EXPLANATORY MEMORANDUM TO

THE SOLVENCY 2 (CREDIT RISK ADJUSTMENT) REGULATIONS 2021

2021 No. 463

1. Introduction

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

2. Purpose of the instrument

2.1 These Regulations set out a new methodology for the credit risk adjustment applied in the calculation of the basic risk-free interest rate term structure used by insurance and reinsurance undertakings to discount their liabilities. Given that the London Inter-bank Offered Rate (LIBOR) is being phased out, these Regulations allow for an appropriate adjustment for the credit risk of other benchmarks, such as for sterling markets the Sterling Overnight Index Average (SONIA).

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 As the instrument is subject to negative resolution procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business at this stage.

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 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

6.1 These Regulations amend Article 45 of the Commission Delegated Regulation (EU) No. 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency 2) ("the Commission Delegated Regulation").

6.2 The Commission Delegated Regulation, which provides a prudential framework for insurance and reinsurance undertakings, forms part of EU retained law for the purposes of the European Union (Withdrawal) Act 2018 (c.16) (see sections 3 and 6 of that Act) following the UK's withdrawal from the EU.

6.3 The Commission Delegated Regulation requires undertakings to calculate certain technical provisions to ensure they meet their commitments towards policy holders and beneficiaries. One of the contributing calculations is the rate of the basic risk-free interest rate term structure which must be adjusted to take account of credit risk (see Article 44 of the Commission Delegated Regulation). Article 45 sets out how the adjustment for credit risk is to be determined.

6.4 Article 45 is to be amended by these Regulations, as described below, using the power in regulation 2 of, and Schedule 1 to, the Solvency 2 and Insurance (Amendment, etc.) (EU Exit) Regulations 2019 (SI 2019/407). This is the first time this power has been exercised.

7. Policy background

What is being done and why?

7.1 These Regulations omit the provision in Article 45 of the Commission Delegated Regulation which specifies an adjustment based on the difference between the credit risk reflected in the floating rate of interest rate swaps and overnight indexed swap rates. Such provision was based on the continued use of benchmarks which reflect the interest rate at which banks can borrow money on unsecured terms in wholesale markets, such as the London Inter-bank Offered Rate (known as LIBOR).

7.2 LIBOR is being phased out. These Regulations therefore amend Article 45 to set out a new methodology for the credit risk adjustment which also allows for an appropriate adjustment for the credit risk of other benchmarks, such as for sterling markets the Sterling Overnight Index Average (SONIA).

7.3 This legislation has no direct impact on business. It allows for an appropriate credit risk adjustment to be set by the Prudential Regulation Authority, without determining what that credit risk adjustment should be.

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

8.1 This instrument does not relate to withdrawal from the European Union.

9. Consolidation

9.1 No consolidation exercise is planned for this legislation.

10. Consultation outcome

10.1 A formal consultation process has not been undertaken given the limited impact of this instrument.

11. Guidance

11.1 No guidance has been produced to accompany this instrument.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 An Impact Assessment has not been prepared for this instrument because in line with Better Regulation guidance, HM Treasury considers that the net impact on businesses will be less than £5 million a year. Due to this limited impact, a de minimis impact assessment has been carried out.

13. Regulating small business

13.1 The legislation does not apply to activities that are undertaken by small businesses.

14. Monitoring & review

14.1 The Regulations do not include a statutory review clause.

15. Contact

15.1 Thomas Hetherton at HM Treasury Telephone: 07711 815983 or email: Thomas.Hetherton@hmtreasury.gov.uk can be contacted with any queries regarding the instrument.

15.2 Emma Kavanagh, Deputy Director for Insurance and Pensions Markets, at HM Treasury can confirm that this Explanatory Memorandum meets the required standard.

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