

Bank of England

Harriett Baldwin MP
Chair of the Treasury Committee
House of Commons
London
SW1A 0AA

Andrew Bailey
Governor

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Dear Harriett,

At the Treasury Committee on 16 January I promised to write with more details about four issues raised at the hearing which you then summarised in your letter of 23 January.

1. Recourse to the public purse and Solvency II reforms

You asked us for an indication of the potential impact of the Government's Solvency II reforms on the probability of failure of insurance companies, and the potential costs to the public purse.

The parts of the package most relevant to this question are the planned changes to the risk margin, and the discussions about whether changes should be made to the Fundamental Spread (FS) design. The risk margin represents an estimate of the cost of transferring an insurer's liabilities to a third party in the event of default. The FS represents the allowance for retained risk in an asset's market spread, and the Matching Adjustment (MA) is the remaining part of the asset spread that can be safely assumed can be earned and therefore contribute upfront to insurers' financial resources. The PRA had set out a case to reform the FS to improve the way it captures risk, which ultimately the government chose not to take forward.

In estimating the impact of the reforms on the probability of insurer failure, we have focused on the life insurance sector as these are the firms most affected by these changes. We first estimate the potential capital released from the package of reforms, then consider how that might affect the probability of failure. We note that there are a number of factors to consider in translating this to potential costs to the public purse.



Finally, we note that there are a number of areas of the reforms which are harder to quantify as they will depend on future insurer behaviour, including the quantities of investment in the economy that will result from the changes.

The key reforms announced by HMT for the life insurance sector are:

1. Reduction in the risk margin by 65%.
2. Existing methodology for calculating the MA will be largely maintained.
3. Reforms that could change the composition of insurers' MA portfolios, including: the broadening of assets that are eligible to be used to match insurance liabilities; and changes to the treatment of sub-investment grade assets.

The impact on the life insurance sector that is most readily quantifiable comes from the risk margin reduction, which will release capital for the life insurance sector. The size of the reduction depends on prevailing economic conditions. It also depends on the date chosen for the comparison, because there are existing transitional measures which smooth the impact of Solvency II on firms until 2032¹. Our estimate on capital release is based on insurers' balance sheets and interest rates as at end-June 2022. Less capital would be released were long term interest rates to be higher, and conversely more capital would be released if they were lower.

Using firms' reported figures at end-June 2022 as a basis, the risk margin for the life insurance sector was £22bn. Post reform, we expect this to shrink to c.£8bn, i.e., a release of c.£14bn, once transitional measures on technical provisions have run off (by 2032). Had the PRA's reforms of the FS been taken forward, we expect that there would still have been a net capital reduction from the combination of these reforms, but that less than half of this capital would have been released in aggregate.

It is challenging to translate an estimated capital release figure to an estimate of the increase in the probability of failure. Our team has attempted this using a variety of approaches. As context, the current Solvency II regime is calibrated to ensure that insurers hold sufficient capital to withstand a stress level with 99.5% probability over a one-year period (in other words, a solvency standard equivalent to an annual "probability of failure" of 0.5 percent).

In the round, we think that over a one-year period, it is likely that the estimated capital release of £14bn (or 14% of the own funds at end-June 2022) could lead to an increase in the annual probability of failure for this sector of approximately 0.1 percentage points. This means that over a one-year period (if a firm just met the minimum regulatory standard), the probability that a life insurance firm would hold sufficient capital to withstand the solvency standard stress level will be 99.4% when compared to the current level – a relative increase in the probability of failure of around 20%. Had the PRA's preferred FS reforms been taken forward, we estimate that less than half of this increase would have occurred.

¹ Upon inception of Solvency II in 2016, insurers were granted transitional relief against the requirements of the new regime. In particular, the transitional relief significantly reduces the impact of the risk margin on insurers' Solvency II positions. This relief is being gradually phased out and will expire in 2032.

As noted above, the transitional measures will lead initially to a lower release of capital upon implementation – a release of £5bn – and therefore dampen the increase in the risk of failure in the short term. In our estimation, the annual probability of failure at this point would still rise by 0.03 percentage points which is an increase of 6% of the standard for solvency capital requirements mentioned above (0.5% over one year).

There are a number of factors to be aware of when interpreting the estimates above, as they involve assumptions about how insurers might behave a number of years into the future once the reforms are implemented. In general, we have assumed that the composition of insurers' balance sheets is unchanged from the current level. We have also assumed that insurers use any capital released from the reforms (for example, by returning capital to shareholders, or to support higher levels of new business) rather than retaining the additional capital unused as an extra buffer. Finally, we have sought to quantify only the increase in failure risk from capital being released, but not any changes in failure risk from the other reforms which will be introduced. In particular:

- We have assumed that over the long term, insurers have the same proportion of longevity risk reinsured as present. At present, the longevity risk of insurers' pre-2016 liabilities are not typically reinsured offshore. But new business is being reinsured at a much higher rate (80-90%). Firms may respond to the risk margin reforms by reducing their levels of reinsurance. Alternatively, firms may seek to maintain their high current levels of reinsurance flow, for example due to commercial pressure. Should insurers maintain their high current levels of reinsurance flow for new businesses, then over time, less risk margin would be released relative to the estimate above. The reinsurance assumption only affects the additional amount of capital that would be released over time as the transitional provisions run off. In addition, the difference between the reforms announced by HMT and the PRA's preferred FS reforms is less sensitive to this reinsurance assumption.
- We have assumed insurers hold the same assets as present. Currently, insurers are required to hold assets with fixed cash flows to obtain an MA benefit, and there is a cap on the level of MA benefit firms can gain from BBB and sub-investment grade assets. The government's reforms will widen the pool of eligible assets to include assets with 'highly predictable' (not fixed) cash flows and remove the caps on the MA benefit for sub-investment grade assets. It is possible, but inherently very hard to quantify, that these changes will lead to changes in insurers' investment strategies which could increase balance sheet risk, and therefore the future risk of insurer failure. To the extent that the FS for those new assets does not reflect all the risks or that the lack of fixed cash flows weakens the ability of firms to match assets and liability payments (particularly in adverse market conditions), there will be an increase in risk beyond that quantified above.

Scale of potential cost to FSCS and public purse

Translating any increase in the probability of failure into potential future costs to the Financial Services Compensation Scheme (FSCS) and on public funds has further challenges. In the first instance, the failure of a large insurer would be likely to result in compensation being payable to eligible policyholders through the FSCS. The costs of funding these compensation payments would be expected to be borne at least in part by increased FSCS levies on surviving insurance firms in subsequent years. The size of these levies and other potential costs would depend on a number of factors which would only be possible to assess at the time. These factors are numerous and are likely to include: the size of the insurer, the products it offers, the specific circumstances and nature of any failure, the extent of FSCS compensation payable to eligible policyholders, what recoveries could be made from a failing firm after default, the ability and willingness of other insurers to take over a failing insurer's policyholder liabilities, other Government decisions at the time, and wider conditions in the financial sector, such as whether the reasons for any failure might affect more than one insurer at a time or coincide with wider disruption in the financial sector or the real economy.

In 2000, the collapse of Equitable Life resulted in a loss to policyholders estimated at around £4bn - £5bn (2010 figures). The firm was unable to fulfil its obligations to policyholders due to the investment returns in the markets not matching up to the optimistic economic assumptions used in pricing the policies. Following this, the government announced compensation worth £1.5bn to affected policyholders in 2010.

Insurer failure is complex and involves policyholder obligations over long durations. The Equitable Life case is an example of one specific failure. If a future failure occurs, it would be difficult to predict the quantum of losses, nor is it certain that it would be limited to a single firm. For example, as corporate pension schemes continue to transfer their pension liabilities into the life insurance industry, the insurance sector might in future have larger and more concentrated exposures to similar types of risks. This could impact the capacity of surviving insurers to take on significant additional liabilities of a failed annuity writer.

Potential mitigants

In support of policyholder protection, the Government has also announced as part of the Solvency II package its support for the PRA making use of a number of additional supervisory measures to hold insurers to account in maintaining safety and soundness and policyholder protection. These include:

1. Requiring insurers to participate in regular stress testing exercises prescribed by the PRA to test insurers' resilience to scenarios the PRA will set out, and to allow the PRA to publish individual firm results;
2. Requiring nominated senior managers under the Senior Managers Regime to attest formally to the PRA whether or not the level of the fundamental spread on their firm's assets is sufficient to reflect all retained risks and that the resulting matching adjustment reflects only liquidity premium;

3. Allowing insurers to apply a higher fundamental spread through an add-on where they conclude that the standard allowance is insufficient taking into account the work undertaken to support the attestations set out above; and
4. Updating the PRA's matching adjustment rules as appropriate to reflect the Government's decision to widen the eligibility requirements to include assets with highly predictable cashflows (for example, to specify increases to the fundamental spread allowances to take into account the additional risks from non-fixed cashflows, portfolio limits etc).

These supervisory measures are designed to mitigate risk, and therefore probability of failure. However, their effect cannot be readily quantified ex ante, and so we have not attempted to do so in our estimates.

As we made clear to the Committee, the PRA has accepted that the government has reached its final view on the key elements of the Solvency II Review, and it is now for Parliament to decide on the legislative aspects required for the necessary reforms. We made clear in our evidence to the Committee that, subject to Parliament's decisions in this area, the PRA does not intend to use these measures as a means of delivering fundamental spread reform through the 'back door'; this would obviously be inappropriate if Parliament legislates for the government's chosen reforms, and in any case the measures could not achieve that outcome. However, we consider the measures to be a key part of the overall package of reforms announced by the government. They will have an important to play in helping the PRA supervise the insurance sector in future, and in helping to foster an appropriate level of public transparency. As HM Treasury noted in its November announcement, the PRA will also report to Parliament in future on how well these tools are working.

Finally, while FSCS compensation to eligible policyholders would be payable to customers in the event of an insurer default, it is important to note that the UK does not currently have a comprehensive insurer resolution regime in the same way as exists for banks. The purpose of a resolution regime is to help further reduce the risks of a firm failure having wider disorderly consequences. To this end, we welcome the proposed provisions within the current Financial Services and Markets Bill to amend existing insolvency arrangements for insurers, and the recent consultation by HM Treasury to create an UK Insurer Resolution Regime. Improvements such as these in the tools available to the authorities to deal with failing insurers may help to reduce in future the risk of a disorderly failure on policyholders or the wider market.

2. Costs incurred by pension funds

You asked us to estimate the costs incurred by pension funds as a result of the forced gilt sales that occurred in September and October 2022.

According to the PPF7800 index, the aggregate funding position of DB pension schemes improved by over £60bn between end-August and end-October 2022.

I should add that I noticed some commentary in a recent debate in the House of Lords on whether my comments on this change suggested that the Bank does not understand pension accounting.

This was not the point. Rather, it was to caution that such calculations, according to accounting standards, should be treated with care when the cashflows are so far ahead.

We also know that, over the period from 23 September to 14 October, DB pension schemes and LDI funds cumulatively sold around £37bn in gilts.

However, it is difficult to estimate exactly what the costs to pension funds from such sales of assets are for a number of reasons. For one, it isn't possible neatly to separate out forced sales from unforced ones. In addition, losses will vary by scheme and depend on the specific actions they took leading up to, during, and after the stress, and how their assets and liabilities evolve now and into the future.

However, had the Bank not intervened, losses to pension schemes could have been significant. A large number of pooled LDI funds could have been left with negative net asset value and faced shortfalls in the collateral posted to banking counterparties. In other words, schemes' investments in those pooled vehicles could have fallen to zero. Had LDI funds then defaulted, the gilts held as collateral by the banks that had lent to LDI funds would then potentially have been sold on the market. This would have amplified the stresses on the financial system and added to self-reinforcing falls in asset prices, which in turn would have impacted pension scheme holdings of those assets.

3. Financial stresses on households with mortgages

You asked for the Bank's analysis of the short-term outlook for the financial stresses on households with mortgages, their ability to service their mortgages, and for mortgage arrears and repossessions.

This analysis is set out in detail in Chapter 2 of the December 2022 Financial Stability Report at <https://www.bankofengland.co.uk/financial-stability-report/2022/december-2022>, but we summarise the key facts here.

Household finances are being stretched by increased living costs and rising mortgage payments. Bank analysis shows that in total around half of owner occupier mortgages (around 4 million) will be exposed to rate rises over the coming year.

Around 2.4% of households (around 670,000) are projected by the end of 2023 to be spending over 70% their income, adjusted for tax and essential spending, on mortgage debt repayments. That compares with around 1.6% of households at the time of the December Financial Stability Report. For those 670,000 households, we estimate mortgage debt repayments would account for around half of their gross income (i.e. income before tax and essential spending).

In aggregate though, the proportion of disposable income spent on mortgage payments is projected to rise but remain below the peak levels during the GFC and the 1990s recession.

4. Impact on financial stability of potential reforms to the SMCR and ring-fencing regimes

Resolution regime and potential reforms to ring-fencing

You asked for main areas of concern around potential reforms to the ring-fencing regime and whether confidence in the resolution regime is strong enough that some provisions of the ring-fencing regime can be relaxed without a reduction in financial stability risks.

The Bank and PRA, through a joint HM Treasury and Bank of England taskforce, are informing the Government's response to the independent review carried out by Sir Keith Skeoch. On 9 December the Government set out its plans on: near-term reforms, the issuance of a call for evidence on the long-term benefits of the ring-fencing regime in light of developments in the resolution regime and relevant advances in the wider regulatory framework, and reviewing the deposit threshold for the ring-fencing regime.

One recommendation in the near-term reforms is a change to the scope of which groups need to be ring-fenced – the independent review suggested introducing a threshold that could be used to exempt groups from ring-fencing if they are largely focused on retail banking and undertake only a small amount of investment banking business.

The impact of this recommendation is that it will likely exempt purely retail groups from ring-fencing even if such groups are quite large. The Bank is working with HMT on the options for calibrating this threshold.

There are several other recommendations (eg the removal of the prohibition on RFBs having branches or subsidiaries outside the EEA; allowing RFBs to service small businesses in the financial sector, such as high street independent financial advisors and mortgage brokers) which are aimed at making the regime more proportionate and less costly to operate for customers, banks, and regulators. The Bank welcomes these reforms.

Notwithstanding the ongoing analysis on the calibration of the metric for exempting purely retail groups from ring-fencing, the near-term reforms do not permit fundamental alterations to the structure of groups that are subject to the ring-fencing regime. Therefore, the Bank considers that the near-term reforms to the ring-fencing regime can be implemented without an increase in financial stability risks.

You also asked about the link between the resolution and ring-fencing regimes, both of which were introduced as core parts of the UK's response to the 2007-08 global financial crisis. The resolution regime developed by UK authorities, in alignment with international standards, successfully reduces risks to depositors and the financial system and better protects the UK's public funds. Last year the Bank published an assessment of the resolvability of the major UK banks, showing that if a major UK bank were to enter resolution now it could do so safely: remaining open and continuing to provide vital banking services to the economy. Shareholders and investors, not taxpayers, would be first in line to bear the costs, overcoming the 'too big to fail' problem.

The ring-fencing and resolution regimes have different but overlapping, aims and objectives. They are complements rather than substitutes. For example, ring-fencing supports the orderly resolution of large banks by reducing the interconnection between retail and wholesale operations that complicated the restructuring of large banks in the financial crisis.

The independent review of ring-fencing considered the links between the two regimes, recommending that HM Treasury “review the practicalities of how to align the ring-fencing and resolution regimes”. The Bank supports HMT’s plans to issue a call for evidence on this topic in the first quarter of 2023.

Whether further changes are needed better to align the ring-fencing regime with the resolution regime requires careful consideration. We stand ready to engage with, and learn from, responses to the Government’s Call for Evidence. We would note at this stage that any post-resolution restructuring of a major firm is likely to be a complex and costly undertaking. The ring-fencing regime has the advantage of providing a common baseline of certainty around the degree of interconnections between UK banks’ retail and wholesale operations that would be likely to serve to mitigate uncertainty, cost and complexity, all else equal. Moreover, drawing a link between assessments of resolvability and the scope of ring-fencing could require point-in-time judgements to be made on the application of the ring-fencing regime. Those judgements could change over time, which would mean that firms could need to be brought in and out of the ring-fencing regime over time.

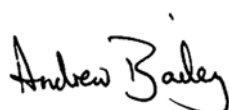
HM Government also announced an intention to consult on an increase to the core deposit threshold from £25bn to £35bn – we would note that this was not a recommendation of the Skeoch review. This is a matter for the government to decide but the Bank has not identified any specific financial stability implications.

Senior Managers and Certification Regime (SMCR)

In regard to the need for reform, scope for relaxation and effectiveness, we strongly support the SMCR but consider that it makes sense to review its operation. We are open to any evidence presented as part of that review. We intend to set out areas for feedback in the coming months.

I hope you find the above material useful and look forward to discussing these issues further in future hearings.

Yours sincerely,

The image shows a handwritten signature in black ink that reads "Andrew Bailey". The signature is written in a cursive, slightly slanted style.