asset classes they can hold within their matching adjustment portfolios has the potential to generate significant benefits to the wider economy.

The Solvency II review is very timely in the context of the broader macroeconomic environment. With interest rates rising and the Bank of England looking to unwind its balance sheet following years of Quantitative Easing, insurers have a major role to play in helping support credit markets. Freeing up insurance capital is particularly important in such a challenging macroeconomic environment.

Accordingly, we support a number of the measures set out in the consultation:

- Permitting assets with prepayment risk to be eligible for the matching adjustment portfolio will facilitate insurance investment in a wider range of assets, such as:

    - Callable bonds
    - Commercial real estate lending
    - Housing association bonds and loans
    - Infrastructure assets such as renewables, waste-to-energy plants and waste-water treatment facilities
    - Local authority loan portfolios

  With appropriate reform some of these assets could be invested in both at the construction and operational phase, where relevant.

- Removing the disproportionately severe treatment of assets in matching adjustment portfolios whose ratings are below BBB will encourage insurers to diversify into a wider range of assets and support issuers, particularly new start-ups and SMEs, who may now be able to access finance they were unable to previously.

- Introducing a more streamlined and flexible approach to reviewing matching adjustment eligibility applications where appropriate will help realise the benefits of the above measures by speeding up the approvals process.

However, there are a number of areas where the reforms could go further, and we are aware of views within the insurance industry in that regard. From our perspective we have particular views in respect of the treatment of real estate assets under Solvency II. Accordingly, we have been liaising with various associations in the real estate, funds and insurance sector, and from these discussions, the Association of Real Estate Funds (AREF), the Investment Property Forum (IPF) and the British Property Federation (BPF) have produced a joint response which is attached as an annex to this letter.

We believe that investment by life insurers in real estate and other illiquid assets is not only beneficial for their investment strategies but if the appropriate reforms are put in place, they could unlock substantial funds to assist in the government's levelling up agenda. We therefore support the position set out in the annex in respect of the treatment of real estate under Solvency II.

Solvency II reform and sustainable and responsible investment by insurers

In recent years Sustainable & Responsible Investing (SRI) strategies have seen interest across retail and institutional investors, with insurers and pension funds being in the vanguard, heavily driven by regulation. In that regard the PRA's focus on insurers' management of climate-related financial risks remains the best way to ensure that capital flows to investments that can help aid the UK's transition to a net zero economy. Supported by their management of climate-related financial risks, the release of insurance capital that will be achieved by Solvency II reform should result in insurers playing a key part in the UK's decarbonisation.

2. Asset management life companies and regulatory reporting under Solvency II: A number of asset managers operate life insurance companies for the sole purpose of manufacturing unit-linked investment products. These are commonly used in the UK pensions market – both by Defined Benefit (DB) and Defined Contribution (DC) pension schemes – as well as in the UK retail investment market. From an investor perspective, unit-linked insurance policies are substitutable with authorised investment funds – indeed, many unit-linked policies simply involve putting an insurance wrapper around an existing authorised investment fund.

Asset management life companies exist because they provide significant benefits to pension schemes and retail investors seeking to gain investment exposure:

- Relative to certain types of authorised funds, life policies are more tax efficient for tax-exempt investors such as pension funds. In particular, insured pension funds can receive interest income gross and qualify for low or zero withholding tax rates. By avoiding tax drag, life policies allow pension funds to benefit from higher returns.

- Life policies are generally not subject to concentration limits[4] and so are, at least historically, more flexible for creating funds of funds than collective investment schemes. Larger pension schemes often use this flexibility to create bespoke life funds for their members.

[4] Other than when sold to DC schemes and retail investors, in which case the permitted links rules in COBS 21.3 apply. These do impose some limits on life policy investment in certain types of underlying collective investment schemes, typically those aimed at professional investors.

- By “wrapping” third party funds as insured pension funds, pension providers can create a common and consistent dealing and settlement cycle for customers even where the underlying funds are trading and settling at different times. This simplifies member record keeping.

- Once monies are received by an insurer, they are not subject to client money rules making it easier to manage investor dealing activity including same-day switching.

- Pension providers can include their own fees and charges for record keeping and other services in the insured pension fund, allowing pricing flexibility and further simplifying administration.

These benefits have meant that unit-linked policies have been very popular with investors: in 2019 the FCA reported that around £1 trillion was invested in unit-linked funds[5], a number that is likely to be higher today. The unit-linked market will in future have a significant role to play in the government’s productive finance agenda, with the launch last year of the new Long-Term Asset Fund (LTAF) regime, through which DC pension schemes and professional investors will be able to invest in long-term, illiquid assets of the sort that government is seeking to encourage insurers and pension funds to invest in. The FCA has explicitly accommodated the LTAF within the permitted links regime, such that unit-linked policies can invest in LTAFs provided certain conditions for investor protection are met.

From a prudential perspective, unit-linked business is viewed as lower risk than other insurance business because assets and liabilities are always in balance, with the investment risk of unit-linked products always being borne by the investor. Investors are exposed to counterparty risk in relation to the writer of unit-linked business, but since their claims can be fully met from the assets backing their policy, this risk is again lower relative to other types of insurance business. Accordingly, for supervision purposes the PRA typically categorises asset management life companies as category 4 or 5 firms (i.e. the lowest) in its impact rating of insurers.

<u>Asset management life companies reporting under Solvency II</u>

Asset management life companies are regulated under Solvency II. However, given that the nature of these firms’ businesses is solely unit-linked, with assets and liabilities fully matched, the proposed reforms of the risk margin and matching adjustment discussed in the consultation are less relevant here.

More relevant are the proposals to further simplify Solvency II reporting requirements, following on from the welcome changes made by the PRA in December 2021[6] to extend the small firm reporting waiver, which has already reduced certain reporting frequencies for asset management life companies (amongst other insurers).

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[5] FCA unit linked funds’ governance review, 2019.

[6] PS29/21 Review of Solvency II: Reporting (Phase I) and SS11/15 Solvency II: regulatory reporting and limitations, 2021.

Ahead of a further PRA consultation on reporting, we recommend that HMT and the PRA consider whether the current 'look-through' requirement for insurers investing in collective investment schemes is relevant for fully-matched unit-linked business.

The purpose of 'look-through' in Solvency II is to ensure that the insurer's investment exposures via collective investment vehicles are fully captured for the purpose of calculating the insurer's SCR. This is required where the insurer bears the risk of exposure to those assets. However, unit-linked business, which is also covered by the look-through reporting requirement, does not form part of the SCR calculation since assets and liabilities are fully matched and all investment risk is borne by the policyholder, with no risk exposure for the insurer.

Collection of holdings data on a look-through basis is currently a costly and complex exercise for asset management life companies: life policies are often fund-of-fund structures with multiple layers to look through, sometimes involving funds managed by third-party managers, who may not always choose to disclose the necessary data[7].

Since the insurer's SCR calculation is not impacted by the underlying asset data generated by look-through on unit-linked business, significant time and cost is incurred by the life company for little benefit. Ultimately this cost is borne by investors, so ending the look-through requirement for unit-linked business where there is no risk to the company would allow for lower costs to be passed on to investors at no increase in counterparty risk to them. The reduction in reporting burden would also benefit third party asset managers reporting to unit-linked insurance clients – again, allowing for savings to be passed on to clients.

I hope this response is helpful and I would be delighted to discuss it further.

Yours Sincerely,

Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

[7] Since portfolio holdings are the result of a manager's proprietary investment strategy, it is natural that they would not be willing to disclose the underlying holdings to another asset manager invested in its fund.

Annex: Real Estate industry response to HM Treasury's consultation on Solvency II

This response has been developed by a working group consisting of representatives from AREF, BPF, IPF, INREV, other real estate experts and in liaison with the representatives from ABI and IA.

July 2022

Introduction

The real estate investment industry strongly supports the Government's decision to undertake a review of Solvency II. In particular, we welcome the recognition in chapter 2 of the consultation of the fundamental difference between long-term life insurers and general insurers. Although the proposal in chapter 2 is a substantial reduction in the risk margin on the basis that the current methodology can overstate the market value of a firm's liabilities, we believe the current methodology also overstates the risks on the asset side of the equation for long-term assets held to match those liabilities. This is particularly the case for real estate and infrastructure. We believe that this distorts life insurers' investment decisions, discouraging investment in illiquid assets, and therefore undermines other government policy initiatives including financing of the real economy and green transition, along with levelling up the regions.

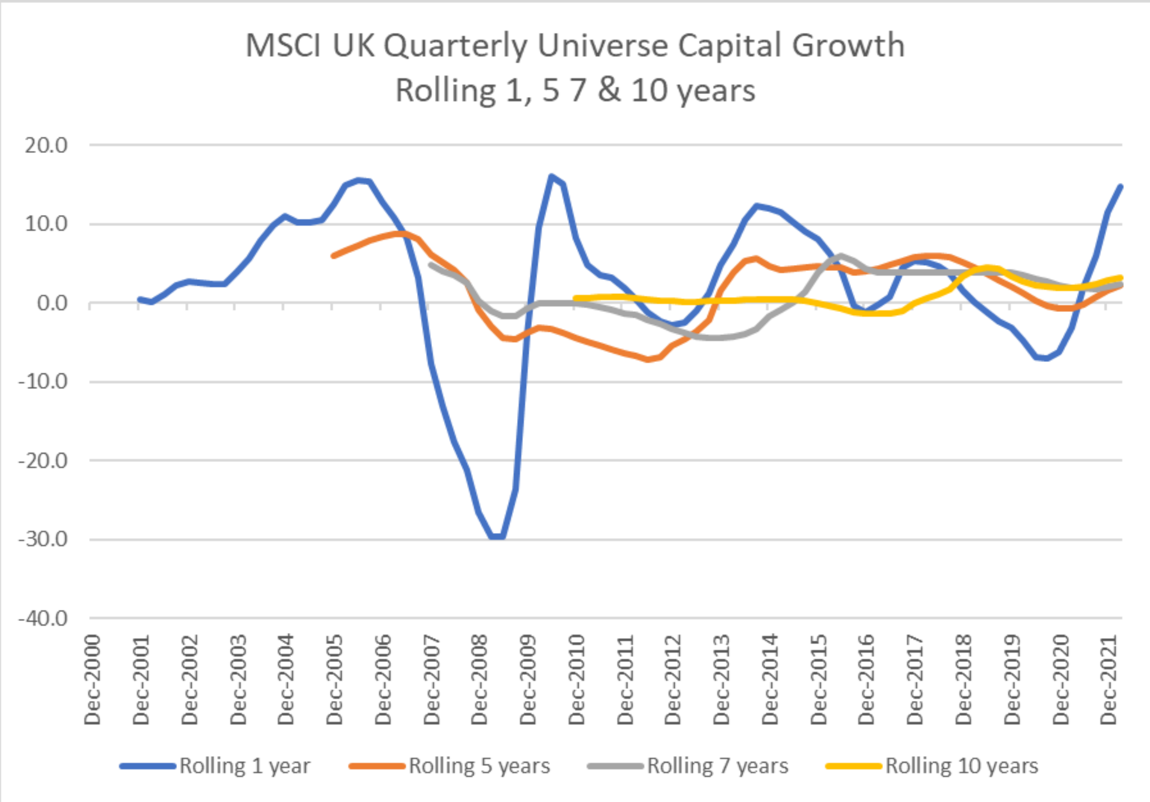
Chapters 3 and Chapter 4 of the consultation look at increasing investment flexibility but both chapters are focused on assets and liabilities within the narrow definition of the matching adjustment. While changes to the matching adjustment are important, we also believe that changes are needed to the treatment of long-term assets that fall outside the matching adjustment.

The EU Solvency II Directive as entered into force on 1 January 2016 did not distinguish between long-term life insurers and general insurers. A significant consequence of this was to treat all investments as short-term and potentially available to meet the short-term liabilities of general insurers. EIOPA recognised the inherent flaw in this model and attempted, with only partial success, to address this through the creation of the long-term equity (LTE) category set out in Article 171a of Solvency II Delegated Acts of 2019. We believe that further changes are needed to these provisions and that an equivalent change is needed to the Solvency Capital Requirements (SCR) charge for property to bring it in line with the LTE category. Prior to the introduction of the LTE category, all equities were subject to SCR charges based on short-term volatility. For listed equities this was 39% and for unlisted 49%. There is a volatility dampener of +/- 10%. For equities falling into the LTE category, the SCR charge is now 22%; however, there are a number of conditions, the key one being that the equities are to be held for more than five years. It is important to note:

- For equities within the LTE category, there is no distinction between listed and unlisted equities;
- Because the longer time period results in a smoothing of the volatility, there is no volatility dampener for LTE equities as this becomes unnecessary; and
- The 39% and 49% remain for equities falling outside the LTE category.

Despite the changes to the LTE category, the SCR charge for property risk of 25% is unchanged from the original EU Solvency II Delegated Act assumption of a worst-case short-term downside scenario (Property risk sub-module, Article 174). However, a review by EIOPA of insurers' average holding periods for the assets identified as long-term holdings suggests that these are considerably longer than for the total portfolio, with real estate (including funds) having the longest average holding period of 14 years[8].

The 25% SCR charge for property risk was based on MSCI data for real estate investment in the United Kingdom. Using MSCI data over 5-year, 10-year and 15-year periods, rather than one year, gives very different outcomes. Holding periods are important in the context of the expected maximum value at risk in real estate portfolios. While the UK market, as measured by MSCI, experienced a fall in capital values of up to 30% over 12 months during the Global Financial Crisis, the largest per annum value declines over longer hold periods are much reduced. As the data below show, an assumed hold period of five years mitigates much of the value decline in any one year, and with a ten year hold period the annual value decline is minimal.



MSCI UK Quarterly Universe CAPITAL Growth Rolling 1, 5, 7 & 10 years
Source: MSCI Quarterly Index March 2022

Life insurers invest in real estate through a variety of routes, including direct property, investment in funds, real estate debt and listed real estate companies, particularly REITs. We

[8] See: https://www.eiopa.europa.eu/content/insurers-asset-and-liability-management-relation-illiquidity-their-liabilities_en

believe consideration should be given to changes to Solvency II in each of these areas, as set out later in this submission. We also believe that it is important to recognise that investments in real estate can cover a very broad spectrum. Using the property shock, subject to the proposed change in its calculation, may not be appropriate for either end of the spectrum. At one end of the range, highly leveraged investments in real estate with substantial operational element, for example hotels, would appear to be closer to private equity. At the other end of the range, property on a 25 year lease to the government, would appear to be closer to a bond eligible for the matching adjustment. These points are reflected in our proposals below.

Why is investment in real estate important?

We believe that removing impediments to investment in real estate and other illiquid assets is important from the perspective of insurance companies and also broader government policy initiatives:

- For life insurers, real estate has always been an attractive asset class due to its liability matching characteristics and predictable income streams in the form of rents. Recent years have seen a significant broadening of the asset base with life insurers investing in:
    - Residential property alongside the more traditional allocation to commercial real estate; and
    - Infrastructure sitting alongside traditional real estate in a broader "Real Assets" approach.
- As identified in the consultation, part of the objective is to unlock tens of billions of pounds for long-term productive investments, including infrastructure. A key component of the government's levelling up mission is encouraging very large scale institutional investment in regeneration, infrastructure and housing across the UK.

The current SCR charges for those using the standard model actively discourage this.

Our proposals

We believe a number of changes would improve the treatment of real estate and infrastructure. Our comments largely relate to the treatment of market risks under the standard model for Solvency II, which is outside the specific questions posed in the consultation. Although we understand that the majority of UK life insurance companies have their own internal models approved by the PRA, the methodology follows that set out in the EU Solvency II Directive, which we believe to be fundamentally flawed. We understand that some UK life insurers who have their own internal models approved by the PRA use standard model volatility for real estate and equities. We therefore believe that changes to the standard model are important.

<u>Property SCR charge</u>

As outlined above, modelling volatility of real estate on a one-year basis does not reflect the commercial reality of life insurance investment in the asset class. We are therefore proposing a reduction in the current SCR charge for property risk from 25% to 10% or below. This is consistent with the reduction in equity volatility for long-term equities. We also believe that some long lease real estate investments be eligible to be within an expanded matching adjustment. This is discussed further below.

<u>LTE category assets</u>

We believe that the current conditions on the LTE category of assets are designed to ensure that they are only held to match long-term liabilities in a typical life insurance business. However, the conditions as drafted are difficult to apply in practice, particularly for private equity. The proposed UK approach of having provisions that apply only to life insurance companies would be a far better route to determining the eligibility of assets for the LTE regime than the specific requirements in the current EU Solvency II Directive. We believe that the treatment of private equity is relevant for some funds investing in real estate, as we believe some funds investing in real estate should more appropriately be treated as private equity funds. This is discussed in “treatment of funds” below.

<u>Treatment of funds</u>

Funds investing in real estate are treated on a look-through basis with the property SCR charge applied to the gross value of the underlying real estate. While this is appropriate for “core” funds, investing in traditional stabilised assets with low levels of borrowing, there are other real estate (and infrastructure) funds that are much closer in character to private equity funds. Life insurers should have the flexibility to decide on a case- by-case basis whether a fund should be regarded as property (real estate fund) or long-term equity (private equity fund). In view of some of the practical issues that have arisen in trying to set rules for eligibility for the LTE category, we think that insurers are better placed to make this assessment than trying to set pre-determined tests in the regulatory framework.

<u>Real estate debt</u>

Real estate loans are typically not rated, but are secured by mortgage over a specific real estate asset or assets. The security does not fall within the specific rules on collateral set out in the EU Solvency II Directive. Changes to the EU Solvency II rules in 2019 significantly mitigated this through the introduction of rules to allow insurers using the standard model to self-rate their investments in unrated bonds. Life insurers are also more likely in practice to use their own internal models for credit risk. The treatment of unrated bonds and anomalies that arise from the use of modified duration might be problematic for anyone using this, and we are not sure if any UK life insurance companies actually are in practice.
The more significant question for UK life insurance companies is the extent to which real estate debt falls within the matching adjustment.

<u>Matching adjustment</u>

We welcome the proposed expansion of the matching adjustment to include a wider range of real estate and infrastructure debt. As noted above, we believe that some long-lease real estate investments should be eligible to fall within an expanded matching adjustment. The consultation does not provide detail on proposed changes to the eligible assets for the matching adjustment; however, we believe that the various real estate industry trade bodies could contribute to the technical discussions on this matter.

Conclusion

Hopefully, the consultation will go beyond the specific issues mentioned and look holistically at the costs and benefits of the Solvency II regime generally. While we fully support Solvency II's goals of providing adequate protection of policyholders and beneficiaries, and to ensure the financial stability and fair and stable markets, the role that Government policy can play in facilitating insurers' financing of the real economy and green transition, along with levelling up the regions, is also extremely important.

The various real estate industry trade bodies that have contributed to this paper would be happy to participate in further technical discussions on this matter with HM Treasury and the PRA. We are also sharing this paper with the PRA.

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Disclaimers

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