EXPLANATORY MEMORANDUM TO

THE INSURANCE AND REINSURANCE UNDERTAKINGS (PRUDENTIAL REQUIREMENTS) REGULATIONS 2023

2023 No. 1347

1. Introduction

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

1.2 This instrument contains information for the Joint Committee on Statutory Instruments.

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 Retained EU law will be repealed and replaced with rules set by our independent and expert regulators, operating within a framework set by government and Parliament.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 This instrument restates and modifies provisions of the Solvency 2 Regulations 2015 (S.I. 2015/575) and the Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 concerning the prudential regulation of the insurance sector. Those instruments are repealed by section 1 of, and Schedule 1 to, FSMA 2023.

2.3 Prudential regulation ensures that firms act safely and reduces the chance of them getting into financial difficulty. This instrument modifies the framework for the 'matching adjustment' – an adjustment that may be applied when calculating the regulatory value of insurance liabilities. The matching adjustment allows insurance firms to recognise upfront as capital part of as yet unearned cashflows, and in doing so reduce the value of their liabilities. It is subject to eligibility conditions and regulatory approval. This instrument expands the eligibility criteria, incentivising insurance firms using the matching adjustment to invest in a wider range of productive assets and will also ensure that the Prudential Regulation Authority (PRA) has the necessary powers to supervise the expanded framework.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 This instrument contains provision under section 84(2)(a) of FSMA 2023 which gives power to make provision by reference to PRA rules as they have effect from time to time. The effect of regulation 2 is that terms used in the instrument have the meanings given in certain PRA rules as they have effect from time to time. The PRA rules are those applicable to insurance firms subject to the set of regulatory capital requirements of which the matching adjustment forms part. As mentioned in section 6 of this Memorandum, the PRA is consulting on new rules relating to the matching adjustment and the plan is for PRA rules and this instrument to come into force at the same time.

3.2 Regulation 7 of this instrument contains provision under section 3(4)(c) of FSMA 2023 authorising the making of PRA rules. Section 3(4)(c) applies by virtue of section 4(5). The PRA's consultation on matching adjustment rules includes rules under regulation 7, and regulation 7 is brought into force early so the instrument and rules can come into force at the same time.

3.3 The requirements on insurance firms in relation to the regulations 5 and 6 calculations are set out in the draft PRA matching adjustment rules, so that all the obligations on firms are consolidated in one place. The PRA rules are intended to come into force at the same time as this instrument. This instrument contains provision for regulations 5 and 6 to be enforceable against insurance firms.

4. Extent and Territorial Application

4.1 The extent of this instrument (that is, the jurisdiction 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 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 4 of FSMA 2023 contains a power to restate retained EU law into domestic legislation.

6.5 Section 4 of FSMA 2023 states that the Treasury may by regulations modify the restated legislation where it considers it to be necessary or desirable for or in connection with one or more of a specified set of purposes. These purposes include promoting effective competition in the interests of consumers in financial services and markets or persons who use, or are likely to use, services provided by payment systems in the course of business carried on by those persons; or, facilitating the international competitiveness of the economy of the United Kingdom and its growth in the medium to long term. The modifications to the matching adjustment framework achieved by this instrument are aligned to those purposes.

6.6 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).

6.7 A separate instrument is proposed to commence the necessary revocations of retained EU law on the date that the regulations in this instrument come fully into force. HM Treasury is also planning supplementary materials in the form of consequential amendments and transitional provisions relating to the revocations, and these will be included in a separate instrument.

6.8 FSMA 2023 provides the Treasury with a new power which can be used to enable a regulator to grant permissions to firms to disapply or modify the regulator's rules. The Treasury intends to use this power to enable the PRA to disapply or modify any PRA rules. This will be the mechanism through which the PRA will grant permission for appropriate firms to apply the matching adjustment. A separate instrument will provide further legislative context on this regulator power in advance of the date at which the regulations in this instrument will fully come into force.

6.9 The regulations in this instrument will be implemented simultaneously with updated PRA rules relating to the matching adjustment. These Regulations in places refer directly to definitions contained in PRA rules. The PRA is currently consulting on new rules relating to the matching adjustment. The consultation paper[1] was published on 28th September 2023, and the consultation period will close on 5th January 2024.

7. Policy background

What is being done and why?

7.1 This instrument is part of a series of instruments needed to implement the Solvency II reforms announced in November 2022[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 relating to Solvency II 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.

7.2 This instrument restates and modifies a subset of the retained EU law relating to the Solvency II matching adjustment – which provides a financial benefit to insurance firms who hold long-term assets with cash flows that match the cash flows of similarly long-term insurance liabilities. The government recognises that the matching adjustment has prudential benefits in that it reduces the risk that insurance firms may need to sell assets to meet payments due to policyholders, due to the close matching between asset and liability cash flows. It may also significantly impact on the investment decisions of insurance firms if they seek to benefit from applying the matching adjustment.

---

[1] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/september/review-of-solvency-ii-reform-of-the-matching-adjustment.

[2] Consultation_Response_-_Review_of_Solvency_II_.pdf (publishing.service.gov.uk)

7.3 At year-end 2022, the value of the matching adjustment to insurance firms, across the sector, was c.£66 billion (with c£294 billion assets held in matching adjustment portfolios).[3]

Explanations

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

7.4 Regulation 4B of the Solvency 2 Regulations 2015 places a duty on the PRA to publish technical information. This information includes the fundamental spread. The fundamental spread is an allowance within the matching adjustment calculation for the risks retained by insurance firms that apply a matching adjustment. This is used by insurance firms to calculate the value of the matching adjustment if they have approval to apply it. A higher level of fundamental spread reduces the level of matching adjustment.

7.5 Regulation 42 of the same Regulations currently sets out the eligibility criteria for insurance firms to meet when making an application to apply the matching adjustment. This includes the requirement that assets in matching adjustment portfolios (i.e. the portfolio of insurance liabilities and the assets that match the cash flows of those liabilities) must have fixed cashflows (other than in cases that satisfy limited exceptions).

7.6 Articles 53 and 54 of the Commission Delegated Regulation (EU 2015/35) set requirements for how the fundamental spread and the matching adjustment should be calculated. These supplement provisions relating to the calculation of the matching adjustment and the fundamental spread included in the PRA Rulebook, which had been transposed from EU legislation – the Solvency II Directive (Directive 2009/138/EC of the European Parliament and of the Council), as part of the implementation of the Solvency II regime in the UK.

Why is it being changed?

7.7 Reform of the matching adjustment will deliver a regime better suited to UK's unique market structure. The UK has a far larger annuity market than any EU member state. As a result, the matching adjustment, for which annuity business can be eligible, has a relatively material importance for the UK, and the reforms achieved by this instrument will deliver a more tailored regime appropriate for the UK market. Setting out all the relevant provisions in legislation will provide insurance firms with greater long-term certainty on the calculation requirements and allow for greater confidence when making investment decisions.

7.8 The government considers that these reforms will not threaten policyholder protection or the safety and soundness of firms. Policyholders will remain protected by the Solvency Capital Requirement, requiring 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.

What will it now do?

7.9 Regulation 3 retains the requirement for the PRA to publish technical information, including that relating to the fundamental spread used by insurance firms to calculate

[3] See consultation paper in footnote 1.

the matching adjustment. It restates regulation 4B of the Solvency 2 Regulations 2015 with modifications to remove detail and provide the PRA with additional flexibility on the technical information that must be published.

7.10 Regulation 4 of the instrument concerns the PRA's determination of applications by insurance firms to gain permission to apply the matching adjustment. It restates parts of regulation 42 of the Solvency 2 Regulations 2015 with modifications. This sets out the conditions under which the PRA is obliged to grant a permission to an insurance firm to apply the matching adjustment. Modifications achieved by this instrument provide a new exception from the requirement that assets in matching adjustment portfolios must have fixed cash flows. This will allow insurance firms to invest in a wider range of matching adjustment portfolio assets. The existing 'cliff edge' impact of breaches to the matching adjustment conditions, which provide for a full revocation of a matching adjustment approval, and a ban from reapplying for approval for two years, if a breach is unresolved for more than two months, will also be replaced by a more proportionate framework. This is provided for by the modifications in this instrument and will be implemented by the PRA in its rulebook.

7.11 Regulation 5 of the instrument concerns the calculation of the matching adjustment. It restates Article 53 of the Commission Delegated Regulation (EU) 2015/35 with modifications to bring together the full set of calculation requirements.

7.12 Regulation 6 of the instrument concerns the calculation of the fundamental spread. It restates Article 54 of the Commission Delegated Regulation with modifications. The modifications will also permit the application of the fundamental spread to reflect a more granular assessment of the likelihood that an asset will default, i.e., asset credit ratings, to increase the level of risk sensitivity in the framework. Further, the modifications made in this instrument will allow insurance firms to increase the fundamental spread, in accordance with PRA rules.

7.13 Regulation 7 of the instrument provides that the PRA's general rule-making power extends to rules relevant to the matching adjustment framework in specific areas that complement the regulations in this instrument.

7.14 Modifications to the MA framework achieved by this instrument also ensure that the extension of the asset eligibility criteria does not compromise policyholder protection, by requiring that the risks to the quality of matching are not material, and by providing the PRA with supervisory tools appropriate to the expanded matching adjustment framework– including the power to require adjustments to the fundamental spread, to ensure coverage of all retained risks on assets that benefit from the new exception from the fixity requirement.

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 is part of 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 This instrument does not consolidate any other legislation.

10. Consultation outcome

10.1 The changes implemented by this instrument were subject to consultation in 2022. The consultation ran from 28 April 2022 to 21 July 2022 and 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. Further instruments will follow that cover other specific aspects of the regime.

10.3 Respondents to the consultation strongly supported proposals to increase investment flexibility by making changes to the matching adjustment eligibility criteria so it is more compatible with a broader range of longer-term, less liquid asset types.

10.4 Respondents did not support the changes to the approach to calibrate the fundamental spread that were consulted on. This would have seen the calibration incorporate market measures of credit risk and place less reliance on credit ratings. Most considered that the current methodology for the fundamental spread was already prudently calibrated. They argued that the proposed approach would increase capital requirements and introduce significant volatility onto insurers' balance sheets, especially where they invest in illiquid assets, thereby disincentivising long term, productive investment. Many respondents did express support for bolstering the current methodology for calculating the fundamental spread by increasing the granularity of the assessment of the likelihood that an asset will default. The regulations in this instrument therefore do not implement the changes consulted upon, and generally retain the existing approach to calibrating the fundamental spread, with some modifications.

10.5 Following the publication of the government's response to the consultation in November 2022, drafts of these Regulations have been shared with industry stakeholders, including by publication on the government's website in June 2023.[4] 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 PRA to enable the regulator to prepare for the changes to the regime and ensure that the regulations in this instrument can work effectively with relevant regulator rules.

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 insurance 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 insurance firms.

[4] https://www.gov.uk/government/publications/draft-insurance-and-reinsurance-undertakings-prudential-requirements-regulations

12. Impact

12.1 HM Treasury has made a preliminary assessment of the likely costs and benefits from the reforms enabled by this instrument, informed by analysis commissioned by the Association of British Insurers from KPMG.[5] It has not been possible to fully quantify all of the direct costs and benefits, either on a one-off or ongoing basis, arising from the reforms to the matching adjustment framework. This is because the legislation relies on subsequent action from the PRA to give full effect to the reforms. Reforms to the matching adjustment are subject to a consultation (including a full assessment of costs and benefits) undertaken by the PRA. It is neither possible nor appropriate for the Government to quantify the impact of future matching adjustment rule changes, as doing so would pre-judge the independent consultations and policy development of the regulator.

12.2 In terms of annual costs to businesses, the costs of writing new business that is eligible for the matching adjustment will be reduced by the changes implemented by this instrument. Where that new business is backed by assets that are below investment grade, there will no longer be a reduction in matching adjustment due to the 'BBB cliff'. KPMG estimate that the increased investment income amounts to a £100m impact over 1-year. KPMG have also assessed the impact of the broadening of the matching adjustment eligibility requirements on the productivity of firms. This analysis assumes that firms will use newly eligible assets to support a proportion of new business (10%), and considers any increase in the associated risk allowance for the overall matching adjustment portfolio as well as other incurred costs, net of any increased investment returns on the newly eligible assets. KPMG assesses that these changes could result in a further £100m impact over one year.

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

12.4 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 undertaking separately by the regulator.

12.5 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' red 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 rated as 'good' or 'satisfactory'. The Government will carefully consider the RPC's feedback and address the issues raised.

12.6 HM Treasury has decided to make and lay this instrument now to provide certainty to the PRA on the rulemaking powers set out in regulation 7 in advance of it publishing final rules made under those powers. It also provides certainty to insurance and reinsurance undertakings on the Government's approach so that the matching adjustment reforms can come into force 30 June 2024.

[5] 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)

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 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 indirectly, for example as a result of larger firms updating their investment strategies following the reforms.

13.3 The basis for the final decision on what action to take to assist small businesses is to retain 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 A statutory review clause is included in the instrument. This review clause applies to regulations 3 to 8 (inclusive).

14.2 In its response to the Solvency II review consultation, the government committed to review whether the calibration of the fundamental spread remains appropriate in 5 years' time. Prior to this, the PRA will undertake an evaluation of its assessment of the impact on its statutory objectives of the Solvency II reforms, including the impact of the additional supervisory measures used by the PRA, and its assessment on whether further changes are needed. The government will take into account the results of the PRA's evaluation when undertaking its review.

14.3 The PRA will also take forward a review jointly with the FCA to assess whether changes may be needed to the Financial Services Compensation Scheme or FSCS levy for insurers, to reflect the government's reforms.

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.