EXPLANATORY MEMORANDUM TO

THE INSURANCE AND REINSURANCE UNDERTAKINGS (PRUDENTIAL REQUIREMENTS) (RISK MARGIN) REGULATIONS 2023

2023 No. 1346

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of His Majesty.

2. Purpose of the instrument

2.1 The Financial Services and Markets Act 2023 (FSMA 2023) repeals retained EU law relating to financial services. This enables the government to deliver a Smarter Regulatory Framework for financial services. Retained EU law will be repealed and replaced with rules set by our independent and expert regulators, operating within a framework set by government and Parliament.

2.2 Each piece of retained EU law related to financial services is now within a "transitional period," lasting until the repeal of each piece is individually commenced by HM Treasury. During this period, the government will ensure retained EU law continues to be updated.

2.3 This instrument makes transitional amendments to retained EU law in Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 and the Solvency 2 Regulations 2015 (S.I. 2015/575) concerning the prudential regulation of the insurance sector. Prudential regulation ensures that firms act safely and reduces the chance of them getting into financial difficulty.

2.4 This instrument makes changes to the calculation of the capital buffer (known as the "risk margin") that insurance firms must hold to ensure they are able to transfer their liabilities to another insurer if required. This change will translate into a direct capital release for insurance firms, which they can use to write new business, increase the affordability and range of their products, or distribute to shareholders as dividends.

3. Matters of special interest to Parliament

Matters of interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Extent and Territorial Application

4.1 The extent of this instrument (that is, the jurisdictions which the instrument forms part of the law of) is England and Wales, Scotland and Northern Ireland.

4.2 The territorial application of this instrument (that is, where the instrument produces a practical effect) is England and Wales, Scotland and Northern Ireland.

5. European Convention on Human Rights

5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

6.1 When the UK left the EU, the body of EU legislation that applied directly in the UK at the point of exit was transferred onto the UK statute book by the European Union (Withdrawal) Act 2018. This is known as "retained EU law"; from 1st January 2024 this will become "assimilated law" as a result of the Retained EU Law (Revocation and Reform) Act 2023.

6.2 The Financial Services and Markets Act 2023 ("FSMA 2023") contains a number of new legislative powers which work together as a set of tools as the government repeals retained EU law to deliver a Smarter Regulatory Framework for financial services.

6.3 Section 1 of FSMA 2023 repeals retained EU law relating to financial services, covered by Schedule 1 to that Act, subject to commencement by HM Treasury.

6.4 Section 3 of FSMA 2023 contains a power to modify that retained EU legislation, providing HM Treasury with a power to make targeted modifications to retained EU law during the transitional period between the Act becoming law and when retained EU law is repealed.

6.5 UK insurance firms are currently subject to an EU-derived regime for prudential regulation – 'Solvency II'. The legislative requirements pertaining to the UK regime for the prudential regulation of insurance firms are contained in retained EU law, in particular the Solvency 2 Regulations 2015, and the Commission Delegated Regulation (EU) 2015/35.

6.6 This instrument will make transitional amendments to relevant aspects of the retained EU law to achieve reforms to the UK regime for the prudential regulation of insurance firms. These amendments will become effective on 31st December 2023.

6.7 The amended legislation will subsequently be revoked, as will all retained EU law relating to Solvency II. FSMA 2023 contains a power to restate retained EU law into domestic legislation and to modify this legislation in order to pursue purposes set out at section 3(2) of the Act. At the point of revocation, Solvency II legislation that is required to remain on the UK statute book will be restated, with modifications where necessary. The government expects this to happen by the end of 2024.

7. Policy background

What is being done and why?

7.1 This instrument is the first in a series of instruments needed to implement the Solvency II reforms announced in November 2022. These transitional amendments will change the calculation of the 'risk margin' and reform reporting and administrative requirements to reduce EU-derived burdens.

7.2 Many of the Solvency II reforms will be implemented by the PRA through changes to its rulebook, including changes to replace aspects of retained EU law that will be revoked by the government to deliver a Smarter Regulatory Framework for financial services. Where there is a significant public policy objective that could not be achieved through the regulators acting in accordance with their statutory objectives alone, the government will retain certain requirements relating to the Solvency II regime (with modifications where necessary) by restating relevant legislation onto the UK statute book.

7.3 The risk margin is intended to cover the potential costs of transferring insurance liabilities to a third party should an insurer fail. It protects policyholders by giving them a high degree of confidence that they will continue to have a claim on a viable business.

7.4 The transitional amendments to legislation made by this instrument will reform the risk margin calculation, to address limitations identified in the government's review of Solvency II. The current methodology's sensitivity to prevailing interest rates can overstate the market value of an insurer's liabilities, especially in a low interest rate environment.

7.5 Transitional amendments are also being made to remove unnecessary reporting burdens on insurance firms, by removing the requirement for specific reports to be provided to the regulator where those reports do not assist the regulator in supervising insurance firms.

Explanations

What did any law do before the changes to be made by this instrument?

7.6 Article 37 of the Commission Delegated Regulation (EU) 2015/35 requires the risk margin for an insurance firm to be calculated as the sum of the 'Solvency Capital Requirement' (a capital requirement that must be held under Solvency II to cover an extreme stress) for each year of its expected future liabilities, multiplied by the cost of capital and discounted at current interest rates.

7.7 Article 39 of the same regulation specifies that the 'cost of capital' parameter is set to be 6%.

7.8 Article 312 of the same Regulation requires insurance firms to submit the regular supervisory report to the regulator every 3 years, and also to provide an interim report setting out material changes to that report in the years between a full report submission.

7.9 Regulation 54 of the Solvency 2 Regulations 2015 provides that an insurance firm may apply to the PRA for permission to apply a transitional deduction to the market value of its liabilities. Under paragraph (5), the PRA may limit the amount of the deduction. Paragraph (6) requires the limit to be no larger than is required to ensure that the deduction does not result in the financial resources the undertaking is required to maintain being less than what it would have been required to maintain under the previous regulatory regime. Paragraph (9) requires the PRA to revoke an approval if it is not possible to apply a limit to ensure this result, amongst other specified conditions.

Why is it being changed?

7.10 There was broad consensus in the responses to the government's consultation that the current calibration of the risk margin is excessively high and overly sensitive to changes in interest rates. Due to the nature of the risk margin calculation, the level of risk margin held by insurance firms with longer term business (usually life insurance firms and annuity writers) will have been particularly impacted by the issues with the risk margin formula.

7.11 Through the amendments to legislation made by this instrument, the government will reform the risk margin to address these limitations, without compromising policyholder protection. The new calculation will safeguard against the risk margin becoming too large and too volatile, and will retain a risk margin that ensures that insurance firms hold sufficient assets to transfer their liabilities to another insurer if required.

7.12 This instrument also removes some administrative reporting burdens on insurance firms subject to the Solvency II regime. The removal of administrative and reporting burdens, where those burdens are duplicative or do not provide helpful information to regulators or market participants will allow insurance firms to streamline their processes, and is expected to achieve efficiency savings for insurance firms.

7.13 Following the reform to the risk margin formula, it will be more likely that a transitional deduction to an insurance firm's technical provisions would result in the financial resources the undertaking is required to maintain being less than what it would have been required to maintain under the pre-Solvency II regulatory regime. In such a circumstance, the PRA would be required to revoke its approval to apply a deduction. It is desirable for the PRA to have discretion to revoke an approval so that it can consider the circumstances of a given insurance firm, rather than being obliged to revoke an approval merely because the result of the underlying calculation has changed.

7.14 The existing legislation is being amended through this instrument so that reforms are implemented by the end of 2023.

What will it now do?

7.15 The updated risk margin calculation will use different parameters for long-term life insurance and other insurance business, reflecting their different natures. This will achieve a cut to the risk margin of around 65% for long-term life insurance, including annuities stemming from general insurance contracts, and around 30% for general insurance business.

7.16 The reforms to the risk margin should not materially impact the level of policyholder protection. Policyholders will remain protected by the 'Solvency Capital Requirement', which is a requirement for insurance firms to hold enough capital to withstand a 1-in-200-year shock. The Financial Services Compensation Scheme and the PRA's supervisory powers will remain in place as further safeguards for policyholders.

7.17 Article 37 of Commission Delegated Regulation (EU) 2015/35 will be updated to introduce a new parameter to the risk margin formula – the 'risk tapering factor'. This new formula requires that the Solvency Capital Requirement for a future year is multiplied by the 'risk tapering factor' to the power of 't', where 't' is the year of the projection. For example, in the fifth year of the projection of Solvency Capital Requirement, the formula would require that Solvency Capital Requirement to be multiplied by the 'risk tapering factor' to the power of five. The 'risk tapering factor' will be subject to a minimum level or floor. The same minimum level or floor will apply in each year of the risk margin calculation.

7.18 The 'risk tapering factor' is set at 0.9 for life insurance and reinsurance obligations, and 1.0 for other insurance and reinsurance obligations. Where the tapering factor is less than 1.0, it will reduce the contribution of the Solvency Capital Requirement in future years to the risk margin calculation. In each future year, the value of the risk tapering factor to the power of 't' will reduce (to illustrate: where the 'risk tapering factor' is 0.9 and is taken to the power of 't', its' value will be: Year 1: 0.90, Year 2:

0.81, Year 3: 0.73, Year 4: 0.66, Year 5: 0.59). Where the ‘risk tapering factor’ is equal to 1.0, it will have no impact. The floor to the ‘risk tapering factor’ is set to 0.25.

7.19 Article 39 of the same regulation will be amended to reduce the ‘cost of capital’ parameter from 6% to 4%. This change will reduce the risk margin by around one third for all kinds of insurance business. The risk margin will be reduced further for life insurance business because of the new risk tapering factor.

7.20 Article 312 of the same regulation will be amended so that insurance firms will no longer be required to provide either a full regular supervisory report, or a report on material changes in the years between a submission of a full regular supervisory report’.

7.21 The change to regulation 54 of the Solvency 2 Regulations will result in the PRA having discretion on whether to revoke an approval to apply a transitional deduction to an insurance firm’s technical provisions, in the circumstance where the financial resources which a firm is required to maintain is less than what it would have been required to maintain under the pre-Solvency II regime.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not trigger the statement requirements under the European Union (Withdrawal) Act 2018.

8.2 This instrument is not being made under the European Union (Withdrawal) Act 2018 but relates to the withdrawal of the United Kingdom from the European Union because it relates to HM Treasury’s programme to deliver a Smarter Regulatory Framework for the UK through repealing retained EU law and tailoring regulation to the UK.

9. Consolidation

9.1 HM Treasury does not propose to consolidate this legislation.

10. Consultation outcome

10.1 Reforms to the risk margin formula were subject to consultation in 2022. The consultation ran from 28 April 2022 to 21 July 2022. The consultation received 67 responses. Respondents to the consultation included life insurers, general insurers and composite insurers, as well as consultancies, industry groups and members of the public.

10.2 The government’s response to the consultation was published on 17 November 2022[1]. The consultation, and the government’s response to it, covered the entire Solvency II regime. Further instruments will follow that cover other specific aspects of the regime.

10.3 There was broad support for the government’s proposal to cut the level of risk margin for insurance firms, and for different levels of relative cut for long-term life insurance business and general insurance business. There was broad consensus that a cut of 60-70% for long-term life insurance business, and 30% for general insurance business, would not materially reduce policyholder protection, but would increase own funds, and would also improve the balance sheet stability of long-term life insurance firms.

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1118359/Consultation_Response_-_Review_of_Solvency_II_.pdf

10.4 Respondents to the consultation strongly supported proposals to reduce reporting and administrative burdens, and expected that reforms will unlock significant efficiency savings. The changes implemented by this instrument are part of a series of reforms to reporting across the regime, including those that have been implemented by the Prudential Regulation Authority.

10.5 Following the publication of the government's response to the consultation in November 2022, drafts of these Regulations were published on the government's website in June 2023. HM Treasury has engaged with insurance firms impacted by these changes, including through industry bodies, to understand the expected impacts and to enable insurance firms to prepare for the changes. HM Treasury has also consulted the regulators (FCA and PRA).

10.6 HMT has complied with the consultation requirements of section 3(6) and 3(7) of FSMA 2023 in preparing this instrument.

11. Guidance

11.1 HM Treasury does not propose to provide any further guidance in relation to this instrument. The aspects and constructs of the Solvency II regime affected by this instrument are established and well understood by firms subject to the regime. The legislation is part of a wider framework of requirements which includes the PRA rulebook. The PRA may provide relevant supporting guidance to its rulebook for use by affected firms.

12. Impact

12.1 At year-end 2021, the risk margin for life business was in excess of £32bn, while for non-life business the risk margin was in excess of £7bn. HMT's internal projection, supported by analyses from the PRA and the Government Actuary's Department (GAD), concluded that an estimated £9.2bn of capital would be released; this is based on insurers regulatory returns and interest rates as at end-June 2023. Analyses undertaken for the Association of British Insurers by KPMG[2] for the day 1 release of financial capital estimates a slightly lower £8.5bn.

12.2 Affected insurance firms are expected to incur one-off costs to implement the changes to the 'risk margin' formula. This is not expected to be significant (c£31m in total), relative to the size of the capital release. This includes costs arising from implementation and familiarisation, training, staffing, changes to calculation engines, new IT systems and pricing models.

12.3 Drawing on analysis from KPMG, reducing the risk margin directly releases financial capital, lowering the insurance sector's ongoing costs on existing business by £300m. There is a further estimated £300m one-year impact from writing new business with a lower risk margin.

12.4 Efficiency savings are also expected for insurance firms that would have been required to provide information relating to the 'Regular Supervisory Report' without this instrument. As this relates to one report, these savings are not expected to be highly significant.

12.5 There is no, or no significant, impact on charities or voluntary bodies.

[2] Report on potential economic impacts of changes to the insurance regulatory framework in response to HM Treasury's review of Solvency II and PRA Solvency II Reform Consultation Papers (abi.org.uk)

12.6 The impact on the public sector is on the implications on resourcing and costs incurred by the PRA across its policy-making, rule-making and supervisory functions. A fuller assessment of costs and benefits for the PRA is being undertaken separately by the regulator.

12.7 An Impact Assessment has been carried out and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website. The Impact Assessment received an initial review notice from the Regulatory Policy Committee (RPC) in November 2023 and was subsequently revised. In its 7 December opinion, the RPC gave a ‘not fit for purpose’ rating. The RPC noted that the revised Impact Assessment addressed many of the issues originally raised, however the RPC felt the analysis of direct costs to business was insufficiently evidenced. The remainder of the Impact Assessment was rated as ‘good’ or ‘satisfactory’. The Government will carefully consider the RPC’s feedback and address the issues raised.

12.8 HM Treasury has decided to make and lay this instrument now due to the Government’s commitment to reform the risk margin by year end 2023.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses.

13.2 To minimise the impact of the requirements on small businesses (employing up to 50 people), the approach taken is to allow the existing exemptions in Solvency II for “non-directive firms”, which are currently defined as firms with gross premium income below €5 million and gross technical provisions of less than €25 million, to apply. Such firms will be unaffected by this instrument. However, there may be other small businesses affected.

13.3 The basis for the final decision on what action to take to assist small businesses is the desired retention of consistency with the existing Solvency II approach to applying exemptions for small businesses. Changes to that approach are not the subject of this instrument.

14. Monitoring & review

14.1 The approach to monitoring of this legislation is that HM Treasury will engage with industry as necessary to confirm that the reforms have achieved the intended outcome. The transitional amendments will apply on a temporary basis only, pending the full revocation of the relevant retained EU law (expected by end of 2024).

14.2 The instrument does not include a statutory review clause and, in line with the requirements of the Small Business, Enterprise and Employment Act 2015, Bim Afolami MP has made the following statement: A review clause would not be appropriate for this instrument, which implements amendments to legislation that will apply temporarily, pending the revocation of retained EU law which is expected by the end of 2024.

15. Contact

15.1 Joe Jones at HM Treasury Telephone: 07977907774 or email: Joe.Jones@hmtreasury.gov.uk can be contacted with any queries regarding the instrument.

15.2 Shannon Cochrane, Deputy Director for Insurance and Pensions Markets Team, at HM Treasury can confirm that this Explanatory Memorandum meets the required standard.

15.3 Bim Afolami MP, the Economic Secretary to the Treasury can confirm that this Explanatory Memorandum meets the required standard.