EXPLANATORY MEMORANDUM TO

THE SOLVENCY 2 AND INSURANCE (AMENDMENTS, ETC.) (EU EXIT) REGULATIONS 2019

2019 No. 407

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Act.

2. Purpose of the instrument

2.1 This instrument is being made in order to address deficiencies in retained EU law in relation to the prudential regulation of the insurance sector arising from the withdrawal of the United Kingdom (UK) from the European Union (EU), ensuring the legislation continues to operate effectively once the UK leaves the EU.

Explanations

What did any relevant EU law do before exit day?

2.2 The Solvency II Directive (Directive 2009/138/EC) and Delegated Regulation EU No. 2015/35 implemented a harmonised prudential framework for insurance and reinsurance firms in the EU. It is designed to provide a high level of protection for policy holders by requiring firms to provide a market-consistent valuation of their assets and liabilities, understand the risks they are exposed to, and to hold capital that is sufficient to absorb shocks. Solvency II was transposed into UK law by the Solvency II Regulations 2015 (No. 575) and through the Prudential Regulation Authority (PRA) Rulebook.

Why is it being changed?

2.3 Current UK Solvency II legislation is drafted on the basis that the UK is a member of the EU, and treats countries in the EEA differently to other third countries. Once the UK has left the EU, this will no longer be appropriate. To ensure that Solvency II regulation continues to operate effectively once the UK is outside of the EU, certain deficiency fixes to the legislation are necessary.

What will it now do?

2.4 This instrument will amend the UK legislation implementing Solvency II and relevant directly applicable EU legislation so that it operates effectively in a UK-only context. These changes are outlined further in 7.10-7.12 below. The SI will reflect the fact that after exit the UK will be outside the joint supervisory mechanism for Solvency II. This mechanism, which is the basis for Solvency II's treatment of groups in the EEA, allocates responsibility for supervision of a cross-border EEA insurance or reinsurance group to a lead supervisor, in addition to supervision of each undertaking by its respective EEA supervisor. As a result of being outside of this mechanism, groups that operate across both the UK and the EEA may become subject to two forms of group supervision. Preferential treatment for EU risk weighted assets and exposures will be removed for insurers that use the standard formula, i.e. the methodology used by firms without an approved internal modelto calculate their

Solvency Capital Requirement (the Standard Formula). Existing equivalence decisions taken by the European Commission (EC) will be incorporated into UK law and the responsibility for conducting technical assessments and making equivalence determinations for third countries transferred to the PRA and HM Treasury from The European Insurance and Occupational Pensions Authority (EIOPA) and the EC respectively. Certain other functions, such as maintaining Binding Technical Standards (BTS), will also be transferred to the PRA. Information sharing and co-operation requirements with EEA supervisors will also be removed for UK regulators.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 The territorial application of this instrument includes Scotland and Northern Ireland.

3.3 The powers under which this instrument is made cover the entire United Kingdom and the territorial application of this instrument is not limited either by the Act or by the instrument.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is to the whole United Kingdom.

4.2 The territorial application of this instrument is to the whole United Kingdom.

5. European Convention on Human Rights

5.1 The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

"In my view the provisions of the Solvency II and Insurance (Amendments) (EU Exit) Regulation 2019 are compatible with the Convention rights."

6. Legislative Context

6.1 This instrument amends the retained Solvency II Delegated Regulation EU No 2015/35 of the European Parliament and of the Council of 10 October 2014 and makes amendments to the Solvency 2 Regulations 2015, which implement Solvency II in the UK. It also makes limited amendments to the Financial Services and Markets Act 2000. This SI addresses deficiencies arising from the UK's exit from the European Union and repeals provisions which are no longer required.

7. Policy background

7.1 The UK will leave the EU on 29 March 2019. The UK and the EU negotiating teams have agreed the terms of an implementation period that will start on 29 March 2019 and last until 31 December 2020. This will provide time to introduce the new arrangements that will underpin the UK-EU future relationship, and provide valuable certainty for businesses and individuals. During the implementation period, common rules will continue to apply. The UK will continue to implement new EU law that comes into effect and the UK will continue to be treated as part of the EU's single market in financial services. This will mean that access to each other's markets will continue on current terms and businesses, including financial services firms, will be able to trade on the same terms as now until 31 December 2020. UK firms will need to comply with any new EU legislation that becomes applicable during the implementation period.

7.2 The government is seeking a deep and special future partnership with the EU, which should be greater in scope and ambition than any such agreement before and encompass financial services. Given the highly regulated nature of financial services, the volume of trade between UK and EU markets, and a shared desire to manage financial stability risks, the UK proposes a new economic and regulatory arrangement that will preserve mutually beneficial cross-border business models and economic integration for the benefit of businesses and consumers. Decisions on market access would be autonomous in our proposed model, but would be underpinned by stable institutional processes in a bilateral agreement and continued close regulatory and supervisory cooperation.

7.3 While the government has every confidence that there will be a deal and an implementation period in place, it has a duty to plan for all eventualities, including a 'no deal' scenario. HM Treasury intends to use powers in the European Union (Withdrawal) Act (EUWA) to ensure that the UK continues to have a functioning financial services regulatory regime in all scenarios.

7.4 The EUWA repeals the European Communities Act 1972 and converts into UK domestic law the existing body of directly applicable EU law (including EU Regulations). It also preserves UK laws relating to EU membership – e.g. legislation implementing EU Directives. This body of law is referred to as "retained EU law". The EUWA also gives ministers a power to prevent, remedy or mitigate any failure of EU law to operate effectively, or any other deficiency in retained EU law, through SIs. These contingency preparations for financial services legislation are sometimes referred to as 'onshoring'. These SIs are not intended to make policy changes, other than to reflect the UK's new position outside the EU, and to smooth the transition to this situation. The scope of the power is drafted to reflect this purpose and is subject to further restrictions, such as the inability to use the power to impose or increase taxation, or establish a public authority. The power is also time-limited and falls away two years after exit day.

7.5 Wherever practicable, the proposed approach is that the same laws and rules that are currently in place in the UK would continue to apply at the point of exit, providing continuity and certainty as we leave the EU. If the UK does not enter an implementation period, some changes would be required to reflect the UK's new position outside the EU from 29 March 2019.

7.6 If the UK were to leave the EU without a deal, the UK would be outside the EU's framework for financial services. The UK's position in relation to the EU would be determined by the default Member State and EU rules that apply to third countries at the relevant time. The European Commission has confirmed that this would be the case.

7.7 In the light of this, the approach in this scenario cannot and does not rely on any new, specific arrangements being in place between the UK and the EU. As a general principle, the UK would also need to default to treating EU Member States largely as it does other third countries, although there are cases where a different approach would be needed including to provide for a smooth transition to the new circumstances.

7.8 HM Treasury published a document on 27 June 2018, which sets out in more detail HM Treasury's approach to financial services legislation under the European Union (Withdrawal) Act. (https://www.gov.uk/government/publications/financial-services-legislation-under-the-eu-withdrawal-act)

7.9 The current legislation (implementing the Solvency II Directive in the UK) relating to the prudential regulation of insurance companies assumes the UK is a member of the EU, and treats countries in the EEA differently to other third countries in certain respects, which will no longer be appropriate after exit day. In line with the approach taken in the other Financial Services EU Exit instruments, this SI will amend the current legislation relating to the prudential regulation of insurance companies so that it operates effectively in a UK only context, and treats the EU no differently to other third countries.

7.10 This means that, in a "no deal" scenario and in the absence of an equivalence determination, EEA Groups with subsidiaries based in the UK will be subject to group supervision by the PRA. The current obligation on UK regulators to co-operate and share information with EEA regulators (such as through the EU college of supervisors) will also be removed from UK legislation. Instead the UK will rely on existing domestic framework provisions for co-operation and information sharing. It is the UK's firm intention to maintain a high level of mutually beneficial supervisory cooperation with EU and EEA authorities.

7.11 HM Treasury will determine whether the prudential regime of a third country is equivalent, thereby taking on the European Commission's function to make equivalence decisions for third country regimes. The PRA will undertake the technical assessment of third country regimes which underpins such equivalence decisions, a role currently held by EIOPA. Existing equivalence decisions by the European Commission will be incorporated into UK law by the EU (Withdrawal) Act 2018 and will continue to apply.

7.12 In addition to the equivalence functions covered above, certain key functions currently carried out by EU institutions will be transferred to the PRA, the Bank of England's Prudential Regulation Committee and HM Treasury:

- EIOPA's function to produce technical information on the 'risk free rate' which insurance and reinsurance firms must use to value their liabilities, and which is used in calculating the Matching Adjustment and Volatility Adjustment. This function will be transferred to the PRA.
- EIOPA's responsibility for maintenance of the correlation parameters, as set out in the Solvency II Delegated Regulation, which are used in standard formula calculations. This function will be transferred to the PRA by deeming these parameters to be a part of the PRA's rulebook.
- The European Commission's responsibility to publish the technical information on the risk free rate and the correlation parameters will transfer to the PRA.
- EIOPA's responsibility for declaring an 'exceptional adverse situation' for the insurance market, which enables supervisors to extend the recovery period firms can use to re-establish compliance with the Solvency Capital Requirement (SCR). This function will be transferred to the Prudential Regulation Committee of the Bank of England.

- The European Commission's responsibility for developing legislation will be transferred to HM Treasury which will be given power to make regulations for certain matters previously dealt with under Solvency II, e.g. the system of governance and risk management, methods and assumptions used in valuations and risk modules.

7.13 EU assets and exposures held by UK insurers will no longer be subject to preferential risk charges when setting capital requirements for insurers that use the Standard Formula. Instead they will be subject to the requirements for third countries, replicating the expected treatment of UK assets and exposures under Solvency II in the EEA. The existing Solvency II BTS, developed by EIOPA, will be brought into UK law and responsibility for them will be transferred to the PRA. The PRA will also be responsible for correcting any deficiencies in the Solvency II BTS, as set out in the Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018, laid before Parliament in draft on 16 July.

7.14 The instrument will also provide a prohibition on pledging of assets, currently set out in Solvency II. This is not currently provided for in UK law and so would otherwise fall away. Including the provision is consistent with our intention not to make policy changes in onshoring SIs. It will prohibit the PRA from requiring collateral to be posted for reinsurance transactions where the reinsurer is a third country insurance or reinsurance undertaking located in a country whose solvency regime is deemed to be equivalent to the UK.

7.15 The instrument will also place into UK legislation a number of definitions currently in the Solvency II Directive which will become inoperable after exit. The intention is not to widen or alter materially the scope of those definitions, other than to apply them in a UK context.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument is being made using powers in the European Union (Withdrawal) Act 2018 in order to address failures of retained EU law to operate effectively or other deficiencies arising from the withdrawal of the United Kingdom from the European Union. In accordance with the requirements of that Act the Minister has made the relevant statements as detailed in Part 2 of the Annex to this Explanatory Memorandum.

9. Consolidation

9.1 There are currently no plans to consolidate the relevant legislation.

10. Consultation outcome

10.1 HM Treasury has not undertaken a consultation on the instrument, but has engaged with relevant stakeholders on its approach to financial services legislation under the European Union (Withdrawal) Act 2018, including on this instrument, in order familiarise them with the legislation ahead of laying and to understand the potential impact of the changes.

10.2 The instrument was also published in draft, along with an explanatory policy note, on 11 October 2018, in order to maximise transparency ahead of laying.

(https://www.gov.uk/government/publications/draft-solvency-ii-and-insurance-amendment-etc-eu-exit-regulations-2018)

10.3 The financial services regulators began public consultation in October 2018 on the changes they propose to make to Binding Technical Standards (BTS) and rules made under the powers conferred upon them by the Financial Services and Markets Act 2000. (https://www.bankofengland.co.uk/paper/2018/the-boes-approach-to-amending-financial-services-legislation-under-the-eu-withdrawal-act-2018)

11. Guidance

11.1 No further guidance is being published alongside this instrument.

12. Impact

12.1 The impact on business will include one-off familiarisation costs for UK insurance firms regulated under Solvency II.

12.2 Cross-border insurance groups may also incur additional costs due to group supervision being applied both at the UK and the EEA levels. Similarly, there may be additional costs from the requirement to submit dual accounts; but as the UK will remain aligned with Solvency II in the immediate period following a no deal exit from the EU this is not expected to be significant.

12.3 UK insurers which use the Standard Formula for calculating capital requirements will be impacted by the removal of preferential treatment for EEA risk-weighted assets and exposures. Such insurers could face higher capital requirements unless they divest themselves of such assets and exposures. However, the government intends to legislate to provide regulators with powers to introduce transitional measures to phase in on-shoring changes to reduce the immediate impact on exit.

12.4 There is not expected to be any additional cost for charities or voluntary bodies.

12.5 The impact on the public sector will primarily be in respect of the PRA, who will need to exercise new group supervision at the UK level, provide technical assessments for equivalence decisions, update BTS and its rulebook and take on certain functions transferred from EU institutions. However, the PRA will no longer be obliged to participate in EU supervisory colleges, although it will need to comply with existing domestic framework provisions for cooperation and information sharing.

12.6 HM Treasury will be required to undertake some functions, such as equivalence decisions, currently performed by the EC.

12.7 A full Impact Assessment is submitted with this memorandum and published alongside the Explanatory Memorandum on the legislation.gov.uk website.

13. Regulating small business

13.1 The legislation will apply to activities that are undertaken by insurers that may be considered small businesses. There is an exemption in Solvency II for "non-directive firms", which are defined as firms with gross premium income below €5 million and gross technical provisions of less than €25 million. This exemption will be maintained by this instrument and such non-directive firms will not be impacted by it. However, there may be other small businesses affected.

14. Monitoring & review

14.1 As this instrument is made under the EU Withdrawal Act 2018, no review clause is required.

15. Contact

15.1 Peter Symons at HM Treasury Telephone: 020 7 270 2828 or email: peter.symons@hmtreasury.gov.uk can be contacted with any queries regarding the instrument.

15.2 Becky Morrison/Hannah Malik, Deputy Director(s) for Insurance and Pensions Markets Team, at HM Treasury can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Economic Secretary to the Treasury can confirm that this Explanatory Memorandum meets the required standard.

Annex A

Statements under the European Union (Withdrawal) Act 2018

Part 1

Table of Statements under the 2018 Act

This table sets out the statements that may be required under the 2018 Act.

Statement	Where the requirement sits	To whom it applies	What it requires
Sifting	Paragraphs 3(3), 3(7) and 17(3) and 17(7) of Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) to make a Negative SI	Explain why the instrument should be subject to the negative procedure and, if applicable, why they disagree with the recommendation(s) of the SLSC/Sifting Committees
Appropriate-ness	Sub-paragraph (2) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) or jointly exercising powers in Schedule 2	A statement that the SI does no more than is appropriate.
Good Reasons	Sub-paragraph (3) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) or jointly exercising powers in Schedule 2	Explain the good reasons for making the instrument and that what is being done is a reasonable course of action.
Equalities	Sub-paragraphs (4) and (5) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) or jointly exercising powers in Schedule 2	Explain what, if any, amendment, repeals or revocations are being made to the Equalities Acts 2006 and 2010 and legislation made under them. State that the Minister has had due regard to the need to eliminate discrimination and other conduct prohibited under the Equality Act 2010.
Explanations	Sub-paragraph (6) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9 and 23(1) or jointly exercising powers in Schedule 2 In addition to the statutory obligation the Government has made a political commitment to include these statements alongside all EUWA SIs	Explain the instrument, identify the relevant law before exit day, explain the instrument's effect on retained EU law and give information about the purpose of the instrument, e.g., whether minor or technical changes only are intended to the EU retained law.
Criminal offences	Sub-paragraphs (3) and (7) of paragraph 28, Schedule 7	Ministers of the Crown exercising sections 8(1), 9, and	Set out the 'good reasons' for creating a criminal offence, and the penalty attached.

		23(1) or jointly exercising powers in Schedule 2 to create a criminal offence	
Sub-delegation	Paragraph 30, Schedule 7	Ministers of the Crown exercising sections 10(1), 12 and part 1 of Schedule 4 to create a legislative power exercisable not by a Minister of the Crown or a Devolved Authority by Statutory Instrument.	State why it is appropriate to create such a sub-delegated power.
Urgency	Paragraph 34, Schedule 7	Ministers of the Crown using the urgent procedure in paragraphs 4 or 14, Schedule 7.	Statement of the reasons for the Minister's opinion that the SI is urgent.
Explanations where amending regulations under 2(2) ECA 1972	Paragraph 13, Schedule 8	Anybody making an SI after exit day under powers outside the European Union (Withdrawal) Act 2018 which modifies subordinate legislation made under s. 2(2) ECA	Statement explaining the good reasons for modifying the instrument made under s. 2(2) ECA, identifying the relevant law before exit day, and explaining the instrument's effect on retained EU law.
Scrutiny statement where amending regulations under 2(2) ECA 1972	Paragraph 16, Schedule 8	Anybody making an SI after exit day under powers outside the European Union (Withdrawal) Act 2018 which modifies subordinate legislation made under s. 2(2) ECA	Statement setting out: a) the steps which the relevant authority has taken to make the draft instrument published in accordance with paragraph 16(2), Schedule 8 available to each House of Parliament, b) containing information about the relevant authority's response to— (i) any recommendations made by a committee of either House of Parliament about the published draft instrument, and (ii) any other representations made to the relevant authority about the published draft instrument, and, c) containing any other information that the relevant authority considers appropriate in relation to the scrutiny of the instrument or draft instrument which is to be laid.

Part 2

Statements required when using enabling powers under the European Union (Withdrawal) 2018 Act

1. Appropriateness statement

1.1 The Economic Secretary to the Treasury, John Glen, has made the following statement regarding use of legislative powers in the European Union (Withdrawal) Act 2018:

"In my view the Solvency II and Insurance (Amendment, etc.) (EU Exit) Regulations 2019 do no more than is appropriate".

1.2 This is the case because this instrument will amend the current legislation relating to the prudential regulation of insurance companies so that it operates effectively when the UK leaves the EU.

2. Good reasons

2.1 The Economic Secretary to the Treasury, John Glen, has made the following statement regarding use of legislative powers in the European Union (Withdrawal) Act 2018:

"In my view there are good reasons for the provisions in this instrument, and I have concluded they are a reasonable course of action".

2.2 This is the case because this SI will amend the current legislation relating to the prudential regulation of insurance companies so that it operates effectively in a UK only context, and treats the EU no differently to other third countries.

3. Equalities

3.1 The Economic Secretary to the Treasury, John Glen, has made the following statement(s):

"The draft instrument does not amend, repeal or revoke a provision or provisions in the Equality Act 2006 or the Equality Act 2010 or subordinate legislation made under those Acts".

3.2 The Economic Secretary to the Treasury, John Glen has made the following statement regarding use of legislative powers in the European Union (Withdrawal) Act 2018

"In relation to the instrument I, John Glen, have had due regard to the need to eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under the Equality Act 2010".

4. Explanations

4.1 The explanations statement has been made in section 2 of the main body of this explanatory memorandum.

5. Legislative sub-delegation

5.1 The Economic Secretary to the Treasury, John Glen has made the following statement regarding use of legislative powers in the European Union (Withdrawal) Act 2018:

"In my view it is appropriate to create a relevant sub-delegated power in the Solvency II and Insurance (Amendments, etc.) (EU Exit) Regulations 2019."

5.2 It is appropriate to delegate the power to make technical standards to the PRA because it will give the PRA the necessary powers to ensure that EU-derived technical regulations, for which the PRA is responsible, will operate effectively after exit, subject to mechanisms to ensure robust HM Treasury oversight. This is considered appropriate as the PRA has the requisite technical expertise and resources required to undertake the relevant functions, such as producing technical information on the 'risk free rate' and maintaining the correlation parameters used in Standard Formula calculations. This is in line with the general approach that the government has set out, in which legislative responsibility for Level 2 technical legislation in financial services will be transferred to the financial regulators, while HM Treasury will have responsibility for changes to Level 1 legislation which Parliament will approve.