

**EXPLANATORY MEMORANDUM TO
THE SOLVENCY 2 REGULATIONS 2015**

2015 No. 575

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

2. Purpose of the instrument

2.1 This instrument implements, in part, Directive 2009/138/EC of the European Parliament and of the Council of 25th November 2009 on the taking up and pursuit of the business of insurance and reinsurance (Solvency II) (“the Solvency 2 Directive”). Together with the Financial Services and Markets Act 2000 (“FSMA”), this instrument establishes the regulatory system for implementing the Solvency 2 Directive. It imposes duties on the Prudential Regulation Authority (“PRA”) and the Financial Conduct Authority (“FCA”) and gives insurance undertakings and reinsurance undertakings the right to apply to the PRA for specified approvals relating to the Solvency 2 Directive (for example, the right to modify their risk assessment process).

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Context

4.1 The Solvency 2 Directive establishes the framework for the prudential supervision of insurance undertakings and reinsurance undertakings in the European Union. It replaces a number of current directives, collectively known as “Solvency 1”. Responsibility for implementation has been split, with HM Treasury creating the regulatory structure and the PRA and FCA regulating insurance and reinsurance undertakings. In practice, this means the majority of implementation has fallen to the PRA. The Treasury is implementing the provisions of the Solvency 2 Directive for which it is responsible through FSMA and this instrument. The PRA and FCA are implementing the provisions of the Solvency 2 Directive for which they are responsible by means of rules and individually imposed requirements made under FSMA. Further implementation is provided by a delegated act (in this case, a directly applicable regulation) made by the European Commission.

4.2 The Solvency 2 Directive has been amended on a number of occasions, in particular by Directive 2014/51/EU (the Omnibus II Directive). Both the Solvency 2 Directive and the directly applicable regulation made under it by the European Commission were subject to the following scrutiny:

(a) EM 11978/08 on the Commission draft Directive of the European Parliament and the Council on the taking up and pursuit of insurance and reinsurance: Solvency II was submitted by HM Treasury on 7th August 2007. It was cleared by the House of Commons European Scrutiny Committee on 23rd May 2008 as politically important. It was cleared by the House of Lords EU Select Committee on 25th November 2008;

(b) EM 5523/11 on the Commission proposal for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority (Omnibus II) was submitted by HM Treasury on 3rd February 2011. It was cleared by the House of Commons European Scrutiny Committee on 1st March 2011 as politically important. It was cleared by the House of Lords EU Select Committee on 29th March 2011;

(c) EM 10230/12 on the Commission proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC (Solvency II) as regards the dates for its transposition and the date of its application, and the date of repeal of certain Directives: the first “Quick Fix” Directive was submitted by HM Treasury on 8th June 2012. It was cleared by the House of Commons European Scrutiny Committee on 14th June 2012 as not politically important. It was cleared by the House of Lords EU Select Committee on 12th June 2012;

(d) EM 14513/13 EM 10230/12 on the Commission proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC (Solvency II) as regards the dates for its transposition and the date of its application, and the date of repeal of certain Directives: the second “Quick Fix” Directive was submitted by HM Treasury on 24th October 2013. It was cleared by the House of Lords EU Select Committee on 29th October 2013. It was cleared by the House of Commons European Scrutiny Committee on 30th October 2013;

(e) EM 14263/14 on the Commission delegated regulation (EU) no [.../..] of [xxx] supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) was submitted by HM Treasury on 10th November 2014. It was cleared by the House of Commons European Scrutiny Committee on 20th November 2014. A follow-up letter was sent by the Economic Secretary to the Treasury to the House of Lords EU Select Committee on 18th November 2014. It was cleared by the House of Lords EU Select Committee on 24th November 2014.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Economic Secretary to the Treasury, Andrea Leadsom MP, has made the following statement regarding Human Rights:

“In my view the provisions of The Solvency 2 Regulations 2015 are compatible with the Convention rights”

7. Policy background

7.1 The current EU minimum standards for an effective insurance prudential regime do not capture the full range of prudential risks which insurers can be exposed to and do not incentivise pro-active management of risk. This has led many Member States to conclude that they are inadequate and to supplement them with their own domestic regimes (e.g. the Individual Capital Adequacy Standards or "ICAS" regime in the UK). This has resulted in a "patchwork" of regulatory requirements for insurers across the EU, hampering the functioning of the single market in insurance and offering sub-optimal protection for insurance policy holders.

7.2 The Solvency 2 Directive, as amended by the Omnibus II Directive, aims to build on previous insurance directives to create risk-sensitive, harmonised requirements for EU insurers, which will ensure strong standards of policyholder protection and will help to promote competition, innovation and consumer choice across the single market. By moving to a maximum-harmonising regime with stronger prudential standards than Solvency 1, UK consumers will benefit from stronger standards of policyholder protection for EU insurers operating in the UK.

7.3 The UK Government is a strong supporter of the Solvency 2 Directive. It adopts the UK model of risk-based regulation and incorporates lessons learned from the financial crisis by ensuring that insurers must be able to withstand financial market shocks. This approach will promote strong standards for policy holder protection across Europe. A single rule-book for prudential regulation will help create a level playing field for insurance companies, opening up new business opportunities for UK insurers. The Solvency 2 Directive also strikes a sensible balance between protecting policy holders and supporting the role of insurers as long-term investors in the wider economy. The UK

played a leading role in the negotiations that resulted in the Solvency 2 Directive, and believes the Solvency 2 Directive represents a good deal for the UK.

- Consolidation

7.4 This instrument does not substantially amend existing enactments, so consolidation is not merited.

8. Consultation outcome

8.1 During the long policy development process which resulted in the Solvency 2 Directive, which took place between 2005 and 2014, its various elements have been subject to thorough impact assessment and consultation by the European Commission. This includes:

- (a) a European Commission impact assessment on the proposal for the Solvency 2 Directive (2007);
- (b) six Quantitative Impact Studies (QISs) conducted by EIOPA – the last two QISs in particular covered the detailed rules covered in the delegated act;
- (c) a consultation on Commission Green Paper on Long-Term Financing (2013);
- (d) an EIOPA impact assessment and consultation on Solvency II's Long-Term Guarantee measures (2013);
- (e) an EIOPA consultation on standard formula risk-charges (2013);
- (f) over twenty meetings of an Expert Working Group made up of policy officials from the Commission, Member States and the European Parliament;
- (g) drafts of the delegated acts have been shared with the European insurance industry and consumer groups for information consultation; and
- (h) a European Commission impact assessment on the delegated acts made under the Solvency 2 Directive (October 2014).

8.2 HM Treasury has consulted on the transposition of those parts of the Solvency 2 Directive for which it is responsible where there is some policy discretion over how the directive might be implemented. The first consultation started in November 2011 and was

open for 12 weeks (the 2011 consultation). This consultation provided an overall explanation of the Solvency 2 Directive and sought views on specific policy questions relating to:

- (a) the treatment of non-UK insurance undertakings in the group capital requirements;
- (b) the imposition of duties on the PRA to carry out certain requirements in the Solvency 2 Directive aimed at national supervisors, such as equivalence determinations, review of capital add-ons, consultation with other supervisors, and withdrawal of permissions when a firm falls below their minimum capital requirements; and
- (c) consideration of financial stability and pro-cyclicality in the PRA's duties.

HM Treasury's second consultation was concerned with how to transpose specific amendments to the Solvency 2 Directive made by the Omnibus II Directive (the 2014 consultation). The consultation commenced in August 2014 and was open for six weeks. It covered only two policy issues:

- (a) whether to include a supervisory approval process for an undertaking's use of the volatility adjustment, which can lower firms' capital requirements (Article 77d of the Solvency 2 Directive); and
- (b) how to withdraw authorisation when an undertaking falls below its minimum capital requirements (Article 144 of the Solvency 2 Directive).

8.3 Both consultations received only a small number of responses (less than 10), in comparison to the number of firms within the scope of the Solvency 2 Directive (over 400). This is likely to be due to the fact that the limited discretion available to Member States to deviate from the Solvency 2 Directive meant the range of available options was limited, as well as due to the majority of the directive being implemented by the PRA by means of PRA rules, which were subject to a separate consultation.

8.4 Most responses to the 2011 consultation proposed minor drafting changes where it was believed the proposed regulations were inconsistent with the directive or needed clarification. One issue that received a significant number of comments was the proposed transposition of the withdrawal of permissions under Solvency 2, Article 144. This approach was modified in response to the feedback and was a new proposal which addressed concerns in the consultation responses was included in the 2014 consultation.

8.5 The responses to the 2014 consultation were largely supportive of the new approach to Article 144 but proposed alternative ways of drafting the regulation. The final text has been amended in response to this feedback. The majority of responses to the 2014 consultation related to concerns around the burden of a supervisory approval process for use of the volatility adjustment in Article 77d of Solvency 2. HM Treasury raised these concerns with the PRA and determined that these concerns could be adequately addressed by implementing a proportionate approval process. This has been reflected in the final statutory instrument.

9. Guidance

9.1 HM Treasury will not be issuing guidance to accompany this instrument. This instrument mostly affects the PRA which has been directly engaged with HM Treasury in preparing to implement the Solvency 2 Directive. It is the PRA and FCA which will introduce rules that will affect the insurance industry. The PRA has issued several supervisory statements and letters of advice to firms explaining how the Solvency 2 Directive will affect them, and hosted several information sessions for firms.

10. Impact

10.1 The impact of the Solvency 2 Directive on business is approximately £2.7 billion in one-off implementation costs and £200 million ongoing yearly costs (for the next ten years). There is no anticipated impact on charities or voluntary bodies. To place the costs on business in context, the UK insurance industry is estimated to receive approximately £188 billion in written insurance premium annually. There are also expected benefits to the UK insurance sector from the Solvency 2 Directive, which are estimated at almost £500 million per year (for the next 10 years). Monetised benefits include a reduced cost of capital, improved efficiency of risk and capital management and additional investment income. The Treasury cost/benefit analysis for the Solvency 2 Directive estimates a net cost of approximately £33 million per year (for the next 10 years). However, there will be additional benefits which are not possible to monetise. Such benefits include improvements in insurance firms' risk modelling and governance, increased competition leading to a more efficient insurance market for consumers and averted losses resulting from more stable insurance undertakings.

10.2 The impact on the public sector is zero, as the PRA and FCA are funded through levies on industry. Their funding costs are included in the impact on business in 10.1 above.

10.3 An Impact Assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 Insurance undertakings with less than €5 million yearly premium income or insurance obligations (liabilities) of less than €25m are excluded from the scope of the Solvency 2 Directive. This means that undertakings that employ less than 20 people are very likely to be excluded from the scope of the directive.

12. Monitoring & review

12.1 This instrument will be reviewed by HM Treasury no later than March 2020.

13. Contact

Lee O'Rourke at the Treasury Tel: 020 7270 6436 or email:
lee.o'rourke@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.