Title: Solvency II Reform **RPC Reference No:** RPC-HMT-5299(1) **Lead department or agency:** HM Treasury **Other departments or agencies:** N/A	Impact Assessment (IA) **Date:** 22/11/2023 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Secondary Legislation **Contact for enquiries:** Daniel.Poxon@hmtreasury.gov.uk

Summary: Intervention and Options

RPC Opinion: Red

Cost of Preferred (or more likely) Option (in 2019 prices)

Total Net Present Social Value	Business Net Present Value	Net cost to business per year	Business Impact Target Status Qualifying provision
3396.5	3396.5	-394.6	

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

- The capital requirements for insurers are set out in the prudential regulatory regime for insurers known as Solvency II. Solvency II is retained EU law which will be revoked by the Financial Services and Markets Act 2023.
- The regime is overly rigid and does not work as well for the UK market as it could on the following grounds:
  - The capital buffer known as the **risk margin** is too high and too volatile, tying up capital and incentivising offshore reinsurance, with a consequent negative impact on the UK economy.
  - Insurers can adjust the rate used to discount liabilities where liabilities are matched with assets with fixed cashflows, a Solvency II concept known as the **matching adjustment**. Costly restructuring of assets to create fixed cashflows hinders investment in otherwise suitable assets.

What are the policy objectives of the action or intervention and the intended effects?

- Cutting the capital buffer known as the risk margin by around 65% for life insurance business and 30% for general insurance business is intended to:
  - Free up substantial capital, removing a barrier to lower product prices and higher annuity yields;
  - Safeguard against the risk margin becoming too large and volatile when interest rates are low; and
  - Ensure that insurers still hold sufficient assets to transfer their liabilities to another insurer if required.
- Permitting insurers to adjust the rate used to discount liability cashflows that match asset cashflows that are not fixed is intended to increase investment in long-term productive assets.
- Maintaining the current design and calibration of the benefit insurers receive for matching asset and liability cashflows is intended to safeguard these economic benefits.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

- The Government has considered:
  - **Doing nothing (option 0).** The Government could choose not to commence the relevant provisions of the Financial Services and Markets Act 2023 to revoke current legislation so that firms continue to operate under the EU retained regime. This would not address the problems outlined above and would therefore fail to realise the Government's policy objectives.
  - **Revoke and replace with regulator rules (option 1).** Rather than legislating for the new reforms, the Prudential Regulation Authority (PRA) could instead address the identified issues in its rules. PRA action would be unlikely to fully realise the Government's policy objectives as its action is constrained by its primary statutory objectives.
  - **Revoke and legislate to restate the existing regime (option 2).** As the Financial Services and Markets Act 2023 will revoke current EU retained legislation, new legislation would be required to used the existing rules. This would prevent reform of overly stringent capital requirements.
  - **Revoke and legislate to reform the regime (option 3).** This option is preferred as it allows the Government's wider economic objectives to be reflected in the prudential regulatory regime for insurers in a manner that the regulator is unable to achieve.
  - Non-regulatory options are not appropriate as the problems under consideration relate to how the existing regulatory system operates. Non-regulatory options are unable to impact on the capital which insurers are required to hold.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date: Q4** 2028				
Is this measure likely to impact on international trade and investment?		No		
Are any of these organisations in scope?	**Micro** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)		**Traded:** **N/A**	**Non-traded:** **N/A**	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible minister: Bim Afolami Date: 07/12/2023

Summary: Analysis & Evidence

Policy Option 0

Description: Do nothing and leave the existing EU-derived regime in legislation

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
2023	2023	10	**Low:** 0.0	**High:** 0.0	**Best Estimate:** **0.0**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Best Estimate	**0.0**		**0.0**	**0.0**

Description and scale of key monetised costs by 'main affected groups'

In the absence of intervention, the existing EU-derived Solvency II regime would continue to apply. UK insurance firms would continue to incur business-as-usual compliance costs (e.g., staffing, training, engagement with regulators) in observing these regulatory requirements but doing nothing will not change this cost. The problems identified in consultation with industry would persist (resulting in opportunity costs).

Other key non-monetised costs by 'main affected groups'

Nil.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Best Estimate	**0.0**		0.0	**0.0**

Description and scale of key monetised benefits by 'main affected groups'

Doing nothing would leave the existing EU-derived Solvency II regime in legislation. UK insurance firms would continue to operate under the same regulatory rules (governing the types of assets insurers can invest in and balance sheet capital requirements). There are high levels of industry awareness and understanding of how the existing Solvency II regime operates. Maintaining the status quo would deliver continuity and certainty for industry given the high levels of industry understanding of how the existing Solvency II regime works.

Other key non-monetised benefits by 'main affected groups'

Nil.

Key assumptions/sensitivities/risks	**Discount rate**	n/a

Nil.

BUSINESS ASSESSMENT (Option 0)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m:
Costs: 0.0	**Benefits:** 0.0	**Net:** 0.0	0.0

Summary: Analysis & Evidence Policy Option 1

Description: Revoke all Solvency II retained EU law, for the regime to be prescribed solely in regulator rules, empowering the regulator to implement all reforms

FULL ECONOMIC ASSESSMENT

Price Base	PV Base	Time Period	Net Benefit (Present Value (PV)) (£m)		
Year 2023	Year 2023	Years 10	Low: 0.0	High: 0.0	Best Estimate: 0.0

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Best Estimate	0.0	0.0	0.0

Description and scale of key monetised costs by 'main affected groups'

Revoking legislation on the EU derived Solvency II regime and transferring the full reform process to the PRA would lead to implementation, IT and training costs as UK insurance firms adjust to reformed regulatory requirements. It is not possible to provide an EANDCB as it would be contingent on subsequent policy development by the PRA.

Other key non-monetised costs by 'main affected groups'

Nil.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Best Estimate	0.0	0.0	0.0

Description and scale of key monetised benefits by 'main affected groups'

This option would support a more proportionate and flexible prudential regulatory regime for UK insurance firms. However, the PRA would be constrained by its primary statutory objectives. For example, the PRA indicated that they would consider changing the methodology and calibration of the fundamental spread to incorporate market measures of credit risk, in combination with the cuts to the risk margin. This could have resulted in higher capital requirements for firms. The Government considered this additional prudence unnecessary and that it would fail to deliver the full extent of reform required. This reduces the relative benefits of this approach which are not possible to quantify as they would have been dependent on further policy development and consultation by the PRA.

Other key non-monetised benefits by 'main affected groups'

Nil.

Key assumptions/sensitivities/risks	Discount rate	n/a

Nil.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m:
Costs: 0.0	Benefits: 0.0	Net: 0.0	0.0

Summary: Analysis & Evidence Policy Option 2

Description: Revoking the retained EU law, and legislating to restate the existing regime

FULL ECONOMIC ASSESSMENT

Price Base	PV Base	Time Period	Net Benefit (Present Value (PV)) (£m)		
Year 2023	Year 2023	Years 10	**Low:** 0.0	**High:** 0.0	**Best Estimate:** 0.0

COSTS (£m)	**Total Transition** (Constant Price) Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Best Estimate	0.0	0.0	**0.0**

Description and scale of key monetised costs by 'main affected groups'

Repealing EU retained law and legislating to restate the existing prudential regime would have the same practical effect as Option 0. Regulatory requirements and practices would be unchanged. We would expect the marginal cost of this approach, relative to the counterfactual, to be negligible for firms and absorbed into business-as-usual compliance costs (e.g., staffing, training, engagement with regulators). Overly stringent capital requirements would not be reformed (resulting in opportunity costs).

Other key non-monetised costs by 'main affected groups'

Nil.

BENEFITS (£m)	**Total Transition** (Constant Price) Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Best Estimate	0.0	0.0	0.0

Description and scale of key monetised benefits by 'main affected groups'

This option would, in practice, maintain the status quo with UK firms subject to the same regulatory rules inherited from the EU. This option would deliver continuity and certainty for industry given the high levels of understanding of how the existing Solvency II regime works.

Other key non-monetised benefits by 'main affected groups'

Nil.

Key assumptions/sensitivities/risks **Discount rate** n/a

Nil.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m:**
Costs: 0.0	**Benefits:** 0.0	**Net:** 0.0	0.0

Summary: Analysis & Evidence Policy Option 3

Description: 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

FULL ECONOMIC ASSESSMENT

Price Base	PV Base	Time Period	Net Benefit (Present Value (PV)) (£m)		
Year 2023	**Year** 2023	**Years** 10	**Low:** 2689.2	**High:** 6776.9	**Best Estimate:** 4327.2

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	22.9	-803.3	-6776.9
High	41.9	-320.0	-2689.2
Best Estimate	31.4	-513.3	-4327.2

Description and scale of key monetised costs by 'main affected groups'

Our best estimate of transition costs for the insurance sector as a result of risk margin reform is **£31.4m**. This includes costs arising from implementation and familiarisation, training, staffing, changes to calculation engines, new IT systems and pricing models.

Drawing on analysis from KPMG[1], 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, and a **£200m** one-year impact as a result of the matching adjustment reforms achieved by our legislation. The overall cost savings across one year sum to **£800m**. The impacts from writing new business, worth **£500m**, repeat for each year and increase in line with growth in the sector. We use real projected GDP growth as a proxy for growth of the insurance sector.

Overall the annualised average cost reduction is estimated to be **£513.3m.** Against the transitional costs expected, our best estimate for the overall cost savings across the sector is **£4,327.2m** over 10 years.

Other key non-monetised costs by 'main affected groups'

No further costs from the legislation have been identified. The costs expected from new regulator rules on the matching adjustment are assessed in the cost benefit analysis published as part of the regulator's consultation on its new rules.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	0.0	0
High	0	0.0	0
Best Estimate	0	0.0	0

Description and scale of key monetised benefits by 'main affected groups'

To avoid double counting, we have treated the productivity impact from the legislation as a negative cost, rather than a benefit.

Other key non-monetised benefits by 'main affected groups'

Firms across the sector have made public commitments that reform of the matching adjustment will allow them to invest around £100bn in productive assets over the next ten years.

[1] 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)

Key assumptions/sensitivities/risks	Discount	3.5%
• The capital release resulting from the risk margin reduction was modelled on firms' reported figures and interest rates at end-June 2023 on the basis of the cut being made instantaneously at that point in time. We do not anticipate a material change to these conditions and therefore the results when firms implement the reforms at the end of this year. • Future PRA policy and rules, insurers' independent commercial decision-making and future economic conditions are all key dependencies on the impact of the reforms.		

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			Score for Business Impact Target (qualifying provisions only) £m:
Costs: -502.7	**Benefits:0**	**Net: -502.7**	**-1972.9**

Evidence Base

1. Problem under consideration and rationale for intervention

1.1 Policy Background

1.1.1 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 Prudential Regulation Authority (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.

1.1.2 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 afforded a historic moment to review the regulatory framework, ensuring regulations are fit for purpose and of benefit to the UK.[1]

1.1.3 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.

1.1.4 The review was launched based on the following objectives:

- to spur a vibrant, innovative, and internationally competitive insurance sector;
- to protect policyholders and ensure the safety and soundness of firms; and
- to support insurance firms to provide long-term capital to support growth.

1.1.5 A Call for Evidence (CfE) was published in October 2020 to which 64 respondents (made up primarily of insurers, reinsurers, industry representative bodies, consultancies, members of the public, and other organisations) provided evidence. Overall, the responses to the CfE provided extensive evidence that certain key features of Solvency II are overly rigid, disproportionate, and ill-adapted to the UK insurance sector. This is because the Solvency II regime is the result of a compromise, designed for 28 EU member states rather than designed specifically for the UK. A substantial focus of the evidence related to the matching adjustment and the risk margin.

1.1.6 The matching adjustment is a component of Solvency II designed to incentivise life insurers to invest in long-term assets which provide incoming cashflows that 'match' their outgoing cashflows from their long-term liabilities to policyholders.[2] When their assets and liabilities are matched in this way, insurers are allowed to

[1] Building a smarter financial services framework for the UK .pdf (publishing.service.gov.uk)

[2] As the matching adjustment relates to the management of long-term assets and liabilities, it is used by life insurers rather whereas general insurers typically conduct business (e.g., motor, home) to shorter timespans, for whom the matching adjustment will be less relevant.

discount the valuation of their long-term liabilities thereby reducing the capital required to be held against those liabilities. The matching adjustment effectively allows insurers to recognise capital upfront (that will be earned over time) on long-term assets; a reflection of the fact that life insurers face fewer short-term liquidity pressures.[3]

1.1.7 The matching adjustment has a large influence on investment decisions as it incentivises insurers to hold matching adjustment eligible assets given the significant capital benefit they accrue on balance sheets. Analysis from the PRA highlights the significant differential benefits that some assets generate over others, which may contribute to the fact that a relatively small proportion of firms' asset holdings are driving most of their matching adjustment benefit.[4]

1.1.8 The matching adjustment is of outsized importance to the UK insurance sector when compared with other jurisdictions due to its structural features such as its uniquely large annuity market.[5]. UK life insurers' balance sheets benefitted from the matching adjustment by c. £81bn as at year end 2020.[6] Whereas only one EU member state's insurance sector (Spain) makes material use of the matching adjustment.[7]

1.1.9 Certain design features of the matching adjustment were found to be suboptimal for investment in long-term productive assets, such as infrastructure.[8] For example, investments in infrastructure (which often come with prepayment risk or construction phases) may be ineligible for matching adjustment treatment as cashflows may not be fixed in timing or amount. Under the current fixity requirement, insurers often must restructure these assets (adding additional cost and complexity) so that they can be included in matching adjustment portfolios. Assets below 'BBB' (a credit rating), which some productive assets may qualify as, were also found to receive disproportionately severe treatment under the matching adjustment.

1.1.10 The Solvency II risk margin (which sets minimum limits on the capital insurers need to set aside to transfer their book of business to another insurer if required) was also found to be too large and sensitive to underlying interest rates, this restricts flexibility for insurer balance sheets, raises the cost of capital and impacts business pricing.

1.1.11 The Government agreed with this evidence. Highly liquid, low-yield assets predominate in insurers investment portfolios relative to longer-term, illiquid assets that could yield better returns and broader benefits for society.[9] For example, an analysis of firm's investment portfolios at year-end 2020 carried out by the Prudential

[3] Also known as **'liquidity risk':** the need for insurers to provide cash or cash equivalents to meet obligations in the immediate future (<12 months). See p.6 'Liquidity Risk; the Insurance Industry's Elephant in the Room' https://www.actuaries.org.uk/system/files/field/document/B3%20EYGEN_Liquidity%20risk%20-%20The%20insurance%20industry%27s%20elephant%20in%20the%20room_v03.00.pdf Life insurers, as providers of annuity products which typically come with predictable and fixed pay-outs over long timespans, are not typically exposed to this risk.

[4] https://www.bankofengland.co.uk/speech/2022/may/charlotte-gerken-speech-at-the-19th-conference-on-bulk-annuities

[5] The matching adjustment is an important feature of Solvency II for annuity products which are backed by assets with closely matched cashflows and held for the long-term.

[6] Solvency II Review: Matching adjustment and reforms to the fundamental spread (bankofengland.co.uk)

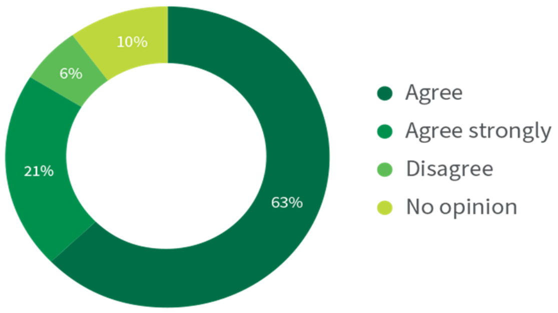
[7] Gabriel Bernardino on four important Solvency II reforms (europa.eu)

[8] **Productive investment**: defined for the purposes of this analysis as spending by businesses that has the potential to expand the productive capacity of the economy, while also generating marginal returns to society that exceed the marginal cost of that investment to society (e.g., infrastructure, plant and equipment, research and development, technologies).

[9] https://www.bankofengland.co.uk/speech/2020/anna-sweeney-speech-delivered-at-the-bank-of-america-25-european-financials-ceo-conference

Regulation Authority (PRA), found that they held c. £150 billion in corporate bonds and c. £30 billion in sovereign UK bonds. By comparison, investment in longer-term productive assets including in infrastructure, totalled c. £22 billion.[10] This is despite insurers having expressed a strong appetite to invest in infrastructure (see Figure 1) due to a range of reasons including meeting stronger yields, ESG policies, portfolio diversification, and hedging against inflation.[11]

Figure 1 – Insurers have expressed considerable appetite to invest in infrastructure



Source: BearingPoint, Infrastructure Journal

1.1.12 The Government further consulted the sector in April 2022 to seek views on the potential reforms identified to address these challenges and evidence their likely impact. The consultation received a total of 67 responses (representing a very significant share of the UK insurance market).[12] After considering the evidence provided by the consultation respondents, that of the PRA, as well as its own analysis, the Government published its consultation response in November 2022, setting out the key features of the final Solvency II reform package:

- Cuts to the risk margin to more proportionate levels (with a 65% cut for long-term life insurance business and 30% cut for general insurance business), freeing up substantial amounts of capital.
  - Long-term life insurance: as part of the Government's consultation in 2022[13], almost all respondents agreed that the existing risk margin is far larger than is necessary. There was broad consensus that a reduction of between 60 and 70% in recent economic conditions would not materially reduce policyholder protection and would increase insurers' own funds and improve balance sheet stability. As such, the Government set out that a cut of 65% would on balance free up substantial amounts of capital, reduce the volatility of life insurers' balance sheets, safeguard against the risk margin becoming too large and too volatile during future periods of low interest rates, and ensure that insurers hold sufficient assets to transfer their liabilities to another insurer if required.
  - General insurance: responses to the Government's consultation in 2022 confirmed that the size and volatility of the risk margin is a less important consideration for general insurers than for life insurers, predominantly due

[10] Four Rs: Creating the conditions for long-term sustainable growth in the life annuity sector – speech by Charlotte Gerken | Bank of England

[11] Building new bridges – are insurers the new banks for infrastructure investments? | BearingPoint United Kingdom

[12] In addition to submissions from individual firms, the three major trade associations, the Association of British Insurers (ABI), the Association of Financial Mutuals (AFM), and Insurtech UK all fed into the consultation on behalf of their members. ABI membership alone has previously accounted for c. 90% of UK insurance premiums - see here. https://www.abi.org.uk/globalassets/sitecore/files/documents/publications/public/2014/key-facts/abi-key-facts-2014.pdf

[13] https://www.gov.uk/government/consultations/solvency-ii-review-consultation

to differences in the duration of their liabilities. There was broad agreement that a cut of 30% would be appropriate; there would be no negative impact on policyholder protection and the cut would reduce extraneous capital requirements which do not meaningfully increasing policyholder protection.

- Changes to the matching adjustment so it is more compatible with a broader range of longer-term, less liquid asset types.
- Maintaining the existing methodology and calibration of the fundamental spread.[14]

1.1.13 The matching adjustment SI removes what is known as the 'BBB cliff edge'. The existing Solvency II regime caps the matching adjustment benefit that insurers can receive on ‘sub-investment grade’ assets (those with a credit rating below 'BBB'), which can include productive assets.[15] For example, infrastructure projects can drop to a BB rating over the construction phase but recover to investment grade at the end of the investment cycle. This disproportionately severe treatment of below ‘BBB’ credit rated assets can disincentivise investing in lower-rated assets.

1.1.14 As the penalty applied to sub-investment grade assets will be less under the new regime, this may make holding these assets more appealing for firms. Eliminating the 'BBB cliff edge' therefore benefits the economics of investing in BBB assets due to the reduction in downside should these be downgraded. This, in turn, reduces incentives for insurers to sell BBB assets in a deterioration of market conditions, limits distortion of investment decisions and minimises procyclicality (the tendency for firms to make investment decisions that compound market movements and volatility in asset prices).[16] This will have indirect benefits for financial stability.

1.2 Rationale for intervention

1.2.1 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 UK insurance industry held c. £2.2 trillion in invested assets as at Q2 2021.[17] This is a significant pool of capital (equivalent to around 81% of total UK GDP for 2022). If invested appropriately and sustainably, it holds huge potential.

1.2.2 In recent years, the private sector has financed £15-20bn of infrastructure investment each year; the insurance sector plays a crucial role in providing this. [18][19] The 2021 National Infrastructure and Construction Pipeline sets out that this finance for infrastructure will have to scale to £650bn over the next 10 years, half of which is expected to be funded privately (c. £325bn in total or 32.5bn pa).[20] For insurers to maintain a 25% share, they will need to double their investments in infrastructure to c. £8bn pa to meet this demand. An appropriate prudential regulatory regime for the UK insurance sector will underpin its ability to fulfil this important role in driving investment and economic growth.

[14] The **fundamental spread** is a key component of Solvency II which reflects the retained risk of an asset (i.e., the probability risk that the income expected to be realised from an asset does not materialise) when a firm is calculating the appropriate matching benefit that asset should accrue. Retained risk includes expected loss due to default (e.g., in the event the issuer of a bond collapses and the yield is lost). See p.8 here for further commentary: IFOA MA WP Fundamental Spread research July 2022.pdf (actuaries.org.uk)

[15] Solvency UK is born - WTW (wtwco.com)

[16] See here for detail on procyclicality What is procyclicality? | Institute and Faculty of Actuaries and here: Solvency II reforms - KPMG Global

[17] p.4, Review_of_Solvency_II_Consultation.pdf (publishing.service.gov.uk)

[18] https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/articles/developingnewmeasuresofinfrastructureinvestment/may2022

[19] PRA data

[20] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1016759/Analysis_of_the_National_Infrastructure_and_Construction_Pipeline_2021.pdf

1.2.3 Unlocking stronger investment in productive assets (research and development, technology, and infrastructure) which are less liquid but yield returns over the longer-term may support growth and innovation in the UK economy as an indirect effect. Solvency II reform could deliver broader macroeconomic benefit in supporting a greater supply of capital for longer-term projects, such as financing the transition to a net zero carbon economy and 'levelling-up' the regions of the UK, which are core Government objectives.

1.2.4 The key sectors and markets that will be directly affected by the Solvency II reforms will be authorised UK insurance firms, as well as any insurance firm intending to operate in, or provide services into, the UK. The PRA, as the regulatory authority responsible for the prudential regime for the insurance sector, will also be directly affected.

1.2.5 The Government anticipates that these benefits will broaden out to society as an additional indirect effect. A more proportionate and nimbler regulatory regime will make regulation less capital intensive for firms. The consequent costs savings may flow through to households and businesses in the form of lower product pricing and a greater range of products on the market, enhancing consumer choice and the penetration of insurance services in society.

1.2.6 Greater access to insurance products for individuals helps to build financial resilience and promotes economic growth. Insurance is an efficient risk transfer and pooling mechanism. It frees individuals from risk that they would otherwise have to reserve excess savings for, promoting consumption, and cushioning the effects of financial loss. It supports businesses to invest, without reserving capital for “risks that they are not equipped to manage or diversify, and so will not be adequately rewarded for”.[21] Wider impacts from the measures in these SIs are covered at further length in the **wider impacts** section.

1.2.7 Government is best placed to deliver regulatory reform of this nature. Firms must operate within the regulatory structure defined by the PRA but which is constrained by the legislative framework for the regulation of financial services.

1.2.8 Market-based innovation or firm-led change would not be a viable way forward to deliver the intended outcomes sought here. Firms are legally bound to comply with their regulatory obligations to be authorised market participants and cannot operate outside these parameters. As they are unable to change their regulatory obligations, they are unable to resolve the barriers identified which can only be overcome with regulatory change.

1.2.9 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) in legislation.

1.2.10 The PRA will be empowered to make the necessary changes to their rules, giving full effect to the reforms in these SIs, as well as delivering further reform for the sector, including streamlined reporting and administrative requirements. The PRA will also be afforded additional supervisory measures to complement the new regime. The Government considers that this combination of Government and

[21] Ask not what the economy can do for insurers – ask what insurers can do for the economy - speech by Anna Sweeney | Bank of England

regulator intervention will strike the right balance by delivering a regulatory regime that is pro-growth and competition, while maintaining high standards of policyholder protection.

2. Description of options considered

2.1 Analysis of Options

2.2 This Impact Assessment considers the Government's preferred option of legislating directly to reform elements of the regime (**option 3**), against doing nothing (**option 0**), repealing the current Solvency II regime, and leaving reform entirely to the PRA (**option 1)**, and legislating to retain the existing regime (**option 2**).

2.3 Option 0 - do nothing

2.3.1 The Financial Services and Markets Act 2023 contains provisions to repeal Solvency II retained EU law. Further SIs need to be laid to commence these provisions in the Financial Services and Markets Act 2023. This needs to take effect at the same time as new legislation (i.e., reforms to the risk margin and matching adjustment) and regulator reforms come into force.

2.3.2 The Government could choose not to lay the SIs so that revocation is not commenced. In this scenario, Solvency II retained EU law would continue to apply and remain on the statute book.

2.3.3 As a continuation of the status quo, this option would not result in additional costs for firms. For example, firms would avoid costs associated with familiarisation, training, and system changes arising from the transition to a new regime if the existing Solvency II regime remains in force.

2.3.4 In the absence of a policy intervention, features of the current Solvency II regime, which evidence suggests are suboptimal for the UK insurance market, would fail to be reformed.

2.3.5 An outcome which sees Solvency II retained EU law remain on the statute book lacks flexibility. Currently, Solvency II requirements can only be amended by primary or secondary legislation. It is more appropriate that these detailed regulatory requirements eventually move into regulators' rules, where they will be easier and less resource-intensive to update. This is in line with wider government policy on financial services regulation.[22]

2.4 Option 1 – repeal and replace with regulators' reforms

2.4.1 The Financial Services and Markets Act 2023 will repeal current retained EU Solvency II legislation when the relevant provisions are commenced. Rather than restating this as new legislation, the Prudential Regulation Authority (PRA) could instead address the identified issues in its rules.

2.4.2 In this outcome the prudential regulatory requirements would be removed from statute and transferred to the regulator rulebook. This may risk the achievement of

[22] A Smarter Regulatory Framework for financial services - GOV.UK (www.gov.uk)

the desired public policy objectives, owing to the regulator's requirement to act in accordance with its statutory objectives alone.

2.4.3 The PRA set out in its discussion paper on potential reforms to risk margin and matching adjustment within Solvency II that decisions on changes to the risk margin need to be taken together with decisions on the fundamental spread when assessing the overall impact of reforms on its statutory objectives.[23] The PRA agrees that the risk margin should be reformed to deal with concerns that it is too sensitive to movements in interest rates and too high when interest rates are low, but without reform of the fundamental spread to include an additional credit risk premium, the PRA could be expected to cut the risk margin by less than the Government considers necessary.

2.4.4 The PRA would be likely to make it easier to include a wider range of assets within matching adjustment portfolios, although potentially not as extensively as the Government considers necessary.

2.5 Option 2 - legislate to restate the existing regime

2.5.1 In this scenario, the UK would maintain the current position by legislating to continue to apply the risk margin and matching adjustment elements of the Solvency II framework that currently exists in both the UK and EU.

2.5.2 There would likely be no immediate, adverse impact for UK insurance firms. We would expect the UK insurance market performance to continue in line with existing growth forecasts.[24] Retaining the existing regulatory regime is the outcome which would achieve the most certainty and minimise disruption for insurance firms as there would be no up-front transitional costs in adjusting to a new regime. The same very high standards of policyholder protection would also be maintained.

2.5.3 The Government received 64 responses to a Call for Evidence (CfE) on Solvency II reform and formally consulted stakeholders on the subject, receiving a further 67 responses.[25] [26] A very significant proportion of stakeholders called for reform to Solvency II.

2.5.4 Retaining the existing Solvency II regime would fail to address the challenges highlighted by the sector (leading to significant opportunity cost) and would not constitute an evidence-based response. It is the view of the Government that this option would fail to deliver on its objectives to spur innovation and competition and support insurance firms to provide long-term capital for greater economic growth. This would be to the long-term detriment of the UK insurance sector's competitive position (as jurisdictions with other major insurance markets, including the EU, bring forward reforms to their regulatory regime for insurers to support growth and competition).

2.6 Option 3 – legislate to reform the regime (preferred)

[23] https://www.bankofengland.co.uk/prudential-regulation/publication/2022/april/potential-reforms-to-risk-margin-and-matching-adjustment-within-solvency-ii

[24] In the absence of reform, the commercial performance of the life insurance sector is expected to be strong, with life premiums projected to grow by 1.5% in 2023 and 8.8% in 2024. https://www.ey.com/en_uk/news/2022/10/insurers-set-for-low-premium-income-growth-in-2023-due-to-rising-interest-rates-and-weakening-economic-picture

[25] Solvency II Review: Call for Evidence - GOV.UK (www.gov.uk)

[26] Solvency II Review: Consultation - GOV.UK (www.gov.uk)

2.6.1 The Government's Call for Evidence and Consultation on Solvency II yielded credible evidence that certain features of the prudential regime were suboptimal for the UK insurance sector.

2.6.2 The Government is proposing to cut the risk margin and widen the eligibility criteria of assets that can qualify for matching adjustment treatment. To note, further discussion of the assumptions and risk sensitivity built into this assessment is covered in the following section on **costs and benefits**.

2.6.3 The Government will directly legislate for these reforms through these SIs, using powers in the Financial Services and Markets Act 2023. The new reformed matching adjustment and risk margin will then be operationalised through PRA firm-facing rules and policy.

2.6.4 This option is preferred as it allows the Government's wider economic objectives to be reflected in the prudential regulatory regime for insurers in a manner that the regulator is unable to achieve.

2.6.5 Cross-references to comparable policies or international precedent is necessarily limited. This is the first major reform to prudential regulation following the UK's departure from the EU, and the purpose of the reform is to better reflect the unique structural features of the UK insurance sector for the first time (while retaining the overall regime).

3 Policy objective

3.1 Reducing the risk margin frees up substantial capital and safeguards against the risk margin becoming too large and volatile when interest rates are low, while ensuring that insurers still hold sufficient assets to transfer their liabilities to another insurer if required. This should feed into more competitive pricing supporting more affordable insurance products and greater choice for consumers.

3.2 Broadening the eligibility requirements of the matching adjustment allows insurers to match liability cashflows with a greater range of asset cashflows than is currently permitted. This incentivises insurers to allocate more capital to newly eligible assets, such as longer-term productive assets. The intention is to further reduce barriers to productive investment by removing the cap on the level of matching adjustment benefit firms can gain from ''BBB' (a credit-rating tier) and sub-investment grade assets. Assets such as infrastructure projects are frequently rated BBB (or sub-investment grade level in the construction phase) due to their amount of leverage.[27]

3.3 The trade body, the Association of British Insurers (ABI), has stated that Solvency II reform creates the potential for over £100 billion to be invested by insurers in productive assets over the next 10 years. The Government will continue working closely with the UK insurance sector on ways to track the firms' investments in productive assets. This will include engagement with the Investment Delivery Forum, convened by the ABI to drive and track new finance for long-term productive assets.[28] The Government will also continue to work closely with the PRA to track material changes in firm investment portfolios and the OBR on the long-term impact of the reforms.

[27] p.5, Solvency II – the Matching Adjustment and its effectiveness in the Covid Crisis (Institute and Faculty of Actuaries) https://www.actuaries.org.uk/system/files/field/document/ICAT%20Life1%20paper%20300721.pdf#:~:text=One%20of%20the%20permitted%20adjustments%20is%20the%20Matching,the%20liability%20cashflows%20to%20within%20a%20specified%20tolerance

[28] Solvency UK: Cross-sector co-operation to drive £100bn investment into UK projects | ABI

4 Summary and preferred option with description of implementation plan

4.1 The preferred option will be given effect through secondary legislation made under powers in the Financial Services and Markets Act 2023. The Government intends to make transitional amendments to the current regime in 2023 to implement the risk margin reforms, and further legislation on this and the matching adjustment when the current legislative regime is repealed, likely in 2024.

4.2 The Government anticipates that the end result of this reform process will be a more nimble, proportionate prudential regulatory regime that is better able to support insurers to fuel growth and innovation in the UK economy, while delivering the same outcomes as the currently retained EU Solvency II legislation with respect to financial stability and policyholder protection.

4.3 Piloting or trialling the reforms is not suitable to this policy. The Government is retaining the overall regulatory framework while making targeted, evidence-based reforms to benefit UK insurance firms (following the Call for Evidence and consultation with stakeholders on Solvency II reform). The regulatory regime will be optimised for the UK but will operate in a similar way.

4.4 Further, HM Treasury closely engaged industry and published draft statutory instruments (matching adjustment and risk margin) to support firms to prepare for the reforms, e.g. to modify and ready their systems.[29] A phased approach to implementation (see **4.7**) has also been informed by the preferences of firms and optimised to existing business cycles to ease implementation.

4.5 Flexibility of implementation is achieved under the framework created by the Financial Services and Markets Act 2023. Once the existing Solvency II legislation is repealed, most of the regime will not be restated in legislation, but instead recreated and enhanced in the PRA's Rulebook. Given how regularly the financial services regulatory framework needs to be updated, it would be neither appropriate nor feasible for the Government to retain responsibility for detailed regulation making on an ongoing basis, not least due to the constraints on Parliamentary time. Handing over these powers to the UK's independent and expert regulator, the PRA, will make it easier to make changes over time, with the aim to ensure the Solvency UK regime remains relevant and fit for purpose in the future.

4.6 The Government will continue to work closely with the PRA, to ensure the successful implementation and operation of the new prudential regulatory regime. The reform package will build in sufficient scope to allow for experimentation and adjustment, if necessary, over the long-term. For example, in five years' time, the Government will review a key component of the matching adjustment (the fundamental spread) to ensure it remains correctly calibrated and continues to deliver on the Government's objectives (to support insurance firms to provide long-term capital to support growth while maintaining high standards of policyholder protection and financial stability). Prior to this, the PRA will also undertake an analysis of the impact of the Solvency II reforms on its statutory objectives and an assessment of whether further changes are needed.

[29] Draft Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations - GOV.UK (www.gov.uk)

4.7 **Summary of legislative plans**

[This section has been redacted]

5 Monetised and non-monetised costs and benefits of each option (including administrative burden)

Direct costs and benefits to business calculations

5.1 Risk Margin

5.1.1 Reforming the risk margin to reduce it significantly (with a 65% cut for life insurers and a 30% cut for general insurers) will release capital on insurers' balance sheets, reducing the costs involved in writing insurance business. This can be used to write new business (thereby gaining more assets that can be invested), invest directly in infrastructure or other assets, or to pay out to shareholders.

5.1.2 Transition Costs

5.1.2.1 Most firms surveyed expected the revision to the risk margin formulation to be straight-forward to implement in their modelling systems (i.e., as a one-off alteration in the calculation of capital requirements) and for costs of doing so to be negligible.

5.1.2.2 One-off familiarisation costs are also expected to be minimised by the high levels of industry awareness of the new risk margin formulation. For example, HMG has consulted on the new approach, held three industry roundtables to test draft legislation and gather feedback, and published draft statutory instruments to implement the Solvency II reforms in June 2023 to maximise the time firms had to engage with the direction and substance of the reforms.[30]

5.1.2.3 Several firms did identify some costs, arising from implementation and familiarisation, training, staffing, changes to calculation engines, new IT systems and pricing models. The mean cost for these firms was c. £116,700. If it is to be assumed that all firms will incur the same cost (i.e., the c. 359 firms estimated to be subject to the new Solvency UK regime), one-off implementation costs for the sector will total c. £41,895,300). We consider this to be a maximalist estimate.

5.1.2.4 In practice, we expect one-off implementation costs to be of a far lower magnitude. Costs are likely to vary substantially across the sector.[31] The £116,700 figure does not reflect the firms that expect implementation to be absorbed within business-as-usual costs and those that have already coded the proposed changes to the risk margin into their systems. To account for this variance, our low side estimate cuts the one-off implementation cost that firms are likely to face by half (£20,947,650).

5.1.2.5 **Our best estimate, which is the average of the maximalist and low side estimates, of direct implementation costs arising from the risk margin SI is therefore found in between these two figures (£31.4m).**

5.1.2.6 Firms regularly calculate the risk margin in determining their capital requirements. Once firms revise their calculations to reduce the risk margin, this change will be reflected in their systems going forward and should not pose any direct ongoing cost that is additional to the costs a firm typically incurs when making these calculations.

[30] Draft Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations - GOV.UK (www.gov.uk)

[31] For example, this may depend on the kind of business a firm writes (i.e., if the firm is a composite insurer and therefore will have a more complicated risk margin calculation process, or if the firm is 'monoline' and writes either life or general insurance business), the quality of existing IT/modelling systems (i.e., how easy it is for a firm to update the relevant calculation process), the use of outsourcing or a third-party supplier to make the risk margin calculation, or the levels of staff training and awareness of the upcoming changes, etc.

5.1.3 Annual costs

5.1.3.1 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 by KPMG for the day 1 release of financial capital estimates a slightly lower £8.5bn.

5.1.3.2 KPMG's analysis indicates that this release of capital lowers the insurance sector's costs of doing business by £300m over the first year. A further £300m impact represents the pricing benefit to policyholders over 1 year. These figures were derived using a bottom-up approach – an annuity cashflow model. To model the productivity impact from the risk margin reduction for life insurance business, cashflow analysis on average new business (with assumed new business premium of £40bn over 1 year) was used. This involves modelling the annuity cashflows (both positive and negative, including for example the solvency capital requirement, other costs, and profit) allowing for the reformed formula for the risk margin. For general insurance, similar analysis was completed based on business assumed to have a 1-year duration (assumed new business premium of £121bn over 1 year). The assumption for insurers cost of capital (used to discount future cashflows) relies on the productivity discount rate within the HMT Green Book project appraisal real rate (3.5%) and long-term CPI assumption (2%). The risk margin reforms will have a sustained impact on insurers over-time. Our analysis has used OBR forecasts of real GDP growth as a proxy for anticipated growth in the level of insurance business written in future years.

5.1.3.3 The improvement in productivity for the insurance sector and across the economy comes in the form of lower costs incurred for the same amount of inputs. Some respondents to the Government's consultation noted that firms are unlikely to modify their investment behaviour in light of risk margin reforms, so we expect that the gains in productivity are driven by lower costs to doing business.

5.1.3.4 KPMG have provided sensitivity analysis that vary the assumed level of new business over the initial 12 months of the analysis on the impact of the reforms to the risk margin. These sensitivities have informed our 'high' and 'low' impact scenarios.

5.2 **Matching Adjustment**

5.2.1 The Government is reforming the matching adjustment (which insurers use to discount liabilities when matched with assets) to reduce frictional costs and to make it easier for firms to invest in long-term productive assets, such as infrastructure.

5.2.2 HM Treasury has made a preliminary assessment of the likely costs and benefits from the reforms enabled by the matching adjustment SI, informed by KPMG analysis. 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.

5.2.3 Direct & Indirect Benefits

5.2.3.1 It is not possible to quantify several benefits, either on a one-off or ongoing basis, arising from the SIs alone due to the dependencies on further action and decisions to be taken by the PRA.

5.2.3.2 Some firms have indicated that the new investment flexibility will encourage investment in new asset classes, which could have broader beneficial impacts on the economy. Increased deployment of long-term investment capital may improve diversification across matching adjustment portfolios, reduce concentration risk, and thereby improve policyholder protection. Industry has made public commitments that the Government's reforms to Solvency II could lead to £100bn in increased productive investment over 10 years as an indirect impact.[32] HM Treasury has also tracked the public commitments from four major UK life insurers (c. 79% market share) which, when added to the commitments mentioned above, sum to £11bn pa in total.[33] It is possible that not all these commitments are additional, as some level of investment (which would have been made in the absence of reform) is likely to be baked into these baselines. HM Treasury views the expected increased investment as an indirect effect of reform to the matching adjustment.

5.2.3.3 The quantification of either one-off or ongoing indirect benefits will also depend on how firms choose to use the increased investment flexibility provided by the SI and is also affected by broader factors such as firms' commercial priorities and the supply of suitable investments. Firms were unable to provide monetised benefits as the details of the most significant changes to the matching adjustment regime will be developed and implemented by the PRA.

5.2.4 Transition Costs

5.2.4.1 The removal of the cap[34] on the amount of capital benefit that sub-investment grade assets accrue under the matching adjustment is potentially quantifiable (as a measure that is achieved by the SI). One firm indicated costs of <£20,000 to make the required changes to its internal models to take advantage of this reform (which is permissive in nature). We consider this to be an upper bound estimate, with costs varying across the sector and likely to be highly firm-specific.[35] Several firms engaged did not report any costs associated with the measure. HM Treasury therefore chose not to include this cost in the final EANDCB figure on the basis that it was anecdotal.

5.2.5 Annual costs

5.2.5.1 The costs of writing new business that is eligible for the matching adjustment will be reduced by the changes implemented by the SI. 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. This is based on annuity cashflow model with similar assumptions as used for the risk margin analysis described above, and is based on an assumed average asset mix for a matching adjustment

[32] https://www.abi.org.uk/news/news-articles/2022/11/solvencyiireform/

[33] Quantified commitments: Legal & General Capital (LGC): £20bn over 10 years; Aviva: £25bn over ten years; Phoenix: £20bn over 5 years; Pension Insurance Corporation (PIC): £20bn over 8 years.

[34] Referred to as the 'BBB Cliff'

[35] For example, the majority of firms have limited sub-investment grade assets in their portfolios, or they may assume in their internal model will assume that downgraded investments are sold and replaced with investment grade assets (and therefore the BBB cliff would have no impact, and the internal model would not require any updates). These firms may therefore not incur the cost associated with remodelling to reflect the new matching adjustment changes.

portfolio for annuity business. While there will be some impact on existing matching adjustment business, this is assumed to be immaterial as the impact will largely relate to new investment decisions taken relating to new business. Therefore it is assumed in HMT analysis that the £100m impact is repeated in future years as more new business is written. As for the risk margin analysis we have assumed that the overall size of new business written will grow roughly in line with OBR forecasts for real GDP growth (as a proxy for growth in the insurance sector).

5.2.5.2 Currently, only assets with fixed cashflows are eligible for matching adjustment treatment[36], making productive assets (which often have less fixed cashflows and more uncertain time horizons) ineligible. Firms often have to restructure these assets to obtain a matching adjustment benefit. The costs involved in restructuring for MA eligibility purposes can vary significantly by firm and by the complexity of the case, but can be significant[37] and recurring under the current regime. By broadening the eligibility criteria to include assets with 'highly predictable' cashflows, this may remove the need for insurers to engage in this prohibitively costly exercise, thereby reducing frictional costs associated with the MA framework.

5.2.5.3 KPMG have assessed the impact of the broadening of the matching adjustment eligibility requirements on the productivity of firms using the matching adjustment. This analysis is based on an annuity cashflow model similar to the risk margin modelling. 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. If firms do not take full advantage of the 10% allocation permitted for investment in assets with highly predictable cashflows, we would expect the cost reductions to be smaller. Drawing on KPMG's analyses this is captured in the 'higher' projected costs in our EANDCB figures. The impact of these changes on existing matching adjustment business is assumed to be immaterial. Therefore it is assumed in HMT analysis that the £100m impact is repeated in future years as more new business is written. As for the risk margin analysis we have assumed that the overall size of new business written will grow roughly in line with OBR forecasts for real GDP growth (as a proxy for growth in the insurance sector).

5.2.5.4 KPMG have completed sensitivity analysis that considers alternative levels of new business, alternative investment returns on newly eligible assets, and alternative investment allocations on new business. These sensitivities have been reflected in our high/low impact scenarios.

6 Impact on Small, Micro and Medium Sized Businesses

6.1 The measures will positively impact small, micro and medium sized businesses, which for the purposes of this analysis we have identified through quarterly regulatory reporting as those solo entities with asset value less than €50m (as per the definitions in the small to medium sized enterprise action plan) as at YE22. This comprises c.80 insurance firms that write both non-life and life insurance business [two micro; 20 small; 56 medium].

6.2 Risk Margin

[36] Other than in very limited exceptions (e.g. inflation-linked assets, where those assets were used to match against inflation-linked liabilities)

[37] For example, one insurance firm provided evidence to the Treasury Select Committee in 2017 that they had spent 'over £3m' setting up a solution to allow a certain class of asset to be held in an MA portfolio SOL0047 - Evidence on EU Insurance Regulation (parliament.uk)

6.2.1 The analysis finds an aggregate reduction in the risk margin of around £25-30m (effectively, a capital release) for insurance firms with assets below €50m. This impact has been estimated using firm portfolios and economic conditions as at YE22. The costs of implementation would be negligible when compared to this capital release, and firms that fall below the threshold for regulation under Solvency II would in any event be exempt.

6.3 Matching Adjustment

6.3.1 None of the insurance firms with assets below €50m would be impacted by the matching adjustment reforms, on the basis that none have regulatory approval to use the matching adjustment. Only larger firms make use of the matching adjustment.

7 Risks and assumptions

7.1 Policy Risks

7.2 Changes to the risk margin may have some impact on prudential risk outcomes which these features of the Solvency II regime were designed to address. A 65% cut to the risk margin for life insurers and the 30% cut for general insurers will mean that capital requirements are lower, and firms would be free to hold less capital overall compared with existing capital requirements. This may lead to some reduction in financial resilience and increase the risk of an insurer failure being disorderly (if a reduced risk margin leads to assets covering liabilities falling below market transfer value such that a third party will not take them on).

7.3 Leaving the core design and calibration of the fundamental spread unchanged risks not effectively capturing all retained risks, particularly the uncertainty around losses due to defaults that were not anticipated and the premium a third party would require in order to assume that risk. However, respondents to the Government's Solvency II Review: Consultation provided evidence that addressing this risk by introducing current market measures of risk would disincentivise long-term productive investment and clearly hinder the Government's objectives to support long-term investment and international competitiveness thereby missing the opportunity to boost growth[38].

7.4 The PRA estimates that the Government's package of reforms to Solvency II will raise the annual risk of insurers failing from 0.5% to 0.6%, calculated from the baseline set by the current, pre-reform Solvency II regime.[39]

7.5 To mitigate risks to policyholders, the Government supports the PRA taking forward additional supervisory tools to complement the new regime and maintain both the safety and soundness firms and high standards of policyholder protection. The PRA will use these new tools consistent with the legislation and will report to Parliament on their efficacy in satisfying the PRA's risk tolerance and assuring that insurers are held to account in applying high standards of risk management. The additional measures are:

- to require insurers to participate in regular stress testing exercises prescribed by the PRA to test insurers' resilience to scenarios the PRA will set out, and to allow the PRA to publish individual firm results;
- to require nominated senior managers with formal regulatory responsibilities and sanctions under the Senior Managers Regime to attest formally whether or not the level of the fundamental spread on their firm's assets is sufficient to reflect all

[38] p.10 Solvency II Review: Consultation Response - GOV.UK (www.gov.uk)

[39] Sam Woods, Chief Executive, PRA, at Treasury Select Committee

retained risks, and that the resulting matching adjustment reflects only liquidity premium, on the basis of a rigorous assessment of the characteristics and valuations of assets held in their matching adjustment portfolios, including the results of the stress testing exercises;

- to allow insurers to apply a higher fundamental spread through an add-on where they conclude that the standard allowance (capturing retained risk) is insufficient, taking into account the work undertaken to support the attestations set out above; and
- to update PRA matching adjustment rules to reflect the Government's decision to widen the eligibility requirements to include assets with highly predictable cashflows (for example, to specify increases to the fundamental spread allowances to take into account the additional risks from non-fixed cashflows, portfolio limits etc).

7.6 HM Treasury has considered the risk that reallocating capital to assets with highly predictable cashflows creates a shortfall in demand for bonds that is not met by other investors. This risk is assessed to be low as the pensions sector, which historically has been a very active buyer of bonds, should absorb some of this demand over the medium term. Further, foreign investors have consistently held c.30% of gilts, so it is assumed that they would take on a proportion of the lost domestic demand, without the share held by this sector materially increasing over the medium term.[40]

7.7 In a scenario where insurers' investment allocation away from safer bonds into more productive assets is not absorbed elsewhere, this would be unlikely to have a material and estimable effect on yields.

8 Wider impacts

8.1 More proportionate regulation will enhance capital efficiencies for insurers, supporting profitability, a higher return on capital and boosting productivity.[41] Through efficient transfer of risk, households and businesses can instead consume more of other goods and services and invest capital back into the economy, demonstrating the linkages of the insurance sector with the rest of the economy.

8.2 In this case, both reform of the risk margin and matching adjustment are expected to lead to an increase in productivity across the sector, the same inputs generating a greater output, this will mean higher returns are realised across the sector. Analyses from KPMG anticipates that these savings would be passed on to customers downstream, both individuals and businesses, in the form of lower pricing for premiums.

8.3 Reforms could also allow for the expansion of other sectors across the economy. For example, those businesses that issue BBB rated debt may see an increase investment from insurers, as insurers are able to take greater advantage of the matching adjustment benefit for these than previously.

8.4 For downstream sectors that purchase insurance, lower premiums reduce input costs for goods and services, boosting productivity (lower cost for the same level of input) and an expansion of output which, in turn, increases demand for inputs such as labour and capital

[40] UK Economic Accounts: institutional sector - general government - Office for National Statistics (ons.gov.uk)

[41] p.2 KPMG - Report on the macro-economic impacts of potential regulatory changes from Solvency II - February 2021 - Final (abi.org.uk)

in other areas of the economy, enhancing real wages and tax receipts.[42] The productivity improvements may then have positive rebounding effects for the insurance sector, as downstream sectors demand more inputs (such as insurance) to support this increased economic activity, improving upstream returns and supporting greater penetration of insurance services.[43]

8.5 Third order benefits that stem from reform to the matching adjustment may be significant. The UK insurance industry held c. £2.2 trillion in invested assets as at Q2 2021.[44] By creating additional incentives and capacity for insurers to invest long-term productive assets, this could help to drive growth across the UK economy, making more capital available for investment in infrastructure which "levels up' the UK by boosting productivity and growth of all regions and nations, and supports the transition to net zero by 2050.

8.6 Adding additional investment capacity is key to meeting many of these goals. For example, recent HMT analysis found that, whilst there is no global shortage of capital for investment in infrastructure projects, there are funding gaps in particular sectors – for instance £50-60bn of (mostly private) capital investment is required each year during the late 2020s and through the 2030s year to reach net zero by 2050.[45] More capital from insurers could increase the availability of finance for more mature/established infrastructure and so could lead to a more competitive financing environment. Even if the additional investment capacity crowds out investment that would've been provided by other financial institutions with higher risk appetite, this capital could be deployed in other infrastructure projects that have funding gaps. A more competitive financing environment would reduce financing costs and support access to capital for other sectors.

8.7 These third order benefits would flow back to the UK insurance sector. Supporting insurers to invest in projects to decarbonise the economy may form its own positive feedback loop in reducing their own balance sheet exposures. In this case, greater investment into long-term, productive green assets diversifies risk and mitigates against the concentration of stranded asset risk (e.g. scenarios where assets such as oil and coal reserves may suffer premature devaluation or may transition into liabilities due to new governmental regulations limiting the use of fossil fuels, changing demand patterns in favours of new emissions or legal action against high emitters).[46]

8.8 The Investment Delivery Forum has been convened by the ABI to drive and track new finance for long-term productive assets. The remit of this forum includes an objective to track the delivery of the £100bn of increased productive investment as a result of reform to Solvency II. The forum specifically works to build a strong understanding of the pipeline of investments, based on the wider pool of assets which will be eligible under the matching adjustment. Its three sub-committees, which are focused on energy generation, energy networks, and housing, underline the industry's commitment to prioritise investments which seek to meet the overarching aims of 'levelling up' and decarbonising the UK. In the last five years, the sector has already invested billions in such projects. For example, Aviva has over £3.2 billion invested in major transport projects, including £110 million for Connected Kerb to create 190,000 on-street electric vehicle chargers by 2030[47]. Separately, M&G has

[42] p.54 KPMG - Report on the macro-economic impacts of potential regulatory changes from Solvency II - February 2021 - Final (abi.org.uk)

[43] p.42 KPMG - Report on the macro-economic impacts of potential regulatory changes from Solvency II - February 2021 - Final (abi.org.uk)

[44] p.4, Review_of_Solvency_II_Consultation.pdf (publishing.service.gov.uk)

[45] Achieving Net Zero: Follow up - Committee of Public Accounts (parliament.uk)

[46] p.6 pdf_stranded-assets.pdf (lloyds.com)

[47] Investment Delivery Forum (idforum.org.uk)

acquired a majority stake in sustainable housebuilder Greencore Construction and pledged a further £500 million of investment in UK climate positive homes[48].

8.9 Public Sector Impact (PRA)

8.9.1 The reforms will have resource implications and therefore costs for the PRA across its policy-making, rule-making and supervisory functions. For example, as a consequence of the matching adjustment SI, and in anticipation of a change in legislation, the PRA are consulting on new rules, guidance and expectations in respect of the matching adjustment, consistent with the safeguards set out in HMT's November consultation response document. Once finalised and in force, the PRA will supervise firms in line with these new rules and policy materials.

8.9.2 A fuller assessment of costs and benefits for the PRA is being undertaken separately by the regulator, although initial PRA consultation documents highlights an expectation that the new regime will help make more efficient and economic use of PRA supervisory resource by streamlining and improving the proportionality of regulatory requirements.

8.10 Competition Assessment Checklist

8.10.1 HM Treasury undertook an initial screening to determine whether an in-depth assessment of the impact of the measures on competition was warranted, in line with guidelines as set by the Competition and Markets Authority. The measures in the Statutory Instrument were found to directly affect a market(s) where products or services are supplied by the private or public sector, as the measures make changes to the regulation of the UK insurance market. The assessment therefore proceeded to the next stage (stage 1) in the initial screening and applied the four questions which form the competition checklist, as set out below.

1. Will the measures directly or indirectly limit the number or range of suppliers?
2. Will the measures limit the ability of suppliers to compete?
3. Will the measure limit suppliers' incentives to compete vigorously?
4. Will the measures limit the choice and information available to consumers?

8.10.2 No areas of concern were identified by the four questions. Overall, the answers tallied with a well-established body of literature that the removal of unnecessarily restrictive regulatory requirements (as the measures in this Statutory Instrument seek to do) tend to be associated with greater competition, productivity, and economic growth.[49] Any impact identified in answering the four questions was found to be positive:

8.10.3 Q1: the measures lighten regulatory burdens and their associated cost, supporting greater productivity and profitability for insurers. This may, in turn, increase the size of the UK insurance market and the number or range of suppliers operating within it. The measures would therefore not directly or indirectly limit the number or range of suppliers.

8.10.4 Q2: the measures make regulation more proportionate and lower cost. For example, cuts to the risk margin (a capital buffer firms must set aside) will free up capital that firms would otherwise have had to reserve on their balance sheets. Reforms to the matching adjustment will reduce unnecessary cost and complexity in the process used by insurers to match their assets with liabilities to recognise profit upfront (a capital benefit). Annual cost savings (in firm's time, capital expenditure) gained from a more proportionate

[48] Investment Delivery Forum (idforum.org.uk)

[49] RPC_case_histories_-_trade_and_investment_Oct_20.pdf (publishing.service.gov.uk)

regulatory regime can be redirected into competing with other firms to capture market share. The measures therefore enable suppliers to compete.

8.10.5 Q3: the measures make regulation less cost-intensive for firms, supporting competition and proportionality. For example, cuts to the risk margin (a capital buffer which was found to be unnecessarily high to fulfil its purpose) will result in a significant capital release for firms. Commercial pressures may incentivise insurers to redeploy this released capital to compete (e.g., on price) and capture market share. The measures therefore support rivalry between firms, delivering better outcomes to customers.

8.10.6 Q4: the measures ensure proportionality of regulation, minimising complexity and compliance costs for insurers. Commercial incentives will drive insurers to redirect these cost savings and innovate to compete with other firms. As firms seek to establish unique selling points by offering products or services that have advantages over those offered by rival firms, this will translate into lowers prices, new products and better outcomes for consumers (affordability, higher quality, more choice). The reforms to Solvency II will in due course also boost the information available to consumers. For example, the PRA will be equipped with additional supervisory tools to accompany the new Solvency UK regime. This will include a requirement for insurers to participate in regular stress testing exercises and to allow the PRA to publish individual firm results. This will strengthen transparency for consumers who will be able to more effectively monitor the safety and soundness of the firms they are purchasing products and services from, contributing to informed purchasing decisions. The particular reform will be set out in PRA rules although the Government's review of Solvency II and associated legislation will create the space necessary to deliver this reform.

8.10.7 As no areas of concern were identified by the four initial screening questions, and in line with the Competition and Markets guidelines, it has not been necessary to undertake an in-depth competition assessment (stage 2).

8.11 Public Sector Equality Duty (PSED)

8.11.1 The Government has made an assessment of the (differential) equality impacts of the measures in this Statutory Instrument with due regard to the Public Sector Equality Duty. The assessment finds that the measures will not directly impact, either positively or negatively, any specific protected characteristics on a differential basis. Possible indirect impacts, which are positive, include:

i. **Age:** reform of the risk margin should increase the availability and affordability of annuities for current and future pensioners. We expect individuals approaching retirement, and therefore from older age groups, to benefit from this reform more immediately, with younger age groups expected to benefit in the longer-term.

ii. **Disability / Ethnicity:** reform of the matching adjustment should incentivise new investment in productive assets, such as infrastructure. New investment could help to address regional inequalities, with the potential to benefit those with some protected characteristics (e.g. some ethnic minority communities and those with disabilities are more likely than the general population to have low incomes and live in areas with higher deprivation levels).

8.12 Family Test

8.12.1 This measure is not expected to have any impact at the level of the family.

9 A summary of the potential trade implications of measure

9.1 HM Treasury has made a consideration of the trade and investment impacts of the measures in the SIs, in consultation with guidance on trade and investment assessments.[50] HM Treasury considers that the measures in the SIs are consistent with the UK's international obligations for equal treatment. This is on the basis that the measures, which relate to the regulation of services, do not introduce new differential requirements for domestic and foreign businesses. The costs and benefits arising from the changes to the risk margin and matching adjustment will apply equally to domestic insurance firms and foreign insurance firms with UK branches. Therefore, no unnecessary barriers to the international trade in services are erected by the measures in the SIs.

10 Monitoring and Evaluation

10.1 This section of the assessment confirms the new and existing arrangements which will be put in place to monitor and evaluate the impact of the measures on the Government's policy objectives, and the future intervention triggers which may necessitate amending the measures in the future.

10.2 Policy Objectives

10.2.1 The Government is legislating to cut the capital buffer known as the risk margin by around 65% for life insurance business and 30% for general insurance business. This will ensure insurers still hold sufficient assets to transfer their liabilities to another insurer if required, whilst lowering the cost of doing business and improving insurers' productivity through increased profits and lower prices. This should feed into more competitive pricing supporting more affordable insurance products and greater choice for consumers.

10.2.2 The Government is also legislating to make changes to the matching adjustment, by removing the BBB cliff edge and enabling insurers to adjust the rate used to discount liability cashflows that match asset cashflows that are not fixed. This will lead to improved productivity across the sector through lowering the costs of writing MA eligible business, allowing firms to realise greater returns on newly eligible investments and removing costs associated with these types of investments.

10.2.3 In conjunction with new PRA rules, these reforms will also help to incentivise investment in a greater range of productive assets. The Government will continue working closely with the UK insurance sector on ways to track the firms' investments in productive assets. This will include engagement with the Investment Delivery Forum, convened by the ABI to drive and track new finance for long-term productive assets. The Government will also continue to work closely with the PRA to track material changes in firm investment portfolios and the OBR on the long-term impact of the reforms.

10.2.4 The reform package will maintain high standards of policyholder protection. These reforms are being set directly in statute and will then be transferred over to the PRA's rulebook to reflect these policy changes, as the regulator responsible for establishing and enforcing firm-facing prudential rules and standards.

[50] RPC case histories - trade and investment Oct 20.pdf (publishing.service.gov.uk)

10.3 Prudential and Consumer Outcomes

10.3.1 The Government will legislate directly to implement reform to certain parts of the existing Solvency II regime i.e., the changes to the risk margin and the matching adjustment in these SIs. As part of this, the Government will carry out post-implementation reviews of both the risk margin and matching adjustment reforms no more than five years from their respective commencement dates. The SI to implement reforms to the matching adjustment includes a review clause, the risk margin SI does not, since this SI only makes transitional amendments to EU law which will be revoked, but a future SI will make the changes to the risk margin permanent and include a review clause. The Government will also legislate to enable the PRA to make the necessary changes to its rules and policy, including through the revocation of relevant areas of retained EU law.

10.3.2 These are reforms to prudential requirements that ensure the safety and soundness of firms, minimise the risk of firms falling into financial difficulty, and act as a safeguard for the wider financial system. The impact of the reforms on these prudential outcomes will be monitored to ensure high standards of policyholder protection are maintained (as a key objective of the intervention).

10.3.3 Under the new regime, the PRA will continue to be the authority responsible for the supervision of firms to uphold prudential standards.

10.3.4 Appropriate flexibility has been built into the current monitoring and evaluation processes to take account of the new measures in these SIs. In addition to its usual supervisory activity, firms will be required to report to the PRA on the new changes to the risk margin and matching adjustment. Ongoing PRA supervision will ensure firms' adherence to robust risk management practices and capital adequacy requirements under the new regime so that they remain resilient to financial difficulty.

10.3.5 The PRA will also be equipped with additional supervisory measures (see section 'Policy Risks'), to strengthen the ability of the regulator to monitor the impact of the reforms on prudential outcomes.

10.3.6 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 measures, and its assessment on whether further changes are needed. Further, the Government will review whether the calibration of the fundamental spread (which captures risk in the calculation of the capital benefit insurers can receive from the matching adjustment) remains appropriate in five years' time. The Government will take into account the results of the PRA's evaluation when undertaking its review. 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 (an industry-funded levy to protect customers of financial services firms that have failed), to reflect the Government's reform.

10.3.7 The Government considers that in line with the original objectives of the intervention, high standards of policyholder protection will be maintained under Solvency UK. For example, separate capital requirements will still require insurers to hold enough capital to withstand a 1-in-200-year shock. If, in the course of the supervisory activities of the PRA and / or the reviews to be undertaken by the regulators and Government, it is clear that these prudential objectives are not being satisfactorily achieved, the Government will support the PRA in the full and proper exercise of its statutory powers to take any additional measures necessary for the safety and soundness of firms and the protection of policyholders.

10.3.8 An additional objective of the reforms to Solvency II is to make regulation more proportionate so that consequent cost savings for firms can be passed through to consumers in the form of lower product prices and more choice.

10.3.9 The Government aims to ensure that individuals and businesses have access to affordable financial products and services such as insurance and works closely together with regulators and stakeholders from the public, private and third sectors on this agenda.[51] The Government, as part of this regular engagement and work, will take appropriate action, as necessary, to ensure the UK insurance market is delivering the right outcomes for consumers under the new reformed regulatory regime.

10.4 Increased Productive Investment Outcomes

10.4.1 A further objective of the reforms is to make changes to regulatory requirements to incentivise insurers to increase their investments in long-term productive assts.

10.4.2 Current processes will allow the Government to monitor how investment over time changes to assess the success of the measures in the SIs e.g., using PRA aggregated regulatory data supplied by UK authorised insurance firms.

10.4.3 The Government also supports the ABI's cross-industry Investment Delivery Forum in its remit of tracking the delivery of the £100bn of increased productive investment made possible as a result of reform to Solvency II.

10.4.4 If, over the course of this monitoring and evaluation, the objective to increase productive investment is not being adequately realised, the Government will work with the regulators and industry to review the measures and consider what changes may be necessary to unlock additional investment.

[51] Financial Inclusion Report 2021/22 - GOV.UK (www.gov.uk)