Title: Transposition of Solvency II Directive (2009/138/EC) and Omnibus II **IA No:** RPC11-HMT-1094(3 **Lead department or agency:** HM Treasury **Other departments or agencies:** Prudential Regulation Authority	**Impact Assessment (IA)** **Date: 11/12/2014** **Stage: Final** **Source of intervention: EU** **Type of measure: Primary legislation** **Contact for enquiries**: Lee.O'Rourke@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£-357.2m	£-357.2m	£32.7m	No	NA

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

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

What are the policy objectives and the intended effects?

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

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

The Directive is Maximum harmonising, and is clear on what must be achieved, so the Government has no effective discretion in terms of policy choices for transposition (in particular, there is no scope for pursuing alternatives to regulation). A copy-out approach will be followed, and the approach will not go beyond what is required in the Directive.

As a result, there are only two policy options: (1) Transpose the Directive, and (2) Do Nothing, where the second option is not a genuine policy option but is included as the baseline.

Will the policy be reviewed? It **will** be reviewed. **If applicable, set review date: 03/2020**

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**	**Non-traded:**	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: Andrea Leadsom ***Date:*** 25 January 2015

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2014	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: £-13251m	**High: £9450m**	**Best Estimate: -£357.2m**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	£2175.6m		£147.4m	**£3360.8m**
High	£13446.2m		£245.7m	**£15421.2m**
Best Estimate	£2706.4m		£196.6m	**£4286.5m**

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

The Best Estimate assumes no capital impact. The High Estimate assumes a capital shortfall of £10,209m, assuming no additional restructures or use of internal models. The key cost to insurers are one-off implementation costs of £2.6bn to industry and £100m to the PRA. Ongoing compliance costs are estimated at £1.5bn for industry over 10 years and £6m for the PRA over two years. Most one-off costs have already been committed (so would have been incurred in the Do Nothing Option).

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

None. NB - The 2011 impact assessment estimated a NPV of -£61m. The decrease in NPV since 2011 is largely due to the increased implementation costs from the delay of Omnibus II. The key change for the UK delivered by Omnibus II was the capital benefit to industry of over £10 billion. However, the 2011 impact assessment already assumed a zero capital impact in anticipation of further negotations so this benefit is not identifiable when comparing NPVs between the two impact assessments.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		1£270m	• **£2169.5m**
High	£7291m		£687m	**£12811.3m**
Best Estimate	0		£489.m	**£3929.3m**

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

Ongoing benefits include reduced cost of capital for industry of £313.4 million and efficiency gains to industry of £3,616.14 million.
The Best Estimate assumes no capital impact. The High Estimate also includes an increase in capital surplus of £7291 million based on an assumption that insurers restructure operations and make more use of internal models.

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

Averted loss from insurer default (benefit for industry, policyholders, regulators and investors); administrative benefits to industry (improved risk modelling and enhanced governance); Level playing field across Europe (benefit to industry, policyholders, regulators, investors); and Increased policyholder protection (benefit to consumers and regulators);

Key assumptions/sensitivities/risks **Discount rate** 3.5%

Analysis is based on sample data that has been extrapolated and there may be sample bias or extrapolation error. Data has been provided by the PRA using information provided by firms that may be incorrest, based on estimates, and only reflect market conditions at end 2013. Results are indicative only and are subject to a high level of uncertainty.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: £392.0m	**Benefits: £359.4m**	**Net: -£32.7m**	No	NA

Solvency II Impact Assessment

Executive Summary

The Solvency II Directive aims to create risk-sensitive, maximum-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. The current EU minimum standards are not risk-sensitive, which has led many Member States to supplement them with their own domestic regimes (e.g. the Individual Capital Adequacy Standards or "ICAS" regime in the UK). This has resulted in a "patchwork" of regulatory requirements for insurers across the EU, impairing the functioning of the single market.

Following adoption of the Solvency II Directive in 2009, HM Treasury completed a full impact assessment on Solvency II in 2011, in anticipation of implementation of the Directive from the end of 2012. The two key areas that are the primary focus of the impact assessment are the impact on UK insurers' capital positions from the new regulatory capital rules which are central to the Solvency II reform, and the costs to industry of implementation and ongoing compliance with Solvency II regime.

Implementation was subsequently delayed until 1 January 2016. Following the agreement of Omnibus II in May 2014, the Treasury has now updated its impact assessment to take into account the changes introduced to the Solvency II Directive via Omnibus II.

The analysis shows that the UK insurance industry's aggregate capital position should be left unchanged by the introduction of Solvency II. This is a significant change compared to the capital impact as estimated in the Treasury's 2011 impact assessment. The 2011 assessment looked at the solvency positions of UK insurers - that is whether the capital insurers held met the current UK regulatory capital requirements and whether that capital would meet the new capital requirements under Solvency II. This showed that the average solvency ratio for UK insurers would have fallen from 157% under the current UK regime based on 2009 data (that is firms on average held capital 57% above the current regulatory requirement) to 139% under Solvency II. This represented an overall reduction in surplus capital of approximately £13 billion.

This reduction in surplus capital has been largely eradicated by the changes made to Solvency II by the Omnibus II Directive. It is now estimated that the aggregate Solvency ratio will change from 166% to 158%. The Long-Term Guarantees package introduced by Omnibus II, which sets capital requirements for long-term insurance liabilities, is largely responsible for this change. The remaining decrease in solvency ratio is expected to be eliminated through the use of internal models by insurers.

In the absence of any recent industry surveys, compliance costs of Solvency II for the UK have been estimated at approximately £2.7 billion for one-off implementation costs and approximately £0.2 billion per year in ongoing compliance costs. This has increased by 30% from the 2011 estimates of £2.0 billion and mainly reflects the 3 year delay to implementation of the Directive. While these costs are significant, they should be viewed in the context of the scale of the UK insurance industry, which currently collects £188 billion in gross written premium each year.

Other key points of analysis to note are:

1. The neutral effect on aggregate capital levels is due to the capital relief from the long-term guarantees package plus the expected use of internal models. Use of an internal model is expected to lower capital requirements by an average of 19%, compared to using the standard formula.

2. In addition to the Matching Adjustment, Solvency II contains several other measures designed to encourage long-term investments, including infrastructure investments. These include new risk categories in the standard formula for lower risk activities such as 'high quality' securitisations, and the lowering of risk charges on some corporate bonds by including an ability to recognise certain guarantees and other risk mitigating efforts, as well as the use of proxy ratings for certain unrated instruments.

3. The transitional arrangements introduced by Omnibus II allow phase-in of capital calculation rules which will provide individual insurers with up to sixteen additional years to comply with the new regime.

4. The increase in compliance costs for industry since the 2011 assessment is roughly £700 million. This is mainly made up of the cost of the delay to Solvency II start date and additional quarterly reporting requirements. Despite the three year delay to Solvency II, the prudential regulator's estimated costs have decreased since 2011 as part of the FSA being replaced by the PRA and the restructure of its Solvency II implementation plan.

5. For small firms, while their solvency ratios decrease under Solvency II, they remain well capitalised in aggregate, with an estimated solvency ratio of 154% for small general insurers and 190% for small life insurers. In addition, Omnibus II introduced reporting exemptions for small firms that will decrease the frequency at which they will be required to report compared to larger firms. Some very small firms, with premiums less than €5 million or with €25 million or less in technical provisions will be exempt from Solvency II and will remain under the current UK insurance regime.

Evidence Base

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Section 1 - Introduction

1.1 Problem under Consideration

The current EU minimum standards for an effective single market in insurance are not risk-sensitive, and do not incentivise pro-active management of risk, which 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.

The Solvency II Directive, 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 from a minimum-harmonising regime to a maximum-harmonising regime, UK consumers will also benefit from stronger standards of policyholder protection for EU insurers passporting into the UK.

1.2 Rationale for Intervention

The current EU-wide solvency regime for insurers is based on the principles of minimum harmonisation[1] and mutual recognition via a single licence or “EU passport”.

The minimum standards are not risk sensitive and do not consider certain key risks such as credit risk (the risk that third parties cannot pay their debts), market risk (the risk of a decline in the market value of investments) or operational risk (caused by factors such as system breakdowns or maladministration), all of which have been demonstrated to be material threats to insurers’ solvency positions. The current EU rules (not including the changes introduced by the UK through its ICAS regime) tend to be backward-looking rather than prospective in nature, and do not incentivise the proactive assessment and management of risk.

The additions that individual Member States have made to these minimum standards are heterogeneous and have resulted in an un-level playing field, affecting cross-border competition, the costs of compliance for cross-border groups, and the extent of supervisory co-operation and convergence across Europe.

The European Commission (“the Commission”) established the Solvency II project in the early 2000s to review and reform the rules that govern direct life and non-life insurance firms and reinsurers operating in the EU.

[1] That is, it sets down minimum standards which individual Member States must meet, but does not preclude these from being exceeded.

The Solvency II framework Directive (Directive 2009/138/EC[2], "the Directive"), which was agreed in April 2009, builds on and consolidates the existing EU insurance directives, and lays down rules for:

1) The taking-up and pursuit, within the European Community, of the self-employed activities of direct insurance and reinsurance.
2) The supervision of insurance and reinsurance groups.
3) The reorganisation and winding-up of direct insurance undertakings.

The Directive was further amended by the Omnibus II Directive[3], ("Omnibus II") to incorporate the new regulatory architecture that established the European Insurance and Occupational Pensions Authority (EIOPA), new rules on capital requirements for long-term liabilities (the long-term guarantees package) and transitional provisions to help insurers transition smoothly to the Solvency II regime.

HM Treasury, as the UK's Ministry of Finance, is obliged to implement the Directive into UK law by the agreed transposition date in order to fulfil its obligations under the EU Treaty. The implementation date in the Directive is 1 January 2016, with a transposition deadline of 31 March 2015.

1.3 Policy Objective

Changes introduced by Solvency II

Solvency II will introduce economic risk-based solvency requirements for insurers and reinsurers across all EU Member States that will be significantly more sophisticated and risk-sensitive than the current minimum standards. The framework will require market-consistent valuation of all assets and liabilities.

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

There will be a dual system of capital requirements – a Solvency Capital Requirement (or "SCR") and a lower Minimum Capital Requirement (or "MCR"), creating a 'ladder' of supervisory intervention and allowing early action by supervisors when a firm's solvency position begins to deteriorate.

Firms will be able to calculate the amount of regulatory capital they require using a standardised formula or alternatively develop their own internal models, which will require supervisory approval.

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[2] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:en:PDF

[3] Directive 2014/51/EU http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.153.01.0001.01.ENG

The regime takes a 'three pillar' approach. Under Pillar 1 (quantitative requirements), the risks to an insurer's assets will be considered alongside the liability risks, under a so-called 'total balance sheet' approach. For the first time, market, credit and operational risks will be covered by the EU-wide regime for insurers. Pillar 2 will place a new focus on risk management and governance, and Pillar 3 will bring a greater level of market disclosure, which is intended to bring increased 'market discipline'.

The supervision of insurance groups will be strengthened, and it is intended that the regime will result in increased convergence between the supervisory regimes and practices of Member States.

Changes introduced by Omnibus II

Omnibus II introduces three main amendments to Solvency II:

- Incorporation of the changes to the European regulatory architecture[4], with the establishment of the new European Supervisory Authorities, including the European Insurance and Occupational Pensions Authority (EIOPA) for insurance business.
- Amends the capital calculation rules to make them more appropriate for long-term insurance products and to encourage long-term investment. This set of rules is referred to as the 'long-term guarantees package', which includes extrapolation of the risk-free interest rate, the Matching Adjustment and the Volatility Adjustment. The long-term guarantees package has a significant impact on UK insurers' solvency positions, bringing over £10 billion of capital relief to the industry when compared to the impact of Solvency II assessed in 2011.
- Transitional provisions that phase in the capital calculation rules over periods of up to 16 years to help insurers adjust to the new rules and minimise disruption to the market.

Where insurers provide long-term insurance products they generally also invest in assets that are held over the long term. This means that they are not as affected by short-term asset price volatility as insurers that provide shorter-term products. The rules of Solvency II, before Omnibus II, did not sufficiently take this into account, leading to long term insurers having to hold excess capital compared to their risks. The long-term guarantees package, in ensuring the capital rules allow for short term volatility of assets (described as 'artificial' volatility) when they are held long term to support long term liabilities, is also intended to reduce pro-cyclicality[5] and systemic risk. The Matching Adjustment is subject to a supervisory approval process. Omnibus II introduces the Member State option of a supervisory approval process for the Volatility Adjustment. Another measure aimed at reducing pro-cyclicality is the 'extension of the recovery period', a forbearance tool which gives supervisors

[4] As agreed under the Lisbon Treaty 2009

[5] Pro-cyclicality in this context refers to behaviours that exacerbate the effects of the business cycle, such as increased selling of assets at depressed prices, which can have disruptive effects on the economy.

flexibility to delay enforcement action on a firm's breach of capital requirements, if certain conditions are met.

Omnibus II also introduces transitional provisions to phase in the change in capital requirements for firms. These transitionals will provide assistance to firms as they apply the new rules, allowing firms up to sixteen years to adjust their level of capital to the new calculation rules and minimising disruption to the market from the change in regimes. While it is clear that they will mitigate regulatory capital increases for some UK insurers in the early years of Solvency II implementation, the extent of the mitigation is difficult to quantify as some transitionals are contingent on either the insurer choosing, or being eligible to apply them. They are discussed in more detail in the Capital Impact section of the cost benefit analysis.

The negotiation of Omnibus II was complex and took much longer than expected, causing the implementation date of Solvency II to move from 1 November 2012 to 1 January 2016. The extended timeline, and its effect on administrative costs has also been taken into account, though the increase in implementation costs since 2011 will be more than offset by the capital relief provided by the long-term guarantees package.

Affected UK firms

UK firms will be well-positioned to make these changes because the current ICAS regime was deliberately designed to better align regulatory capital with the risks faced by individual firms (including asset-side risks), and to encourage firms to make their own assessments of their risks and capital needs. Solvency II is therefore consistent with the direction of travel of the UK financial regulator and industry in seeking a more risk sensitive and economic way of determining capital adequacy standards for insurers.

It is expected that approximately 400-450[6] individual firms will be in the scope of Solvency II in the UK, down from 2011 when the estimate was between 550 and 600 individual firms. This figure includes individual Lloyd's syndicates and firms in run-off. Since 2011, the amount of insurance business has increased from £1.6 trillion assets to £1.8 trillion assets[7]. This decrease in the number of firms while total assets of the industry grow indicates that some consolidation of the industry has already taken place, as predicted in the 2011 impact assessment. This consolidation could also be due to normal competitive forces as less efficient firms leave the market, and more efficient firms absorb their business.

Policy Aims

The Government has an objective to transpose the Directive in such a way that it meets its Treaty obligations, and in doing so, to allow the UK's insurance industry and

[6] Source: PRA

[7] ABI Key Facts https://www.abi.org.uk/Insurance-and-savings/Industry-data/Key-Facts-2014

policyholders to recognise the full extent of the available benefits, whilst not being placed at a disadvantage versus other Member States. Any additional regulatory burden will be minimised.

The Government's main objective for the negotiation of Omnibus II was to ensure the continued viability of the UK's existing annuities market, ensuring annuity providers and other long term insurers were not penalised in the capital rules for risks to which they are not exposed (such as liquidity risk and short-term market volatility). The capital impact in this assessment suggests that this objective was achieved.

1.4 Description of Options Considered

The Directive is maximum harmonising, and is clear on what must be achieved, so the Government has very little discretion in terms of policy choices for transposition (in particular, there is no scope for pursuing alternatives to regulation). A copy-out approach will be followed. As a result we only have two overall policy options: (1) Transpose the Directive, and (2) Do Nothing, where the second option is not a genuine policy option but is included as the baseline.

The Directive does contain several areas where Member States can choose how to implement the Directive. These are identified in Option 1.

Option 1 – Transpose the Directive

Transposition will require the Government to amend UK legislation, and the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to amend their Regulatory Handbooks[8]. The majority of rule changes will be made by the PRA. The PRA and the FCA have consulted separately on Handbook changes, with further consultations expected to complete transposition before the deadline of 31 March 2015.

Most of the requirements of the Directive can already be met using powers provided by the Financial Services and Markets Act 2000 ("FSMA"), so the number of changes required to primary legislation is relatively small compared to the number of provisions in the Directive.

The required legal changes by the Government can be categorised as:

i. New conditions for the authorisation and de-authorisation of firms.
ii. New powers for the PRA, chiefly:
    - Powers of supervisory approval (e.g. for firms' use of internal models, partial internal models, Undertaking-Specific Parameters[9] (USPs),

[8] The PRA intends to update the structure of its rules and rename the Handbook as the PRA Rulebook http://www.bankofengland.co.uk/pra/Pages/publications/rulebookcon.aspx

[9] As an alternative to a full or partial internal model, firms have the option to use the standard formula but with some of the standard parameters replaced by ones specific to their own risk profiles; these will, however, require supervisory approval.

ancillary own funds[10], Matching Adjustment and some transitional measures);
- Powers relating to the outsourced activities of insurance firms.

iii. New mandates for the PRA, chiefly:
- Requirements to consult, communicate or co-operate with supervisors in other Member States in certain specified circumstances;
- Requirements to review certain regulatory decisions at pre-defined intervals, or to make verifications.

iv. Alignment of definitions.

In keeping with the Government's Guiding Principles for EU Legislation[11], the proposed legal changes do not go beyond the minimum that is required to implement Solvency II in the UK, i.e. no gold-plating will be introduced, without the existence of exceptional circumstances. "Copy-out" has been used wherever possible to transpose the Directive.

Member State Options

The Directive contains several areas of discretion for Member States or their supervisory authorities to choose a particular way of implementing the Directive. Some of these are within the remit of HM Treasury and others are within the responsibility of the PRA, for example, determining the transitional period for public disclosure of capital add-ons. Those Member State options that are within the remit of the Treasury must comply with the Government's Guiding Principles for EU legislation.

The Government's Guiding Principles for EU legislation require that the UK does not go beyond the minimum requirements of the measure which is being transposed, except in exceptional circumstances.

Article 225 and Article 227 use of local rules in the group solvency calculation

These two articles give the Member States the option of allowing the use of local rules as part of the group solvency calculation, provided the insurer can also satisfy the criteria for use of the deduction and aggregation method, and, for non-EU jurisdictions, an equivalence determination (including temporary or provisional) has also been made. These options were consulted upon by the Treasury in 2011[12]. The Treasury recommended, in line with responses submitted to the Treasury's 2011 consultation, that this was transposed as a default rule that local rules could be used if the other two conditions are met, but identified that this could lead to a detrimental effect on policyholder protection if there is a significant change to the regime that was

[10] Ancillary own funds are only eligible to count as regulatory capital if they have received supervisory approval that they meet the relevant criteria.

[11] https://www.gov.uk/government/publications/guiding-principles-for-eu-legislation

[12] See proposed transposition of articles 225 and 227 of the Directive in the Treasury CP *Consultation on Solvency II* published in November 2011
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81581/condoc_consultation_solvencyII.pdf

previously judged to be equivalent. In this circumstance, the PRA would be able to waive the ability to use local rules, but only if a significant change to the regime that reduces policyholder protection is considered to exist. This is considered to be an exceptional circumstance and therefore consistent with the guiding principles.

Article 77d supervisory approval process for the volatility adjustment

Another Member State option is to create a supervisory approval process for the use of the Volatility Adjustment[13] (VA) (part of the long-term guarantees package and set out in Article 77d of Omnibus II). This option was consulted upon by the Treasury in August and September 2014.

The VA is required to be subject to supervisory review, including a specific reference in the Directive for regulators to impose capital add-ons where insurers have used it inappropriately.[14] The VA raises prudential questions because its design permits the measure to be applied to all liability types and not just those which would genuinely allow insurers to safely hold assets over the long term. This creates an incentive for insurers to engage in maturity transformation activities where they use long-term illiquid assets to support short-term liabilities.

The Government's view has been that the VA may be much less appropriate for liquid or volatile liability types, such as those where there can be sudden large claim payments, or where policyholders can surrender their policies in exchange for a guaranteed amount. In such cases, assets may unexpectedly need to be sold at depressed prices, leading to losses. If the VA is used for such products, asset losses will not have been allowed for within a firm's technical provisions or capital requirements, meaning the firm is undercapitalised relative to the true risks it faces. Where multiple insurers are undercapitalised, this increases systemic risk.

The Government considers that the Member State option of prior supervisory approval allows regulators to ensure compliance from the onset of Solvency II rather than have to rectify misuse on review, which is likely to be more disruptive to the insurer, especially if the insurer has relied on a large capital benefit as part of its capital management strategy.

Information from the PRA indicates that firms intend to use the VA to reduce their aggregate capital requirements by at least £850 million in aggregate, and possibly up to £2.8 billion based on data from year end 2013. Regardless of whether Member States choose to exercise the option of requiring supervisory approval for the VA, national supervisors will still be required to correct imprudent use of the measure. The Government believes this requirement, combined with the need to avoid the build-up of systemic risk in the financial sector that could flow from imprudent use of the measure, means that supervisory approval represents the optimal approach to transposition for the insurance industry, insurance policy holders and the wider

[13] Article 77d of the Directive

[14] Article 37(1)(d) of the Directive

financial sector. As supervisory approval is specifically allowed for in the Directive, this is not considered to go beyond the requirements of the Directive. However, if it did, the Government believes that the risk posed to financial stability from imprudent use of the VA is an exceptional circumstance.

The impact of the long-term guarantees package, including the volatility adjustment, is separately set out in Annex 5. It provides analysis from the PRA that implementation of a supervisory approval process for the VA will increase firms' administrative costs by only 0.01% of the total implementation costs of firms.

Conclusion on Option 1

HM Treasury believe that this approach to transposition of the Directive is the optimal approach for UK firms and the UK financial sector, and will not leave UK firms at a disadvantage versus their European counterparts.

The Government's micro-business moratorium will not apply in this case; however, micro-businesses should automatically be exempted by the *de minimis* criteria that define the scope of the Directive. More information is in the Small Firms Impact Test at Annex 4.

The proposals are out of scope of 'One-in-two-out' (OITO) because they relate to the transposition of an EU Directive, and the Government is not proposing to introduce any gold-plating.

There will be a ministerial duty to review the legislation transposing Solvency II after 5 years, and every 5 years thereafter.

Option 2 – Do Nothing (Baseline)

This is not a genuine policy option, because it would violate the UK's Treaty obligations, but is included as the baseline for assessing the impact of transposition.

Baseline prudential regime: Individual Capital Adequacy Standards (ICAS)

The ICAS regime was introduced by the Financial Services Authority (the predecessor to the PRA) in 2004 and supplements the existing minimum EU requirements. Insurers produce an Individual Capital Assessment (ICA)[15] setting out their risks and the capital they believe is needed to support these risks over a one-year timeframe. The PRA then reviews the ICA and gives the firm Individual Capital Guidance (ICG). Neither the ICA nor ICG are publicly disclosed. If a firm's capital falls below the ICG, the PRA may intervene to ensure that the firm takes action to restore its capital position.

[15] The assessment of a firm's capital adequacy must: reflect the firm's assets, liabilities, intra-group arrangements and future plans; be consistent with the firm's management practice, systems and controls; consider all material risks that may have an impact on the firm's ability to meet its liabilities to policyholders; and use a consistent valuation basis throughout.

The similarities between the ICAS regime and Solvency II should mean that UK insurers are well-placed to make the transition in comparison to insurers operating in Member States whose prudential regimes have remained closer to the pre-existing (Solvency I) EU minimum requirements.

Difficulties in establishing a wider baseline landscape for the UK

If the Directive were not implemented, UK insurers would still face regulatory, accounting, tax and legal changes in the next few years. For example, since the 2011 impact assessment, the Retail Distribution Review and the Test Achats judgement which prohibited price differences by insurers based on gender, have been implemented, introducing changes to the way insurance is sold. Still to come are the changes to International Financial Reporting Standards (IFRS), as well as the changes which will give more choice to consumers over the purchase of an annuity when they reach retirement, announced as part of Budget 2014.[16]

These changes may drive IT system upgrades, recruitment of additional resource, changes to pricing and product offerings, entry to and exit from markets, and asset allocation shifts. There may be changes to the competitive environment and effects on policyholders.

Because Solvency II is also likely to drive such changes, it is very hard to identify the baseline level of change that would have 'happened anyway'. When estimating the costs of Solvency II, insurers are likely to be including costs that they would have incurred regardless, because Solvency II will act as a catalyst in bringing forward or accelerating planned change programmes. This will inevitably be reflected in the overall cost estimates by firms for implementing the regime.

Other aspects of the baseline

Rather than setting them out here, other aspects of the baseline position for the UK insurance industry (such as level of capital surplus, asset allocation, competitive environment) are mentioned at appropriate junctures in the cost-benefit analysis.

[16] Set out in 'Flexibility for DC pension savers' from April 2015 – Commons Library Standard Note http://www.parliament.uk/briefing-papers/SN06891/flexibility-for-dc-pension-savers-from-april-2015

Section 2 - Cost Benefit Analysis (CBA)

2.1 Introduction

Because there is only a single proposed policy option for transposition, the cost benefit analysis looks at the impact of transposing the Directive in the UK versus a baseline of doing nothing. The intention is to consider the cumulative impact of the new measures.

The overall impact of the transposition will be far wider than just the direct impact of the legal changes proposed by the Government. Further, an assessment of the individual effects of each legal change would not be meaningful; the changes are intended to integrate with existing UK law and with the PRA's handbook changes, and would not be introduced individually or outside of this framework. For this cost benefit analysis, the proposed legal changes have been considered as a package, the combined purpose of which is to allow the Solvency II regime to be introduced in the UK; in other words, we have treated the impact of transposing the Directive as synonymous with the impact of introducing Solvency II in the UK.

However, in line with the proportionality approach to Government impact assessments, we have separately identified the impact of Omnibus II in Annex 5, given the importance of the long-term guarantees package for the UK industry.

Conclusion on Impact of Solvency II

With the agreement of Omnibus II's long-term guarantee package, the capital impact of the overall Solvency II package in the UK is expected to be neutral. This is a significant change over the predicted capital shortfall of £12.5 billion estimated in the 2011 impact assessment.

This means that the bulk of the costs to industry of Solvency II are one-off administrative costs associated with adapting compliance systems to the new regime of approximately £2.7 billion, spread across more than 400 insurers. To put the costs in context, in 2012, UK insurers received more than £188 billion in premium.[17] These administrative costs are more than likely to be offset by the significant benefits that will flow from increased competition among EU insurers and the improvement in UK policyholder protection by introducing a maximum-harmonising prudential insurance regime across Europe.

Basis for the 2014 Impact assessment

A full impact assessment on the Solvency II Directive was carried out in November 2011, before the changes in Omnibus II were negotiated. This impact assessment updates the 2011 impact assessment by including the following information:

[17] Source: *European Insurance in Figures* Statistics No. 48 published by Insurance Europe in February 2014 report, euro converted to GBP using 0.78 exchange rate - http://www.insuranceeurope.eu/uploads/Modules/Publications/european-insurance-in-figures-2.pdf

- Changes to the capital impact analysis using updated ICAS numbers as the baseline and an updated Solvency II calculation that incorporates the Omnibus II changes (replacing the use of the Technical Specification for the Fifth Quantitative Impact Study[18] (QIS5) as a proxy for Solvency II). The changes in Omnibus II increased the predicted solvency ratios of insurers from the QIS5 position by 19%.
- Updated data on the UK insurance market including numbers of firms.
- Updated data on the costs of implementation by the PRA, indicating significant cost reduction by the PRA despite the delay to implementation.
- Updated analysis of costs to industry related to the delay to implementation of Solvency II and the creation of quarterly reporting requirements.
- Identifies main differences between QIS5 and the expected final Solvency II implementing measures that may impact the results of the cost benefit analysis. Overall, the impact of the implementing measures is that capital requirements under the standard formula are likely to decrease and the compliance costs are likely to increase compared to the 2011 impact assessment.

2.2 Basis for the CBA

Omnibus II was adopted by the European Parliament and Council in early 2014 and came into force on 23 May 2014. While the final version of Solvency II, as amended by Omnibus II, has been agreed, the actual impact of introducing Solvency II will depend also on the final shape of the implementing measures and guidance, which include delegated acts, technical standards and EIOPA guidelines. The Delegated Acts were adopted for scrutiny on 10 October 2014 but are not yet formally adopted by the European Parliament.

Delaying this impact assessment until after the EU institutions have approved and published the Delegated Acts would not have allowed adequate time for the transposition process, which has a deadline of 31 March 2015, and would have left firms uncertain as to the Government's intentions for transposition.

The cost benefit analysis provided in the impact assessment published in 2011, which we have updated, was based on the latest complete package of proposed implementing measures to have been comprehensively modelled by industry in QIS5. Omnibus II came into force on 23 May 2014, but much of the supporting detailed calculation rules are set out in implementing measures. The Delegated Acts were adopted for scrutiny on 10 October 2014, which does not allow sufficient time to undertake a new cost benefit analysis for the UK based on this version before the transposition deadline passes. The key changes between the implementing measures and the assumptions used in QIS5 that are likely to have a material effect on the CBA

[18] QIS exercises have been used to assess the impact of successive iterations of the proposed framework. The fifth and final exercise for Solvency II, QIS5, was conducted between July and October 2010. For the QISs, EIOPA published templates and draft calculations for insurers to test, using their own data, how their solvency positions would be affected by the new capital calculation rules. Insurers provided the results to their supervisors and EIOPA for analysis.

are described in more detail in 'capital impact', as well as under 'administrative costs', 'wider impacts' and the 'Smaller Firms test', and draws on the European Commission's impact assessment of the Delegated Acts published on 10 October 2014[19].

The vast majority of the changes to implementing measures that have been made since 2011 are minor technical amendments, but there are three areas of change which are likely to have a material impact on costs. These are:

i. Regulatory reporting by firms will now be required on a quarterly basis rather than only an annual basis. This will of course increase administrative costs for firms;

ii. Some of the investment risk charges in the Standard Formula have been reduced and this is expected to lead to a material reduction in capital requirements; and

iii. The process for approving accounting methods for the calculation of group solvency requirements where EU insurance groups operate in equivalent third country regimes has changed. This should mean that the use of local rules and Deduction and Aggregation methods are more likely to be approved, leading to lower group capital requirements in some instances.

We expect the increase in administrative costs resulting from the change in point i to be outweighed by the lower capital requirements that should result from points ii and iii.

In updating this CBA we have worked closely with the PRA. Where calculations have not been updated since 2011, this is also indicated in the text.

2.3 Structure of the CBA

The direct costs of Solvency II is split into two categories: the cost of any additional capital that needs to be raised, and the administrative costs of implementing the new regime. These administrative costs can be subdivided into costs to industry and costs to the regulator on a one-off and ongoing basis.

Not all of the main benefits are quantifiable, so we consider both monetised and non-monetised benefits in the analysis. We also consider the wider effects of implementation, including the impact on small firms, competition and equality, which are dealt with in separate annexes. The structure is as follows:

[19] http://ec.europa.eu/finance/insurance/docs/solvency/solvency2/delegated/141010-impact-assessment_en.pdf

Costs
Capital Impact on UK insurers
Administrative Impact

Benefits
Monetised Benefits
Non-monetised Benefits

Wider Impacts
Asset Allocation
Financial Market Impacts
Consumer Impacts: Product Price and Quality
Insurance Market Impacts

Annex 1: Post Implementation Review Plan
Annex 2: Equality Impact
Annex 3: Small Firms Impact
Annex 4: Competitive Environment
Annex 5: Omnibus II and the long-term guarantees package
Annex 6: Background information on Capital Impact
Annex 7: 2011 Assessment of direct administrative cost to industry

2.4 Capital Impacts

The baseline for assessing capital impacts should be the UK's ICAS regime, since for the majority of firms the current 'biting[20]' capital requirement is ICAS Individual Capital Guidance, rather than the statutory Solvency I (EU minimum) requirement. The Solvency I position is shown for completeness.

In the 2011 impact assessment, QIS5 results (which are as at year-end 2009) were used as the best available indication of firms' capital positions under Solvency II. The PRA has also provided more recent analysis for the purposes of this assessment that takes into account the likely capital impact from Omnibus II, using data as at year-end 2013.

Impact on Capital Surplus

Overall we do not expect the UK insurance industry, as a whole, to experience a deterioration in their solvency position. This is based on analysis of insurers' capital positions before and after Solvency II and is set out below using insurers' 'solvency ratios'.

The 'solvency ratio' is a ratio of available capital resources to the regulatory capital requirement.

[20] 'Biting' in the sense that it results in a lower level of surplus capital, and so will be the dominant requirement that firms manage their capital around.

$$solvency\ ratio = \frac{capital\ resources}{capital\ requirement}$$

A ratio of greater than 100% indicates that the insurer has a surplus of capital. Currently, UK insurers are operating with a ratio of roughly 166% (in aggregate).[21] A ratio of less than 100% indicates a capital shortfall that the insurer will need to rectify, possibly by raising new capital.

The capital impact was estimated in 2011 for the Treasury's first consultation on transposing Solvency II, and then estimated again for the purposes of this impact assessment. Given the differences in sample sizes used to estimate the capital impact in the two time periods, it is more informative to present the impact as changes in solvency ratios rather than absolute figures. The absolute figures from the samples are located in Annex 6, along with a summary of the capital impact from the 2011 assessment, as background information.

This table shows an updated and estimated change in capital requirements in moving from ICAS to Solvency II for a sample of 191 firms for both life and non-life. This takes into account the Matching Adjustment and Volatility Adjustment from Omnibus II (shown separately in Annex 5). The Solvency II ratio is calculated on the basis of using the Standard Formula for the solvency capital requirement.

Solvency ratio comparing ICAS baseline to Solvency II, before and after Omnibus II LTG amendments				
Firm type	**No of firms included in sample end 2013 (QIS5 sample)**	**BASELINE Average ICAS solvency ratios (as at end 2013)**	**Solvency II ratios based on QIS5 (as at end 2009)**	**Solvency II ratios including LTG changes due to Omnibus II (as at end 2013)***
Life	92	165%	Not available	158%
General	99	172%	Not available	160%
Total	191 (178)	166%	139%	158%

Source: PRA

**Actual aggregate solvency ratio is expected to be higher as this figure excludes use of internal models, undertaking specific parameters, recent changes to the standard formula in the Delegated Acts and use of transitionals by insurers*

This shows that the worsening of capital positions identified in the QIS5 proxy calculations, before the agreement of Omnibus II, has been largely eliminated through the changes negotiated in the long-term guarantees package. The figure above is based on standard formula calculations and so does not take into account further capital position improvements through the use of internal models.

Analysis from the PRA on firms preparing their internal model applications indicates that the median internal model increases solvency ratios by approximately 37%[22] for those intending to use an internal model from day one. Because of this, it is likely that,

[21] Source: PRA

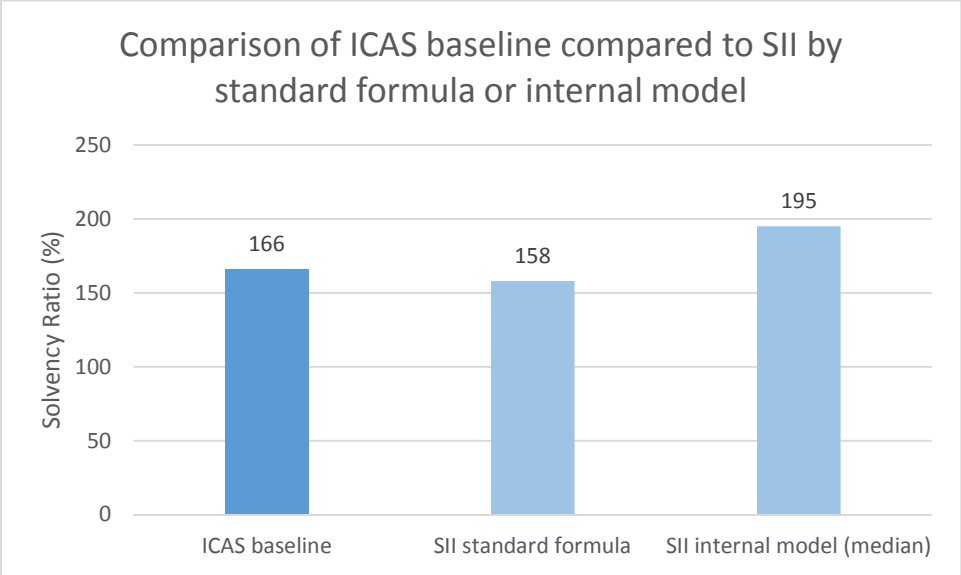
[22] Source: PRA Median internal model is 81% of the capital requirement calculated under standard formula. Converted into a solvency ratio = increase in ratio of 37%

in aggregate, Solvency II will not lead to any deterioration to UK insurers' capital positions.

It does not take into account the changes to the capital calculation rules from the expected final version of the implementing measures which are expected to further increase solvency ratios.

Of course, as Solvency II is a risk-based regime, some individual insurers will likely see their capital positions improve (or worsen) under Solvency II as capital requirements are reallocated between less risky (or more risky) insurers. Where individual insurers' positions worsen, transitional arrangements will provide relief by phasing in the new capital requirements over periods of up to sixteen years. This will also minimise disruption to the market. The effect of transitionals has not been included in the capital impact calculations and are expected to further increase the aggregate solvency ratios during the transitional period.

The transitionals in Omnibus II and the capital calculation rules in the implementing measures are described in more detail later in this assessment.



Impact on different types of firms

The table below shows approximately how the impact can be broken down for different type and size of firms:

Solvency Ratios comparing current regime to Solvency II standard formula by different types of firm					
General Insurance			Life Insurance		
	ICAS solvency ratio (as at end 2013)	SII solvency ratio (including OMII changes)		ICAS solvency ratio (as at end 2013)	SII solvency ratio (including OMII changes)
Small	190%	154%	Small	192%	190%
Medium	147%	137%	Medium	181%	174%
Large	195%	193%	Large	161%	153%
Total	**181%**	**173%**	**Total**	**165%**	**158%**

Source: PRA

Small general insurance firms experience the worst fall in solvency ratio out of the different types of firms, but still remain well capitalised on average under Solvency II, more so than medium general insurers and large life insurers. The effect of Solvency II on small firms is considered further in Annex 4.

While the 2011 assessment identified some types of insurers as particularly vulnerable to capital increases, this situation has changed since 2011, both for annuity writers, in benefitting from use of the Matching Adjustment, and P&I Clubs as a result of changes in the Standard Formula (the counterparty risk module has been modified to now accommodate unique pooling structures such as those used by P&I clubs).[23]

Effect on expected capital impact through use of Internal Models

The table above does not take into account the effect of internal models. The PRA has provided analysis of firms' intended use of internal models which shows that an internal model could improve their solvency ratio by an average of 37%.[24] This may change depending on which models receive approval from the PRA to use. Firms will be able to apply for use of an internal model after 1 April 2015 (after the transposition deadline has passed).

Comparison of SCR calculation by standard formula and internal model using sample of UK firms		
Standard formula	Internal model as a % of the standard formula calculation (median)	Internal model as a % of the standard formula calculation (average)
100%	81%	92%

Source: PRA

The distribution of internal model results range from 68% as the 25th percentile to 111% as the 75th percentile

In 2011, the FSA expected that ultimately around 100 firms will use an internal model under Solvency II, with around a third of these likely to apply for model approval from

[23] Protection and Indemnity Clubs are type of mutual insurer that provide international maritime insurance

[24] Due to a decrease in the denominator, the regulatory capital requirement, of 19% using the median figure, solvency ratio increases by 37% from 158% to 195%

'day one' of the new regime. Since then, the number of firms has dropped to approximately 40 firms, with most of them likely to apply for approval from 'day one'.

Because of the costs involved in developing an internal model, most firms will only do so if the capital 'saving' that results is in excess of the development cost, suggesting that internal models will tend to reduce the aggregate capital requirement – although there will be some exceptions to this rule. Analysis from the Bank for International Settlements (BIS), undertaken by the Committee on the Global Financial System (CGFS) in their July 2011 paper *Fixed Income Strategies of Insurance Companies and Pension Funds*,[25] suggests that internal model requirements might be 20% lower than the standard formula on average across the EU.

The decrease in the number of internal model applications could likely be due to the changes from Omnibus II. Omnibus II improved the solvency position of insurers through the long term guarantees package as well as the set of transitionals and likely reduced the incentive to use an internal model by firms if they found that the capital benefit was outweighed by the cost of development. There may be additional model applications post 'day one' as the transitional provisions reduce over time.

Effect on expected capital impact through Transitional Arrangements

Transitional measures, which were agreed as part of the Omnibus II Directive[26], will phase in some aspects of the new regime, so any capital impacts may be spread out over time. Any capital-raising activity could be pushed further out into the future, or firms may use the extra time to pursue alternatives to capital-raising (such as de-risking, group restructuring, use of internal models or seeking to merge with or be taken over by another firm).

Some transitionals are not automatic but are subject to the choice of the firm, and some are mutually exclusive (an insurer cannot use both the technical provisions transitional and the risk-free interest rate transitional). As such, it is not possible to accurately predict the final impact of the transitionals on the UK market. Below is a description of each transitional and its likely impact.

Transitional for the risk-free interest rate

This provision allows firms to delay moving to the Solvency II risk-free interest rate when calculating their technical provisions for existing business (insurance business written before 1 January 2016) that is not subject to the Matching Adjustment.

This transitional is voluntary for the firm and subject to supervisory approval. It will improve firms' capital positions for the next 16 years, though the benefit will reduce over time and disappear by 1 January 2032. It will give firms more time to meet

[25] http://www.bis.org/publ/cgfs44.pdf

[26] Omnibus II amends Article 308 of the Solvency II Directive

Solvency II capital requirements, reducing the likelihood that firms will need to raise capital.

Because it affects the risk-free interest rate used to value insurance liabilities, it is most relevant for long term insurance business. However, as it cannot be used in conjunction with the Matching Adjustment, it is unlikely to be used extensively by UK long term insurers.

Transitional for the calculation of technical provisions

This provision allows firms to phase in their new technical provisions calculation over 16 years where the level of technical provisions under Solvency II compared to current requirements is higher. This transitional is an alternative to the transitional to phase in the risk-free interest rate.

It will improve some firms' capital positions for the next 16 years, though the benefit will reduce over time and disappear by 1 January 2032. It will give firms more time to meet Solvency II capital requirements, reducing the likelihood that firms will need to raise capital.

Both the transitional measure for the risk-free rate and the calculation of technical provisions will be more significant for firms that have long-term insurance business. Firms must choose between using either the risk-free rate or the technical provisions transitional measure. Because the risk-free rate transitional cannot be used in conjunction with the Matching Adjustment, it is likely UK insurers would choose the use the technical provisions transitional instead. It will likely provide significant additional capital relief for individual long term insurers who choose to apply it.

Transitionals for the solvency capital requirement (standard formula)

The application of the equity risk charge to equities purchased before Solvency II came into force will be phased in over seven years.

Application of concentration risk charges and spread risk charges to sovereign debt issued by EU jurisdictions in EU currencies other than their own will be treated as zero for two years, before the risk charges gradually increase to the prescribed amount by 2020.

Both of these transitional provisions will improve some firms' capital positions for up to seven years, though the benefit will reduce over time and disappear by 1 January 2023. They give firms more time to meet Solvency II capital requirements, reducing the likelihood that firms will need to raise capital.

Transitional allowing grandfathering of own funds items

This transitional allows firms to include already issued basic own-fund items, such as subordinated debt instruments, that meet the current criteria but don't meet the Solvency II criteria to be classified as Tier 1 or Tier 2 own funds, to be included as own funds under Solvency II for up to 10 years.

This will reduce the need for firms to raise new capital before the end of the transitional period, meaning firms will have more flexibility to choose the optimal time to issue replacement capital.

Transitional for the group solvency capital requirements

The transitionals applicable for individual insurance firms can also be applied to the group solvency calculation.

In addition, groups that are using the deduction and aggregation method for non-EU insurance companies yet to be determined equivalent will be able to incorporate them using non-EU local rules for a period of time if the non-EU regulatory regime is determined by the Commission to be temporarily or provisionally equivalent. Temporary or provisional equivalence can last for up to 10 years and be renewed under certain conditions.

The jurisdictions that will be deemed equivalent, or temporarily or provisionally equivalent, by the Commission have not yet been identified so the impact cannot be assessed. However, as the group generally chooses whether to use deduction and aggregation (subject to supervisory approval), it is likely that this will result in a decrease in the group solvency capital requirements compared to using Solvency II rules for non-EU insurers in the group.

Cross-border groups will also be allowed to apply for partial internal models for parts of its group that are located in the same jurisdiction and have a distinct risk profile from the rest of the group without having to apply a full group internal model for seven years. This will allow firms to have the benefit of a partial internal model for the parent's jurisdiction from day one while still developing an internal model for the rest of the group.

The effect of these transitionals is to improve firms' capital positions for up to sixteen years, and give firms more time to meet Solvency II capital requirements, reducing the likelihood that firms will need to raise capital.

The interaction between all the different long-term guarantee measures and the transitional measures for technical provisions is complex with firms not able to combine certain measures. The table below details how they can be combined. Overall, firms are likely to choose to use the combination that provides the most capital relief.

Summary table of transitional provisions

LTGP and transitional measures	Can be used with Matching Adjustment	Can be used with Volatility Adjustment	Can be used with risk free rate or technical provisions transitional	Can be used with SCR transitional measures	Can be used with Own Funds transitional
Matching Adjustment	N/A	no	Can be used with TP transitional but not risk free rate transitional	yes	yes
Volatility Adjustment	no	N/A	Yes, but only one of them	yes	yes
Risk free rate transitional	no	Yes (only if TP transitional not used)	Cannot be combined with the TP transitional	yes	yes
Technical provisions transitional	yes	Yes (only if risk free rate transitional not used)	Cannot be combined with risk free rate transitional	yes	yes
SCR transitional measures	yes	yes	Yes, but only one of them	N/A	yes
Own funds transitional	yes	yes	Yes, but only one of them	yes	N/A

Effect on capital impact of implementing measures

The main differences between the implementing measures adopted in October 2014 and the QIS5 technical specifications (as outlined in the Commission's impact assessment on the Delegated Acts[27]) that will impact capital are the changes to the risk charges in the standard formula for different financial instruments.

The categories of equities that receive the lower risk charge (39% as opposed to 49%) has been broadened to include private equity funds and some European-created investment funds. Risk charges on corporate bonds have been reduced by including an ability to recognise certain guarantees and other risk mitigating efforts, as well as the use of proxy ratings for certain unrated instruments. Additionally, infrastructure project bonds, even when tranched, will receive the lower corporate bond risk charges instead of the securitisation risk charges. For firms holding or planning to hold high-quality securitisation assets ('high-quality' is defined in the implementing measures), risk charges have decreased (although risk charges for other types of securitisation assets have increased).

These amendments are likely to reduce firms' capital requirements when compared to the 2011 estimate (and therefore increase the level of surplus capital insurers hold) and reduce the need to raise additional capital. It is difficult to say by how much as firms may choose to restructure their investment portfolios in response to the

[27] http://ec.europa.eu/finance/insurance/docs/solvency/solvency2/delegated/141010-impact-assessment_en.pdf

different types of risk charges. This is the intention of the Commission, which states in its impact assessment that the changes to the risk charges are intended to stimulate long-term investment by insurers.

How much capital might need to be raised as a result of Solvency II?

Where individual insurers experience a material decrease in solvency ratios, they may need to raise capital as a result of Solvency II.

The 2011 impact assessment showed that while on aggregate across the UK industry the QIS5 exercise showed a capital surplus, 20% of solo firms were unable to meet the QIS5 standard formula capital requirement as at year end 2009. The combined reported capital shortfall below the SCR for these firms was £12.5bn.

However, the new analysis of the capital impact that takes into account Omnibus II shows that less than 10% of firms have a capital shortfall, and that aggregate shortfall has fallen to £1.7 billion. This is based on standard formula calculations, so the number of firms will be lower once internal models or use of 'undertaking specific parameters'[28] are taken into account.

A shortfall does not necessarily mean that firms will raise capital, as they could undertake alternative action such as:

- as previously mentioned, using an internal model or undertaking specific parameters in their solvency calculation to decrease their capital requirements;
- derisking their portfolios in order to decrease their capital requirements;
- where the insurer is part of a larger group, the group may provide capital injections to the insurer; and
- retaining more profits over time (a more viable solution now that Omnibus II introduces material transitionals that phase in higher requirements over a period of up to sixteen years).

Capital Buffers

Firms typically hold a 'buffer' above the minimum regulatory capital requirement. Therefore, individual insurers may raise capital where they do not have a capital shortfall but they wish to increase their capital 'buffer'. It is difficult to predict whether firms will choose to retain the same 'buffer' under the new regulatory regime.

Literature on capital buffers for insurers[29] suggests that rating agency requirements and business planning decisions are usually the dominant factors in determining the

[28] Firms can apply to use 'undertaking specific parameters' (USPs) to replace some of the calculation rules in the standard formula subject to supervisory approval.

[29] See for example the DNB Working Paper *Are non-risk based capital requirements for insurance companies binding?* available at http://www.dnb.nl/binaries/Working%20Paper%20145_tcm46-159718.pdf

size of any buffer held. Regulatory requirements only become a dominant factor when firms are close to breaching the regulatory minimum.

This suggests that firms' behaviour in terms of buffers may be divergent. Firms that find themselves close to the regulatory minimum under Solvency II are likely to want to maintain or increase their existing buffer, to provide protection against a breach, particularly given the greater balance sheet volatility that may arise from a move to a market-consistent framework.

On the other hand, firms with a healthy existing buffer, and who partly hold this buffer because of a belief that they are exposed to risks other than those captured by the ICAS regime, may be content with a smaller buffer once they have moved to a Solvency II framework, if they (and rating agencies) believe these risks are now adequately captured within the Solvency Capital Requirement.

2.5 Administrative Impact

Updates to the 2011 costs estimate

Total costs of implementing Solvency II are expected to be just over £2.6 billion as a one-off cost, and £199.1 million annually in compliance costs incurred by the PRA and by UK insurance industry.

Total Costs (incurred and estimated)	**Industry (excluding fees paid to PRA)**	**Direct PRA costs**	**PRA special project fee**	**Total costs (ultimately paid by industry)**
One-off implementation	2601.5	104.9	94.6	**2706.4**
Ongoing compliance (per year)	195.9 per year	3.2 per year	Nil (regular levies will absorb)	**199.1 per year**

Source: PRA

This is an increase to one-off costs of roughly 30% from the 2011 assessment, and 5% increase to ongoing costs. This is due mainly to the delay in implementation caused by the Omnibus II negotiations as insurers would not have been able to completely 'pause' their Solvency II preparations this period.

It is also important to note that the PRA is funded through levies on the firms it supervises. This means that the PRA's costs are ultimately paid for by industry. Some of the cost is paid through a specific Solvency II special project fee and the rest will be paid for by the non-Solvency II specific levies payable by authorised firms.

Impact of delayed implementation

The 2011 impact assessment included a detailed estimate of costs to industry and to the FSA, both one-off and ongoing. At the time of the costs estimate, Omnibus II was expected to be agreed in early 2012, though the impact assessment acknowledges the risk that agreement could be delayed. This risk crystallised and Omnibus II did not come into force until May 2014, with an implementation date for Solvency II of 1 January 2016.

While this delay significantly increased the one-off costs of preparing for Solvency II as firms and the PRA continued to use resources contributing to the negotiation of Solvency II as well as continue their implementation plans, the capital relief for the UK industry secured by the agreed Omnibus II of over £10 billion, compared to the estimated decrease in capital surplus under QIS5 in 2011, more than offset the UK's share of the additional estimated administrative costs of the delay.

Impact of PRA/FSA restructure

Over the same timeframe, the FSA was replaced by the PRA, and the PRA undertook significant restructuring of its implementation project for Solvency II.

The PRA has provided updated information on both its one-off costs and ongoing compliance costs and these have been included below. The detailed cost estimates from 2011 covering costs to the FSA have not been repeated here but can still be accessed via the Treasury's 2011 impact assessment.[30]

The FCA is also responsible for implementing some minor parts of Solvency II, but the costs are much smaller and are assumed to be absorbed into business as usual, and are not considered further in this assessment.

Direct Administrative Cost to Industry

	Estimated Direct Administrative costs (£m) (excluding fees and costs to PRA)
2011 estimate	1,934 (+190 per year)
2014 estimate	2,601.5 (+195.9 per year)

The direct administrative costs to industry calculated in the 2011 impact assessment were based on extensive research conducted by Ernst & Young (EY) on behalf of the FSA in July 2010[31]. They estimated a total one-off implementation cost to industry of £1,934 million (excluding fees paid to the FSA/PRA).

[30] The 2011 impact assessment is annexed to Treasury's 2011 consultation paper *Consultation on Solvency II* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81581/condoc_consultation_solvencyII.pdf

[31] For full details of the methodology, and the full data request sent to firms, see Ernst & Young's Compliance Impact Assessment, http://www.fsa.gov.uk/pubs/other/ey-solvencyii-cba.pdf

Since that analysis, the implementation timeline was extended, adding three years of additional costs. A survey by Deloitte in 2012[32] on costs to industry shared views from survey participants who estimated that a delay to implementation from 1 December 2012 to 1 Jan 2014 (which was the expected start date at the time of the survey) would add up to 10% to current programme budgets[33]. Solvency II was ultimately delayed an additional two years to 1 January 2016. Extrapolating the 10% increase for an additional two years would lead to an increase in implementation costs of £580.2 million[34].

Specifically in relation to ongoing costs, EY estimated in 2011 that ongoing compliance costs for industry would be £190m per year. This has been revised upwards to £199.1m to take into account additional reporting requirements introduced in the Delegated Acts. This new figure is broadly consistent with a later survey by EY in 2012[35] where 35% of respondents believed ongoing compliance costs would make up 5-10% of one-off implementation costs and 30% of respondents believed 1-5%. Only 12% of respondents believed that ongoing costs would be greater than 10% of the one-off implementation costs.

The changes related to the implementing measures are discussed further below and contribute an additional £86.9m to one-off implementation costs and £5.9 million to yearly compliance costs. The use of the volatility adjustment prior supervisory approval process is discussed in Annex 5 and adds £400 000 to one-off implementation costs to industry. Also including the costs attributable to the PRA, leads to estimated total costs to industry of £2,706.4 million as a one-off cost and £199.1m per year[36] in ongoing compliance costs.

Costs associated with changes to Solvency II since 2011

This estimate would also be affected by changes introduced in Omnibus II and the implementing measures that create additional processes and requirements on firms.

Impact of Omnibus II

The changes to the administrative costs of implementation and compliance for firms caused by Omnibus II are likely to be minimal compared to overall administrative costs. They relate mostly to additional risk management processes that accompany the use of the Matching Adjustment, Volatility Adjustment and transitional measures agreed as part of the long term guarantees package, as well as costs from a new requirement for firms to assess the appropriateness of external rating agencies. Because they are minimal, we do not make any adjustments to administrative costs.

[32] Deloitte Solvency II Survey 2012 *Where are insurers heading?*

[33] 82% of respondents to the Deloitte 2012 survey said that costs would increase between 1 and 10%, 5% said more than 10%, and 13% were unsure.

[34] $£1{,}934 * 0.3 - £1{,}934 = £580.2\text{m}$

[35] Deloitte Solvency II Survey 2012 *Where are insurers heading?*

[36] £190m + £5.9m (additional reporting costs) + £3.2m (ongoing PRA costs)

Impact of Implementing Measures

The 2011 assessment of firms' costs relied on the assumptions in the QIS5 technical specifications rather than the current version of the Delegated Acts, published in October 2014. The Commission published an impact assessment along with the latest version of the Delegated Acts. Overall, it found that the impact of the Delegated Acts was approximately €1 billion for the entire EU insurance industry.

The main differences between the implementing measures and the QIS5 technical specifications, as outlined in the Commission's impact assessment[37], in relation to administrative costs, are:

- Creation of a requirement for firms to have a remuneration policy will increase administrative costs (slight increase in compliance costs)
- Allowing insurers to opt out of using IFRS if it is too costly and burdensome and the alternative is sufficiently market consistent. This will reduce ongoing compliance costs though a firm may incur some one-off cost increases if firms currently use a GAAP that is not market consistent (slight decrease in compliance costs).
- Creation of quarterly reporting requirements (significant increase in compliance costs)

Estimating costs of additional reporting requirements from the Implementing Measures

The 2010 Deloitte survey referred to in the Commission's impact assessment identifies reporting requirements as the principal contributor to compliance costs for firms. Deloitte (2010) estimate that if the entire set of annual quantitative information required from firms was also required quarterly, it would add €418 – €696 million in one-off costs and ongoing costs of €38 million per year for the entire EU industry. We can expect the actual figure to be lower than this, as the latest version of the implementing measures requires only a partial set of quarterly reporting compared to the assumptions in the survey of a complete set of quarterly reporting. Therefore, our estimate should be considered conservative.

Assuming the UK firms incur reporting compliance costs in proportion to their share of the EU market, we can estimate the figure attributable for the UK to be roughly 25%[38] of total reporting costs, using market share based on assets under management[39]. Further, Omnibus II introduces the ability for Member States to exclude smaller firms from quarterly reporting for up to 20% of their market[40]. Taking

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[37] http://ec.europa.eu/finance/insurance/docs/solvency/solvency2/delegated/141010-impact-assessment_en.pdf

[38] 80% of the 25% will incur quarterly reporting costs assuming that the reporting exemptions lead to 20% of insurers not incurring reporting costs and that costs are allocated proportionately.

[39] Figures on UK and EU assets under management are from Insurance Europe's publication *European Insurance in Figures* Statistics No. 48 published in February 2014 (EU assets under management of €8.4 trillion converted to GBP using an exchange rate of 0.78) and ABI's Key Facts 2014 document previously cited (UK assets under management of £1.8 trillion)

[40] This is only an estimate, for example, it would likely be made lower due to the disproportionately high number of firms that take up the bottom 20% share of the market compared to the top 80%.

these adjustments into account indicates additional compliance costs of £86.9 million as part of one-off implementation, and £5.9m in ongoing compliance costs.

Estimated additional cost of reporting requirements from implementing measures				
	EU-wide estimate (£m)[41]	UK share (£m)	20% reporting exemptions (£m)	**Estimated additional compliance costs for UK (£m)**
One-off compliance costs	434	108.6	(21.7)	**86.9**
Ongoing compliance costs (per year)	38	7.4	(1.5)	**5.9**

Further detail of how the original 2011 administrative costs were estimated is located in Annex 7.

Direct costs to the PRA

Comparison of cost estimates between 2011 and 2014	PRA One-off implementation costs (£m)	PRA Ongoing compliance costs (£m per year)
2011	110	21.5[42]
2014	104.9	3.3

One-off costs for the PRA

The PRA have estimated that their total one-off or transition cost for implementing Solvency II at £104.9m, this is slightly down from the FSA's 2011 estimate of £110 million, even with the three year delay to implementation. This is because the implementation programme has undertaken significant cost reduction since 2011.

[41] A middle estimate for the range of €418-€696m of €557m was used. It was then converted to GBP using an exchange rate of 0.78.

[42] Middle point between the estimated 20-23 million from Treasury's 2011 impact assessment https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81581/condoc_consultation_solvencyII.pdf

Cost Breakdown (£m)	Actual Costs to Mar 14	FY13/14	FY14/15	FY15/16	FY16/17	Total Cost
Business Resource Costs	48.1	5.4	-	-	-	53.5
Programme Team	8.5	0.9	0.8	0.8	0.1	1.1
Additional business resources	-	0.3	0.2	0.4	-	0.9
Non-Staff Costs	13.2	3.4	3.8	3.5	0.2	24.2
IT costs	3.2	0.1	7.9	3.8	-	15.1
Total Cost	**73.1**	**10.2**	**12.8**	**8.5**	**0.3**	**104.9**

Source: PRA

Costs predominantly relate to staff resources for supervision, actuarial and policy areas. The wind-down in the Programme Team costs and Business resource costs indicate that Solvency II is transitioning from a project-based funding arrangement to part of business-as-usual costs, replacing the resources dedicated to the ICAS regime currently in place. Main costs to programme after March 2014 include incremental programme resources, non-staff costs including professional fees and training, and IT costs.

As part of the changeover to the PRA, the FSA undertook a strategic review of its Solvency II implementation plan. Changes included relocating project management of Solvency II implementation within the existing supervisory, actuarial and policy teams rather than running a larger, more decentralised team.

Ongoing Costs for the PRA

The supervision of Insurance firms after the implementation of Solvency II will require some additional supervisory resources. The 2011 assessment estimated ongoing costs of the FSA at between 20-23 million per year after 'Day 1' but this included some implementation costs that continued after Day 1 when the implementation date was 1 January 2014. Since that estimate the FSA has been replaced by the PRA, the allocation of costs as ongoing compliance costs has been recalculated to take into account the later implementation date, and has reduced down to approximately £3.2 million per year after 'Day 1'.

Ongoing Costs £m	FY16/17	FY17/18
IT Maintenance costs	0.3	0.2
Increased supervisory resource	3.0	3.0

Source: PRA

Special Project Fees charged to insurers

	Fees Charged		
Year	IMAP	Non-IMAP	Total
FY11/12	15.8	23.6	39.4
FY12/13	12.0	18.4	30.4
FY13/14	5.4	6.2	11.6
FY14/15*	n/a	n/a	13.2
Total			**94.6**

*special project fee for FY 14/15 predicted value only

Source: PRA

The FSA, and later, the PRA, have implemented a special project fee to be paid by firms that are within scope of Solvency II to assist with the costs of implementation. Because of the significant amount of resources needed from the regulator to approve internal models, the fee differentiates between internal model and non-internal model insurers. The total special project fees of £94.6 million is reduced from the 2011 estimate of £110m, in line with the reduction in the PRA's total implementation costs.

The noticeable decrease in special project fees charged for FY13/14 onwards shown in the table is due to Solvency II costs being moved into business as usual. In line with the shift to business-as-usual, the last special project fee charged to industry will be for FY14/15. The remainder of the costs for future years will be absorbed by the regular levies paid by firms to the PRA.

2.6 Benefits

There are some key difficulties with estimated benefits of implementing Solvency II in the UK. Generally, discussion of benefits to date has been qualitative rather than quantitative and will depend on individual insurers' behaviour. The 2012 survey by Deloitte of the UK insurance industry[43] reported that 73% of insurers believed Solvency II would bring some or significant tangible business benefit compared to 27% who did not.

Because of the difficulty, benefits have been assessed on a 'best efforts' basis using a mixture of quantitative and qualitative analysis, and the quantified benefits are indicative only.

[43] Deloitte Solvency II Survey 2012 *Where are insurers heading?*

Monetised Benefits

The methodology in this section is based on the Impact Assessment[44] produced by the European Commission to accompany the publication of the Solvency II Directive, with some adjustments to reflect the UK rather than EU-wide position.

We attempt to monetise an improvement in the efficiency of firms' risk and capital management. This benefit is modelled by using improved investment returns as a proxy for the savings arising from improved risk and capital management practices within firms.

The ICAS regime will already have brought a portion of these benefits to UK firms, so the incremental benefit in the UK will be smaller than that available in other EU countries whose current regimes are closer to the Solvency I requirements. We take this into account in the calculations that follow by making prudent assumptions about the reduced capital costs, efficiency gains and improvement in investment that are likely to emerge.

Reduced cost of capital

The 2011 cost benefit analysis provided an estimate of the reduced cost of capital due to the increased resilience of the sector, improved transparency and better access to risk mitigation tools, identified by the European Commission in their impact assessment for the Solvency II proposal. This has been updated using new figures for the level of available capital. This is a conservative estimate as the sample does not include all insurers so the estimated level of reduced cost of capital would be higher for the whole UK insurance sector.

[44] http://ec.europa.eu/internal_market/insurance/docs/solvency/impactassess/final-report_en.pdf

		Assumed reduction in cost of capital per annum (bps)				
		0	3.75	5	7.5	10
Capital scenario	**Total available capital (at end 2013)**	**2014 present value of saving arising from assumed reduction in cost of capital over 10 years from 2016 (£m)**				
Lower estimate (90% of estimated capital levels)	93,683	**0**	281.2	377.7	562.5	755.3
Best estimate (100% of estimated capital levels)	104,092	0	**313.4**	417.8	626.8	835.7
High estimate (110% of estimated capital levels)	114,501	0	345.5	**458.0**	634.0	845.6

Omnibus II also introduces monetised benefits from measures to reduce pro-cyclicality across the insurance sector. The Matching Adjustment, Volatility Adjustment, and ability for supervisors to extend recovery periods of individual firms who breach their capital requirements are designed to prevent situations where firms sell assets at depressed prices to address regulatory capital rules rather than a real need for liquidity. This risk is discussed in more detail in the PRA's consultation paper CP 16/14.

Improved efficiency of risk and capital management

As the Commission noted in their 2011 impact assessment[45], Solvency II has been designed to bring about improvements to firms' risk management processes. By better managing their risk and their capital requirements, firms will be able to manipulate their risk/return profiles (for instance through diversification activity), leading to efficiency gains. Solvency II also requires higher levels of data quality, for example, through its data quality standards for internal model approval. Where firms make significant investments in improving data quality, this should also improve risk management as well as improved implementation of investment strategies in line with the firms' risk appetites. The size of insurers' balance sheets means that even very small efficiency savings are likely to be substantial when considered in aggregate. However, since these efficiency gains are very difficult to quantify directly, an alternative approach is to use an improvement in investment returns as a rough proxy.

[45] http://ec.europa.eu/finance/insurance/docs/solvency/impactassess/final-report_en.pdf

Analysis of impact on investment income

Analysis from 2011, indicates that the value of additional investment income over 10 years from 2013 (the then date Solvency II was expected to commence) would be £3,214 million. This was based on the UK insurance industry of approximately £1.6 trillion[46] of assets in aggregate. This benefit was based on an assumption that investment returns on these assets improved by between 1 and 3.5 basis points.

The level of assets in aggregate has increased to £1.8 trillion[47] so we expect the benefit to also increase, all other things being equal. We have estimated this to be £3,616.14 million.

For each of the scenarios modelled below, it is assumed that the additional returns persist for ten years, with the total assets remaining fixed at £1.8 trillion over that period. Given the increase in total assets from 2011 to 2014 has been 12.5% in practice, this is a conservative estimate.

Scenario	Assumed improvement in return (bps)	Resulting additional investment income per annum (£m)	Total additional investment income over 10 years (£m)	2014 present value of additional investment income over 10 years from 2016 (£m)
Very Low	1	180	1800	1446.4
Low	1.5	270	2700	**2169.5**
Low - Moderate	2	360	3600	2892.7
Best Estimate	2.5	450	4500	**3616.14**
Moderate - High	3	540	5400	4339.1
High	3.5	630	6300	**5062.3**

The size of the benefit is very sensitive to the assumption about the basis point increase in achievable returns, so lower and higher estimates have also been calculated as shown in the table above.

Non-monetised Benefits

These are largely unchanged by Omnibus II and so we have not made any changes to the analysis from 2011 besides providing figures on Financial Services Compensation Scheme (FSCS) claims paid out after 2011.

[46] Source: ABI Key Facts September 2010

[47] Source: ABI Key Facts September 2014 https://www.abi.org.uk/Insurance-and-savings/Industry-data/Key-Facts-2014

Administrative benefits to industry

As part of their research for the FSA, EY asked sample firms to try to quantify the administrative benefits of complying with the Solvency II regime. Firms struggled to do so, and not enough data was gathered to undertake a quantitative analysis, but firms did describe the administrative benefits they expected:

- improved risk modelling, analysis and management;
- enhanced governance processes;
- improvements in management information;
- a greater definition of risk appetite; and
- improvements to documentation and the internal control framework.

These administrative benefits are mostly attributable to Pillar 2 of the regime (which deals with risk management and governance). EY believe these benefits are likely to materialise, and will also contribute to the better management and avoidance of downside risk (or in other words to 'loss aversion'), which is in itself a significant benefit of the new regime (discussed below).

A harmonised regulatory framework across Europe should reduce ongoing compliance costs for UK firms with operations in other EU countries.

Insurance Market Benefits

Solvency II will create a 'level playing field' across Europe for the provision of insurance and reinsurance services. This will create an increased opportunity for UK insurers to compete within Europe, and will also open up the UK market to increased competition from insurers in other Member States. Competitive effects are considered further within the Competition Impact Test at Annex 3.

The risk-based nature of the new framework should make the insurance market in Europe more efficient, in the sense that if pricing and capital allocation are more closely aligned to the real risks faced, then policyholders are more likely to be charged appropriately according to the risks they choose to insure, and shareholders compensated more appropriately for the risks they assume.

Pillar 3 of the Solvency II regime concerns disclosure; in particular, it is intended to increase the level of transparency in insurers' public and regulatory reporting. This enhanced level of disclosure aims to bring greater 'market discipline' to bear. The amount and range of information that will be publicly disclosed will be greater than at present. It is hoped that this will result in market participants exerting greater supervision over, and greater competition to, other insurers. The Commission have suggested[48] that insurers following best practice might be more likely to be rewarded by a lower cost of financing.

[48] See the Solvency II FAQ document previously referenced.

Internal Model benefits to industry

Analysis from the PRA indicates that use of an internal model will decrease an insurer's capital requirements by an average of 19% when compared with the standard formula (based on median internal model in sample data). In addition, there are other benefits to firms of internal model usage[49]:

- Better understanding of the firm's business and capital requirements through identification of the true risk profile of the business;
- Improved evaluation of risk-adjusted returns on capital;
- Better understanding of the relative contribution of the major categories of risk to the firm's overall risk profile;
- Improved capability to balance risk with reward, to measure performance, and to identify strengths, weaknesses and opportunities;
- Better assessment of the impact of strategic decisions on capital requirements;
- Improved quality of documentation; and as a result,
- Better communication of results to supervisors and ratings agencies, as well as for internal communications.

Increased confidence of rating agencies in a firm's risk management is one of the factors that may help to reduce a firm's cost of capital, as discussed and modelled above.

Benefits to Consumers

The main benefit of Solvency II to consumers of insurance products will be the greater level of policyholder protection they will enjoy; that is, the greater likelihood that insurance providers will be able to meet their liabilities as they fall due.

It is very likely that Solvency II will affect the price of insurance, but it is not possible to predict the direction or magnitude of price changes for specific products at this stage.

It seems likely that as firms re-calculate their capital requirements on a Solvency II basis, and re-evaluate their business for profitability and return on capital, some products may become more expensive to provide whilst others may become cheaper. Competitive shifts in the market will also drive price changes. Consumers of products that end up with a lower price will benefit, but this benefit will be at least partially offset by consumers of products that increase in price.

A 2007 briefing note by the Comité Européen des Assurances (CEA) (now Insurance Europe)[50] listed the key consumer benefits of Solvency II as being: greater consumer

[49] See for example *Internal Models – A Winning Solution for Solvency II,* Guy Carpenter (2007), and *Benefits and challenges of using an internal model for Solvency II,* Milliman (2008).

[50] CEA (now Insurance Europe) *Solvency II Why it Matters to Consumers,* September 2007,, http://www.insuranceeurope.eu/uploads/Modules/Publications/1202314902_solvency-ii-briefing-note-4-consumers.pdf

confidence; enhanced policyholder protection; cost-effective protection; and more innovative and competitive products.

Benefits to the financial system – averted loss

There have been some insurance failures that have had a substantial impact on policyholders and investors in the UK. Payouts under the Financial Services Compensation Scheme (FSCS) in respect of insurer failure totalled £172m in the 3 years to 2011[51]. Since 2011, the FSCS has paid out an additional £224.3m. Of the £224.3m paid out by the FSCS, £15.8m was paid out for EU insurers that were passporting into the UK under the EU single market rules.[52]

Some of the past causes of insurer failure have been:

- inadequate provision for the guarantees within policies or for policyholders' reasonable expectations;
- poor risk management processes and controls;
- under-pricing of contracts;
- overly-rapid expansion;
- difficulties within other (non-insurance) parts of an insurance group;
- under reserving; and
- multiple exposures to the same pool of risks, and opaque reinsurance structures.

The PRA considers that Solvency II will lead to greater market discipline and more resilient insurers under the 'three-pillar' approach: Pillar 1 will align capital requirements more closely with the actual assets and liabilities held; Pillar 2 will lead to more pro-active risk management activity; and Pillar 3 will improve transparency via heightened public disclosure.

The UK will directly benefit from the implementation of Solvency II in other Member States as the maximum harmonisation nature of the solvency requirements means that insurers in other Member States, including those that passport into the UK, will also be required to meet the Solvency II standards. The UK has benefitted from enhanced Solvency I requirements under the ICAS regime for a number of years.

[51] This figure has been derived from annual reports of the FSCS for 2008/09, 2009/10, 2010/11, 2011/12, 2012/13, 2013/14 available at www.fscs.org.uk.

[52] Source: FSCS. Amounts paid out for EU-passporting insurers include £4.2m in 2011/12, £1.1m in 2012/13, £5.5m in 2013/14 and £5.0m from April 2014 to date.

2.7 Wider Impacts

The wider impacts identified in the 2011 impact assessment will be impacted by the amendments introduced in Omnibus II concerning the long-term guarantees package, as well as the implementing measures, if adopted unchanged by the European Parliament.

Where Omnibus II or the implementing measures are likely to affect the previously identified wider impacts, they are specifically addressed below.

According to a July 2011 paper[53] from the Bank for International Settlements' Committee on the Global Financial System (CGFS), insurance firms may adjust their operations in several ways as a result of new regulations:

- Change the size and allocation of investment portfolios;
- Transfer risk to the financial markets using reinsurance, securitisation or hedging with derivatives;
- Streamline group structures to better capitalise on diversification benefits;
- Redesign products over time.

In this section we consider the wider impacts of Solvency II implementation. In particular we consider the investment, financial market, product/pricing and insurance market implications. Competition effects are considered in the Competition Impact Test at Annex 3.

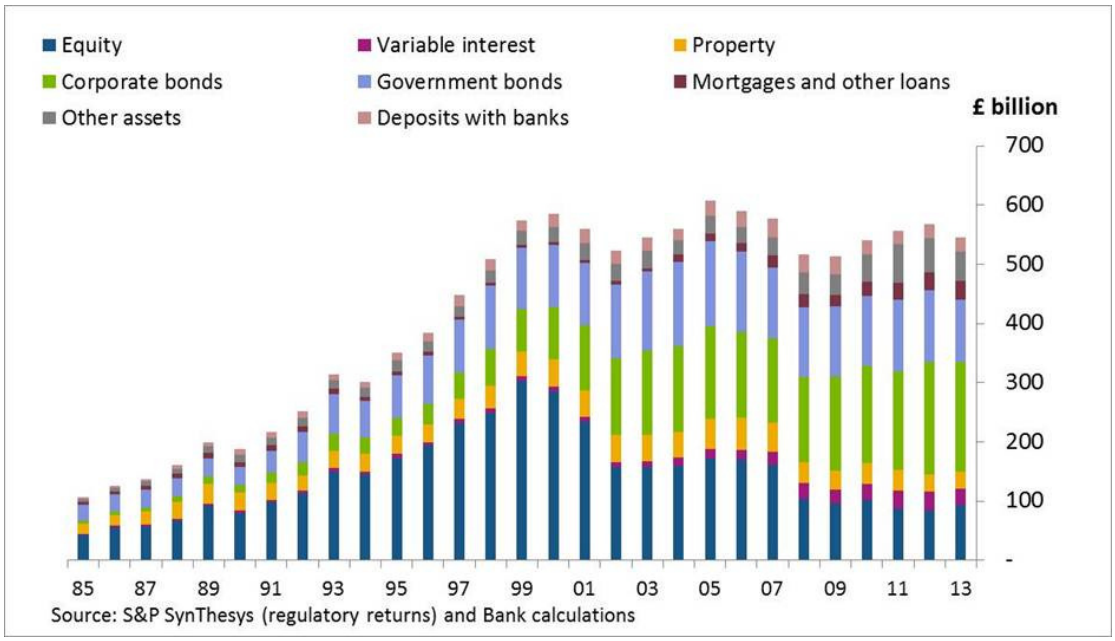
Asset Allocation

Baseline

The following graph shows trends in asset allocation amongst insurers for the period from 1985 - 2013. The graph indicates a reduction in equity holdings following a peak in 1999 and a steady increase in holdings of corporate bonds for life insurers. However, the graph incorporates changes that arise from changes in valuation, not necessarily reflecting a change in the insurer's preferences for asset allocation. The analysis that follows should be interpreted in the context of this shifting 'baseline', since asset allocation has clearly not been static over the period preceding the introduction of Solvency II, and some of the non-Solvency II drivers of the changes seen in past years will still be in evidence.

[53] http://www.bis.org/publ/cgfs44.pdf

Figure 5: Assets backing non-linked liabilities of UK life insurers 1985-2013[54]



The graph excludes linked liabilities of UK life insurers as policyholders are responsible for asset allocation decisions, and they directly bear the market risk and volatility risk.

Implications of Solvency II for asset allocation

At the time of the 2011 impact assessment, Analyst literature[55] on the asset allocation impacts of Solvency II was focussed on the implications of the standard formula calibration as tested under QIS5. The broad conclusion at that time was that this calibration would make it more expensive to hold equity-like instruments, structured products, and long-term or low-rated corporate bonds, whilst government bonds in the issuer's domestic currency and covered bonds would appear more attractive[56]. However, this analysis did not take into account subsequent changes introduced by Omnibus II and the implementing measures.

There are two main changes that may encourage more long term and real economy investment, which alone would imply financial stability benefits, relative to the 2011 position. First, with respect to changes to the standard formula capital requirements set out in the implementing measures (although noting that major UK insurers are expected to use internal models) and second with respect to the Long Term Guarantees Package (LTG), set out in Omnibus II. A number of changes increase risk sensitivity by introducing new categories of lower requirements for lower risk

[54] *Procyclicality and structural trends in investment allocation by insurance companies and pension funds* Discussion Paper by the Bank of England and the Procyclicality Working Group (July 2014)

[55] See for example Fitch Ratings' June 2011 paper *Solvency II Set to Reshape Asset Allocation and Capital Markets*, the JPMorgan/IIA paper *Solvency II: A Briefing for the CIO* or the Oliver Wyman/Morgan Stanley paper *Solvency 2: Quantitative and Strategic Impact – The Tide is Going Out*.

[56] These assessments have tended to use a 'return on capital' approach to evaluate the relative merits of different asset classes. The overall attractiveness is then a function of both the assumed returns available and the amount of capital required to support the investment.

activities (such as 'high quality' securitisations), which is to be welcomed from a financial stability perspective.

However, benefits in terms of incentives for long term investment arising from LTG (and standard formula) changes must be weighed against potential risks, both in terms of policyholder protection (and financial stability), of reductions in reserving and capitalisation where these incentives might be used imprudently by insurers. Supervisory approval could provide an important mitigant against the risk of inappropriate use of measures in the LTG package.

Effects of Implementing Measures

Based on the Commission's own impact assessment of the Delegated Acts[57], the main changes relative to 2011 are:

- inclusion of European Social Entrepreneurship Funds (ESEF) and European Venture Capital Funds (EVCF), and other private equity funds in the (lower) 39% equity risk category which reduces their equity risk charge from 49%;
- allowing the use of proxy ratings for certain unrated instruments and recognising the risk-mitigating effect of collateral on spread risk on unrated bonds and loans, (Commission notes bonds issued for example by medium sized enterprises on private placement markets as an example);
- clarification of treatment of infrastructure project bonds (even when tranched) by reference to CRR as corporate bonds and not securitisations; and
- establishing a category of Type 1 'high quality' securitisations with lower capital requirements (than type 2).

All else equal, these changes should encourage investment in these assets relative to the 2011 position.

However, it is important to note that firms that use internal models are not required to use the standard formula risk charges and therefore the risk charges in the implementing measures are not likely to affect their investment preferences.

Effects of Omnibus II

As set out in the PRA's consultation paper CP16/14, the effect of Omnibus II was to recognise the beneficial liquidity risk management that arises when long term liabilities are closely matched with long term assets. . The LTG package allows insurers to discount eligible insurance liabilities at a higher rate than the risk-free rate, recognising the illiquidity premium earned on the portfolio of eligible assets. Such asset portfolios are likely to include corporate debt, making it a more attractive asset to hold than had been considered prior to the changes introduced by Omnibus II.

The potential impacts of asset allocation changes on individual markets are explored further in the following section.

[57] http://ec.europa.eu/finance/insurance/docs/solvency/solvency2/delegated/141010-impact-assessment_en.pdf

Financial Market Impacts

Our expectation is that Solvency II should not lead to significant changes in asset allocation for most insurers in the UK; as noted above major UK firms are expected to use internal models. Relative and absolute capital charges are likely to be a factor influencing asset allocation for standard formula firms. If insurers are not capital constrained then incentives to reallocate assets implied by the standard formula will be lower. Furthermore, firms' own strategies for asset-liability matching and risk appetite will remain important for asset allocation decisions. Below we consider individual types of asset in more detail.

Capital Markets

Equity Markets

As Figure 5 above shows, over the past decade there has been a general trend for proportionately lower holdings of equity investments. This is likely to have been driven by a combination of poor equity performance, the market crises of the early 2000s and 2008, and the new regulatory requirements of the ICAS regime putting increased focus on the asset side of the balance sheet.

Longer run and structural shifts in asset allocation may mean that the equity holdings of insurers continue to decline.[58] And, trends in equity holdings will depend in part on any trends on product provision. For example, the trend of increasing provision of unit-linked products, where investment risk is borne by the policyholder may continue, something that is more likely to occur now than in 2011 with the Government's removal of compulsory annuities on retirement. Insurers will also be incentivised to hold a wide range of investments in order to achieve a diversification benefit, so equities would still have an attraction for this purpose.

Additionally, the implementing measures now allow more types of funds to receive the lower equity risk charge of 39%, (for Type 1 equity as opposed to the 49% charge for Type 2, excluding the symmetric adjustment). This may encourage more holdings in private equity funds such as the European Social Entrepreneurship Funds and European Venture Capital Funds.

While the SCR transitional measures from Omnibus II are in place, equity-like instruments will not be as expensive to hold so the overall effect on investment in equities may not fully appear until 2023.

Corporate Bond Markets

The Matching Adjustment created explicit benefits from exact cash-flow matching (rather than duration matching) that can be achieved through investment in fixed-

[58] Source: Bank of England and Procyclicality Working Group (2014) *Procyclicality and structural trends in investment allocation by insurance companies and pension funds*

income assets and the limited availability of instruments such as interest rate swaps at the longest durations will retain incentives to hold physical bonds. This will increase the attractiveness of longer-term and lower-rated corporate bonds (though the Matching Adjustment for sub investment grade credit assets is capped at the level of the Matching Adjustment for investment grade assets of the same asset class and duration).

In the implementing measures, risk charges on some corporate bonds have been reduced by including an ability to recognise certain guarantees and other risk mitigating efforts, as well as the use of proxy ratings for certain unrated instruments.

Securitisation

The revised Delegated Acts describe the introduction of requirements for 'high quality securitisation'. The Delegated Acts apply materially lower standard formula capital requirements (per year of duration) for the new category of 'Type 1' securitisations relative to the 2011 proposals. All else equal, such changes may therefore be expected to increase incentives to hold Type 1 securitisations (such as qualifying RMBS) relative to 2011 proposals and relative to higher Type 2 securitisation charges.

Covered Bonds

Covered bonds are seen to receive a relatively favourable capital treatment under the standard formula. If the calibration of their capital charges in the final regime is unchanged from QIS5 then this asset class could see continued growth as a result of increased interest from insurers.

Investment in Infrastructure

Much of UK infrastructure is funded by the issue of long-term debt. As mentioned above, life insurers have traditionally been well-placed to invest in such debt because the resulting cashflows can be used to match those of long-term contracts such as annuities. The Matching Adjustment, similar to the UK's current regulatory regime, will encourage insurers to continue providing long-term investment in infrastructure (as desired by the Commission in its impact assessment on the Delegated Acts). Additionally, the current version of the implementing measures allow infrastructure project bonds, even when tranched, to receive the lower corporate bond risk charges instead of the securitisation risk charges, which could incentivise investment in infrastructure.

Recently, insurers announced a commitment to invest £25 billion in UK infrastructure[59] indicating that Solvency II can create incentives to invest in infrastructure.

[59] See *The UK insurance growth action plan* published by HM Treasury https://www.gov.uk/government/publications/the-uk-insurance-growth-action-plan

Government Bond Markets

The standard formula will assign European sovereign debt (issued in the domestic currency of the issuer) a zero spread risk and concentration risk charge. This could incentivise insurers to invest more heavily in this asset class, including in higher-yielding periphery debt.

Under the SCR transitional measures outlined in Omnibus II, insurers receive a temporary additional incentive to hold all EU-government bonds, not just those in the issuer's domestic currency, by reducing their risk charges to zero until 2017 and then phasing in the relevant risk charge by 2020.

Consumer Impacts: Product Price and Quality

Solvency II is making changes to the way technical provisions, capital requirements, and capital resources are calculated. Whether these changes affect product prices and product design depends on several factors. The first of these factors is a firm's risk-appetite, as many firms choose to be funded with greater levels of capital than required by regulations, to demonstrate to policyholders, brokers, and market analysts their financial strength. The second factor is the mix of assets and liabilities of individual firms since capital requirements are calculated at the level of the firm rather than for individual lines of business. The third factor is strategic decisions made by the firm in how to price its products and the level of cover to offer. The fourth factor is competition in the market.

Overall, it is very difficult to determine whether Solvency II may result in certain types of insurance product becoming more expensive or less expensive to provide. As our analysis shows, very few firms are expected not to meet Solvency II financial resource requirements in 2016. This would tend to suggest that, by and large, most firms have adequate financial resources, so we should not expect to see concerted prices changes for particular lines of business because of the introduction of Solvency II.

In the long run, Solvency II could lead to increased cross-border competition, which may lead to reduced prices and a greater variety of products offered.

Impact on the Annuity Market

The impact assessment in 2011, focussed on the effect on the annuities market due to products offering guaranteed returns to policyholders (such as annuities) expected to become more expensive to provide, possibly causing insurers to raise prices to reflect the increased cost of the guarantees. It also noted that the size of the annuity market might change as insurers choose to offer unit- or index-linked products which transfer some or all of the investment risk to the policyholder.

This analysis has been superseded by material changes made to Solvency II as part of the Long-term Guarantees package of measures, agreed as part of the Omnibus II Directive. Our analysis suggests very few UK providers of annuities will have

insufficient financial resources to meet Solvency II requirements. The implication of this finding is that Solvency II should not cause prices to rise in the UK. Furthermore, material changes to the annuity market are expected because of the Government's decision to remove the requirement to purchase an annuity on retirement, likely to overwhelm any changes caused by Solvency II.[60]

Insurance Market Impacts

The UK insurance market is the largest in Europe and the third largest in the world, accounting for 8% of worldwide premium income. The industry is also a significant exporter; one fifth of net premiums come from overseas business[61].

Solvency II could potentially affect the structure of the UK insurance market. The range, quality and price of products offered may change, and firms may enter and exit certain product lines, changing the composition of market subsectors. The competitive environment is also likely to change, particularly if cross-border competition intensifies and there is consolidation activity. Competition effects are treated separately in the Competition Impact Test, annexed.

Consolidation

The 2011 impact assessment noted that UK insurance industry saw an increase in actual and attempted consolidation activity in 2010, driven by the aims of both increasing operating efficiency, and diversifying the underwriting portfolio. This has continued since 2011, with approximately 10% to 20% decrease in number of firms (while size of the industry increased from £1.6 trillion assets to £1.8 trillion assets).

Solvency II is likely to be a driver for increased consolidation activity, for two main reasons; firms will be able to spread their fixed costs (including regulatory compliance costs) over a wider base, receiving an economy of scale, and will also benefit from greater diversification, reducing capital requirements. This should lead to greater profitability for the combined entity. The extent of the diversification benefit would depend on the activities of the consolidating firms; the more differentiated their individual activities, the greater the benefit of consolidation. This would tend to suggest that merger activity would be most likely between firms operating in different markets, that are not currently well-diversified, and that are not already at the size where they cannot benefit further from economies of scale. However, consolidation naturally occurs in competitive markets as less efficient firms exit the market and more efficient firms absorb their business.

Consolidation activity may result in a reduced number of players in the market; however, the need for approval from competition authorities should preclude mergers that are likely to reduce the level of competition.

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[60] Set out in 'Flexibility for DC pension savers from April 2015 – Commons Library Standard Note http://www.parliament.uk/briefing-papers/SN06891/flexibility-for-dc-pension-savers-from-april-2015

[61] All of these statistics are from ABI Key Insurance Facts Facts 2014 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2014/Key%20Facts/ABI%20Key%20Facts%202014.pdf

2.8 Risks and Assumptions to this impact assessment

The ultimate impact of the Solvency II Directive will still be reliant on the details of the accompanying implementing measures and guidance, which are yet to be finally agreed. The cost benefit analysis presented here therefore does not and cannot fully reflect the final form of the regime.

- Data provided by the PRA was obtained from firms on a 'best-efforts basis'. This means that, although it has been subject to sense-checking and basic validation by the PRA, the data that was provided may have been incomplete, or have been based on estimates.
- The results of the exercise do not take into account management actions, such as restructuring, changing product mix, changing investment strategy et cetera, that are highly likely to occur between now and the introduction of the new regime.

Risks of using sample data

Other conclusions of this analysis have been based on sample data which has been extrapolated to provide an industry-level estimate. There is therefore a risk that the resulting estimates are inappropriate, whether due to sample bias, extrapolation error, or the presence of material errors or estimates in the underlying sample data, which has not been independently validated.

Firms have provided their own individual views and these views may change between the time that the data was provided and the time that the regime comes into force. The views of the sample firms may not be representative of the industry. The sample of firms used to provide the one-off and ongoing administrative cost estimates contained only two firms that planned to use the standard formula. This means that the costs of using the standard formula may not have been accurately reflected.

External Risks

In the 2011 impact assessment the risk of slips to the European timetable was highlighted as a risk. This risk crystallised, with the Omnibus II Directive being finalised roughly two years after its intended date. This moved the initial implementation date from 1 November 2012 to 1 January 2016.

Since then, at the time of drafting this impact assessment, the implementing measures have been adopted for scrutiny but not yet agreed by the European Parliament. A delay to the subsequent agreement of the implementing measures, could significantly affect the total implementation cost for firms, national supervisors, and EIOPA in its role as the European Supervisory Authority (ESA) for insurance. Material changes to the implementing measures by the European Parliament or the Commission could also affect the costs, including any changes in the level of capital insurance companies will have to hold under Solvency II.

Rationale and evidence for the level of analysis used in the impact assessment (proportionality approach)

The proportionality approach for Government impact assessments requires that the level of analysis undertaken should be in proportion to certain factors. These factors are listed below, together with brief notes on how they apply in this case:

Level of interest and sensitivity surrounding the policy	There is a relatively high level of interest and sensitivity in the content of the Directive and implementing measures. There is less interest and sensitivity around exact method of transposition employed in the UK as most provisions are maximum harmonising and very little discretion in transposition remains.
Scale, duration and distribution of expected impact	Solvency II is likely to have a significant, long-lasting and widespread impact on the insurance market in the UK. There may also be spill-over effects on financial markets.
Degree to which the policy is novel, contentious or irreversible	Regulatory policy for insurers is not new in itself, and Solvency II has been several years in development. The content of the Directive and implementing measures has been widely consulted on. There will be a statutory duty to review the policy after 5 years.
Stage of policy development	The majority of the rules to be transposed by HM Treasury were consulted on in 2011 with a detailed and comprehensive impact assessment. There have been significant but limited changes since that consultation and so this impact assessment focusses on those areas that were either not covered in or have changed materially since the previous impact assessment.
Level of uncertainty around likely impacts	There is still some degree of uncertainty at this stage: implementing measures are not yet agreed; internal models and other supervisory approvals not yet finalised;
Data already available and resources required to gather further data	The QIS5 exercise was a major undertaking for UK firms, and collecting more data on a similar (industry-wide) scale was not feasible or proportionate whilst the implementing measures are not yet agreed. Waiting until they are is not feasible as we would miss the transposition deadline.
Time available for policy development	Delaying the Government's consultation on transposition until final implementing measures are agreed would not leave enough time for the transposition process, risking infraction proceedings against the UK.

Our approach has been to perform a 'best efforts' assessment of the likely costs, benefits and wider impacts, quantifying these as far as is possible or reasonable given the data available at this time, and the marginal benefit of further refining the analysis provided in 2011.

A full monetisation of the benefits, or of the wider impacts, has not been possible. Those costs and benefits that have been monetised must be seen as indicative only.

Further cost benefit analysis of Solvency II can be found within the FSA's consultation document and the Ernst & Young reports (not taking into account Omnibus II), and the Commission's impact assessment for the Delegated Acts.

Summary of Monetised Cost and Benefit Estimates

	2014 PV of Costs (assuming ongoing costs spread over 10 years from 2016) (£m)					2014 PV of Benefits (assuming ongoing benefits are spread over 10 years from 2016) (£m)		
	One-off administrative cost to industry	Ongoing admin cost to industry	One-off cost to PRA	Ongoing cost to FSA/PRA	Capital Release/ Raising	Reduced cost of capital	Efficiency Gains	2014 PV of Net Benefit (£m)
Optimistic Estimate	-2,081.2	-1,180.5	-94.41	-4.8	7291.82	458	5,062.5	**9451.4**
Best Estimate	-2,601.5	-1,574.0	-104.9	-6.0	0	313.4	3,616.14	**-357.1**
Pessimistic Estimate	-3,121.8	-1,967.6	-115.4	-7.2	-10,209	0	2,169.5	**-13251.5**

The 'best' estimates in the above table have been supplemented with both optimistic and pessimistic estimates. These adjustments are detailed below.

One-off administrative cost to industry

This value excludes costs to the PRA as these are identified separately here. Excluding costs to the PRA gives a best estimate of £2,601.5 million. Optimistic and pessimistic calculations have been generated using a 20% adjustment.

	One-off administrative cost to industry
Optimistic Estimate (80% of best estimate)	-2081.2
Best Estimate	-2601.5
Pessimistic Estimate (120% of best estimate)	-3121.8

Ongoing administrative cost to industry

The best estimate of £195.9 million per year has been revised into a lump sum that is the present value of 10 years of ongoing compliance costs, commencing in 2016. Optimistic and Pessimistic calculations have been generated using a 25% adjustment reflecting the additional uncertainty in estimating future ongoing costs of compliance.

	Ongoing cost to industry (£m)
Optimistic Estimate (75% of best estimate)	-1,180.53
Best Estimate	-1,574.04
Pessimistic Estimate (125% of best estimate)	1,967.55

One-off cost to PRA

The best estimate has been adjusted into optimistic and pessimistic estimates using a 10% adjustment.

	One-off cost to PRA (£m)
Optimistic Estimate (90% of best estimate)	-94.41
Best Estimate	-104.9
Pessimistic Estimate (110% of best estimate)	-115.4

Ongoing cost to PRA

The PRA will occur ongoing costs for Solvency II for two years after implementation of £3.3m and £3.2m until the costs of Solvency II are expected to be fully absorbed into 'business as usual'. Optimistic and pessimistic estimates are generated using a 20% adjustment.

	Ongoing cost to PRA (£m)
Optimistic Estimate (80% of best estimate)	-4.8
Best Estimate	-6.0
Pessimistic Estimate (120% of best estimate)	-7.2

Capital Release/Raising

The best estimate is that there is zero capital impact.
In the optimistic scenario, all firms introduce efficiencies equal to capital benefit that the median internal model brings and capital surplus increases by 19%, creating a benefit of £7291.82 million.
The pessimistic scenario assumes that no internal models are approved, creating an aggregate decrease in capital surplus of £10,209 million.

	Capital impact (£m)
Optimistic Estimate	7,291.82
Best Estimate	0
Pessimistic Estimate	-10,209

Reduced Cost of Capital

Reduced cost of capital due to increased resilience of the sector, improved transparency and better access to risk mitigation tools.

	Benefit from reduced cost of capital (£m)
Optimistic Estimate	458.0
Best Estimate	313.4
Pessimistic Estimate	0

Efficiency Gains

This has been calculated using the same underlying assumptions from the improvement in investment income analysis from 2011, adjusted for the increase in assets in aggregate since 2011. Assets in aggregate increased from £1.6 trillion to £1.8 trillion.[62] This is an increase of 12.5%. The optimistic and pessimistic scenarios have been generated by assuming different improvements in investment.

	Efficiency Gains estimate (£m)
Optimistic Estimate (assume 3.5 bps improvement in return)	5,062.3
Best Estimate (assume 2.5 bps improvement in return)	3,616.14
Pessimistic Estimate (assume 1.5 bps improvement in return)	2,169.5

Summary of Non-Monetised Impacts

The table above shows a net present value of -£269.9m on a best estimate basis; however, the figures in the table above only reflect the costs and benefits that have been monetised and so do not capture all of the relevant benefits.

A negative net benefit is not unexpected as many of the impacts of implementing Solvency II, including most the benefits, have not been assigned a monetary value.

The non-monetised impacts discussed in this assessment were:

- **Administrative benefits** to industry (e.g. better risk management and governance, better management information, better defined risk appetite, better documentation and internal controls);
- **Internal model benefits** to industry (e.g. better understanding of the risk profile, identification of strengths weaknesses and opportunities);
- **Insurance market benefits** (greater market efficiency, competition, a level playing field, more transparency due to Pillar 3 disclosure requirements);
- **Consumer benefits** (greater consumer confidence, enhanced consumer protection, greater cost-effectiveness of insurance provision, product innovation and competition);

[62] ABI key facts 2014

- **Averted loss** (lower probability of a repeat of past causes of insurer failure);
- **Asset allocation** impacts;
- **Capital market** impacts;
- **Product price and quality**;
- **Insurance market** impacts;
- **Competition** impacts;
- Impacts on **smaller and lower-risk firms**.

Annex 1: Post Implementation Review Plan

The Statutory Instrument for the proposed legal changes will contain a clause that imposes a ministerial duty to review the changes 5 years after they are implemented.

The primary focus of this Post-Implementation Review (PIR) should be whether the legislative changes have had the intended effect. Any unintended consequences that have been observed should also be set out.

Stakeholders will need to be consulted as to the effectiveness of the implementation of the new regime. As mentioned in the Small Firms Impact Test, it will be particularly important to canvass the views of smaller firms and to ensure that they have not been disproportionately affected by the introduction of the new regime.

In line with the guidance on conducting post-implementation reviews, the following key questions will need to be considered:

- To what extent have the legislative changes achieved their objectives?
- To what extent have there been unintended consequences?
- What are the costs and benefits, in hindsight and going forward?
- Has the market changed as a result of the policy?
- Is there any scope for simplification, improvement or deregulation?
- Do compliance levels indicate that the enforcement process is appropriate?

Data will need to be gathered to allow the post-implementation review to be performed. It is likely that supervisory data from the PRA, in particular the regulatory reports that firms will produce under Solvency II, will be used for this purpose.

Publicly available data that firms will publish in accordance with the Pillar 3 requirements of the new regime may be useful to consider, and there are also likely to be several analyst reports in the public domain considering the effects of implementation.

Annex 2: Equality Impact Test

We have assessed the Solvency II proposals against the relevant equality criteria and have concluded that there will be no impact on equality considerations as a result of implementing Solvency II in the UK.

Annex 3: Competition Impact Test

Affected markets

Insurance and reinsurance markets in EU Member States will be directly affected.

There will also be indirect effects on insurance and reinsurance markets outside of the EU, alternative risk transfer markets (e.g. catastrophe bonds, longevity swaps, securitisations) and on distributors of insurance and reinsurance products (e.g. wholesale or retail brokers, or Independent Financial Advisors).

For this consultation-stage impact assessment, we focus on the direct effects on competition within the UK markets for insurance and reinsurance.

Aim

This competition assessment considers whether the implementation of Solvency II is likely to:

1. Directly or indirectly limit the number or range of insurers operating in the UK;
2. Limit the ability of UK insurers to compete;
3. Reduce UK insurers' incentives to compete vigorously.

However, as there is no scope for the Government to pursue alternatives to regulation in this area, or to exercise material discretion when implementing the Directive, we do not investigate any potential actions to modify or mitigate any competitive effects.

Baseline: Current competitive environment

Number and location of suppliers in the affected markets

Insurance markets tend to have a large number of competitors. The PRA[63] note that in the UK, each sub-sector has more than 20 competitors. However, in each sub-sector the top 5 firms earned at least 50% of total Net Written Premiums, suggesting that there is some concentration of market power.

Nature of competition: price-based, or product differentiation?

The nature of competition in each sub-sector will depend on factors such as whether the insurance is a discretionary purchase or is compulsory, the number of market participants, the concentration of market power, the barriers to entry and exit, and the nature of the product offered. Competition in the market for a product such as private motor third party liability insurance is likely to be based almost entirely on price because the products will be homogeneous, whereas for example travel insurance offerings are likely to be more differentiated in order to cater to the needs

[63] Source: PRA

of different types of consumer, and so higher quality products will be able to command higher prices.

Characteristics and prices of products affected

Insurance products range from the highly standardised (e.g. term assurance) to the highly differentiated (e.g. bespoke cover provided by the Lloyd's market). Prices are similarly heterogeneous since they will be commensurate with the size of the risks insured.

Ease and degree of switching between products

This will depend on several factors, including: the standard length of contract term (e.g. monthly renewal, annual renewal, multi-year contracts for term or whole-of-life assurance); the terms offered for surrender or early termination of contracts, including any penalties imposed; the accrual of any discretionary benefits and the treatment of these if the contract is terminated; embedded options and guarantees and the way these are valued for surrender or termination purposes; the ability of consumers to compare prices and contract terms across providers; the number of alternative providers in a given market; the sales channel used to distribute the product.

Degree of invention and innovation in recent years

Insurance tends to be a relatively static market in terms of product innovation. Technological advances such as the advent of smart-phones will have seen the creation of a small number of new retail product lines in recent years, but the overall insurance market is slow to evolve and will continue to be constrained by the criteria that make a risk 'insurable'. Although drivers such as increasing annuitant longevity have created incentives for insurers to offer innovative new products for retirement provision, attempts to introduce products such as variable annuities on a large scale have been relatively unsuccessful to date.

One of the main sources of product innovation in the UK is likely to be the London Market because of the highly individual nature of some of the risks that are covered. There have also been some attempts to create markets for 'quasi-insurance' or alternative risk transfer methods such as catastrophe bonds or weather derivatives but these have been small in number to date.

<u>Possible effects of Solvency II on the Competitive Environment</u>

Direct limit on the number or range of insurers

The introduction of Solvency II will not place any direct limits on the number or range of suppliers. It awards no exclusive rights of supply, does not require insurance or reinsurance to be procured from a particular supplier or group of suppliers, does not

create any form of licensing scheme, and does not place any fixed limit on the number of suppliers.

Indirect limit on the number or range of insurers

The introduction of the new regime may have an indirect impact on the number or range of insurers writing certain lines of business.

Costs of new insurers relative to existing insurers

It is unlikely that the costs of new suppliers would generally be higher than the costs of existing suppliers (since e.g. it may actually be cheaper and more efficient to design Solvency II-compliant systems from scratch than to adapt existing systems). The costs to new entrants are therefore unlikely to create additional barriers to entry or to limit innovation and product development.

Costs of some existing insurers versus other existing insurers

Any increase to the cost of provision may be higher for firms that are less well-diversified (since they will generally face a higher increase in the capital required to support each pound of premium written reflecting the higher level of concentrated risk). This may push undiversified niche providers out of certain markets, but the desire to increase the diversity of business underwritten may also mean that better-diversified players are incentivised to branch out into these niche markets.

Incremental cost increases will also be higher for firms who have to do more work to reach the minimum standards required by Solvency II (for instance firms whose data handling or reporting systems are inadequate and must be redesigned or upgraded). In this sense Solvency II will favour those insurers whose businesses are already run in a way which is compatible with the new regulations (and so may favour UK insurers competing in other Member States because of the existence of the ICAS regime).

The costs associated with implementing Solvency II may make it harder for EU insurers to compete in territories outside of the EU that are not subject to the new regime. However, transitional measures are expected to apply in the years immediately following implementation, and some countries have signalled an intention to develop regulatory regimes that would be deemed 'equivalent' to Solvency II, so the extent to which this effect will materialise in practice is currently uncertain.

Costs of entry or exit

If the capital requirements for writing certain classes of business increase (because e.g. the calibration of the standard formula is more onerous than the general status quo), the cost of entering the market for that type of business will increase. However, firms already in the market will also generally experience a cost increase, so if the increased cost can be passed on, this may not translate into a higher barrier to entry

than would previously have existed. If capital requirements for certain types of business were to decrease, the opposite conclusions would apply.

Limits on the ability of insurers to compete

Solvency II will not place any restrictions on the prices that can be charged for insurance products, or on the characteristics of the products provided (e.g. by introducing minimum quality standards). One of the long-term objectives of the new regime is to foster innovation and to increase the range of products offered.

The sales channels that can be used will be unaffected. The geographic area in which insurers can supply products will be unchanged, but the harmonisation of requirements across Member States should improve the functioning of the single market, increasing cross-border competition and reducing the costs (e.g. compliance costs) for firms operating in several territories, which would tend to increase competition. There will be no additional restrictions on the advertising of products or on the organisational forms that can be adopted by market participants.

The rules on counterparty default risk may mean that insurers are incentivised to purchase reinsurance from highly-rated reinsurers. However, there will also be an incentive to purchase from a wide range of providers in order to retain diversification, which would tend to mitigate any concentration of the reinsurance market.

Limits on the incentives for insurers to compete vigorously

Solvency II will not introduce any exemptions from general competition law. It will not impose minimum contract periods or notice periods and so will not directly affect the cost to consumers of switching between products (although it is not possible to rule out indirect effects on contract terms resulting from the Solvency II concept of contract boundaries.

The new regime will require the disclosure of a greater amount of information than previously. This information may give market participants greater insight into the business of their competitors. It is difficult to say whether this would have a pro- or anti-competitive effect since, as discussed above, the markets for individual lines of business within the wider insurance market are highly divergent in terms of their competitive characteristics. Anti-competitive effects could arise as a result of tacit price collusion between market participants, but this would only really be a possibility within markets where competition is focused on price and products are highly similar. Such markets (e.g. retail motor insurance) are generally already highly competitive and price information is readily available via aggregator websites.

Annex 4: Small Firms Impact Test

This section considers the potential impact of the Solvency II regime on smaller firms, and in particular, whether this impact is likely to be disproportionate.

Scope of the regime and effect on micro-businesses

The Solvency II Directive will apply to almost all EU insurance and reinsurance firms regardless of size or complexity. Since it is a maximum harmonising Directive, the Government cannot choose to exempt certain firms from its scope, or reduce the extent to which its provisions apply to certain firms, as this would lead to infraction proceedings. However, the very smallest firms (with premium income less than €5m and technical provisions of less than €25m) will be exempted by the *de minimis* criteria laid down in the Directive. This should mean that any micro-businesses (those with fewer than 10 employees) are out of scope.

The FSA estimated in 2011 that around 130 small insurance firms (mainly Friendly Societies) and a few other special cases will fall outside the scope of the Directive. This has now decreased to approximately 100 small insurance firms. For these firms, the rules in the current PRA Handbook, and the provisions that apply to Solvency I insurers, will remain in place[64]. Firms that are out of scope because of the *de minimis* criteria can still apply for authorisation under Solvency II.

Rationale for including smaller firms in the scope of Solvency II

The Commission have stated[65] that "[t]o make the new rules only available to large insurers would put all other insurers at a potential competitive disadvantage. These insurers would not benefit from the possibility of using full or partial internal models and from potentially lower capital requirements and they would be seen by the market as 'second tier insurers' operating under outdated and less sound rules, with matching higher funding costs. This might further advance consolidation of small insurers in the EU rather than protect their present position."

Concerns of smaller firms with respect to Solvency II

The FSA's Smaller Businesses Practitioner Panel[66] (SBPP), now the FCA's SBPP[67], represented the views and interests of smaller regulated firms, and provided advice to the FSA on its policies and the strategic development of financial services regulation. The Panel's members are all senior practitioners from smaller regulated firms across the financial services industry.

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[64] The PRA may review and update the rules that apply to these firms, independent of the implementation of Solvency II

[65] See the Commission's *Solvency II Frequently Asked Questions*.

[66] See the Smaller Businesses Practitioner Panel's website for more information: http://www.sbpp.org.uk

[67] With the split of the FSA into the PRA and the Financial Conduct Authority (FCA), the SBPP was retained by the FCA. The PRA has a 'PRA Practitioner Panel' though its objectives and membership differ from those of the SBPP. http://www.bankofengland.co.uk/pra/Pages/about/practitionerspanel.aspx

The SBPP's 2010/11 annual report[68] highlights the Solvency II concerns of smaller firms that had been discussed with the FSA to date. The concerns that related specifically to the burden of the regime on smaller firms were:

- Proportionality, in particular the regulatory uncertainty surrounding the transition to the FSA's successor bodies and how this will affect the application of the 'proportionality principle';
- The implementation costs for smaller firms;
- The burden of increased technical resource requirements for smaller insurers such as mutual insurers;
- The capacity of smaller firms to choose to use internal model approaches;
- The potential for capital increases at firm level.

For the purpose of this impact test, these concerns have been assumed to be a representative list of the concerns of smaller firms with respect to the burden of Solvency II.

We examine these concerns in turn, consider the available evidence to date for the likely impact on smaller firms, and discuss the provisions within the Directive and the forthcoming implementing measures and guidance that are intended to ensure that the requirements placed on smaller firms are not unduly burdensome.

Principle of proportionality

It is a cornerstone of the Solvency II regime that the qualitative and quantitative requirements on firms should be proportionate to the nature, scale and complexity of the risks that are faced. This concept is referred to as the 'proportionality principle', and one of its intentions is to avoid placing an undue burden on lower-risk firms. Firms will not be able to expect less burdensome treatment purely on grounds of their size (e.g. in terms of number of employees), since it is the size of a firm's risks that matter.

National supervisors, including the PRA and FCA, will have to ensure that the supervisory processes they develop for Solvency II fully embed this principle. The practical application of the proportionality principle by supervisors will play a crucial role in ensuring that the full flexibility and judgement allowed under the Directive is utilised to avoid placing unnecessary burdens on lower-risk firms.

Changes for small firms introduced in Omnibus II

Omnibus II introduced specific reductions for reporting requirements for smaller firms.[69] Member States are now able to reduce reporting requirements for up to 20% of their insurance markets. They are required to prioritise granting reduced reporting requirements to the smallest firms first.

[68] http://www.sbpp.org.uk/publications/annual_reports/AR_2011.pdf

[69] Article 35 of the Directive, as amended by Omnibus II

The reductions include reducing some quarterly reporting requirements to annual reporting requirements, and reducing some annual reporting to less than annually, down to every three years as a maximum reduction.

Implementation costs for smaller firms

Initial work undertaken by the FSA, first described in the 2011 impact assessment, in this area suggests that the implementation cost per pound of liabilities (or per pound of liabilities plus premiums in the case of non-Life insurers) may be no greater for small firms that for larger firms, although it should be noted that this analysis was based on a very small sample size, and so may not generalise to the entire population of smaller firms.

A possible reason for this is the tendency of larger firms to pursue internal model development (leading to higher costs), partially offsetting any economies of scale they may otherwise enjoy from having a wider base over which to spread their fixed costs.

Application of the proportionality principle will also mean that smaller firms will have less onerous requirements in some areas; for example, a smaller insurer conducting simple business will not have to have the same systems and controls as a larger insurer that has multiple business lines in multiple countries.

Anecdotal evidence from conversation with practitioners at smaller firms suggests that there may also be some pooling of technical and modelling resources amongst smaller firms in order to reduce costs.

Technical resource requirements for smaller insurers, and capacity to use internal model approaches

Insurers with relatively straightforward operations will be able to take advantage of certain simplifications to the standard formula and the calculation of technical provisions (e.g. in the areas of counterparty default risk, or the risk margin), which would reduce the technical burden in these instances.

If the standard formula is not appropriate, but a full internal model would be overly complex and expensive to implement, there are other options that firms can pursue:

- Undertaking Specific Parameters (USPs) may present a solution for firms for whom certain standard factors in the formula are inappropriate, providing they have adequate data to set their own parameters, and can satisfy the regulator that their use is justified;
- Partial internal models are likely to be an attractive option for smaller firms, since they will allow the idiosyncrasies of a firm's business to be modelled according to the firm's own methods, whilst other more generic parts of the business are modelled using the standard formula. However, partial internal models will be subject to supervisory approval, and firms will still have to

demonstrate their compliance with a subset of the criteria for use of a full internal model. Aggregation of the internally-modelled and standard formula-derived parts of the capital model will also present a technical challenge.

Use of a full internal model will require significant investment in the technical aspects of model development, and probably also investment in IT and data capability. However, the build of the model is only part of the overall requirement; firms must also demonstrate that the model is used for business decisions, and show extensive documentation and control procedures relating to the use of (and any changes to) the model. These requirements may be a very high hurdle for smaller firms to overcome, and as mentioned above, it seems likely that partial internal models will be a more realistic and cost-effective solution in this case.

To some extent, smaller firms' ability to benefit from internal model usage will depend on the PRA and the regulatory approach taken to the model approval process. The number of firms intending to apply for an internal model from 1 January2016 has decreased to roughly 40, eight of those being small firms, and 10 being medium firms[70]

Capital increases at firm level

The capital impact section of the evidence base showed that *on average*, smaller general insurers saw a large decrease in solvency ratio and smaller life insurers saw a small decrease in solvency ratio versus ICAS when using the standard formula. However, small firms remain well capitalised, with an estimated aggregate solvency ratio under Solvency II of 190% for small life insurers. Small general insurers will on average have an estimated solvency ratio of 154%, above that estimated for medium general insurers and large life insurers. It is also important to note that the intention of Solvency II is not to preserve the status quo, and some smaller firms may see an increased capital requirement if this is more reflective of their real risks. This does not constitute a disproportionate burden on a firm.

Other effects on smaller firms

Small firms may be particularly likely to be the targets of consolidation activity, since they are generally likely to have the most to gain from any resulting economies of scale and greater diversification. Larger firms may want to acquire smaller insurers writing niche lines of business in order to gain diversification, whilst smaller firms may want or need access to the capital base and modelling expertise contained within larger firms in order to remain viable under the new regime.

[70]Small firm is defined here as having $\leq$1 bn EUR technical provisions for life insurance and $\leq$ 0.1 bn EUR gross written premium for non-life insurers. Medium firm is defined here as having between 1 and 10 bn EUR technical provisions for life insurers and between 0.1 and 1 bn EUR gross written premiums for non-life insurers. Large firm is defined here as having $\geq$ 10 bn EUR technical provisions for life insurers and $\geq$ 1 bn gross written premiums for non-life insurers.

Need for Further Work

Any assessment of the likely impact of Solvency II on smaller firms is subject to the same uncertainties as a more general assessment. In particular, there is not sufficient evidence at this stage to say whether implementation and/or ongoing costs will be proportionately greater for smaller firms even with the reporting exemptions, whether the application of the proportionality principle will have all of its intended effects, or whether the new regime will disadvantage smaller firms in other ways versus the current regime.

The impact of the regime on smaller firms is an area we would identify for further work and scrutiny. In particular, the impact on smaller firms should be considered explicitly as part of the post-implementation review.

Annex 5: Omnibus II and the Long-term Guarantees Package

The Long-term guarantees package is a set of rules introduced by Omnibus II that affect the capital requirements and valuation of long-term insurance liabilities. The measures are designed to reduce pro-cyclicality and systemic risk. Pro-cyclicality can occur, and has occurred in the past, where insurers are incentivised during economic downturns to sell assets experiencing temporary low values due to wider volatility in the financial system. The Bank of England notes that the combination of risk-based capital requirements with market consistent valuation can create incentives for pro-cyclicality and regulatory flexibility can help to offset it.[71]

While it is important that insurers are not penalised by being required to hold capital against risks to which they are not exposed (such as 'artificial volatility' that will not affect the value of their investments over the long term), care must be taken to ensure that the volatility is truly 'artificial' and insurers will not suddenly face a capital shortfall if adverse market conditions are longer or more severe than expected. If capital shortfalls are widespread across the industry at the same time, the long-term guarantees package will not reduce pro-cyclicality and will in fact increase systemic risk[72]. Because of this, the use of the capital relief provided by the LTGP is required under Solvency II to be subject to either supervisory approval or supervisory review, as well as public disclosure requirements that will encourage market discipline over their use.

The rules have four distinct parts:

- Extrapolation of the risk-free interest rate
- Matching Adjustment
- Volatility Adjustment
- Recovery period extension

Extrapolation of the risk-free interest rate

This measure is intended to derive a market consistent risk-free rate where existing market data is insufficient. This is relevant for long-term liabilities in markets where there are not sufficient long-term assets to generate reliable market data. Omnibus II increased the time frame used from 10 years to 40 years for the Eurozone. This measure is automatically applied on an individual jurisdiction basis and is less relevant

[71] Source: Bank of England and Procyclicality Working Group (2014) *Procyclicality and structural trends in investment allocation by insurance companies and pension funds*

[72] Systemic risk, as defined in De Bandt and Hartmann, to include systematic risk, the risk that market participants are affected at the same time through an exogenous shock, increasing spillover effects to other entities and the real economy - Working paper no. 35 - Systemic risk: a survey by Olivier de Bandt and Philipp Hartmann, November 2000 http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp035.pdf

for the UK as the UK's data on interest rates covers a much longer length of time than other markets, such as those in the Eurozone.

EIOPA's technical assessment of the proposed extrapolation published in 2013 show that the impact of applying extrapolation is much smaller for the UK than other Member States. Therefore, we do not consider it further in this assessment.

Matching Adjustment

The Matching Adjustment is designed to recognise the lack of market risk for assets to recognise the reduced level of spread risk that insurers face when they hold assets to maturity to support liabilities that also have matching, fixed cash-flows. Because the Matching Adjustment allows insurers to not reserve for market risk, there are strict rules around what assets and liabilities can benefit from the Matching Adjustment.

Matching Adjustment is subject to supervisory approval, with the process set out in the Directive. The PRA has set out its approval process in its consultation paper CP23/14 Solvency II Approvals, accompanied by guidance in a letter to firms on how to apply the Matching Adjustment rules.[73]

Volatility Adjustment

The Volatility Adjustment is analogous to the Matching Adjustment but for liabilities that are not necessarily fixed. Even where liabilities are not fixed, insurers will still be able to benefit from a reduced level of spread risk on the assets backing those liabilities if they are able to 'wait out' any short term volatility in the assets before selling. This means that insurers can recognise reduced spread risk through a premium added to the risk-free rate. It is also designed to be counter-cyclical by having the premium increase as volatility in the market increases by being tied to spreads of a 'reference set' of assets.

The PRA, in their consultation paper transposing rules regarding use of the Volatility Adjustment, note the following costs and benefits of the use of the Volatility Adjustment.

> *'The baseline for the comparison of the costs and benefits of the Volatility Adjustment are the rules consulted on in CP11/22. In CP11/22 the view of the FSA was that the combination of market consistent valuation and a risk-free discount rate could create volatility for regulatory balance sheets and incentivise insurers to make greater use of derivatives to reduce any volatility.*
>
> *Compared to the baseline, the benefits of allowing use of the Volatility Adjustment are:*

[73] Consultation paper and letter published 15 October 2014
http://www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp2314.aspx

(a) For business to which the Volatility Adjustment is applied, there may be less need to sell assets, unnecessarily, during market down-turns or to incur the costs of setting up hedging arrangements to mitigate asset price movements.

(b) The increase in the discount rate is expected to reduce the amount of capital raising needed to meet the SCR on the introduction of the Solvency II regime in 2016, reducing firms' costs of meeting capital requirements. The reduction in required capital is a benefit to the extent that it avoids firms holding capital against market volatility risks to which they are not exposed. The impact of the Volatility Adjustment on the balance sheet will, however, vary over the economic cycle.

Compared to the baseline, the costs of allowing the Volatility Adjustment are:

(a) The reduction in capital needed to meet the SCR at the implementation of Solvency II could reduce policyholder protection compared to what it would have been under the baseline scenario. However, the PRA does not expect financial resources under Solvency II to fall materially below their current levels under ICAS thereby maintaining current levels of policyholder protection.

(b) The application of the Volatility Adjustment could lead firms with a liquid liability profile to underestimate their technical provisions. The Volatility Adjustment is a premium to compensate for the excess volatility in spreads over a short time and as such is an increase to the risk free rate (used in the valuation of technical provisions). But if the liquidity of the liability profile led to liabilities crystallising unexpectedly, firms would not be to be able to realise this premium, as they would have to sell those assets in order to meet their liabilities.'

The Volatility Adjustment is subject to supervisory review.[74] Omnibus II also provides a Member State option to include a supervisory approval process for use of the volatility adjustment. This option is considered explicitly later in the Annex.

Overall impact on capital levels from the long-term guarantees package

The PRA has provided two estimates of the capital impact of the Matching Adjustment and Volatility Adjustment based on a data request to industry in mid-2014.

The PRA indicate that the aggregate reduction in capital requirements when compared to the Solvency II calculation assessed in the 2011 assessment will be £16,229 million. However, the impact of the Matching Adjustment and Volatility Adjustment is difficult to conclusively quantify as it will interact with the transitional

[74] See for example, the specific reference to application of capital add-ons where the supervisor concludes that the risk profile of the insurer deviates significantly from the assumptions underlying the volatility adjustment in Article 37(1)(d), as amended by Omnibus II.

provisions and will also affect how the SCR is calculated. The PRA believe that the capital benefit attributable separately to the Matching Adjustment and Volatility Adjustment can be estimated as being between £8,649m-£15,349m for the Matching Adjustment and £859m-£2,797m for the Volatility Adjustment.

As the Matching Adjustment's criteria is more restrictive, some insurers who have indicated they intend to use the Matching Adjustment may have their application rejected. If that happens, they may instead apply the Volatility Adjustment. Therefore the actual impact of the Volatility Adjustment may be higher than estimated here (and the impact of the Matching Adjustment may be lower).

	Impact of MA (£m)	**Impact of VA (£m)**	**Total Impact (£m)**
Reduction in liabilities	15,369	859	16,229
Increase in capital resources*	8,649	2,797	11,445

Source: PRA

* In submitting data for this estimate, some firms included other adjustments related to transitionals and use of ring-fenced funds.

As part of the PRA's consultation on in CP 16/14 *Transposition of Solvency II Part 3,* the PRA undertook a cost benefit analysis of the impact of the long-term guarantees package. They found that the Matching Adjustment mitigated 70% to 80% of the impact of Solvency II on capital resources. This is consistent with their analysis provided for this assessment, which notes the estimated aggregate solvency II ratio for the UK insurance industry in moving from ICAS decreases by 8% rather than the 34% predicted in 2011 before Omnibus II amendments were agreed. The PRA conclude in their cost benefit analysis that:

> *'It is estimated that following the redesign of the measures as per OMD II, and allowing for other factors, such as the approval of internal models, the change of capital on the life insurance sector induced by the introduction of Solvency II should be broadly neutral, compared to the PRA's current ICAS regime.'*

The PRA expect approximately 20 firms to apply for use of the Matching Adjustment, and 45-50 firms to apply for use of the Volatility Adjustment.

Besides the capital impact, the PRA identified the following benefits and costs:

> *'…The PRA considers that where [use of the LTG measures] reflects the beneficial liquidity risk management effects of closely matching assets and liabilities, then regulatory capital will be better aligned with economic capital, and will contribute to insurance companies with long-term liabilities being able to withstand short-term volatility in financial markets.*

Given supervisory powers under Solvency II and the effect of market discipline on capital resources, the PRA does not expect the current level of capital resources to be reduced. As a result, the PRA does not expect that the capital measures in the LTG package will reduce policyholder protection.

The costs to the UK economy of introducing OMD II arise largely as insurance companies adjust their balance sheets, if relevant rebalance their investments, and adapt risk management and governance systems to comply with the requirements of OMD II. As explained in the individual chapters covering the Matching Adjustment, Volatility Adjustment and risk management the PRA expects incremental administrative compliance costs to be of minimal significance.

The PRA expects that some firms may seek to re-balance their existing asset portfolios in order to maximise the benefit obtained from the Matching Adjustment, and the Volatility Adjustment. It is difficult to estimate the extent of these portfolio effects, as applications are required to be reviewed on a case-by-case basis by supervisory authorities, and firms may reallocate assets internally to avoid trading costs.'

Supervisory approval for use of the volatility adjustment – cost benefit analysis

The cost benefit analysis has been developed using data from the PRA. The PRA provided information on their planned approach to the supervisory approval process, as well as data based on an information request on planned use of the Matching Adjustment and Volatility Adjustment by UK insurers. It also reflects feedback received on the Treasury's second consultation paper *'Solvency II: resolving the remaining policy issues for UK transposition'* that closed on 19 September 2014.

The Directive requires that supervisors subject the use of the volatility adjustment to supervisory review regardless of whether an approval process is in place. In the absence of an approval process, the supervisor would still be required to review how the firm has used the volatility adjustment and form a judgement on its appropriateness. If necessary, the supervisor would need to take action to address the improper use of the VA, either through capital add-ons or objection to distribution of profits. This means that the creation of a supervisory approval process should not lead to an insurer being required to hold a higher level of capital than would otherwise be the case.

The identified benefits of an approval process are:

- Regulatory certainty around proposed use of the VA
- Increased policyholder protection

The identified costs of an approval process are:

- Cost of application
- Initial uncertainty while a VA application is being considered.

Overall, the Treasury believes that prior supervisory approval is the most appropriate way to supervise the use of the VA.

The main concerns set out in responses to the Treasury consultation were that a supervisory approval process would be unduly burdensome and that it is not needed given use of the VA would be subject to supervisory review. However, the Treasury believes that an approval process is still appropriate if the application process itself is not overly burdensome. If supervisors instead rely on a review process to correct imprudent use of the VA after it has already occurred, there will be a significant delay for firms having certainty that their particular use of the VA is allowed under Solvency II. In addition, if a firm has used the VA inappropriately and capital is released immediately as a consequence, it could take up to three years to identify its inappropriate use.

Comparison of the planned supervisory approval process versus supervisory review process

	Supervisory approval	Supervisory review
Information to be submitted	Liquidity plan, ORSA, SFCR	Liquidity plan, ORSA, SFCR,
Date of submission	Applications open from April 2015.	Annual reporting for 2016 will commence in early 2017, and could be as late as 2019 for smaller firms with reporting exemptions.
Date of first decision	Maximum six months after application received. Firms will likely apply as soon as applications open to ensure can be applied from 'day one' therefore decisions likely to be made by November 2015.	No time limit on when supervisors can respond to information received, supervisor will review using a risk-based approach (concentrating on most urgent risks of the firm first).
Subsequent changes to decisions	Supervisors are required to review the use of the volatility adjustment on an ongoing basis. If any concerns are not addressed by the firm, supervisor can apply a capital add-on or take other supervisory measures.	Supervisors are required to review the use of the volatility adjustment on an ongoing basis. If any concerns are not addressed by the firm, supervisor can apply a capital add-on or take other supervisory measures.

Source: PRA

Key benefits to industry/policyholders

Under the planned supervisory approval process, firms would in most cases receive approval six weeks after submitting an application, unless an application is dependent on use of an internal model or related to an application to use the Matching Adjustment. Applications will open in April 2015. In response to suggestions from the

insurance industry during the Treasury's consultation, the PRA has indicated it plans to review a firm's application for VA concurrently with their application for MA where a firm applies to use both measures. This means that the VA would take a maximum of six months to approve where its use is contingent on the separate approval (such as an internal model or a decision on use of the Matching Adjustment). The PRA have indicated that standalone Volatility Adjustment approvals could be completed sooner, within 6 weeks.

Without the approval process, firms would be able to use the VA from the start date of Solvency II, however, they may be required to take corrective measures if the PRA finds its use is inappropriate and contravenes other requirements in the Directive, such as the prudent person principle. They will not know if the PRA will find its use is inappropriate until they receive feedback on their first submission of information to the supervisor. Under a supervisory review approach, supervisors won't receive information on how a firm uses the VA until 2017 - 2019 when the supervisor is able to review the first reports submitted under Solvency II. There is additional risk to policyholder protection if the firm is consequently undercapitalised over this time, so an approval process would increase policyholder protection.

It is difficult to estimate the monetised benefits of an approval process for the volatility adjustment. Where use of the volatility adjustment leads to capital relief, firms will benefit from the certainty of an approval process as some firms might be unwilling to release capital without confirmation that they will not have to increase capital resources later once use of the VA has been reviewed. However, this would depend on the firm's overall business model and capital release strategy.

Key costs to industry

It is projected that of a UK population of 400-450 firms, about 45-50 could be expected to apply to use the VA. PRA estimate one-off administrative costs of 'prior supervisory approval' have provisionally been estimated to be £400 000 in total. The majority of these costs would be human resources, staff familiarising themselves with the application criteria for approval and the time taken to complete the application form. This is a conservative (high) estimate as it does not include an estimate of the savings incurred where lack of an approval process would have led to corrective measures by the supervisor later on.

The costs of undertaking the analysis and sourcing the information needed to calculate the volatility adjustment is not included in these costs as this analysis must be undertaken by the firm regardless of whether the use of the VA is subject to supervisory approval.

In terms of overall costs of implementing Solvency II, the cost to firms of a supervisory approval process for the volatility adjustment is 0.01% of their overall implementation costs. This is a relatively negligible cost, especially when comparing it to the prudential implications of the capital impact (capital relief of between £850 million and £2.8 billion) for the industry.

Annex 6: Background information on Capital Impact

This annex contains background information on the capital impact, including the capital impact as assessed in 2011.

In 2011 the capital impact was assessed in two ways, Solvency I versus QIS5 (SII proxy) and ICAS versus QIS5 (SII proxy). The data in the table below is from 177 UK solo insurance entities for which Solvency I, ICAS and QIS5 data is available as at year-end 2009. This subset of firms represents the majority of the UK market, but necessarily excludes those firms that did not complete QIS5, and also any firms that completed QIS5 but on a basis that is not comparable with the way their business is currently supervised (since this would preclude a comparison with ICAS or Solvency I). No scaling-up has been applied.

Available and Required capital for 177 firms under different regimes as at 31/12/2009

Source: FSA

Regime	**Solvency I**	**ICAS**	**QIS5 (proxy for Solvency II)***
Available capital resources	104	112	100
Regulatory capital requirement	44	71	72
Capital surplus	60	41	28
Change in capital surplus on moving to QIS5 basis	(33)**	(14)**	N/A
% Change in capital surplus on moving to QIS5 basis	(54%)	(34%)	N/A

*The QIS5 figures are based on the standard formula, and so do not take into account internal models, or the effect of transitional arrangements which may be in place when Solvency II comes into force.

**Inconsistency with the figures in the row above is introduced by rounding to nearest £bn.

It can be seen that for these 177 firms there was a large (£33bn, or 54%) reduction in aggregate capital surplus when moving from a Solvency I to a QIS5 basis. This indicates that firms operating in regimes who have not introduced supplementing regimes like the UK's ICAS would be subject to a significant worsening of their solvency position.

However, for UK firms, ICAS provides a more meaningful comparison for QIS5. The aggregate capital requirement for these 177 firms was broadly similar between ICAS and QIS5, but the amount of available capital reported was substantially lower under QIS5 than ICAS. In aggregate these 177 firms showed a £14bn, or 34% reduction in

surplus when moving from an ICAS to a QIS5 basis.[75] However, the long-term guarantees package in Omnibus II, and the changes to the implementing measures mean this is no longer the case. The new analysis shows that it is unlikely there will be any drop in aggregate solvency positions overall.

Updated Capital Impact

Table of available and required capital under the current UK ICAS regime for 191 firms as at 31 December 2013 compared to Solvency II estimates that take into account Omnibus II amendments

Firm type	Number of firms	ICAS capital resources	ICG	ICAS solvency ratios	S2 cap resources	SCR SF	Solvency ratios
Life	92	£102,367m	£61,899m	165%	£85,297m	£53,993m	158%
General	99	£19,401m	£11,282m	172%	£18,795m	£11,721m	160%
Total	191	£121,768m	£73,181m	166%	£104,092m	£65,714m	158%

Source: PRA Solvency II status sheets

This table shows an updated and estimated change in capital requirements in moving from ICAS to Solvency II for a sample of 191 firms for both life and non-life. This takes into account the Matching Adjustment and Volatility A from Omnibus II (shown separately in Annex 5). The Solvency II ratio is calculated on the basis of using the Standard Formula for the solvency capital requirement.

While the 2011 assessment identified some types of insurers as particularly vulnerable to capital increases, this situation has changed since 2011, both for annuity writers, in benefitting from use of the Matching Adjustment, and P&I Clubs as a result of changes in the Standard Formula (the counterparty risk module is now designed more appropriately for pooling structures such as P&I clubs).

2011 Conclusions on Capital Raising

The 2011 impact assessment showed that while on aggregate across the UK industry the QIS5 exercise showed a capital surplus, 20% of solo firms were unable to meet the QIS5 standard formula capital requirement as at year end 2009. The combined reported capital deficit below the SCR for these firms was £12.5bn, breaking down as follows:

[75] More detailed commentary and comparisons can be found in Ernst & Young's Capital Impact Assessment. http://www.fsa.gov.uk/pubs/other/ey-solvencyii-cba.pdf

Total (£m)		12,455	
Split by sector:		*Split by size:*	
Life	87%	Small	13%
Non-Life	13%	Medium	51%
		Large	35%

Source: FSA

The impact of Omnibus II on likely capital positions under Solvency II now demonstrate this capital shortfall has fallen to £1.7 billion[76]. It is unlikely to result in any significant capital raising due to the alternative options available (internal model or use of USPs) and the availability of transitionals to phase-in any higher capital requirements.

Scenario Analysis on capital raising from 2011

If in fact there is net capital-raising (releasing) by UK insurance firms in aggregate in response to Solvency II, this will represent a cost (saving) to the industry. Because of the many uncertainties outlined above, the 2011 impact assessment included two scenarios to derive a higher and lower estimate of the potential impact.

Lower Scenario: Assumes £10bn of capital is released following implementation due to (e.g.) increased capital efficiencies, restructuring, use of internal models, consolidation activity leading to greater diversification benefit arising.

Higher Scenario: Assumes industry capital requirements at implementation are as reported in QIS5 at 31/12/2009, and there is no reallocation of capital within groups, use of internal models, transitional arrangements, de-risking, restructuring, or consolidation activity. Further assumes that there is no capital release by those firms in surplus, but that the 20% of solo firms at a capital deficit raise £12.5bn of new capital in order to meet the SCR.

The total costs of both the lower and higher estimates were considered below. These were carried out in 2011 and have not been recalculated. Any cost would be made up of both the one-off fees for capital raising services and the ongoing cost of servicing the net new capital issued. It is assumed that fees are charged at 5%[77] of the amount raised, and that the cost of capital is 4%[78] per annum.

[76] Source: PRA

[77] The Institutional Investor Council's *Rights Issue Fees Inquiry* (published in December 2010 and available at http://www.iicomm.org/docs/rifireport.pdf) suggested that post-2007, the gross underwriting fees for rights issues were between 3 and 4%. 5% has been chosen as a prudent estimate.

[78] This is consistent with the weighted average cost of capital used by the FSA in previous consultations. The figure of 4% is net of the return that firms are assumed to earn from investing the capital in financial assets.

		A	B	A + B
Scenario	Net capital required (£m)	2011 PV of Fees @ [5%] (£m)	2011 PV of Cost of Capital @ [4%] p.a. for 10yrs (£m)	2011 PV of Total Cost (£m)
Lower	(10,000)	N/A	(3,214)	(3,214)
Higher	12,500	583	4,018	4,601

Annex 7: 2011 Assessment of direct administrative cost to industry

This annex contains background information on the assessment of the direct administrative cost to industry in 2011.

In 2011, EY asked 26 firms to estimate the administrative impact that they would face as a result of Solvency II. The firms were drawn from a cross-section of the market, were of various sizes, and represented just less than 50% of total UK insurance liabilities.

The firms were asked to estimate:

i. **total one-off transition costs** to deliver Solvency II, during the period from September 2008 to 1 January 2013 (when Solvency II was assumed to go live);
ii. **incremental costs of maintaining regulatory compliance** with Solvency II following implementation; and
iii. **incremental administrative benefits** resulting from ongoing regulatory compliance with Solvency II.

Firms did not provide enough data on points (ii) and (iii) to enable a quantitative analysis. The FSA conducted some follow-up work in July 2011 which did provide data on point (ii) and which updated the estimates for point (i); we reflect this work in our conclusions.

EY used the following definitions:

Administrative impacts – the additional administrative costs and benefits of complying with the Solvency II regime that are incremental to complying with the UK's current ICAS regime. These include:

- **Business and technical resource** – technical resources (e.g. actuarial, risk and finance); business change resources (responsible for defining and implementing the people, process and cultural change resulting from Solvency II);
- **Technology and data resource** – those resources responsible for the design, delivery, test and roll-out of the technology and data solution to meet the requirements of Solvency II;
- **Programme and governance resource** – those resources responsible for managing the overall delivery of the Solvency II programme; and
- **Non-resource costs** – costs relating to the purchase of toolsets and license fees, software and hardware, third-party development costs, development of test environments, recruitment and other costs (e.g. training, travel, FSA/PRA special project fees[79]).

[79] In this analysis we have considered direct costs to the FSA separately, and so have stripped the special project fees out of the total cost to industry to avoid double counting. However, the graphs provided by E&Y will still include the special project fees.

Total estimated one-off administrative cost to industry

For each of the three resource areas defined above (business and technical, technology and data, and programme and governance), firms were asked to estimate:

- The person-days of effort required;
- The split of person-days by internal, external contractor and external consultant resource used;
- The average person-day rates that applied for internal, external contractor and external consultant resource;
- The total cost in respect of that area;
- An indicative split of what constituted the total cost in that area.

For non-resource costs, firms were asked to provide a cost estimate and an indicative split of the costs making up the total.

The estimates provided by the 26 firms in summer 2010 were grossed up to industry level by EY, using factors for each sub-sector that were agreed with the FSA. This gave a total one-off administrative cost to UK insurers over the period from September 2008 to 1 January 2013 of approximately £1.8bn (some breakdowns of this cost are shown below).

Follow-up work by the FSA in July 2011, based on updated cost estimates received from 12 of the original 26 sample firms, then put this figure at closer to £2bn. When special project fees payable to the FSA are stripped out (to avoid double-counting), this reduces to £1.9bn. Note that although special project fees are presented and estimated separately (in the section on costs to the FSA), since they represent a levy on firms, they have been included in the net cost to business figures used in the summary sheets at the front of this document.

Sectoral breakdown of one-off administrative cost estimate

Source: EY compliance impact assessment for FSA, FSA analysis

Sub-sector	EY's original cost estimate (£m)	FSA's revised cost estimate[80] (£m)	Percentage Increase
Reinsurance	150		
Mutuals	24		
Commercial London Market	213		
General insurance	288		
Life and pensions	693		
Health	77		
Run-offs	39		
Composites	293		
Total (including Special Project Fee)	**1,777**	**2,044**	**15%**
Special Project Fee	**110**	**110**	**-**
Total (exc. Special Project Fee)	**1,667**	**1,934**	**16%**

One-off administrative cost to industry

Scenario	Estimated Cost (£m)
Low (80% of Best Estimate)	1,520
Best Estimate	**1,900**
High (120% of Best Estimate)	2,280

Ongoing administrative cost to industry

Scenario	Estimated 2011 Present Value of Cost (£m)
Low (75% of Best Estimate)	1,145
Best Estimate	**1,527**
High (125% of Best Estimate)	1,908

The percentage range either side of the best estimate is wider for the ongoing cost than for the one-off cost to reflect the fact that a smaller sample was used to derive the ongoing cost estimate and so there is greater potential for sample bias and extrapolation uncertainties.

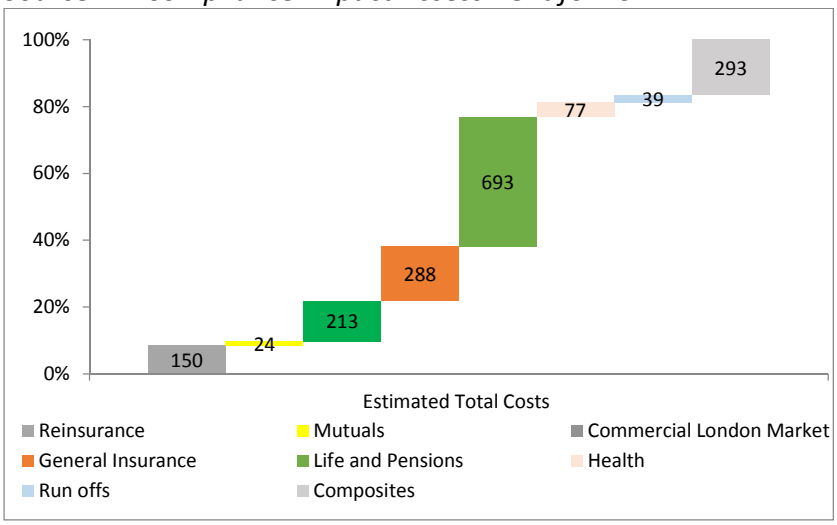
[80] The revised cost estimate has not been broken down by sector to preserve data confidentiality for the firms that provided updated cost estimates. The 12 firms were representative of a cross-section of the industry.

Breakdown of total estimated one-off administrative cost to industry

The graphs below give a breakdown of EY's original cost estimate (before FSA revisions and removal of special project fees), firstly by industry sector and then by type of cost.

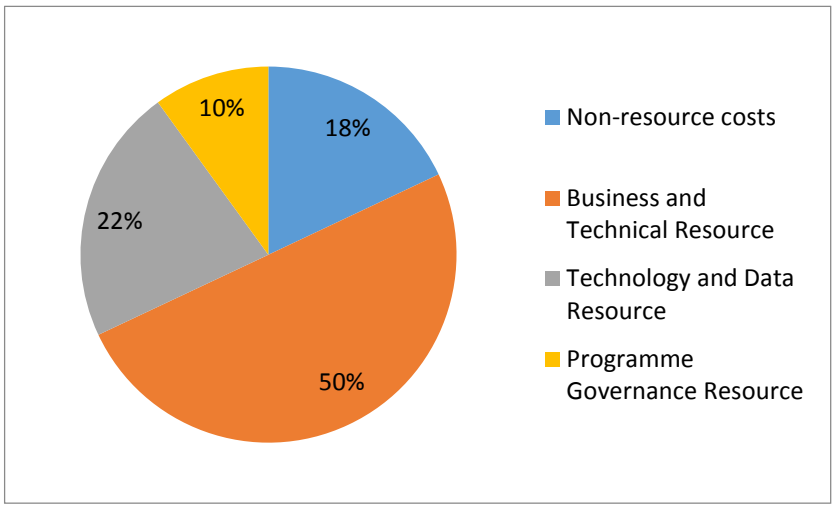
Figure 1: Total estimated one-off transition costs by sector (in £m)

Source: EY Compliance Impact Assessment for FSA



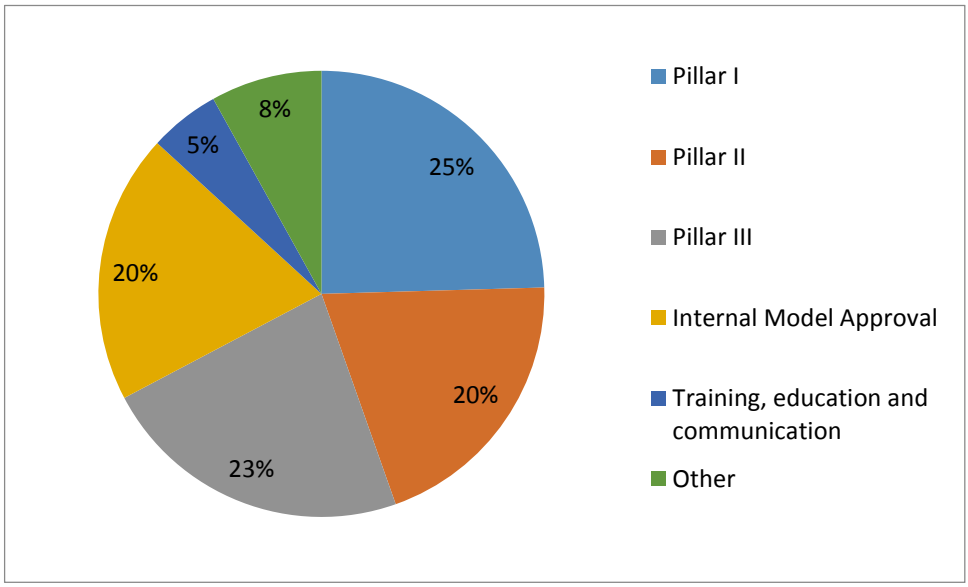
Split of total estimated one-off transition cost by type

Source: EY Compliance Impact Assessment for FSA



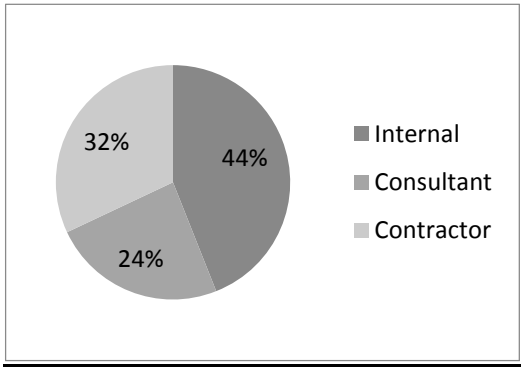
It can be seen that almost half of the total cost estimate is for business and technical resource, which can be broken down as follows:

Business and technical resource cost breakdown
Source: EY compliance impact assessment for FSA



It is also possible to look at the average split between the internal and external resources expected to be employed by firms:

Split of resources employed
Source: EY compliance impact assessment for FSA



Total estimated ongoing administrative costs to industry

At the time of EY's research, firms were unable to quantify their ongoing incremental administrative costs. However, the FSA's July 2011 follow-up work with 12 of the original 26 sample firms did yield ongoing cost estimates that were then grossed up to industry levels using the same methodology as for the one-off costs.

Firms were asked to include in their ongoing cost estimates:

- Additional business resources e.g. actuarial, risk, reporting, document management resources;

- Additional data and IT resources e.g. data cleansing, data governance and IT support resource;
- Other expenses, including ongoing annual software license fees and reporting costs.

The FSA's estimate based on firms' sample data was for a £193m per annum ongoing incremental cost. At the FSA's request this has not been shown broken down by sector in order to preserve data confidentiality for the contributing firms.

Assuming £190m of additional administrative costs per annum for 10 years from 2013 gives a present value of approximately £1.5bn.

Sensitivities and limitations of the industry administrative cost estimates

The methodology used to derive the industry cost estimates is subject to several sensitivities:

'Point-in-time'	The Solvency II requirements are not yet finalised and firms will be reviewing their business plans and budgets before implementation, particularly now that the implementation date may change.
Multi-national firms	Some firms were only able to provide an indicative split of costs between UK and non-UK aspects of their programmes.
Overlap	Because of overlaps with other change projects, the disentanglement of pure Solvency II costs was not always possible.
Extrapolation	Industry-level estimates have been extrapolated from samples, which may introduce distortion, particularly where the sample size is small. The analysis is based on the views of individual firms which have not been independently validated.
Sample bias	Only two firms in the research sample intend to use the standard formula, so it has not been possible to take into account the relative cost of using an internal model versus the standard formula in the industry estimate.