



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Rt Hon. Nicky Morgan MP
Chair of the Treasury Committee
House of Commons
Committee Office

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Sam Woods

Deputy Governor, Prudential Regulation
CEO, Prudential Regulation Authority

4 June 2018

Dear Nicky —

Solvency II Risk Margin

In my letter of 27 March 2018 I said that I would provide an update on the PRA's work on the risk margin.

The current design of the risk margin is too sensitive to the level of interest rates, and it is therefore too high at current low levels of interest rates. This is particularly true for long-dated insurance contracts such as annuities. Broadly speaking, transitional measures off-set the risk margin for business written before Solvency II, and for new annuity business firms have responded to the level of risk margin by reinsuring a substantial proportion of the longevity risk offshore. This build-up of the stock of offshore reinsurance is an unintended consequence and, if left unconstrained, would become a significant prudential concern. Our supervisory reviews of firms' reinsurance activities have not, however, brought to light significant immediate concerns about the way in which that reinsurance is being conducted. Similarly, it does not appear that Solvency II is having a detrimental impact on policyholders via annuity prices, the dominant drivers of which continue to be risk-free interest rates and corporate bond spreads.

As I indicated in my previous letter, we have been considering our supervisory approach to the use of future risk mitigation and transfer mechanisms in a number of contexts, including the calculation of the risk margin. We have looked at this option very carefully, and think it has some merit as a solution to the problem the risk margin is causing. However, in the context of the ongoing uncertainty about our future relationship with the EU in relation to financial services we do not yet see a durable way to implement a change with sufficient certainty for firms to be able to rely on it for pricing, capital planning and use of reinsurance. We will keep this position under review and will update the Committee as soon as we can see a clear way forward.

I hope that you find this update useful and thank the committee again for the attention it has given to this important issue.

Yours sincerely

Sam Woods
Deputy Governor and CEO, Prudential Regulation Authority