

Draft Regulations laid before Parliament under sections 4(9) and 5(3) of the Financial Services and Markets Act 2023 for approval by resolution of each House of Parliament.

Draft of 20th June 2023

DRAFT STATUTORY INSTRUMENTS

2023 No.

FINANCIAL SERVICES AND MARKETS

The Insurance and Reinsurance Undertakings (Prudential Requirements) (No. 2) Regulations 2023

Made - - - - - ***
Coming into force - - - - - ***

In accordance with sections 4(9) and 5(3) of the Financial Services and Markets Act 2023, a draft of these Regulations has been laid before, and approved by a resolution of, each House of Parliament.

The Treasury make the following Regulations in exercise of the powers conferred by section 349(1)(b) and (2) of the Financial Services and Markets Act 2000 and sections 4, 5, 76(2) and (5) and 78(5) and (6) and 428(3) of the Financial Services and Markets Act 2023.

PART 1

Introductory

Citation, commencement and extent

1.—(1) These Regulations may be cited as the Insurance and Reinsurance Undertakings (Prudential Requirements) (No. 2) Regulations 2023 and come into force on.....

(2) These Regulations extend to England and Wales, Scotland and Northern Ireland.

PART 2

Prudential requirements

Interpretation of Part 2

2.—(1) In this Part—

“credit rating” means a credit rating (defined in Article 3(1) of Regulation (EC) No 1060/2009 of the European Parliament and the Council of 16 September 2009 on credit rating agencies) issued by a credit rating agency;

“credit rating agency” means a credit rating agency registered by the FCA in accordance with Regulation (EC) No 1060/2009 of the European Parliament and the Council of 16 September 2009 on credit rating agencies;

“insurance undertaking” has the meaning given by section 417(1) of FSMA 2000;

“PRA rules” means the rules made by the PRA under FSMA 2000, as they have effect from time to time;

“reinsurance undertaking” has the meaning given by section 417(1) of FSMA 2000.

(2) Any other term used in this Part which is used in PRA rules has the same meaning as in those rules.

PRA duty to publish technical information

3.—(1) Every quarter the PRA must publish on its website—

(a) for each currency, duration, credit quality and asset class, a fundamental spread for the calculation of the matching adjustment to the relevant risk-free interest rate term structure used to calculate the best estimate for a portfolio of life insurance or reinsurance obligations;

(b) such other information as the PRA considers appropriate relating to the calculation of—

(i) technical provisions;

(ii) the SCR on the basis of the standard formula.

(2) Paragraph 17(9)(b) of Schedule 6A to the Bank of England Act 1998 (restriction on delegation of functions by the Prudential Regulation Committee) does not prohibit the making of a rule that imposes an obligation on PRA-authorized persons by reference to information published by the PRA under this regulation.

Calculation of risk margin

4. Where PRA rules provide for a risk margin for the whole portfolio of insurance and reinsurance obligations of an insurance or reinsurance undertaking to be calculated separately from the best estimate, the risk margin must be calculated in accordance with the following formula—

$$RM = CoC * \sum_{t \geq 0} \frac{SCR_t * \max(\lambda^t, \lambda_{floor})}{(1 + r_{t+1})^{t+1}}$$

where—

(a) “RM” denotes risk margin;

(b) “CoC” denotes the cost-of-capital rate, which equals 4%;

(c) the sum covers all integers including zero;

(d) “ SCR_t ” denotes the SCR of the reference undertaking after t years, calculated in accordance with PRA rules;

(e) “ λ ” denotes the risk tapering factor, and equals—

(i) 0.9 for long-term insurance and reinsurance obligations, and

(ii) 1.0 for general insurance and reinsurance obligations;

(f) “ λ^t ” denotes the risk tapering factor to the power of t years;

(g) “ λ_{floor} ” denotes the floor of the risk tapering factor, and equals 0.25;

(h) “ r_{t+1} ” denotes the basic relevant risk-free interest rate for the maturity of t + 1 years, derived from the basic relevant risk-free interest rate term structure.

Application of the matching adjustment

5.—(1) The PRA must grant an application to waive or modify its rules, such that the applicant insurance or reinsurance undertaking (“the undertaking”) may apply the matching adjustment to a risk-free interest rate term structure in order to calculate the best estimate of a portfolio of life insurance or reinsurance obligations, where each of the conditions set out in paragraphs (2) to (8) and (10) is met.

(2) The undertaking must assign a portfolio of assets, consisting of bonds or other assets with similar cash flow characteristics, to cover the best estimate of the portfolio of insurance or reinsurance obligations.

(3) The credit quality of the assets in the portfolio referred to in paragraph (2) must be capable of being assessed through a credit rating or the undertaking’s internal credit assessment of a comparable standard.

(4) The undertaking must maintain the assignment referred to in paragraph (2) over the lifetime of the obligations, except for the purpose of maintaining the replication of expected cash flows between assets and liabilities where the cash flows have materially changed.

(5) The portfolio of insurance or reinsurance obligations to which the matching adjustment is applied and the assigned portfolio of assets must be—

- (a) identified; and
- (b) organised and managed separately from the other activities of the undertaking.

(6) Subject to paragraph (7), each of the expected cash flows of the assigned portfolio of assets must replicate the expected cash flows of the portfolio of insurance or reinsurance obligations in the same currency.

(7) Any mismatch between the expected cash flows referred to in paragraph (6) must not give rise to risks which are material in relation to the risks inherent in the insurance or reinsurance business to which the matching adjustment is applied.

(8) The cash flows of the assigned portfolio of assets must be fixed and not capable of being changed by the issuers of the assets or any third parties, except—

- (a) where the risks to the quality of matching are not material, and
- (b) where only such limited proportion of the portfolio as the PRA may determine is affected.

(9) In paragraph (8)(a), whether a risk is material is to be determined in accordance with any PRA rules under regulation 8(c).

(10) The undertaking’s application must comply with the requirements of [*regulations under new section 138BA of FSMA*] and the undertaking must comply with rules under regulation 8(b).

(11) If an undertaking to whom the PRA has granted a permission to waive or modify PRA rules under paragraph (1) has failed to comply with any of the conditions set out in paragraphs (2) to (8) or (10)—

- (a) the PRA may vary or revoke that permission, and
- (b) for the period during which the undertaking is in default, or for such shorter period as the PRA decides, the PRA may impose a limit on the value of the reduction in the best estimate of a portfolio of life insurance or reinsurance obligations that results from the matching adjustment.

Calculation of the matching adjustment

6.—(1) For each currency the matching adjustment must be equal to the difference of—

(a) the annual effective rate, calculated as the single discount rate that, where applied to the cash flows of the portfolio of insurance or reinsurance obligations, results in a value that is equal to the value of the portfolio of assigned assets; and

(b) the annual effective rate, calculated as the single discount rate that, where applied to the cash flows of the portfolio of insurance or reinsurance obligations, results in a value that is equal to the value of the best estimate of the portfolio of insurance or reinsurance obligations where the time value of money is taken into account using the basic risk-free interest rate term structure.

(2) For the purpose of the calculation referred to in paragraph (1)—

(a) “assigned assets” only includes assets whose expected cash flows are required to replicate the cash flows of the portfolio of insurance and reinsurance obligations, excluding any assets in excess of that;

(b) valuations must comply with any requirements set out in PRA rules.

(3) In paragraph (2), the “expected cash flow” of an asset means the cash flow of the asset adjusted to allow for the probability of default of the asset that corresponds to the element of the fundamental spread set out in regulation 7(3)(a) or, where no reliable credit spread can be derived from the default statistics, the portion of the long term average of the spread over the basic risk-free interest rate (as provided in regulation 7(4) and (5)).

(4) The matching adjustment must not include the fundamental spread reflecting the risks retained by the insurance or reinsurance undertaking.

(5) The deduction of the fundamental spread under paragraph (4) from the result of the calculation set out in paragraph (1) must include only the portion of the fundamental spread (as calculated in accordance with regulation 7) that has not already been reflected in the adjustment to the cash flows of the assigned portfolio of assets in accordance with paragraphs (1) to (3).

Calculation of fundamental spread

7.—(1) The fundamental spread referred to in regulation 6 must be calculated in a transparent, prudent, reliable and objective manner that is consistent over time and based on relevant indices where available.

(2) Subject to paragraph (9), the fundamental spread must be calculated in accordance with paragraphs (3) to (8).

(3) The fundamental spread must be equal to the sum of the following—

(a) the credit spread corresponding to the probability of default of the assets, and

(b) the credit spread corresponding to the expected loss resulting from downgrading of the assets.

(4) For exposures to the central government of the United Kingdom and the Bank of England, where the fundamental spread would otherwise be lower than 30% of the long-term average of the spread over the risk-free interest rate of assets of the same duration, credit quality and asset class, as observed in financial markets (the “average spread”), the fundamental spread must be 30% of the average spread.

(5) For assets other than exposures to the central government of the United Kingdom and the Bank of England, where the fundamental spread would otherwise be lower than 35% of the long-term average of the spread over the risk-free interest rate of assets of the same duration, credit quality and asset class, as observed in financial markets (the “average spread”), the fundamental spread must be 35% of the average spread.

(6) For the purposes of this regulation—

(a) the calculation of the “credit spread” must be based on the assumption that in case of default 30% of the market value of the assets can be recovered;

(b) the “probability of default” must be based on long-term default statistics that are relevant for the asset in relation to its duration, credit quality and asset class;

(c) the “expected loss” must correspond to the probability-weighted loss the insurance or reinsurance undertaking incurs where the asset is downgraded to a lower credit quality and is replaced immediately afterwards, and the calculation of the expected loss must be based on the assumption that the replacing asset meets all of the following criteria—

(i) the replacing asset has the same cash flow pattern as the replaced asset before downgrade;

(ii) the replacing asset belongs to the same asset class as the replaced asset;

- (iii) the replacing asset has the same credit quality as the replaced asset before downgrade or a higher one;
 - (d) the “long-term average of the spread over the risk-free interest rate” must be based on data relating to the previous 30 years;
 - (e) the methods to derive the fundamental spread of a bond must be the same for each currency and each country and may be different for government bonds and for other bonds.
- (7) For the purposes of paragraph (6)(b), where no reliable credit spread can be derived from the default statistics, the fundamental spread must be equal to the portion of the long-term average of the spread over the risk-free interest rate set out in paragraph (4) or (5).
- (8) Where part of the data referred to in paragraph (6)(d) is not available or where the available data is not reliable, constructed data based on prudent assumptions may be used; and the constructed data must be based on available and reliable data relating to the previous 30 years.
- (9) At the option of the insurance or reinsurance undertaking concerned, the fundamental spread may be increased where necessary to ensure that it covers all the risks retained by the undertaking.

Power of PRA to make rules

8. The power of the PRA to make general rules under section 137G of FSMA 2000 (the PRA’s general rules) includes power to make rules setting out—

- (a) the categories of insurance undertakings and reinsurance undertakings to whom regulations 4, 5, 6 and 7 apply;
- (b) conditions, in addition to those set out in regulation 5, under which an undertaking is eligible to apply a matching adjustment;
- (c) circumstances in which a risk is to be treated as material for the purposes of regulation 5(8);
- (d) the use in the calculation of the fundamental spread of any information published by the PRA under regulation 3(1)(a).

Supervision and enforcement by the PRA

9. The PRA has the functions of supervising and enforcing the obligations imposed by regulations 4, 6 and 7 as they apply to insurance and reinsurance undertakings.

PRA’s functions and powers under FSMA 2000

10. FSMA 2000 applies in relation to regulations 4, 6 and 7 as if they were qualifying provisions within the meaning of FSMA 2000.

PART 3

Savings: Gibraltar groups and undertakings

Saving for Gibraltar groups and undertakings

11.—(1) The relevant legislation applies in relation to a Gibraltar group or a Gibraltar undertaking on and after [date 1 *insert here the date this SI comes fully into force which is also the date of the full commencement of the revocations*], as if it had not been revoked, and paragraph 2 applies.

(2) The relevant legislation is to be read with any modifications necessary to ensure that the relevant legislation continues to apply in relation to a Gibraltar group or a Gibraltar undertaking on and after [date 1] [as it had effect immediately before [date 1] in relation to a Gibraltar group or a Gibraltar undertaking], as if it had not been revoked.

(3) The “relevant legislation” means—

- (a) Part 3 of the Solvency 2 Regulations 2015;
 - (b) regulations 4C and 4D of the Solvency 2 Regulations 2015; and
 - (c) any other legislation revoked by the Commencement Regulations which is referred to in, applies by virtue of, or modifies the legislation listed in sub-paragraphs (a) to (b).
- (4) This regulation ceases to have effect immediately after Schedule 2A to the Financial Services and Markets Act 2000 comes fully into force.
- (5) In this regulation—
- “Commencement Regulations” means [*the related SI commencing the revocations*];
- “Gibraltar group” means a group that—
- (a) falls with regulation 9A(a), (b) or (c) of the Solvency 2 Regulations 2015, and
 - (b) includes a Gibraltar undertaking falling within regulation 9A(a), (b) or (c) of the Solvency 2 Regulations 2015, containing a Gibraltar undertaking;
- “Gibraltar insurance undertaking” means an undertaking which—
- (a) has its head office in Gibraltar, and
 - (b) is authorised by the Gibraltar Financial Services Commission to effect or carry out contracts of insurance (other than contracts of reinsurance) under paragraph 24 of Schedule 2 to the Financial Services Act 2019 of Gibraltar;
- “Gibraltar reinsurance undertaking” means an undertaking which—
- (a) has its head office in Gibraltar, and
 - (b) is authorised by the Gibraltar Financial Services Commission to effect or carry out contracts of insurance that are limited to reinsurance contracts under paragraph 24 of Schedule 2 to the Financial Services Act 2019 of Gibraltar;
- a “Gibraltar undertaking” is either of the following—
- (a) a Gibraltar insurance undertaking, or
 - (b) a Gibraltar reinsurance undertaking;
- “Solvency 2 Regulations 2015” means the Solvency 2 Regulations 2015/575.

PART 4

Amendments to the Financial Services and Markets Act 2000

Amendments to FSMA 2000

12. FSMA 2000 is amended as set out in regulations 13 to 18.

Amendment to section 165 (powers to gather information)

13. In section 165 (powers to gather information) in subsection (7)(e) for “, reinsurance undertaking or third-country insurance undertaking” substitute “or reinsurance undertaking”.

Amendment to section 167 (appointment of persons to carry out general investigations)

14. In section 167 (appointment of persons to carry out general investigations), in subsection (2)(c) for “, reinsurance undertaking or third-country insurance undertaking” substitute “or reinsurance undertaking”.

Amendments to section 417 of FSMA 2000 (definitions)

15. In section 417(1) (definitions)—

- (a) for the definition of “insurance undertaking” substitute—

““insurance undertaking” means—

- (a) an undertaking which is authorised by or under this Act to carry on the regulated activity of effecting or carrying out contracts of insurance as principal, or
 - (b) the underwriting members of the Society of Lloyd’s (within the meaning of the Lloyd’s Act 1982) taken together;”;
- (b) omit the definition of “minimum capital requirement”;
- (c) for the definition of “reinsurance undertaking” substitute—
- ““reinsurance undertaking” means—
- (a) an undertaking which is authorised by or under this Act to carry on the regulated activity of effecting or carrying out contracts of insurance that are limited to reinsurance contracts as principal, or
 - (b) the underwriting members of the Society of Lloyd’s (within the meaning of the Lloyd’s Act 1982) taken together;”;
- (d) omit the definition of “solvency capital requirement”;
- (e) omit the definition of “third-country insurance undertaking”.

Amendment to section 425 (expressions relating to authorisation in the single market)

16. In section 425 (expressions relating to authorisation in the single market), in subsection (1)(a) omit “, “Solvency 2 Directive””.

Amendments to Schedule 3 (EEA passport rights)

17. In Schedule 3 (EEA passport rights), in Part 1 (defined terms)—

- (a) in paragraph 1, omit sub-paragraph (c);
- (b) omit paragraph 3;
- (c) in paragraph 5 omit sub-paragraphs (d) and (da).

Amendments to Schedule 6 (threshold conditions)

18. In Schedule 6 (threshold conditions), in Part 1D (Part 4A permission: conditions for which the PRA is responsible in relation to insurers etc.)—

- (a) in paragraph 4A(7)—
 - (i) for “third country insurance or reinsurance undertakings” substitute “overseas insurance undertakings or overseas reinsurance undertakings”;
 - (ii) omit from “and for these purposes” to the end.
- (b) after paragraph 4A(7) insert—

“(8) In this paragraph—

“Gibraltar insurance undertaking” means an undertaking which—

- (a) has its head office in Gibraltar; and
- (b) is authorised by the Gibraltar Financial Services Commission to effect or carry out contracts of insurance (other than contracts of reinsurance) under paragraph 24 of Schedule 2 to the Financial Services Act 2019 of Gibraltar;

“Gibraltar reinsurance undertaking” means an undertaking which—

- (a) has its head office in Gibraltar; and
- (b) is authorised by the Gibraltar Financial Services Commission to effect or carry out contracts of insurance that are limited to reinsurance contracts under paragraph 24 of Schedule 2 to the Financial Services Act 2019 of Gibraltar;

“overseas insurance undertaking” means a person who—

- (a) is established in a country or territory other than—
 - (i) the United Kingdom, or
 - (ii) Gibraltar;
 - (b) is not an authorised person;
 - (c) is not an authorised person for the purposes of the Financial Services Act 2019 of Gibraltar; and
 - (d) effects or carries out contracts of insurance as principal;
- “overseas reinsurance undertaking” means a person who—
- (a) is established in a country or territory other than—
 - (i) the United Kingdom, or
 - (ii) Gibraltar;
 - (b) is not an authorised person;
 - (c) is not an authorised person for the purposes of the Financial Services Act 2019 of Gibraltar; and
 - (d) effects or carries out contracts of insurance that are limited to reinsurance contracts as principal.”.

PART 5

Amendments to secondary legislation

Amendments to the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001

19.—(1) The Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 are amended as follows.

(2) After regulation 10C insert—

“Disclosure of information in order to publish a stress test in relation to insurance undertakings and reinsurance undertakings

10D. The PRA or a person employed who is employed by the PRA may disclose confidential information if it is necessary to do so in order to publish the outcome of a stress test conducted in respect of an insurance undertaking or a reinsurance undertaking.”.

(3) After regulation 12C insert—

“Disclosure of information in order to publish a stress test in relation to insurance undertakings and reinsurance undertakings

12D. The PRA or a person employed by the PRA may disclose confidential information if it is necessary to do so in order to publish the outcome of a stress test conducted in respect of an insurance undertaking or a reinsurance undertaking.”.

Amendment to the Financial Services and Markets Act 2000 (Variation of Threshold Conditions) Order 2001

20. In article 3 of the Financial Services and Markets Act 2000 (Variation of Threshold Conditions) Order 2001 (non-UK insurers), in paragraph (1)(b) omit paragraph (ii).

Revocation of the Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023

21. The Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023 are revoked.

Date

Two of the Lords Commissioners of His Majesty's Treasury

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