Solvency II Reform

Lead department	HM Treasury (HMT)
Summary of proposal	To make changes to key features of the Solvency II framework, to free up capital and remove barriers which disincentivise UK insurance firms from investing in long-term productive assets.
Submission type	Impact assessment (IA) – 29th September 2023
Legislation type	Secondary legislation
Implementation date	31st December 2023
Policy stage	Final
RPC reference	RPC-HMT-5299(1)
Opinion type	Formal
Date of issue	7th December 2023

RPC opinion

Rating[1]	**RPC opinion**
Not fit for purpose	Initially, the IA received an initial review notice from the RPC. The amended IA has addressed the issues affecting the SaMBA, clearly stating that insurance firms with asset values below €50 million, would not be impacted by the reforms to matching adjustment and reduction in risk margin. However, the EANDCB is still insufficiently substantiated. Some of the main impacts included do not have sufficient supporting discussion to justify them being classified as direct impacts, e.g., the annual £300 million reduction in premium payments. There also appears to be an over-reliance on KPMG's study, which is cited multiple times. Much of the figures underpinning the EANDCB have not only been drawn from this single study but the calculations to arrive at the figures are also not adequately explained or justified.

[1] The RPC opinion rating is based only on the robustness of the EANDCB and quality of the SaMBA, as set out in the Better Regulation Framework. RPC ratings are fit for purpose or not fit for purpose.

Business impact target assessment

	Department assessment	RPC validated
Classification	Qualifying provision (IN)	-
Equivalent annual net direct cost to business (EANDCB)	-£394.6 million	-
Business impact target (BIT) score	-	-
Business net present value	£3.4 billion	
Overall net present value	£3.4 billion	

RPC summary

Category	Quality[2]	RPC comments
EANDCB	**Red**	The IA uses an appropriate counterfactual and has been transparent about its inability to fully quantify all direct costs and benefits due to the legislation relying on action from the PRA. However, some of the main impacts included in the EANDCB do not have sufficient supporting discussion to justify them being classified as direct impacts and there is a lack of explanation both in the KPMG report and the IA, to substantiate the estimate of impacts provided.
Small and micro business assessment (SaMBA)	**Green**	The SaMBA now clearly states that insurance firms with asset values below €50 million, would not be impacted by the reforms to matching adjustment and reduction in risk margin. While it is made clear that the policy would not directly impact SMBs, it would be beneficial for the SaMBA to discuss how freeing up investment may provide more opportunities for smaller and potentially more innovative businesses, to secure funding.
Rationale and options	**Good**	The IA clearly sets out the problems with the current Solvency II regime, underpinned by supporting evidence from the 2020 Call for Evidence and 2022 consultation responses. The IA explains why regulatory intervention is necessary to address the problems under consideration, as opposed to firm-led change. The IA also discusses the suitability of each option in addressing the problems under consideration.
Cost-benefit analysis	**Satisfactory**	The IA sets out one-off and annual costs and remains transparent about where full quantification

[2] The RPC quality ratings are used to indicate the quality and robustness of the evidence used to support different analytical areas. Please find the definitions of the RPC quality ratings here.

		has not been possible. Much of the analyses have been underpinned by supporting work by KPMG and potential risks of the reforms have been explored, with risk mitigation measures also having been discussed. However, the IA appears to be over-reliant on KPMG's analyses.
Wider impacts	**Satisfactory**	The IA explores a number of wider impacts including trade, competition and productivity. The identified wider impacts are largely deemed to be positive or negligible (e.g., trade impacts), with the exception of the public sector impact to the PRA, as the PRA will be responsible for conducting its own full assessment of costs and benefits resulting from the reforms. However, the IA could be understating potential impacts on the UK in attracting international investment.
Monitoring and evaluation plan	**Satisfactory**	The IA states that the department will conduct a PIR of both the risk margin and matching adjustment reforms no more than five years from their respective implementation dates. However, the MEP could be more developed for a final stage IA.

Response to initial review

As originally submitted, the IA was not fit for purpose as the department had incorrectly classified the entirety of the now freed capital, as a direct benefit to business, while also failing to adequately consider the impacts of the margin adjustment. In addition, within the department's appraisal they had made use of incorrect present value base year in the analysis.

In response to the Initial Review Notice (IRN) issued, the department has now revised the estimated EANDCB from -£836.1 million to -£394.6 million. The department has now also used supporting analyses from KPMG to provide an estimate for annualised average cost reduction. Additionally, they have now included a figure attributable to the cost of capital saving, rather than classifying the entirety of the freed capital as the direct benefit. There is now also more discussion and consideration of the quantified impact of the matching adjustment.

Despite making these changes to the pre-IRN IA, the post-IRN IA remains 'not fit for purpose'. While the SaMBA is sufficient, the EANDCB includes large impacts without supporting evidence. The department's over reliance on KPMG's analyses[3], some areas of which remain uncertain, has meant the IA has been unable to justify key estimates (see 'EANDCB' section below for further explanation).

Summary of proposal

The current UK domestic model of financial services regulation was established by the Financial Services and Markets Act 2000 (FSMA). Under the FSMA model of regulation, the financial services regulators, the PRA and the Financial Conduct Authority (FCA), are generally empowered to develop the regulatory requirements which apply to firms in their rulebooks. The regulators operate within an overall legal framework set by government and Parliament.

When the UK left the EU, the body of EU legislation that applied directly in the UK at the point of exit, including that pertaining to financial services legislation, was onshored onto the UK statute book to ensure a functioning regime. This approach left detailed regulatory requirements in primary and secondary legislation, which under a FSMA model of regulation should normally sit in the regulators' rules. The UK's departure from the EU led to a review of the regulatory framework, ensuring regulations are fit for purpose and of benefit to the UK.

On 23 June 2020, the Government announced that it would review the prudential regulatory regime underpinning the UK insurance sector: Solvency II. Solvency II aims to ensure the safety and soundness of the UK insurance sector. It sets capital requirements (how much capital they need to hold to cover their liabilities) and what types of assets they can invest in to ensure insurers can meet future liabilities.

[3] 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)

The Government is making changes to key features of the Solvency II framework to free up capital and remove barriers which disincentivise UK insurance firms from investing in long-term productive assets. The IA considers the following options:

- Option 0 (Do Nothing) – Do nothing and leave the existing EU-derived regime in legislation.
- Option 1 – Revoke all Solvency II retained EU law, for the regime to be prescribed solely in regulator rules, empowering the regulator to implement all reforms.
- Option 2 – Revoking the retained EU law but restating the existing regime in UK statute without undertaking reforms.
- Option 3 (Preferred Option) – Legislating to implement reforms and revoke retained EU law, with some areas remaining on the statute book but most of the regime moving to the regulator rule book.

For the preferred option, the IA estimates a net present value (NPV) of approximately £3.4 billion over the appraisal period (2019 prices). The overall annualised average cost reduction is estimated to be £513.3 million. Against the transitional costs expected, the department's best estimate for the overall cost savings across the sector is £4.3 billion over 10 years. The IA estimates an EANDCB figure of -£394.6 million (2019 prices) and a business NPV figure approximately of £3.4 billion.

EANDCB

The IA's 'Do Nothing' counterfactual option is described as a continuation of the status quo (Solvency II retained EU law remains on the statute book) and is therefore an appropriate baseline against which to assess the other options.

One-off implementation costs which include familiarisation, training and staffing, were calculated based on estimates provided by firms, with a mean cost of approximately £116,700 being calculated across these firms. The IA provides high and low impact estimates for implementation costs across the sector, with the former calculated based on the assumption that all firms would incur the same cost and the latter calculated based on there being a variation in costs across firms, e.g., some firms may have already implemented some of the proposed changes to risk margin, in their systems. In addition, the IA's 'best estimate' (£31.4 million) for direct one-off implementation costs arising from the risk margin SI, is based only on a simple average of the high and low impact estimates. The IA should explain how the disparities in costs across firms were calculated and explore alternative ways to build a more bespoke and robust central ('best') estimate.

The department's assessment of the likely costs and benefits arising from the Solvency II reform measures, has been informed by analysis produced by KPMG – a paper that the IA appears to heavily rely on. The main impacts included in the EANDCB are:

- One-off £300 million cost of capital saving from the risk margin reform;
- £200 million annual increase in investment income from the matching adjustment reform; and
- £300 million annual reduction in annuity and non-life premiums achieved by reduction in capital cost by risk margin reform and increase in return by matching adjustment reform.

There is a significant lack of analysis, evidence and explanation on the magnitude of the impacts included in the EANDCB (see bullet points above). The IA's reliance on the KPMG report would be acceptable, provided the IA presented a detailed discussion on how the results were calculated. However, this is not provided in the IA, nor can it be found in the KPMG report. Figures 2.2 and 2.3 in the KPMG report include crucial estimates, but there is no explanation on how these figures are arrived at. The IA must also provide evidence to support its decision to classify investment income that is dependent on firms choosing to invest, as direct. Changes to investment strategies resulting from direct balance sheet impacts due to the reform measures, should be classified as second-order impacts.

The IA states that it has not been possible to fully quantify all the direct costs and benefits arising from reforms to the matching adjustment framework, as this legislation relies on action from the PRA to implement the reforms. The IA states that the PRA will conduct a consultation and full assessment of costs and benefits, for reforms to the matching adjustment framework; however, the IA attributes a £200 million annual benefit to this without sufficient underlying evidence or explanation. In addition, the IA briefly explains that any expected increases in investment as a result of the reforms, would be treated by the department as indirect impacts.

SaMBA

Instead of using RPC guidance to define small, micro and medium-sized businesses, the IA classifies these businesses as solo entities with asset values of less than €50 million and headcounts of less than 250 employees, based on the definitions in the Government's small to medium-sized enterprise action plan[4]. The SaMBA makes clear that insurance firms with asset values below €50 million, would not be impacted by the reforms to matching adjustment as they would not have regulatory approval to use the matching adjustment. Similarly for the reduction in risk margin, businesses that fall below the threshold for the regulation under the reformed Solvency II regime, would be exempt. The IA's analysis found an aggregate reduction in the risk margin of approximately £25-30 million for insurance firms with assets below €50 million; the IA states this was estimated using firm portfolios and economic conditions as of year-end 2022. However, it remains unclear how this aggregate reduction in risk margin was calculated.

[4] FCDO Small to medium sized enterprise SME action plan.

While it is now made clear that the policy would not directly impact SMBs, it would be beneficial for the SaMBA to discuss how freeing up investment may provide more opportunities for smaller and potentially more innovative businesses, to secure funding. In addition, the department should consider how SMBs, while not directly impacted by the changing requirements, will be impacted by the response of larger businesses to the changing measures, e.g., competition impacts.

Rationale and options

Rationale

The IA provides detailed information on the policy background and results from the 2020 Call for Evidence (CfE) where respondents including insurers, highlighted the rigidity and unsuitability of Solvency II, to the UK insurance sector. The IA explains that specific features of the matching adjustment were found to be suboptimal for investment in long-term productive assets such as infrastructure. The rationale further highlights that the current Solvency II risk margin appears to be too large and sensitive to underlying interest rates, which has the potential to restrict flexibility for insurer balance sheets, in turn raising the cost of capital with impacts on business pricing. This is strongly supported by evidence from the PRA and the Government consultation which launched in April 2022 and had a high response rate from those in the UK insurance market. However, it should be noted that April 2022 is now approaching 2-years ago and at the beginning of 2022, interest rates were still below 1 per cent; it would therefore be helpful to know if the consensus figure would still be as high if consultees were asked today.

The rationale for intervention also states that for insurers to maintain a 25 per cent share in infrastructure investments, they would need to double their investments in infrastructure to approximately £8 billion per annum over the next 10-years. It would be beneficial to understand how this estimate of £8 billion to maintain a 25 per cent share, has been derived.

Options

The IA explains why market-based innovation and firm-led change would not be appropriate to deliver the intended outcomes, further highlighting why regulatory reform is best placed to address the problems under consideration. The IA discusses the suitability of each option in addressing the problems under consideration and aligning with the policy objectives set out. For example, the IA explains that Option 2, which involves legislating to restate the existing Solvency II regime, could fail to deliver on the objective of encouraging innovation and competition and supporting insurance firms in providing long-term capital for greater economic growth. The IA sets out that a significant proportion of stakeholders who responded to the consultation, also supported reforms to Solvency II. The IA explains the phased approach to implementation of the reformed Solvency II regime, is based on findings

from industry engagement. The IA additionally discusses the merits of the department and the PRA working together under the preferred option (Option 3), instead of the PRA acting alone, which would have been the case under Option 1.

Cost-benefit analysis

The IA explains that the implementation of the reduced risk margin formulation is expected to have a negligible cost, based on what the surveyed firms have stated as well as this being a one-off change in the calculation of capital requirements. Similarly, one-off familiarisation costs are expected to be minimised due to the amount of time firms have had to engage with the reforms; for example, the IA states that the Government consulted on the new approach, held various industry roundtables to gather feedback and published draft SIs to implement the Solvency II reforms in June 2023.

The department's internal projection of annual costs (£9.2 billion of capital release resulting from a reduction in risk margin) is supported by analyses from the PRA and the Government Actuary's department and is based on insurers' regulatory returns and interest rates as of end-June 2023. However, analyses conducted by KPMG estimated a slightly lower day 1 release of financial capital (£8.5 billion). The IA explains the differences between KPMG's approach and the department's internal approach to the calculation of capital release. In summary, KPMG analyses uses an annuity cashflow model and utilises the Green Book's productivity discount rate of 3.5 per cent, along with the long-term CPI assumption of 2 per cent. The department's internal analysis uses the OBR's forecasts for real GDP growth as a proxy for future anticipated growth in the level of insurance business.

With regards to transition costs for the removal of the cap on the amount of capital benefit that sub-investment grade assets accrue under the matching adjustment, the department has chosen to exclude this cost from the final EANDCB figure based on current evidence being purely anecdotal. For the annual costs associated with the matching adjustment framework, the IA states that the cost of writing new business that is eligible for the matching adjustment will be reduced by the changes implemented by the SI; this is supported by KPMG's estimate that the increased investment income would amount to a £100 million impact over one year and the department assumes this £100 million impact will be repeated in future years as more business is written, based on an annuity cashflow model. The department's risk margin analysis also assumes that the overall size of new business written will grow approximately in line with the OBR's forecasts for real GDP growth, which has been used as a proxy for growth in the insurance sector.

The IA discusses potential risks of the reforms. For example, it states that a reduction in the risk margin would reduce capital requirements, which could result in some reduction in financial resilience. The IA is transparent about the PRA's

estimate that the reforms would raise the annual risk of insurers failing, from 0.5 (pre-reforms) to 0.6 per cent. The IA sets out a number of risk mitigation measures including a requirement for insurers to conduct regular stress testing exercises, with the PRA being allowed to publish the results of individual firms. The IA additionally explores the risk that reallocating capital to assets with highly predictable cashflows could reduce demand for bonds that may not be met by other investors. However, using supporting data from the ONS, the IA labels this a low risk due to the pension sector historically being an active buyer of bonds and foreign investors consistently holding approximately 30 per cent of gilts; it's therefore assumed that these parties would absorb some of the lost domestic demand over the medium-term.

Wider impacts

Productivity

The IA identifies various wider impacts and includes detailed commentary. Potentially positive productivity impacts are discussed using analyses produced by KPMG and the IA details the mechanisms through which productivity could be boosted. For example, the IA states that through efficient transfer of risk, households and businesses could consume more of other goods and services and invest capital back into the economy. Potential third order benefits of investments in decarbonisation and infrastructure projects are discussed, which is supported by the work of the Investment Delivery Forum run by the Association of British Insurers.

Public sector impact to the PRA

The IA briefly explains that the reforms will have resource implications and costs to the PRA across its various functions; however, the full extent of these costs are currently unknown as the PRA is conducting its own assessment of costs and benefits. In addition, the IA should consider any impacts to the UK's public sector, if there are knock-on effects to the bond market resulting from the measures.

Competition Assessment Checklist

The IA provides answers to the four questions set out in the Competition and Markets Authority's competition checklist. The IA states that no areas of concern were identified by the four questions and that the removal of regulatory requirements that have been identified as restrictive and burdensome, would be associated with greater competition, productivity and economic growth. As negative competition impacts were not identified, an in-depth competition assessment has not been conducted.

Inflation

The IA should consider potential asset price inflation impacts as a result of firms changing their investment strategies in response to the release of capital.

Trade

The IA briefly discusses potential trade implications; however, concludes that the reforms will not pose any barriers to international trade. The IA explains that this is due to the reforms not introducing any new differential requirements for domestic and foreign businesses. However, given the magnitude of the capital expected to be freed, the IA should discuss how this may attract new international investment; the IA should clarify this to allay fears there may be some displacement within the UK.

Furthermore, the IA should explore the impact of the risk of divergence from EU plans to reform Solvency II. While UK and EU plans may have similar objectives, they may use different tools which could create potential for divergence between the two jurisdictions, hence the impacts of any divergence should be considered. The IA should also clarify whether the released capital and subsequent investment would be international or domestic.

Monitoring and evaluation plan

The IA states that the department will conduct a PIR of both the risk margin and matching adjustment reforms no more than five years from their respective implementation dates. Furthermore, the IA briefly outlines ways the department will monitor and evaluate the effectiveness of the reforms, against the policy objectives set out. This includes close engagement between the department and the UK insurance sector to track investments in productive assets by firms and using PRA aggregated regulatory data supplied by UK authorised insurance firms, to monitor how investments change over time. In addition, under the reforms, the PRA will be responsible for the supervision of firms in upholding prudential standards, as the reforms which will be set directly in statute, will subsequently be transferred to the PRA's rulebook. The PRA is expected to have a number of additional supervisory measures to monitor the impact of the reforms and will undertake its own evaluation of the impacts of the reforms. The department has stated that it will consider the PRA's evaluation when conducting its own review and remains open to making further changes if the objective to increase productive investments, is not being met.

Regulatory Policy Committee

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