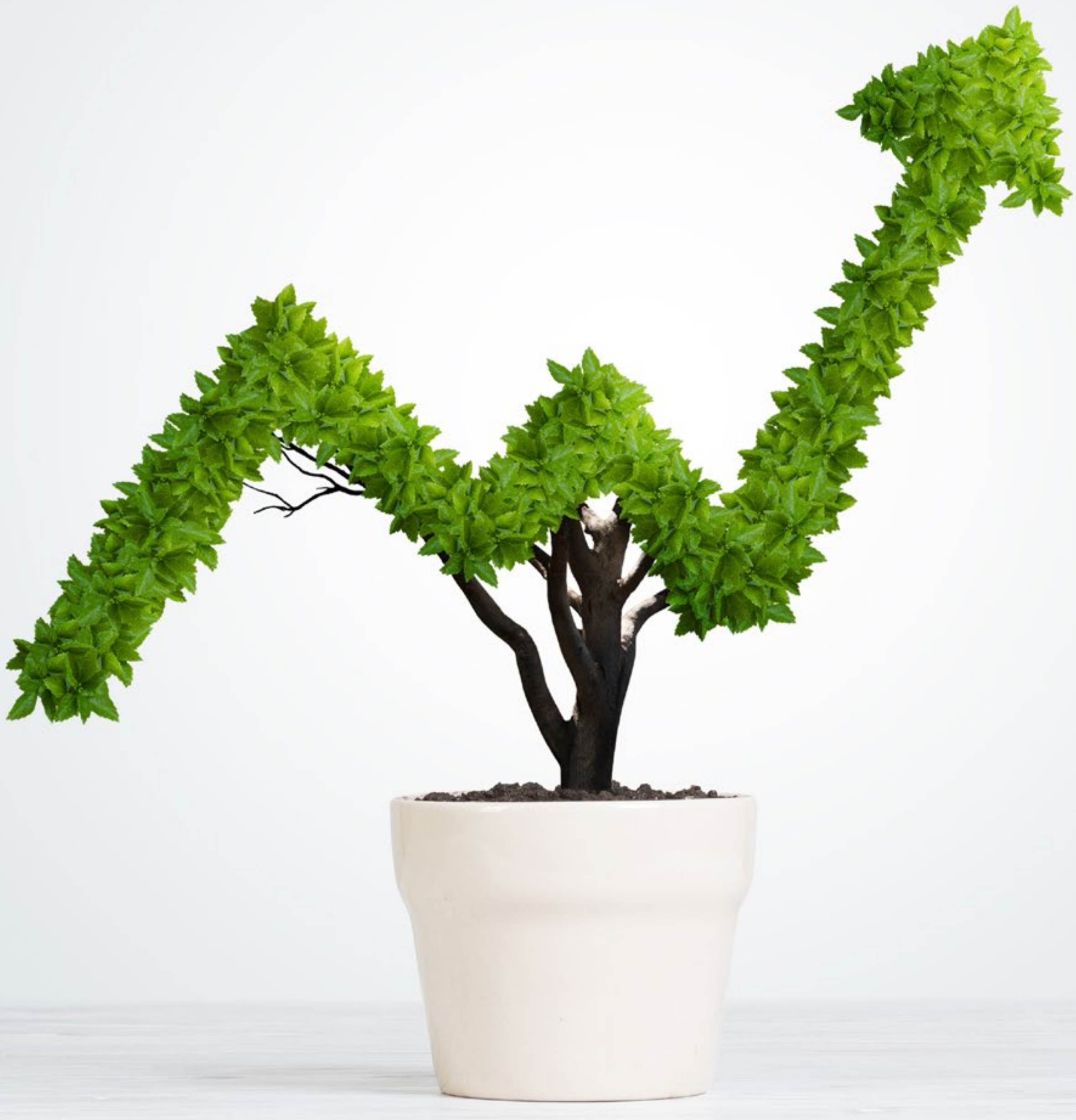

Investment Unleashed:

How reforming Solvency II can improve the life chances and financial security of millions of people across the UK

A WPI Strategy report for Pension Insurance Corporation plc

December 2021

Contents

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About Pension Insurance Corporation plc

The purpose of PIC is to pay the pensions of its current and future policyholders. PIC provides secure and stable retirement incomes through leading customer service, comprehensive risk management and excellence in asset and liability management. At half-year 2021, PIC had insured 270,800 pension scheme members and had £47.6bn in financial investments, accumulated through the provision of tailored pension insurance buyouts and buy-ins to the trustees and sponsors of U.K. defined benefit pension schemes. Clients include FTSE 100 companies, multinationals and the public sector. PIC is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority (FRN 454345). For further information please our website below.

pensioncorporation.com

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WPI Strategy is one of the UK's leading political communications consultancies, with a track record of delivering high impact public affairs campaigns. We offer senior strategic counsel and work extensively with our sister company WPI Economics to ensure that campaigns are underpinned by evidence-based content.

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Executive summary

The life chances and financial security of millions of people up and down the country depend on the success of a little-noticed government battle to reform a key piece of financial services regulation. Success would incentivise tens of billions of Pounds of long-term investment into levelling-up and the net zero challenge, whilst enhancing consumer protections.

The Government's ambitions in these areas can only be realised through UK-specific reform of a piece of EU financial services legislation, Solvency II, the regulatory framework for insurance companies.

Primarily designed to protect the pensions of millions of savers already within the protective walls Solvency II, the rules as currently implemented do not take into account the system-wide benefits of significantly increased infrastructure investment, even where that increases policyholder protections over the long-term.

As Andrew Bailey, Governor of the Bank of England, said in a recent speech, *"…achieving stronger and more sustainable growth in the economy will enhance the primary [regulatory] objectives of safety and soundness and policyholder protection."*[1]

Whilst Solvency II has many features that benefit the UK, reforming it to better suit our specific needs rather than the general needs of all insurance companies across every EU member state presents a once-in-a-generation opportunity to unlock and channel hundreds of billions of Pounds of UK savings into projects that support the race to net zero and the levelling-up agenda - into what the Treasury is calling productive finance.[2] There is a real danger of missed opportunities through delay and a failure to achieve the full potential of reform, which woul affect the lives of millions of people.

The opportunity is huge. Pension Insurance Corporation plc ("PIC") alone currently expects to invest £30bn in productive finance by 2030. With appropriate reform of Solvency II, that number could be as large as **£50bn**.

Appropriate and timely reform of Solvency II would represent a considerable success for proponents of long-term, system-wide thinking and those seeking to generate social value: the creation of good jobs; significant environmental benefits; more urban regeneration; and greater intergenerational equity.

Investing for net zero

PIC calculates that with appropriate and UK-specific reform of Solvency II, the company would have an additional £2bn per annum to invest in productive finance in the short-term, which includes £500mn to invest in renewables or green assets, which would equate to:[5]

- 34 offshore wind turbines; generating 254 MW of electricity, or
- 14 new solar parks

It would also mean an additional £450mn of investment by PIC into social housing, which would equate to:

- The energy efficiency retrofit of 53,500 social homes, meaning social housing residents would face lower fuel bills and fewer associated health problems from cold homes; or
- Maintenance costs for 285,000 existing social homes.

PIC has calculated that longer term, the benefit of Solvency II reform could scale up to around £2bn of fresh collective capital each year, potentially allowing the insurance of an extra c.£20bn of pension scheme liabilities per annum. **The assets backing these liabilities would need to be invested, equating to potentially 15,000 additional affordable homes being funded every year (and 45,000 in the first 12 months), more than 10% of the total of new social homes needed across the UK annually.**

While PIC cannot commit to specific investments following Solvency II reform, the figures arising from the analysis are based upon PIC's current investment mix.

Analysis

Solvency II has been a vital part of consumer and systemic protection since 2016, ensuring insurance companies are designed to pay the pensions of their policyholders. The flaws within Solvency II, however, funnel insurers to invest in large, well-funded companies to such an extent that the country is deprived of the systemic benefits of increased long-term investment in the economy. In this way,

> Solvency II is the economic equivalent of riding a bike wearing three helmets – extremely secure, but ultimately limiting to overall performance.

Reform of Solvency II is currently being led by the Treasury, working with the Prudential Regulation Authority. There is potential for this reform to be the first major 'Brexit Bonus', unleashing a wave of productive investment ahead of the next general election and throughout this decade. However, reform needs to happen sooner rather than later. HMT have three objectives for Solvency II reform:

- To spur a vibrant, innovative, and internationally competitive insurance sector;
- To protect policyholders and ensure the safety and soundness of firms; and
- To support insurance firms to provide long-term capital to underpin growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the Government's climate change objectives.

The Government's levelling up and net zero ambitions require significant investment if they are to be achieved. Quite simply, the Government itself cannot provide this funding: even the brand new UK Infrastructure Bank, *"tasked with accelerating investment into ambitious infrastructure projects, cutting emissions and levelling up every part of the UK"* only has an initial £12bn of capital to deploy. It will also be able to issue £10bn of government guarantees, *"helping to unlock more than £40bn of overall investment"*[3]

Previous efforts to enhance investment in the regions have proved how difficult it is to succeed through direct government investment. New Labour's new deal for communities only committed around £2bn of government spending across the country in the late 1990s.[4] Over 18 months from the start of 2020 to June 2021 – which includes the lockdown period – PIC alone invested £2.7bn into areas like social housing, renewable energy, universities and urban regeneration.

It is vital that reform enhances policyholder protection by increasing investment into productive finance, which not only enhances policyholder protection over the long-term but also makes opportunities more equal across the county. However, to succeed the Government needs to incentivise long-term institutional investors. Ideally reform would:

- Preserve insurer balance sheet resilience throughout the cycle – protecting policyholder pensions – whilst discouraging investment in relatively riskier assets in overvalued markets.
- Encourage investment into productive finance throughout the cycle.
- Bank the UK's "Brexit Bonus" by ensuring a competitive UK insurance industry – especially when compared to insurers operating under the European Solvency II regime.

About Pension Insurance Corporation plc (PIC)

The purpose of PIC is to pay the pensions of its current and future policyholders. It has a portfolio of £50bn of assets backing the guaranteed pensions of about 300,000 people.

PIC's investments have to be long-term. Stable returns over long-term horizons are needed to pay the pensions of policyholders over many years into the future. In addition, the assets PIC invests in have real social value. This is because what makes sense for society helps the company achieve its long-term aims. Proven renewables technologies meet these criteria – an offshore wind farm will produce clean electricity for decades as long as the wind keeps blowing. Social housing meets the criteria too, as there will always be people who are priced out of the private market and need access to affordable housing.

PIC's investments in renewables and social housing take place all over the country. It has invested in renewables company Ørsted, which has offshore wind facilities off the coastlines of Liverpool, Skegness and Clacton-on-Sea. It has invested in solar farms, including via the UK's first-ever publicly listed solar finance bond, used to fund two solar parks in Somerset. It has invested in social housing projects in County Durham, West Bromwich and Wellingborough (to name just a few).

Of its £50bn in assets, PIC has so far invested more than £10bn in areas like urban regeneration, social housing, renewable energy and the UK's education sector.

As well as providing long-term financial returns, these investments create much wider social and environmental benefits. High-value job creation, cleaner energy production, reduced poverty and less homelessness are just some of the outcomes from PIC investments.

PIC regards risk mitigation as being at the very heart of its investment process, including those risks associated with climate change. Climate risk has also been incorporated into PIC's corporate risk taxonomy covering physical, transition and liability risks.

Chapter 1: A 'Brexit Bonus' for communities across the UK – defining the problem

Solvency II is a major piece of EU legislation that regulates the insurance industry. It was introduced to update and consolidate 13 separate EU Directives following the financial crisis. As a member of the EU at the time, the UK adopted Solvency II at the beginning of 2016.[6] It was designed to provide a one-size-fits all framework for all EU insurers, but was not obviously designed to specifically meet the needs of the UK economy.

The purpose of Solvency II is – broadly speaking – to provide consistency and transparency around how insurers hold capital. It ensures they have consistent measures of risk quantification and asset valuation. It also guides how insurers should report their financial position.

While Solvency II has many features that benefit the UK, it also contains several flaws that are less than beneficial to our country and our society over the long-term. The most negative effect of these is to force long-term insurers to behave in an overly risk-averse way. The problem is compounded by the UK's regulatory system. It can be argued that the UK has over-engineered its implementation of Solvency II. At the same time, under the current interpretation, there is no incentive to consider the negative impact on wider economic growth or competitiveness. Yet these are two of the three objectives for reform of Solvency II set out by HM Treasury.

One of the technical areas of Solvency II, known as the Risk Margin, is widely acknowledged as an inefficient, volatile and largely superfluous way of protecting policyholder pensions. From a regulatory perspective, it is rather opaque and less easy to control.

Another, the Matching Adjustment, needs to be reformed to enable a more efficient investment process. At a conservative estimate, since it was introduced in 2016, the eligibility criteria within the Matching Adjustment have already prevented PIC alone from investing more than £10 billon into productive finance.

These are discussed in more detail on P.8.

The net result of these unintended consequences means that capital - that could and should be invested - remains trapped on insurer balance sheets. If it were invested, it could improve the life chances and financial security of millions of people up and down the country - socially, environmentally and economically - at the same time as increasing protection for policyholder pensions.

There is a real danger the current opportunity we have to refine Solvency II to better meet the country's needs is missed through delay, or a failure to achieve the full potential of reform – affecting the lives of millions of people.

The opportunity

HM Treasury is already looking at how reform of Solvency II could work in practice, and ministers are currently considering what the changes will be.

There are many benefits to changing the legislation:

- Increased investment into the real economy.
- Enhanced policyholder protection through the long-term investment cycle.
- UK corporates will be able to insure the defined benefit pensions of their scheme members at lower cost and pension risk will move to the part of the system best able to manage it.
- Members of schemes that become more viable to insure following reform will subsequently receive guaranteed pensions. As a result, the Pension Protection Fund will benefit because there will be less need for its support.
- The UK will be a more attractive place to conduct insurance business, with an appropriate risk-focussed regulatory regime that still meets extremely high regulatory standards.

Yet because Solvency II reform involves changing a balance sheet calculation, there are other benefits that can be quantified.

Since 2016, PIC has invested **£10.9bn**[7] in productive finance. However, over the same period:

- **£10bn** of productive finance investment was foregone by PIC due to eligibility criteria restrictions within the Matching Adjustment. (These restrictions include: pre-payment protections; the borrower wanting more flexibility on drawdown than we can offer; and the BBB cliff-edge.).
- PIC expects to invest **£30bn** into productive finance by 2030. Appropriate reform of Solvency II could see that number boosted to **£50bn**:
    - This could include up to £5bn into renewable energy/green investments, £4.5bn of direct investment into social housing, and £5bn of investment into urban regeneration projects, such as Private Rental Sector housing.

This extra funding could benefit people across the entire UK. PIC’s current investments include offshore wind facilities off the coast of Skegness, solar farms in Somerset and social homes in County Durham. But there are many more massive opportunities still waiting to be taken by private investments all over the country. Without reform, many of them will never happen. And the UK will find it harder to level up.

Ideally, reform will:

- Preserve insurer balance sheet resilience throughout the cycle – protecting policyholder pensions – whilst discouraging investment in relatively riskier assets in overvalued markets.
- Encourage investment into productive finance throughout the cycle.
- Bank the UK’s 'Brexit Bonus' by ensuring a competitive UK insurance industry – especially when compared to insurers operating under the European Solvency II regime.

These principles would combine enhanced long-term policyholder security with the ability to support the economy to the greatest extent possible. In short, reform can create a win/win situation.

Chapter 2: How can we seize the opportunity?

Excessively rigid attitudes towards policyholder protection are effectively putting a brake on the potential to invest in the UK.

The main problems with Solvency II can be found in two mechanisms: the "Risk Margin" (RM) and the "Matching Adjustment" (MA). Both of these can and should be reformed to improve the resilience and efficiency of UK insurers without weakening policyholder protection.[8]

As Andrew Bailey, Governor of the Bank of England, said in a recent speech, *"…achieving stronger and more sustainable growth in the economy will enhance the primary [regulatory] objectives of safety and soundness and policyholder protection."*[9]

Risk Margin – too volatile, too high

Life insurance companies hold technical provisions (reserves) calculated on actuarial bases to ensure they have sufficient funds available to pay their technical liabilities when they fall due. The technical provisions comprise a Best Estimate Liability (BEL) and a Risk Margin (RM).

Under the Solvency II regulations, the RM calculation is unduly complex and results in a capital requirement that is very sensitive to interest rates.

The reason for this is that the calculation is determined by considering the amount that a notional third party – a reference undertaking – would require in order to take over the liabilities and have sufficient capital to support them over their future lifetime.

In practical terms, the RM calculation under Solvency II:

- increases the cost of doing business for life insurers;
- increases the premiums required from DB pension schemes wishing to buy insurance; and
- ties up more capital (or creates an additional cost to managing capital through the use of reinsurance).

This way of calculating the RM leads to two problems:

I. It creates volatility. A small change in interest rates has a huge impact on the capital needed to be held on the balance sheets of insurers. This means short-term balance sheet management is required, increasing costs and management time, and reducing the competitiveness of the UK insurance industry.

II. The RM is too high. It deters investors from putting money into the industry. This in turn means that insurers underwrite less pension risk.

In fact, the extreme interest rate sensitivity of the Risk Margin creates significant issues for life insurers seeking to manage their exposure to movements in interest rates. This sensitivity is such that a one basis point movement in gilt yields causes an approximately 15 basis point move in an insurer's Best Estimate of Liabilities (BEL), leading to a movement of over 45 basis points in the Risk Margin. In short, the Risk Margin acts in practice more like a 48-year bond, compared to the liabilities the capital is backing, which have an average duration of 15 years.

As a result, billions of Pounds of capital is tied up managing 'artificial' problems on balance sheets, meaning less is available to go into real economy investments.

The Matching Adjustment – too rigid

The insured annuities that insurers offer need to be backed by secure assets that produce the cashflows to exactly match expected pension payments decades into the future.

In order for those annuities to be priced at a level that is both appropriate and affordable for their purchasers (i.e. employers sponsoring defined benefit pension schemes) insurers must be able to invest in secure long-term assets, such as social housing, renewable energy and projects that help the urban regeneration process. These assets deliver a level of return that includes a margin above that available on risk-free assets (such as UK government bonds) which is fed into pricing. This margin also acts as insurers' cushion in case of market turmoil and protects their portfolios – and policyholders' pensions.

The MA is the technical mechanism within Solvency II which allows insurers to invest in these assets. It can only be applied to liabilities that have certainty and predictability and can only be employed if the assets held are of investment-grade quality and have a term and profile closely matching the future pension payments (liabilities) they back. The MA allows insurers to ride out periods of asset volatility without forcing them to sell out of these assets during market downturns. This means insurer portfolios are anti-cyclical, protecting insurers against losses from short-term volatility. This helps avoid driving the market lower and creating the potential for systemic risk. Through the MA, insurers can both act as a stabiliser for the economy and the markets while ensuring that their policyholders are protected in the long-term.

However under Solvency II as it stands, it can be difficult and costly to ensure that specific or "new" assets are eligible for MA. This is even the case when other insurers have already invested in the same asset class. Insurers are shunning investment opportunities because of the uncertainty around MA eligibility.

Investing for net zero

We know that getting to net zero will depend on a wide variety of investment. At the very least, many more renewable energy facilities need to be built. Companies that are designing the technology for the low-carbon transition need financing.

To date, PIC has already invested more than £1.5bn in renewable energy and other carbon efficient investments (see Manchester New Victoria case study on p.11) that help the country meet its net zero commitments.

The Climate Change Committee – the Government's own independent advisors on net zero – has set out what infrastructure is needed to meet net zero by 2050. It will require massive amounts of further investment, significantly above that which has already occurred (see examples in Table One, below).

Table One: Increase in clean power generation needed to meet net zero

Net zero infrastructure	Increase needed to meet net zero
Offshore Wind	• The UK's existing capacity for offshore wind electricity generation is 10GW. • The Government's target is for 40GW in 2030. • For net zero to be met, then 95GW is needed by 2050.[10]
Onshore Wind	• The UK's existing capacity for onshore wind generation is 14GW. • For net zero to be met, 25-30GW is needed by 2050.[11]
Solar PV	• Solar capacity in 2050 is expected to be 85GW, average build rate is 3 GW / year between 2030-50.[12]

Source: Climate Change Committee

Solvency II reform could help free up billions of Pounds of capital to make net zero happen. PIC calculates that, with appropriate reform to Solvency II, it alone could have an additional £500m to invest in renewables or green investments in the short-term. This could add up to funding for:

- **34 new offshore wind turbines – generating 254 MW of electricity**
- **14 new solar parks**

Investing in social homes

The country desperately needs more affordable social homes. But not enough are being built. In fact, to meet housing need in the decade from 2021, an estimated 145,000 social homes will need to be built each year.[13] Each one of them could help reduce homelessness and child poverty. At the same time, they will save taxpayers money by reducing the need to pay Housing Benefit to private sector tenants.

Building more social housing brings benefits to many more people than those who live in these new homes. For instance, it supports the construction supply chain because it is more resilient during economic downturns (private housing starts fell by 18% during the pandemic, Housing Association starts fell by 5%).[14]

Private finance is expected to meet roughly half (47%) of the costs of building the social homes that are needed.[15]

To date, PIC has invested £2bn directly into social housing, lending to more than 25 Housing Associations (HAs) across England, Scotland and Wales since its first investment in a social housing bond in 2013. This investment has funded the development, acquisition and maintenance of properties.

As the role of HAs has grown in increasing the UK housing supply, they have increasingly sought long-term relationships with long-term investors like insurers and pension funds. This has required strengthening of corporate governance structures to allow the sector to attract the funds that it needs.

PIC calculates that Solvency II reform could mean the company has an additional £450m to invest in social housing in the short-term. This could help fund:

- **53,500 more environmentally-friendly social homes.** An estimated 39% of socially rented homes are below energy efficiency rating EPC C (the minimum rating thought to be adequate to address fuel poverty).[16] Unlocked capital from Solvency II could help improve this, reducing carbon emissions, lowering bills and helping more social housing residents to avoid fuel poverty and associated health issues.[17]
- **285,000 better-maintained social homes.**[18]

PIC has also calculated that, longer term, the benefit of Solvency II reform could scale up to around £2bn of fresh collective capital each year, potentially allowing the insurance of an extra c.£20bn of pension scheme liabilities per annum. **The assets backing these liabilities would need to be invested, equating to potentially 15,000 additional affordable homes being funded every year (and 45,000 in the first 12 months).**[19]

Manchester Victoria – investment that creates economic, environmental and social value

PIC has invested in a £130m Private Rental Sector (PRS) development in central Manchester with urban regeneration specialists Muse Developments. The project consists of 520 residential apartments and over 6,000 square feet of commercial space.

It is an exemplar of how investment from the insurance and long-term savings sector can create local economic, environmental and social benefits. Key numbers for the project are:

- £2mn a week since September 2020 when construction started has been spent in Greater Manchester's economy through a deliberate policy of sourcing construction materials and products locally.
- The development is creating 40 new jobs and employing 550 people in total during the construction phase.
- 3,000 apprentice weeks will take place over the course of the construction phase.
- 99.5% of waste will be recycled, reused, or disposed of in more environmentally-friendly ways than landfill (a typical construction project would dispose of 8%-10% of waste created through landfill).
- 100% of electricity used at the development site during construction is procured through renewable energy suppliers.
- Key Victorian culvert on the River Irk – a major plank of central Manchester's flood defences – has been given enhanced protection as part of the development.
- It is the first time that the site has seen the creation of any green space for more than 100 years.

PIC and Muse Developments formed the partnership to deliver Manchester Victoria because they liked each other's approach to business. PIC offers rigorous due diligence and surety of funds. Muse Developments design, procure and deliver schemes with rigorous regulatory compliance, going above minimum regulatory standards in some areas, such as fire safety, and is fully committed to the green environmental agenda.

Endnotes

1 BoE Speech, December 2021, Reforming Solvency II, https://www.bankofengland.co.uk/speech/2021/december/andrew-bailey-speech-at-the-ifoa-delivering-policyholder-protection-in-insurance-regulation

2 "Investment in productive finance refers to investment that expands productive capacity, furthers sustainable growth and can make an important contribution to the real economy. Examples of this include plant and equipment (which can help businesses achieve scale), research and development (which improves the knowledge economy), technologies (for example, green technology), infrastructure and unlisted equities related to these sectors. Productive finance investment can generate desirable outcomes for investors. It also provides various challenges, including that it may necessitate long-term commitments from investors in some cases." https://www.fca.org.uk/news/press-releases/treasury-bank-england-fca-productive-finance

3 HM Treasury 17 June 2021, UK Infrastructure Bank opens for Business, https://www.gov.uk/government/news/uk-infrastructure-bank-opens-for-business

4 Communities and Local Government, March 2010, the New Deal for Communities Experience, https://extra.shu.ac.uk/ndc/downloads/general/A%20final%20assessment.pdf

5 These are illustrative examples. The costs of solar parks and offshore wind facilities can vary significantly. However, these figures are based upon actual investments previously undertaken by PIC and are conservative estimates.

6 House of Commons Library, February 2017, Solvency II, https://researchbriefings.files.parliament.uk/documents/SN06339/SN06339.pdf

7 Figure as at HY2020

8 The explanations of Risk Margin, the Matching Adjustment and Policyholder Protection have been written in an accessible style. Technical detail is provided in PIC's response to HM Treasury's call for evidence during its Review of Solvency II. A redacted version of this call for evidence is available upon request.

9 BoE Speech, December 2021, Reforming Solvency II, https://www.bankofengland.co.uk/speech/2021/december/andrew-bailey-speech-at-the-ifoa-delivering-policyholder-protection-in-insurance-regulation

10 Climate Change Committee, December 2020, The Sixth Carbon Budget: Electricity Generation, https://www.theccc.org.uk/publication/sixth-carbon-budget/

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13 NHF, June 2019, Capital Grant required to meet social housing need in England 2021 – 2031, https://www.housing.org.uk/globalassets/files/resource-files/grant_modelling_report_june_2019.pdf

14 Work and Pensions Select Committee, July 2020, Building more social housing, https://committees.parliament.uk/publications/2102/documents/19835/default/

15 NHF, June 2019. Capital Grant needed to meet social housing need in England 2021-2031, http://s3-eu-west-1.amazonaws.com/doc.housing.org.uk/Editorial/Grant_modelling_report_June_2019.pdf

16 MHCLG, July 2021, English Housing Survey Energy Report, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1000108/EHS_19-20_Energy_report.pdf

17 WPI Strategy Calculation based on the average cost of retrofitting a home under the Government's Green Homes Grant Local Authority Delivery Scheme.

18 WPI Strategy Calculation based upon the average cost of repair and maintenance per unit of a housing association (a conservative figure).

19 PIC calculation, included in call for evidence response.

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December 2021

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