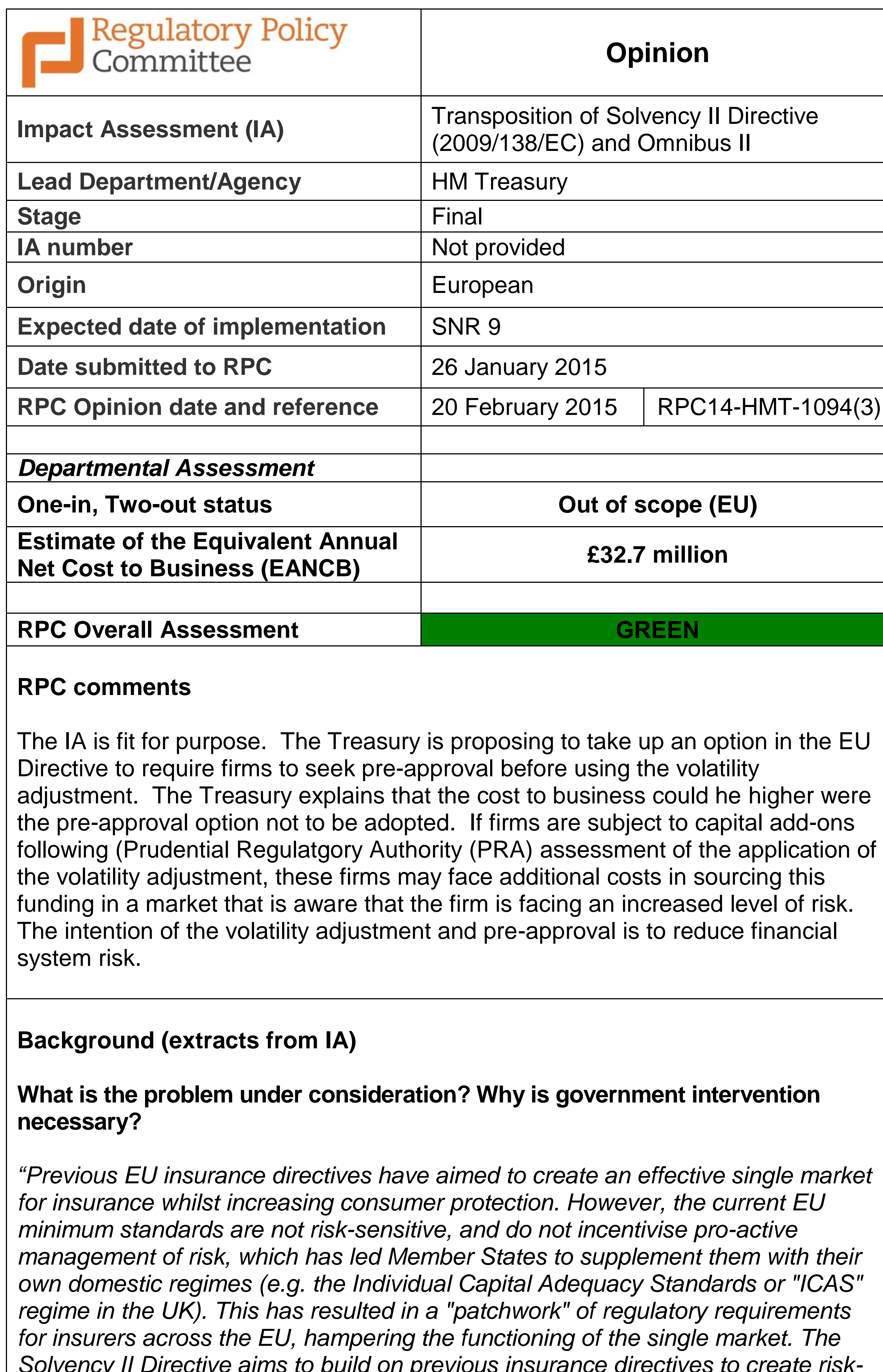

Regulatory Policy Committee	Opinion	
Impact Assessment (IA)	Transposition of Solvency II Directive (2009/138/EC) and Omnibus II	
Lead Department/Agency	HM Treasury	
Stage	Final	
IA number	Not provided	
Origin	European	
Expected date of implementation	SNR 9	
Date submitted to RPC	26 January 2015	
RPC Opinion date and reference	20 February 2015	RPC14-HMT-1094(3)
Departmental Assessment		
One-in, Two-out status	**Out of scope (EU)**	
Estimate of the Equivalent Annual Net Cost to Business (EANCB)	**£32.7 million**	
RPC Overall Assessment	**GREEN**	

RPC comments

The IA is fit for purpose. The Treasury is proposing to take up an option in the EU Directive to require firms to seek pre-approval before using the volatility adjustment. The Treasury explains that the cost to business could he higher were the pre-approval option not to be adopted. If firms are subject to capital add-ons following (Prudential Regulatgory Authority (PRA) assessment of the application of the volatility adjustment, these firms may face additional costs in sourcing this funding in a market that is aware that the firm is facing an increased level of risk. The intention of the volatility adjustment and pre-approval is to reduce financial system risk.

Background (extracts from IA)

What is the problem under consideration? Why is government intervention necessary?

“Previous EU insurance directives have aimed to create an effective single market for insurance whilst increasing consumer protection. However, the current EU minimum standards are not risk-sensitive, and do not incentivise pro-active management of risk, which has led Member States to supplement them with their own domestic regimes (e.g. the Individual Capital Adequacy Standards or "ICAS" regime in the UK). This has resulted in a "patchwork" of regulatory requirements for insurers across the EU, hampering the functioning of the single market. The Solvency II Directive aims to build on previous insurance directives to create risk-

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sensitive, harmonised requirements for EU insurers."

What are the policy objectives and the intended effects?

"The key policy objective is to develop the single market in insurance services and to increase the level of policyholder protection. Other intended effects are to: ensure the soundness of insurance firms and their ability to withstand shocks; protect the stability of the financial system; improve firms' risk management processes; increase confidence of policyholders in insurance products; increase competition, particularly in mass retail lines of business, leading to reduced prices; encourage product innovation to increase consumer choice."

Comments on the robustness of the OITO assessment

The proposal is of European origin. There is no evidence that the increase in regulation would go beyond minimum requirements or that the Treasury is failing to take advantage of available derogations that would reduce the costs to business. The Treasury is proposing to take advantage of the option to introduce and require firms to seek pre-approval before using the volatility adjustment. However, the Treasury explains that the overall cost to business could he higher were the pre-approval option not to be adopted, it is therefore out of scope of 'One-in, Two-out', in accordance with the Better Regulation Framework Manual (paragraph 1.9.8.ii). The Treasury also explains that the purpose of the volatility adjustment and pre-approval (see below) is intended to reduce financial systemic risk which would also be out of scope of OITO in accordance with the Better Regulation Framework Manual (paragraph 1.9.8.v)

Comments on the robustness of the Small & Micro Business Assessment (SaMBA)

The proposal is EU in origin. A SaMBA, therefore, is not required.

The Treasury, however, explains in its impact assessment that the regime is intended to apply to all EU insurance and reinsurance firms, regardless of size. Nonetheless, the 'principle of proportionality' will apply, meaning that the application of the requirements will be proportionate to the nature and scale of the risks faced by individual firms. The Treasury adds that the very smallest firms with premium income of less than €5m and technical provisions (liabilities plus a risk margin calculated according to prescribed rules) of less than €25m will be exempted by *de minimis* criteria.

Quality of the analysis and evidence presented in the IA

The Treasury explains that the EU Solvency II Directive (agreed in 2009) will introduce solvency requirements for insurers and reinsurers across all Member States that better reflect the economic risks that they face. The requirements establish significantly more sophisticated and risk-sensitive standards than the current minimum standards. There will be a dual system of capital requirements –

a Solvency Capital Requirement and a lower Minimum Capital Requirement, creating a 'ladder' of supervisory intervention and allowing early action by supervisors when a firm's solvency position begins to deteriorate. Firms will be able to calculate the amount of regulatory capital they require using a standardised formula or alternatively develop their own internal models, which will require supervisory approval. The Solvency II Directive has been amended by the EU's Omnibus II Directive in March 2014.

The Treasury expects the proposals to affect between 400 and 450 firms that, together, currently collect £1.8 trillion in gross written premiums each year. The Treasury explains that its initial 2011 impact assessment, prepared after the Solvency II Directive had been finalised, showed that 20% of firms would require additional capital to meet the requirement as at year end 2009. The combined reported capital shortfall of these firms was estimated to be approximately £12.5 billion.

However, the Treasury explains that following the amendment of Solvency II by Omnibus II, this capital shortfall of £12.5 billion has been largely eradicated. The Treasury explains that the majority of the reduction in the capital shortfall arises because Omnibus II introduces further flexibilities which will provide individual insurers with up to an additional sixteen years to comply with the new regime. The remaining capital shortfall will be eradicated through the use of internal models by insurers. Use of an internal model is expected to lower capital requirements by an average of 37%, compared to using the standard formula prescribed by the Directive.

On this basis, the main costs of the proposal will be one off costs and compliance costs. Using survey evidence from the Financial Conduct Authority and external consultants, the Treasury estimates the one-off costs to business will be approximately £2.6 billion which includes additional resource and training costs, new IT systems and the costs of changing business practices in response to the Directive; and estimates that on-going costs to business will be approximately £196 million each year. The ongoing costs arise mainly from the new requirement for firms to have a remuneration policy and the introduction of new quarterly reporting requirements.

The PRA specific costs include £105 million in one off costs and £3.3 million in on-going costs (IT maintenance costs, increased supervisory resource) each year. The Treasury explains that because the PRA is industry-funded, PRA's costs are ultimately paid for by business. Some of the cost is recouped through specific Solvency II project fees, and the remainder is sourced through the general PRA levy placed on business.

The Treasury explains that the main benefits of the proposal will be a reduction in the cost of capital for UK insurers brought about by the market perceiving such firms to be more robust. The Treasury's modelling of these likely benefits is based on responses from surveying UK insurance firms. The Treasury's estimates of the annual benefits to business is based on a range of 0 to 10 basis points of plausible reductions in the cost to firms of servicing the capital that they will need to hold under the Directive. The Treasury's best estimate of the benefits to firms will be in the region of £313 million in present value terms, based on a 3.75 basis points

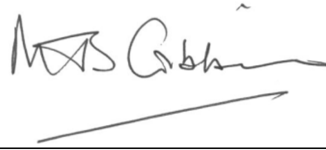
reduction in the cost of servicing 100% of the capital that is required by the Directive. To allow for uncertainty, the Treasury also provides low and high estimates of these potential benefits. The low estimate assumes no basis points reduction in the cost of servicing the capital that business is required to hold under the Directive, giving a benefit of zero. The Treasury's high estimate of the benefit to business is approximately £458 million in present value terms, based on a 5 basis points reduction in the cost of servicing 110% of the capital it is required to hold by the Directive.

The Treasury assesses the benefits of the proposals by using improved investment returns as a proxy for the savings arising from improved risk and capital management practices within firms as a result of the Directive. The Treasury's 2011 impact assessment estimated that the value of additional investment income over 10 years from 2013 (the then date Solvency II was expected to commence) would be £3,214 million. This was based on the then size of the UK insurance industry (approximately £1.6 trillion of assets), and the assumption that investment returns on these assets improved by between 1 and 3.5 basis points. Updating the analysis to reflect the increase in the size of the sector (now £1.8 trillion in assets) and testing various ranges for assumed improvement in return on assets results in a best estimate of £3,616 million for the value of additional investment income. The Treasury explains that this benefit is indirect.

The Treasury also explains that there would be additional un-quantified administrative benefits of complying with the Solvency II regime. These administrative benefits are mostly attributable to the better risk management and governance arrangements that firms would have implemented as a result of the regime.

Volatility adjustment: The Treasury explains that the Directive provides for a volatility adjustment which permits a firm to adjust the level of capital it is required to hold relative to the nature of the investments it holds. If the products a firm offers are short-term, then it may need to hold a greater level of capital in the event of fluctuations in the market, than a firm that offers long-term products underpinned by less liquid, long-term investments. The volatility adjustment permits a firm to calculate the capital requirements it holds based on the level of risk it is exposed to in the market.

The Directive permits Member States to introduce supervisory approval of a firm's intended use of the volatility adjustment. The Treasury is proposing to take advantage of this option and require pre-approval from the PRA. While this approach may represent going beyond EU minima, the Treasury explains that the cost of approximately £400,000 to the sector as a whole each year to seek pre-approval is outweighed by the longer-term benefits. The Treasury explains that the use of the volatility adjustment is required to be subject to supervisory review as set out in the Directive. The Treasury argues that pre-approval provides firms with assurance that they are applying it correctly and in relation to appropriate liability types from the outset. The PRA would be in a position to advise firms where additional capital in the form of a 'capital add-on' would be required. Without pre-approval, the PRA's assessment of a firm's use of the volatility adjustment may not take place until three years after it has been applied. If a firm is then found to have applied it incorrectly, the PRA would then place a 'capital add-on' requirement.

The firm would then be exposed to sourcing additional capital in a market that is aware of the increased risk the firm is facing. The Treasury also explains that the volatility adjustment and pre-approval are intended to reduce financial systemic risk within the insurance sector and prevent possible ripple effects from firms needing to liquidate assets facing a downturn in the market to meet short-term draw-down on investments.		
Signed		**Michael Gibbons,** Chairman