PS2/24 – Review of Solvency II: Adapting to the UK insurance market

Policy statement 2/24

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1: Overview

1.1 In June 2023, the Prudential Regulation Authority (PRA) published the consultation paper (CP)12/23 – **Review of Solvency II: Adapting to the UK insurance market** This marked an important milestone towards adapting the Solvency II framework to the UK market. The CP set out the PRA's proposals to deliver significant reforms for Solvency II, designed to support a more competitive and dynamic sector in the UK, while maintaining high standards of policyholder protection.

1.2 This PRA policy statement (PS) provides the PRA's feedback to responses received to the following chapters of CP12/23:

- Chapter 1 – Overview
- Chapter 2 – Transitional measures on technical provisions (TMTP) and the risk-free interest rate
- Chapter 3 – Internal Models
- Chapter 4 – Capital Add-Ons
- Chapter 5 – Flexibility in calculating the Group SCR
- Chapter 6 – Third-country branches
- Chapter 8 – Mobilisation
- Chapter 9 – Thresholds
- Chapter 10 – Currency redenomination

1.3 This PS also contains the PRA's final policy in the form of near-final rules and updated near-final policy materials, including supervisory statements (SSs) and statements of policy (SoPs).[1] Please see Appendix 1 for a full list of the materials that have been amended, introduced, or deleted as part of the final policy in this PS.

1.4 While this PS contains the PRA's final policy in relation to the proposed reforms in CP12/23, the related rules and policy materials are considered near-final due to the potential for further changes resulting from the PRA's phased plan for consulting on Solvency II reforms and the transfer of the remaining firm-facing Solvency II requirements from assimilated law (previously known as retained EU law)[2] into the PRA Rulebook and other policy materials (the PRA policy framework). The PRA expects such changes are likely to be limited to minor amendments only, to ensure that all the PRA rules and policy across the relevant CPs for the review of Solvency II are aligned and operate coherently with each other, and relevant legislation, as explained in paragraph 1.35 to 1.40 below. The near-final rules and policy materials in this PS will be finalised as part of the transfer of the remaining firm-

facing Solvency II requirements into the PRA policy framework later this year. However, this transfer process will make no further policy changes in relation to the reforms set out in this PS.

1.5 The PRA's feedback to responses received to Chapter 7 (Reporting and disclosure) of CP12/23 is not included in this PS. To provide a holistic view of the remaining reforms to Solvency II reporting and disclosure requirements,[3] the PRA's feedback to responses received to both Chapter 7 of CP12/23 and CP14/22 – **Review of Solvency II: Reporting phase 2** will be set out together, in a separate PS.[4]

1.6 The PRA's feedback to responses received to Chapter 11 (Administrative amendments to PRA rules) of CP12/23 has been set out separately in PS19/23 – **Responses to proposed minor amendments in CP8/23, Chapter 11 of CP12/23 and CP22/23**, which was published in December 2023. These proposed minor amendments were consequential to HM Treasury's (HMT) **reforms** to the Solvency II risk margin, which are now in force.[5]

1.7 This PS is relevant to UK Solvency II firms, the Society of Lloyd's and its members and managing agents, insurance and reinsurance undertakings that have a UK branch (third-country branch undertakings), and UK holding companies. This PS will refer to these collectively as 'insurers' or 'firms' unless otherwise specified.

1.8 The PS will also be of interest to non-Directive firms and anyone intending to provide insurance services operating in, or providing services into, the UK, in so far as the proposals relate to the thresholds for Solvency II to apply and a new mobilisation regime for prospective insurers intending to enter the UK insurance sector.

Background and developments since CP12/23

1.9 Chapter 1 (Overview) of CP12/23 set out the background to the Solvency II Review, the key benefits envisaged by the CP12/23 reforms, and the planned future structure of the Solvency II regime under the new regulatory framework for financial services regulation in the UK. As explained in CP12/23, the new UK prudential regime for insurers will eventually be known as 'Solvency UK'. However, for clarity and internal consistency of the PRA's policy materials, the PRA will continue to refer to the regime as Solvency II until such time as all references to Solvency II can be changed across all relevant materials. Therefore, this PS will continue to make reference to Solvency II, where relevant.

1.10 On 28 September 2023, the PRA also published CP19/23 – **Review of Solvency II: Reform of the Matching Adjustment**. This consultation closed on 5 January 2024. This PS does not cover the reforms proposed in CP19/23.

1.11 On 8 December 2023, **the Insurance and Reinsurance Undertakings (Prudential Requirements) (Risk Margin) Regulations 2023** (the Risk Margin Regulations) were laid before Parliament and came into force on 31 December 2023.

1.12 The Risk Margin Regulations primarily set out HMT's reforms to the Solvency II risk margin. To ensure that the PRA Rulebook aligned with these risk margin regulations, the PRA finalised related consequential amendments to the rules in **PS19/23**.

1.13 In advance of the PRA's final decisions on the Solvency II reform proposals from CP14/22 and CP12/23, the PRA also worked with HMT to bring forward certain reforms relating to regulatory reporting requirements and TMTP. This was in response to consultation feedback received calling for the earlier implementation of some reforms so that firms could benefit from them at year end 2023, rather than year end 2024. Some of these reforms were also facilitated by certain amendments made to existing Solvency II legislation[6] by the Risk Margin Regulations.

1.14 Specifically, on 8 December 2023, the PRA published a statement: **Solvency II Review – considerations for year-end 2023** which:

- brought forward reform proposals in CP14/22 on the removal of the requirement on firms to submit the Regular Supervisory Report (RSR) with effect from 31 December 2023;
- brought forward reform proposals in CP14/22 on the removal of the requirement to receive a number of quantitative reporting templates from 31 December 2023 to 30 December 2024;
- brought forward reform proposals in CP12/23 to remove the TMTP Financial Resource Requirement (FRR) test from year end 2023, subject to a case-by-case assessment for some firms; and
- provided some clarification as to how firms may interpret HMT's reforms to the risk margin in respect of Period Payment Orders (PPOs).

1.15 Finally, HMT's regulations, **The Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023** were also laid before Parliament on 8 December 2023 and will come into force for firms on 30 June 2024. These regulations set out HMT's reforms to the Solvency II matching adjustment (MA). The PRA's proposals consulted upon in CP19/23 will implement and work alongside these MA reforms.

1.16 The proposed reforms to Solvency II included in CP12/23 and relevant for this PS consisted of the following:

- **Simplifications and process improvements to the calculation of the TMTP** to reduce costs and complexity for firms, including the costs involved in retaining legacy Solvency I models, while ensuring firms plan effectively for the end of these transitional measures in 2032;
- **A new, streamlined set of rules for internal models (IM) where these are used by insurers to calculate their capital requirements**, designed to maintain robust standards while reducing the number of prescriptive requirements firms have to meet under the

current framework; and **two new safeguards to support granting of model permissions**, where required, in order to maintain an appropriate level of prudential soundness: a residual capital add-on tool, and model use requirements.

- **Greater flexibility for insurance groups in the calculation of group solvency requirements** to provide more flexibility in the development of group IMs and allow a better reflection of groups' underlying risks;
- **The removal of certain requirements for branches of international insurers operating in the UK**, to facilitate entry/expansion and competition, and the international competitiveness of the UK insurance sector:
- **A new 'mobilisation' regime** to facilitate entry and expansion for new insurers and to facilitate competition, and the international competitiveness and growth of the UK insurance sector; and
- **An increase to the size thresholds** at which small insurers are required to enter the Solvency II regime, to increase proportionality for smaller or newer insurance firms.

Summary of responses

1.17 The PRA received 36 responses to CP12/23. Responses relevant to Chapter 7 (Reporting and disclosure) will be covered in a separate PS to follow. Responses to Chapter 11 (Administrative amendments) have already been considered in PS19/23. For the remaining chapters covered by this PS, there were 31 respondents. A brief summary of the relevant responses is given below, and further details and the PRA's feedback can be found in the individual chapters that follow.

1.18 Most respondents were broadly supportive of the majority of the CP12/23 proposals covered in this PS and the PRA's objectives for the reforms. A number of respondents made the following general comments in support of the proposed reform package covered by CP12/23:

- the proposals struck a good balance between maintaining broad regulatory equivalence with the EU and tailoring the regulatory regime to the UK specific market;
- the proposals would provide some clear and tangible benefits to market participants, without any material change to the level of policyholder protection;
- the proposals were wide-ranging in scope and a positive step for the insurance market; they would enable the new Solvency UK regime to provide a better fit with the needs and specificity of the UK insurance market than was possible across the entire EU market;
- respondents supported the PRA's efforts to simplify and increase flexibility for Solvency II requirements, and to encourage investment and entry into the UK insurance market; and
- the PRA's proposals would spur a vibrant, innovative, and internationally competitive insurance sector, while also protecting policyholders, ensuring the safety and soundness of firms, and supporting insurers in providing long-term capital to underpin growth.

1.19 Respondents also raised some general points, questions, and requests for clarification or further changes to specific proposals in CP12/23. The general points raised, and those relating to Chapter 1 (Overview) of CP12/23, are addressed in Chapter 10 of this PS. The issues raised in relation to the specific reform proposals in CP12/23 are set out in the relevant chapters that follow in this PS.

1.20 A summary of the overall responses to each reform area in CP12/23 is also included below.

- The majority of responses in relation to **TMTP** were supportive of the PRA's proposals, in particular the simplification of the calculation and governance processes for TMTP. While responses supported the removal of the FRR test, some respondents encouraged the removal of the test at the end of 2023, a year earlier than proposed. Some respondents also sought the potential for further flexibility in the approach to TMTP calculation.
- Respondents supported the PRA's proposed streamlining of the **internal model** tests and standards. Additionally, some respondents were supportive of the PRA's proposals to introduce residual model limitation **capital add-ons** (CAOs) to facilitate faster internal model permissions, referred to in CP12/23 as moving away from the binary nature of IM approvals. Some respondents expressed concern about capital increases resulting from the use of CAOs, however the PRA confirms that the CAO proposals were not intended to be used as a mechanism to structurally increase capital held by firms, as explained in Chapter 4 – Capital add-ons. And in relation to the internal model and capital add-on chapters of CP12/23, respondents also made a number of observations, and requests for changes and clarification.
- Respondents noted support for the PRA's proposals regarding the calculation of the **group SCR**, saying they met the objectives of the review and would provide greater flexibility to insurance groups. However, some respondents raised concerns regarding the factors assessed when granting permission for greater flexibility.
- Policy proposals for **third-country branches** received support overall, notably for the removal of branch capital requirements. Some respondents sought clarifications in certain areas including the branch security deposit and branch assets.
- The proposals to introduce a **mobilisation stage** received support as a way of helping new entrants into the insurance market, though some respondents suggested the PRA should provide greater flexibility regarding the length of the mobilisation period and the variety and volume of business permitted during mobilisation.
- Respondents welcomed the proposed increases to the size **thresholds** for firms to be regulated under Solvency II, with some concerns relating to data quality and suggestions for inflation indexing. One response called for a further sizeable upward revision in the thresholds, beyond what was proposed in CP12/23. Respondents also suggested changes to the thresholds relating to accepted reinsurance.

- Respondents were generally supportive of proposals related to **currency redenomination**.

1.21 The PRA also received a number of comments from respondents that did not relate directly to the proposals in CP12/23 or otherwise fell outside of the scope of the CP. The PRA is not addressing these points, unless specifically stated otherwise in the individual chapters of this PS but may consider some of the points raised when developing policy in the future. Any comments in response to such points are intended to provide clarity or further information only.

Changes to draft policy

1.22 Where the final rules differ from the draft in the CP in a way which is, in the opinion of the PRA, significant, the Financial Services and Markets Act (FSMA) 2000[7] requires the PRA to publish:

- details of the difference together with a cost benefit analysis; and
- a statement setting out, in the PRA's opinion, whether or not the impact of the final rule on mutuals is significantly different to: (a) the impact that the draft rule would have had on mutuals; or (b) the impact that the final rule will have on other PRA-authorised firms, and if so, details of the difference.

1.23 The PRA is grateful for the responses received to CP12/23 and has carefully considered the feedback and representations made by respondents. Having done so, the PRA has identified a number of areas where it is appropriate to make adjustments to the draft policy, to reflect its consideration of the feedback received. The most material changes include:

- the removal of the proposed requirement for firms to disclose residual model limitation capital add-ons (RML CAOs) and removal of safeguards (including RML CAOs) from the PRA's regular aggregate report on CAOs (see Chapter 4 – Capital Add-Ons);
- allowing explicitly for the possibility of setting a CAO which moves dynamically in line with certain outputs calculated by a firm in order to reflect how the underlying risk deviation varies over time (eg due to changes in the business and economic conditions), which may also benefit firms in mitigating the need for as frequent reviews of CAOs (see Chapter 4 – Capital Add-Ons);
- allowing an insurance group up to six months after an acquisition to create a clear and realistic plan to integrate any internal models, amending the proposal that required this plan at the point of acquisition, and a two-year period thereafter to implement this plan (see Chapter 5 – Flexibility in calculating the group SCR);
- increasing the threshold for gross written premiums above which a firm enters Solvency II to £25 million, a further increase of £10 million compared with the CP12/23 proposals (see Chapter 8 – Thresholds); and

- as explained in paragraph 1.13, the PRA confirmed in December 2023 that it will no longer expect firms to carry out the FRR test when recalculating the TMTP, subject to case-by-case assessments for some firms, which is a year earlier than the proposed date to remove the FRR test in CP12/23 (see Chapter 2 – TMTP).

1.24 Further details on all issues raised in responses, and any related amendments to the draft policy, are set out in the relevant chapters of this PS. The PRA considers the changes made to the draft policy are appropriate and improve the near-final rules, and the near-final policy materials, in a manner that aligns with the PRA's statutory objectives.

1.25 The PRA considers the costs and benefits of the near-final rules and final policy in this PS do not significantly differ overall from those derived from the draft policy proposed in CP12/23 and, therefore, the aggregated CBA presented in Chapter 1 (Overview) and the individual chapters of the CP remains appropriate, unless specifically stated otherwise in the chapters of this PS.

1.26 While there are no substantial changes to the CBA, the PRA considers that the changes to draft policy could bring further or alternative benefits to firms in some areas. The PRA also considers that any potential risk of an increase in costs or a reduction in benefits compared to the original proposals in CP12/23 is not material or is otherwise sufficiently mitigated, as explained in the individual chapters of this PS, where applicable. For example, the PRA considers that:

- the removal of the requirement for firms to disclose RML CAOs would bring a reduction in costs through a less burdensome and more proportionate regime, as well as supporting more effective competition and competitiveness – and any reductions in the benefits of disclosure would be insignificant, as they relate to residual (not material) model limitations and would be mitigated through the PRA's publication of a summary report (see Chapter 4 – Capital Add-Ons);
- allowing firms up to six months to create a plan to integrate any internal models following an acquisition would allow them to better utilise the competition, competitiveness and growth benefits of temporarily adding the results of two or more different calculation approaches when calculating the consolidated group SCR – and would overcome issues relating to availability of the data required to create an integration plan at the previously proposed point of acquisition (see Chapter 5 – Flexibility in calculating the Group SCR);
- raising the gross written premium income threshold by a further increment would result in a more proportionate application of Solvency II and would enable smaller firms to write more business under simpler prudential rules, without increasing materially the risks to the PRA's primary objectives. To ensure risks remain limited, the PRA is maintaining the technical provisions threshold in line with the proposals in CP12/23 (see Chapter 8 – Thresholds); and

- removing the expectation for firms to carry out the FRR test a year earlier than proposed in CP12/23 brings forward the expected reduction in resource costs for firms and the PRA, while the case-by-case assessment limits risks to the PRA's objectives (see Chapter 2 – TMTP).

1.27 Further details regarding any potential changes to CBA are provided in the individual chapters that follow in this PS, alongside the PRA's feedback to specific points raised regarding CBA in response to the CP.

1.28 The PRA does not consider that the impact of the final policy and near-final rules in this PS would have a significantly different impact on mutuals relative to the impact of the draft policy and rules on mutuals[8], or on other PRA-authorised firms.

Accountability framework

1.29 Before making any proposed rules, the PRA is required by FSMA to comply with several legal obligations, including to have regard to any representations made to it, and to publish an account, in general terms, of those representations and its feedback to them.[9] The PRA has considered the responses received to CP12/23. The individual chapters in this PS set out the PRA's feedback to the relevant responses for each policy area, and its final decisions.

1.30 When making rules, the PRA is also required to consider responses to consultation and publish an explanation of the PRA's reasons for believing that making the proposed rules is compatible with its objectives and with its duty to have regard to the regulatory principles.[10] In CP12/23, the PRA set out details of the applicable accountability framework in Chapter 1 (Overview) and Appendix 1 – PRA Statutory obligations. The PRA also provided an assessment of relevant considerations for the proposed reforms against its objectives separately in each chapter. The PRA has provided a summary of its updated overall assessment below, to take into account consultation responses where relevant. Where the PRA has made changes to the draft policy proposed in CP12/23, it considers that generally this analysis provided against the PRA's primary and secondary objectives continues to apply, unless otherwise explained in the relevant chapters of this PS.

1.31 In CP12/23 the PRA outlined how the proposals would advance its primary objectives to promote the safety and soundness of the firms that it regulates and secure an appropriate degree of policyholder protection. The PRA still considers this to be the case. The reforms focus on areas where the PRA considers that existing requirements can be simplified, streamlined, or made more flexible without compromising safety and soundness and policyholder protection. As explained in CP12/23, the proposed reforms included some new requirements where necessary, which the PRA considered would be sufficient to address any potential risks to safety and soundness and policyholder protection that might otherwise occur. The PRA considers that these explanations continue to apply to the final policy and near-final rules outlined in this PS, which will advance its primary objectives.

1.32 The PRA also considered that the proposals in CP12/23 would advance its secondary objective for competition, and its new secondary objective as introduced by FSMA 2023: to facilitate the international competitiveness of the UK economy and its growth in the medium to long term, subject to alignment with international standards. In particular, the PRA considered the proposed reforms would result in a less burdensome regime and streamline existing processes, thus facilitating entry to the market and expansion of new firms and branches. They would also provide firms with greater flexibility when applying for IMs and calculating the group SCR. The PRA considers that these explanations continue to apply to the final policy and near-final rules outlined in this PS, which will advance its secondary objectives.

1.33 In developing the proposed reforms set out in CP12/23, the PRA had regard to the FSMA regulatory principles, and the aspects of the Government's economic policy set out in the HMT recommendation letter from December 2022. FSMA 2023 amended the FSMA regulatory principles to include a principle relating to the UK's net zero emissions target. The PRA had regard to this matter when developing the policy set out in this PS, as explained in the CP.

1.34 The PRA considers that the near-final rules and final policy have taken into account the wide range of feedback raised by respondents, and continue to support the 'have regards' analysis as set out in Chapter 1 (Overview) of CP12/23 and the individual chapters of the CP. In most cases, the PRA considers that the responses to the consultation, and associated changes to the near-final rules and final policy, did not significantly alter its consideration of the matters to which it must have regard in implementing the final policy. Where the consideration of the matters to which the PRA must have regard changed in relation to any proposed reforms, further explanation is provided in the individual chapters that follow.

Potential further changes to the PRA rulebook and policy materials

1.35 In light of the PRA's overall phased plan for consulting on Solvency II reforms, there may be further changes to the near-final rules, SSs and SoPs contained in this PS prior to the PRA making final rules and issuing final SSs and SoPs. Any further changes could arise particularly as a consequence of transferring the remaining firm-facing Solvency II requirements from assimilated law into the PRA Rulebook and policy materials. The PRA also notes the following particular dependencies that may necessitate further amendments:

- Secondary legislation relating to the use of s138BA of FSMA and the proposed SoP setting out the PRA's approach to the granting of rule permissions under that legislation[11] (see paragraphs 1.36 to 1.39 below).
- The finalisation of the PRA's policy in relation to the matching adjustment and draft rules, SoP and SSs contained in CP19/23.
- Further amendments may be necessary to take into account any other secondary legislation made by HMT under FSMA 2023, where this is relevant to the PRA's rules and

policy included in this policy statement, for example in relation to equivalence, savings provisions, and amendments to FSMA 2000. The timeframe of this legislation is dependent on the government's overall legislative timetable.

- There remain a number of cross references in the near-final rules and policy materials to assimilated law that is revoked by the FSMA 2023 but for which the revocation has not been commenced. The PRA expects that by the time the policy in this PS comes into effect on 31 December 2024, the majority of those provisions will have been revoked and are likely to have been replaced by equivalent requirements, including in the PRA's rules. The rules and other policy material included in this PS will, therefore, be updated prior to being made and issued to include new cross references where possible.

1.36 Once made available by secondary legislation[12], the new s138BA of FSMA allows the PRA to grant firms permissions to not apply rules, or to apply them in a modified way ('rule permission'). As explained in CP12/23, the PRA intends to use these permissions to replace the approvals currently in Part 4 of the Solvency 2 Regulations 2015. In practice, this generally means a firm must apply to the PRA for permission where it previously applied for an approval in some areas. This PS therefore uses the language of 'permissions' rather than 'approvals' when discussing final policy in these areas. Specific criteria which the PRA will consider in deciding whether to grant the rule permissions will generally be communicated in subject specific SoPs the PRA may publish. The PRA issued **CP3/24** proposing a new SoP to explain the PRA's approach to the application of s138BA, which contains further information.

1.37 HMT has set out its intention to ensure that any existing approvals firms have in place to use measures covered by Part 4 of the Solvency 2 Regulations 2015 will continue to be valid. [13] The PRA does not, therefore, expect that firms will need to reapply for rule permissions that have been previously granted as approvals under that legislation.

1.38 The final policy in this PS includes reforms that will use (and, therefore, rely on) the PRA's powers under s138BA FSMA to give rule permissions to:

- apply the TMTP (Chapter 2 – TMTP);
- calculate the SCR and group SCR using an IM (Chapter 3 – Internal Models);
- calculate the group SCR using the output of multiple IMs (Chapter 5 – Groups); and
- use an IM to calculate a single sub-group SCR, where a group contains a sub-group located in a country that applies a solvency regime to insurers that is equivalent to the UK regime, and Method two is used to calculate the group SCR in respect of that sub-group (Chapter 5 – Groups).

The specific criteria the PRA will consider in deciding whether to grant rule permissions in the above areas are set out in the related near-final SoPs.

1.39 s138BA (1), (5) and (6) of FSMA provides that HMT may make secondary legislation providing that s138BA applies to rules made by a regulator as well as making provision about procedural matters in relation to the giving of permissions. HMT laid such **secondary legislation** before parliament on 27 February 2024. The PRA will consider this legislation, in particular in respect of the PRA's power to direct the manner of the making of applications for the permissions included in this PS, and whether this necessitates further changes to the near-final rules and other policy material published within this policy statement.

1.40 As explained in paragraph 1.9, the new UK prudential regime for insurers will eventually be known as 'Solvency UK'. However, for clarity and internal consistency of the PRA's policy materials, the PRA will continue to refer to the regime as Solvency II until such time as all references to Solvency II can be changed across all relevant materials.

1.41 References related to the UK's membership of the EU in the policy materials covered by this PS have been updated as part of these proposals to reflect the UK's withdrawal from the EU. Unless otherwise stated, any remaining references to EU or EU-derived legislation refer to the version of that legislation which forms part of assimilated law (previously known as retained EU law).[14]

The PRA's overall consultation and plans for reform following the Solvency II review

1.42 With the publication of both CP12/23 and CP19/23, the PRA has completed its consultation on the substantive reforms consistent with the areas originally covered by the **Solvency II Review** and outcomes set out in the Government's **response** to the Solvency II review consultation.

1.43 The PRA also intends to consult, in Q2 2024, on transferring the remaining firm-facing Solvency II requirements from assimilated law into the PRA Rulebook and other policy materials, without significant policy reforms. The PRA expects the transfer of these remaining firm-facing requirements will take effect from 31 December 2024, in line with the implementation date of the final policy set out in this PS. As explained in paragraph 1.4 above, the PRA also expects to finalise the near-final rules and policy materials set out in this PS as part of the transfer of the remaining Solvency II requirements, but without making any further policy changes.

1.44 For EIOPA guidelines that were not considered as part of CP12/23, the PRA intends to consult separately on the transfer of such guidelines (where appropriate) into PRA policy materials in the future, as part of its commitment to streamline the current framework into a single Rulebook.[15] Until such time as the remaining guidelines are transferred, firms are reminded that the PRA expects them to continue to make every effort to comply with the existing EIOPA Guidelines and Recommendations that are applicable, to the extent these

remain relevant as at the end of the transition period, as confirmed by the PRA's statement of policy: **Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU**

Structure of the PS

1.45 The PRA's feedback to responses received to the proposed reforms in CP12/23 and an explanation of the final policy and near-final rules are structured into the following chapters, which correspond with the chapters in the CP.

- Chapter 2 – Transitional measures on technical provisions and the risk-free interest rate
- Chapter 3 – Internal models
- Chapter 4 – Capital add-ons
- Chapter 5 – Flexibility in calculating the Group SCR
- Chapter 6 – Third-country branches
- Chapter 7 – Mobilisation
- Chapter 8 – Thresholds
- Chapter 9 – Currency redenomination
- Chapter 10 – General points raised by respondents

1.46 Appendix 2 of this PS sets out amended near-final rules for the reforms set out in Chapters 2 to 9 of this PS. Near-final versions of the relevant SSs and SoPs arising from the reforms in this PS are included in the remaining appendices, as explained in the individual chapters.

1.47 Within this PS, to increase the readability of each chapter, a number of abbreviations have been defined in full upon first usage in each chapter.

Implementation

1.48 The implementation date for final rules and policy materials reflecting policy changes set out in this PS is 31 December 2024, as consulted on in CP12/23, unless otherwise stated in the respective chapters.

1.49 The PRA received feedback relating to this implementation date from a number of respondents to the CP. Any points raised relating to the implementation of specific reforms are addressed in the corresponding individual chapters that follow. General points raised around implementation in response to the CP are addressed in Chapter 10 of this PS – General points raised by respondents.

2: Transitional measures on technical provisions and the risk-free interest rate

Introduction

2.1 This chapter provides feedback to responses relating to the proposals in Chapter 2 (Transitional measures on technical provisions and the risk-free interest rate) of CP12/23. It also contains the PRA's near-final policy, as follows:

- a new Transitional Measure on Technical Provisions Part of the PRA Rulebook (Appendix 2);
- amendments to the Glossary Part of the PRA Rulebook, the Conditions Governing Business Part of the PRA Rulebook, the Transitional Measures Part of the PRA Rulebook, and the Third Country Branches Part of the PRA Rulebook (Appendix 2);
- updated supervisory statement (SS) 17/15 – Solvency II: transitional measures on the risk-free interest rates and technical provisions (Appendix 3);
- deleted SS6/16 – Maintenance of the 'transitional measure on technical provisions' under Solvency II (Appendix 5); and
- a new statement of policy (SoP) – Permissions for transitional measures on technical provisions and risk-free interest rates (Appendix 4).

2.2 In Chapter 2 of CP12/23 the PRA proposed to:

- introduce a simplified new default method for calculating the transitional measure on technical provisions ('TMTP') (the 'TMTP method');[16]
- permit firms for which the new TMTP method would be inappropriate to continue to use the existing calculation approach, with some modifications (the 'legacy approach');
- remove the financial resource requirement (FRR) test;
- require all firms to amortise TMTP so that it is expected to decrease in a consistent manner to zero by the end of the transitional period;
- introduce an expectation that firms consider risks to meeting their solvency risk appetite in the medium term due to TMTP run-off;
- allow firms to calculate TMTP at the final day of each reporting period, and remove the requirement for firms to seek the PRA's permission for a recalculation;
- remove the expectation for TMTP calculations to have audit committee sign-off;
- introduce an expectation that the Chief Actuary oversee the calculation of TMTP as part of their responsibility for the actuarial function, in particular calculation of the technical provisions;

- introduce a more consistent approach to TMTP methodology changes where business is transferred or 100% reinsured;
- only grant any new permissions to apply TMTP in circumstances where a firm without an existing TMTP permission acquires or accepts business that already benefits from TMTP; and
- as a consequence of the policy proposals set out in Chapter 6 of CP12/23, remove the ability for third-country branches to use TMTP or the transitional measure on the risk-free interest rate ('TMIR').

2.3 The PRA received 18 responses to Chapter 2 of CP12/23. The responses were generally supportive of the proposals but asked for clarifications in some areas and recommended adjustments to some of the proposals. In particular, several respondents sought adjustments to the TMTP method and acceleration of proposals around the removal of the Financial Resource Requirement (FRR) test. Details of the responses, and the PRA's feedback and final decisions, are set out below.

Changes to draft policy

2.4 Following consideration of the respondents' comments, the PRA has made changes to the near-final policy. A summary of the key changes is set out below:

- Application of the Financial Resource Requirement (FRR) test prior to year end 2024 – the PRA issued a **statement on 8 December 2023** noting that for firms whose TMTP is limited due to the test, the PRA would consider removing the test following a case-by-case assessment, and that for all other firms the PRA no longer expected them to carry out the test. Furthermore, the PRA will continue with its proposal in CP12/23 to remove the FRR test from the TMTP framework in its entirety at year end 2024.
- TMTP method components – the PRA has amended the wording of the proposed rules to allow matching adjustment ('MA') – eligible business (rather than annuity business) to be used to calculate the dynamic best estimate liability ('BEL') component of the new TMTP method. This is to clarify the liabilities eligible for the component while maintaining the policy intent behind this component.
- TMTP method component flexibility – the PRA has amended the wording of the proposed rules to allow firms flexibility in how MA-eligible business is allocated across the dynamic and non-dynamic components of TMTP. This is to provide firms with greater flexibility and to help mitigate potential operational complexity.
- Limiting new TMTP permissions –The draft SoP stated that there is only one circumstance in which the PRA would consider granting a new TMTP permission, which is where a firm without TMTP permission acquires business that is subject to TMTP. The PRA has amended this wording to note that this is its expected approach to new TMTP permissions. This amendment acknowledges that there may be unforeseen exceptional circumstances in which the PRA may consider granting a new TMTP permission.

- Insurance business transfers and 100% reinsurance – the PRA has amended the wording of the SoP to provide an example circumstance of when the PRA may consider a waiver or modification to the rule that aggregate TMTP should not increase at the point of transfer. The example is that where changes in diversification have caused the risk margin of the firms to increase or decrease.
- Use of the new TMTP method for internal management purposes – the PRA has amended the wording of SS17/15 to clarify that the TMTP at an overall firm level must be calculated in accordance with the PRA rules, but that for internal management purposes, firms may choose to allocate TMTP across different groups of liabilities (eg different ring fenced funds).
- Preliminary calculation of the new TMTP method – the PRA has amended the wording of SS17/15 to clarify that for the purpose of the 'base TMTP' calculation (ie the final recalculation based on the existing calculation method), firms should use their agreed methodology as at the last recalculation prior to 31 December 2024 that adjusts for a 'double run-off' effect.[17]
- Amortisation of TMTP to 1 January 2032 – the PRA has amended the wording of SS17/15 to clarify that when calculating the projected risk margin and dynamic portions for the purposes of the amortisation adjustment in Transitional Measures on Technical Provisions 5.2, the Chief Actuary may select appropriate methodologies consistent with the calculation of Technical Provisions and the principles set out in Article 56 of the Commission Delegated Regulations 2015/35 ('CDR').
- References to reporting periods in the PRA rules and policy materials – the PRA has amended the wording of SS17/15 and the SoP to clarify that references to 'reporting periods' in the PRA rules refer to the reporting periods in which firms should report their TMTP as detailed in the Reporting Part of the PRA Rulebook. However, TMTP can be calculated more frequently for the firm's own internal management purposes.
- Formulation of the TMTP Calculation in the PRA rules – the PRA has amended the rules to clarify the policy intent.

2.5 The PRA considers that its amendments address the feedback received on the draft policy contained in Chapter 2 of CP12/23. The changes to draft policy will not generally increase the burden on firms (including mutuals) or have a differential impact on mutuals compared to other firms, and will in certain areas reduce the likely costs of implementing the policy. In the limited but unlikely instances where changes to draft policy could increase the burden on firms, the PRA considers that this increase will not be significant.

2.6 The PRA has taken into account the impact of the near-final rules and policy on the cost benefit analysis (CBA). The PRA does not consider that the limited changes to the near-final rules and final policy in light of the feedback received would result in any material changes to

the original CBA, as set out in paragraphs 2.61 – 2.82 of CP12/23; therefore, the PRA considers that the CBA as consulted remains appropriate. The PRA has provided feedback to specific responses on the CBA below.

Implementation

2.7 TMTP method firms should provide their supervisors with details of their initial TMTP method calculation, including how they calculated Z_A, Z_B, and C_0 and their designation of MA-eligible business by 31 March 2025.

2.8 Firms that wish to use the legacy approach should submit an application to the PRA by 30 June 2024. Permissions to use the legacy approach will only be granted up to 30 December 2024. The PRA will assess applications to use the legacy approach by considering whether, when compared to the legacy approach, use of the TMTP method would either:

- lead to a material financial impact under certain economic scenarios;
- carry a disproportionately high compliance cost for a firm; or
- significantly disrupt a firm's risk management practices.

2.9 As also noted in CP12/23 and the SoP, a financial impact would be considered material where it would change a firm's solvency coverage ratio by five percentage points or more under certain forward-looking economic scenarios. So, when applying to use the legacy approach, a firm's assessment of the potential financial impact would need to, on a forward-looking basis:

- include a comparison of both approaches over an appropriate time horizon, consistent with the scenarios in the firm's medium-term capital management plan;
- include a separate consideration of stress conditions that are consistent with the reporting sensitivities set out in the existing SS7/17; and
- take account of the expected amortisation of TMTP under both approaches.

2.10 Firms' applications for the legacy approach should include evidence and analysis to cover the above areas. Firms should contact supervisors for further information.

Feedback to responses

2.11 The PRA has considered the responses received to Chapter 2 of CP12/23. Feedback to the responses has been grouped as follows:

- The TMTP method;
- The legacy approach to calculating TMTP;
- Removal of the FRR test
- Amortisation of TMTP;

- Management of TMTP run-off;
- TMTP calculation in each reporting period;
- Removing audit committee oversight of TMTP;
- Insurance business transfers and reinsurance;
- Limiting new TMTP permissions;
- Removal of branch eligibility for TMTP and TMIR; and
- Other responses
- Other minor changes to policy

The TMTP method

2.12 In CP12/23 the PRA proposed to introduce a new, simplified default method for calculating TMTP (the 'TMTP method'). Under this method, the TMTP would be derived in each reporting period exclusively from figures produced under Solvency II. The method would simplify the TMTP calculation and make it more consistent, with the aim of reducing resource costs for firms and the PRA.

2.13 Twelve respondents commented that they supported the proposed new TMTP method, with five stating that they agreed that the method was reasonable, workable, in line with the reducing materiality of the TMTP, or that it struck an appropriate balance between simplicity and risk-sensitivity. Four respondents stated that they agreed that the proposals would reduce costs and remove the need to maintain Solvency I models, and two stated that they considered that the proposals would help increase consistency of approaches across the industry. One respondent also noted that they expected the new TMTP method to make it more straightforward to hedge risks.

2.14 Eight respondents commented that the formula for the 'base TMTP' appeared to reintroduce a 'double run-off' effect as the draft PRA rules contained the same formula as set out in Regulation 54 of the Solvency 2 Regulations 2015, ie the existing TMTP calculation formula.

2.15 After reviewing the responses, the PRA has added further clarification in SS17/15 that firms – for the purpose of calculating the base TMTP (ie the final TMTP calculation based on the existing calculation method) – should utilise their existing agreed methodology for avoiding 'double run-off' that was used at the last recalculation prior to 31 December 2024.

2.16 Five respondents commented that firms should be able to set the factors Z_A and Z_B in the TMTP method at fund or portfolio level, rather than just at entity level which can lead to risk of cross-subsidies between open and closed funds or perverse outcomes on attributions between funds. These respondents also commented that entity level factors could lead to inappropriate TMTP reallocation having an impact on estate distribution and not appropriately reflecting the characteristics of the portfolios.

2.17 Having reviewed the responses, the PRA has amended the wording of SS17/15 to clarify that firms should calculate TMTP at an overall firm level in accordance with the rules, but that the rules do not set requirements for how TMTP is allocated across different groups of liabilities (eg different ring fenced funds) and, therefore, firms have flexibility in these areas for the purposes of their internal management of TMTP. The PRA considers that this will provide firms additional clarity on implementing the new policy, while remaining in line with the original policy intent as described in CP12/23.

2.18 Three respondents requested that additional flexibility be provided around the business to be included in the dynamic, annuity best estimate liability (BEL) component (B_r) of the new TMTP method, so that it can include ’annuity-like’ business rather than just annuities.

2.19 Having considered the responses, the PRA considers it important to further clarify what liabilities are eligible for component B_r, and also recognises that there may be other business that would be appropriate for such a component. Therefore, the PRA has amended the wording of the proposed rules on the new TMTP method to state that component B_r of the TMTP calculation should reflect the amount of TMTP attributable to the BEL of MA-eligible business, instead of annuity business. The PRA considers that this better clarifies which liabilities are eligible for component B_r while maintaining the policy intent, which is for the business that generates the most material BEL contribution to TMTP to be sensitive to changes in risk profile and market conditions. The PRA notes that due to the changes proposed in CP19/23, this may mean some non-annuity business is included in the dynamic component, such as some income protection products. These changes have also caused a number of textual changes to the rules and policy documents.

2.20 Two respondents commented that they should have flexibility to put business eligible for the component B_r in the non-dynamic component (C_r) for operational reasons. For example, putting non-MA portfolio business in the component C_r, even if the portfolio contains business otherwise eligible for the component B_r eg annuities.

2.21 Having considered the responses, as noted above, the PRA has amended the wording of the proposed rules on the new TMTP method to state that component B_r of the TMTP calculation should reflect the amount of TMTP attributable to the BEL of MA-eligible business,[18] instead of annuity business. The PRA has also amended the proposed rules to allow firms to put business that is eligible for component B_r in the non-dynamic component C_r instead, if desired. This assignment can happen at the date of commencement and after a transfer event.[19] These changes have also caused a number of textual changes to the rules and policy documents, to reflect the new dynamic component, the additional flexibility and how this operates following transfer events.

2.22 One respondent noted that the TMTP method was not sensitive to specific liability types and that the PRA should allow firms to address this issue through appropriate risk management techniques but did not elaborate further.

2.23 Having considered the response, the PRA notes the above change to the policy which has widened the range of liabilities that the TMTP method is sensitive to. In addition, the PRA notes that any proposed risk management techniques should comply with the relevant PRA rules and policy. Finally, where firms would be materially impacted by adopting the TMTP method, they have the option to apply for the legacy approach by 30 June 2024.

2.24 One respondent requested clarification on elements of the TMTP method formula, including amortisation, and commented on the notation used to define variables.

2.25 Having considered the response, the PRA has made some amendments to the notation of the new TMTP method formula to remove ambiguity and further clarify the policy intent. These amendments include:

- stating more clearly how the non-dynamic component in the TMTP method ('C_r') is amortised, when the amortisation component (W_r) should be calculated and updated, and that W_r should be updated following a transfer event to reflect the change in risk profile; and
- redefining 'final reporting period' to '31 December 2024' to clarify when the base TMTP calculation and designation of MA-eligible business to be used to calculate the dynamic portion will take place.

2.26 Four respondents commented that firms should have flexibility over when they carry out the base TMTP calculation (which is used to determine the components of the TMTP method), so that the calculation could be carried out at year end 2023, or delayed if there is a stress event.

2.27 During policy development the PRA performed analysis exploring the impact of the base TMTP calculation being performed under different market conditions and noted that it would only make a material difference for a small number of firms. The PRA notes that firms that would be materially impacted by the TMTP method will be able to apply for the legacy approach. Therefore, having considered the responses, the PRA does not propose making any changes to the draft policy in this area.

2.28 One respondent commented that firms should have an opportunity to set or reset the TMTP if the regulatory framework following Solvency II reforms is more onerous than the original Solvency II requirements, for example, if there is a stress event post-implementation.

2.29 The PRA considers that it is not the purpose of TMTP to absorb further regulatory reform. It considers the proposed TMTP reforms will ensure TMTP continues to be utilised for its purpose of helping firms transition from Solvency I to Solvency II. In addition, as noted above, the PRA performed analysis exploring the impact of the base TMTP calculation being performed under different market conditions and noted that it would only make a material difference for a small number of firms. The PRA notes that firms that would be materially impacted by the TMTP method will be able to apply for the legacy approach. Therefore, having considered the responses, the PRA does not propose making any changes to the draft policy in this area.

2.30 Three respondents commented that firms should be able to make bespoke simplifications to the new TMTP method, combining parts of the legacy and simplified approaches.

2.31 The PRA considers that the new TMTP method is a simplified method that is designed to achieve a reasonable degree of risk-sensitivity to existing drivers of TMTP benefit, and which can be used consistently by firms. Any simplified method will deviate at times from the more complex approach it replaces, and this is true of the TMTP method as well. The PRA's analysis has concluded that it can be considered a reasonable approximation for the vast majority of firms, and for firms where the potential differences are more material, the legacy approach will remain available. The PRA also considers that allowing bespoke simplifications to the TMTP method, including combinations with the legacy approach, would be inconsistent with the policy goals of simplifying and increasing consistency in the TMTP calculation, and would likely create increased costs for firms making such bespoke adjustments, and the PRA in supervising their use. Furthermore, the PRA considers that increased costs to both firms and the PRA from allowing bespoke adjustments, would become less justifiable over time as TMTP continues to diminish in materiality, and eventually reach zero by 2032. Having considered the responses, the PRA has maintained the draft policy, which already includes the potential for firms to apply by 30 June 2024, to maintain their current TMTP calculations within the legacy approach, subject to meeting certain conditions.

2.32 One respondent requested clarification as to whether existing simplifications for the purposes of the TMTP calculation can continue to be used in the new TMTP method.

2.33 Any approaches used to derive risk margin or BEL for TMTP purposes must be in accordance with the relevant rules, including that risk margin and BEL figures for the relevant business are accurate. The PRA considers that it is the Chief Actuary's responsibility to ensure that the technical provisions, including TMTP, are calculated accurately and in accordance with the PRA rules. It is likely that any simplifications previously agreed with supervisors in accordance with the expectations in SS6/16 would continue to be appropriate.

2.34 One respondent asked for the PRA to clarify whether it had an expectation that the BEL component could be negative and remain negative throughout the run-off period, for example, for unit-linked business where the BEL under Solvency II is less than the BEL under Solvency I.

2.35 The PRA considers that within the new TMTP method, the BEL component can start negative and potentially remain negative throughout the transitional period. This is set out in the definitions of dynamic portion and non-dynamic portion in the PRA Rulebook.

2.36 One respondent commented that it was important to understand the outcome of other Solvency II reforms, such as those to the matching adjustment, in case they impact the TMTP in a way that invalidates the TMTP method.

2.37 Since CP12/23, the PRA has published CP19/23 which sets out proposed reforms to the MA. The PRA notes that any changes to Solvency II BEL, as a result of MA reforms, would be captured in the base TMTP calculation at year end 2024. The PRA notes that it has investigated the potential impact of the proposed reforms to the matching adjustment on the TMTP method. Following this investigation, the PRA continues to consider that that the TMTP method remains appropriate. Having considered the response, the PRA does not propose any changes to the draft policy in this area.

2.38 One respondent commented that the PRA should clarify whether the simplification of the TMTP method, when compared to the existing method, has a discernible downside and whether it would bring issues of consistency.

2.39 The PRA considered the costs and benefits of this proposal in CP12/23, which noted that the proposal would lead to a significant overall reduction in the complexity of calculating and reviewing the TMTP, and make it easier for firms to maintain TMTP. The CBA also noted that there could be some implementation costs that are not expected to be material, and that for most firms the final TMTP figures calculated using the TMTP method will be a reasonable approximation for the existing calculation, and where there is a material difference firms can apply for the legacy approach. The PRA also considers the TMTP method will lead to more consistent, standardised calculation of TMTP across firms, as there are a wide range of approaches to calculating TMTP currently.

2.40 Two respondents commented that the new TMTP method could result in material differences compared to existing approaches. One respondent commented that assuming a linear glidepath for the non-annuity BEL component would not be appropriate for all firms.

2.41 The PRA recognised in CP12/23 that for some firms in certain economic conditions, the TMTP method could produce different results than the existing approach, particularly where the existing TMTP calculation captures idiosyncratic features of firms' risk profiles. For this

reason, firms that would be materially affected by the TMTP method, have the option to apply for the legacy approach. Having considered the responses, the PRA has maintained the draft policy.

2.42 One respondent commented that it agreed the administrative costs of the proposal were likely to be minimal, but that the new TMTP method could create additional administration costs related to managing the sensitivity of the calculation to market movements, particularly for certain business lines.

2.43 The PRA considers that the administrative costs are not likely to be material, as the methodology is simplified and based on existing elements of the Solvency II balance sheet that firms should already be calculating. The PRA also notes that there could be reduced hedging costs, as firms would no longer need to manage the Solvency I balance sheet or run Solvency I models. However, the PRA notes that there may be some instances where the TMTP method does create additional costs for managing certain lines, where these costs are material, firms have the option of applying for the legacy approach by 30 June 2024. Having considered the response, the PRA has maintained the draft policy.

The legacy approach to calculating TMTP

2.44 The PRA proposed to permit firms for which the new TMTP method would be inappropriate to continue to use the existing calculation approach, with some modifications (the 'legacy approach'). The PRA proposed that it would assess applications by firms to use the legacy approach by considering whether, when compared to the legacy approach, use of the new TMTP method would either lead to a material financial impact under certain economic scenarios; carry a disproportionately high cost of compliance for a firm; or significantly disrupt a firm's risk management practices.

2.45 Four respondents noted their support for the proposals around the legacy approach. One of these also stated their support for limiting future permission to apply the legacy approach after December 2024, while one supported the proposed restrictions on firms making changes to Solvency I Pillar 2 assumptions. One of the four respondents also stated their support for the legacy approach helping firms avoid potential unintended consequences of the proposed default approach.

2.46 Eight respondents commented that the requirements to apply the legacy approach should be less onerous, or that firms should be allowed to choose their method freely, while one respondent stated their support for the new TMTP method being the default approach for most firms, noting there should be a high bar set for firms wanting to use the legacy approach.

2.47 As stated in CP12/23, the PRA has selected these criteria so that firms are only eligible for the legacy approach where the TMTP method would materially alter their ongoing amount of TMTP compared with their existing approach, or where it would create material operational impacts. In other cases, the PRA expects the TMTP method will be a proportionate simplification to existing calculations. Therefore, the PRA does not consider it appropriate to either lower the thresholds or remove the annual expectation for firms to monitor the threshold criteria, as this would not be consistent with the objectives of the reform, notably, simplifying and increasing consistency of the calculation. Having considered the responses, the PRA has decided to maintain the draft policy.

2.48 One respondent commented that allowing firms to use legacy approaches may give some firms a material advantage and have a negative impact on competition.

2.49 The PRA will only permit firms to use the legacy approach where firms are materially impacted by the TMTP method. If materially impacted firms were not able to apply for the legacy approach, then there could be material impacts on the ongoing TMTP amount which could impact capital planning and risk management. The PRA considers that the legacy approach helps ensure there is a stable and predictable regulatory environment where firms are not unduly burdened by regulatory change. In addition, the PRA expects that over time most legacy approach firms are likely to switch to the TMTP method, due to the decreasing materiality of TMTP over the remaining transitional period.

2.50 One respondent requested that the PRA clarify that firms would not be required to use the legacy approach. Firms will not be required to use the legacy approach and must use the TMTP method unless they apply and meet the relevant criteria set out in the new SoP for the legacy approach. Having considered the responses, the PRA has decided to maintain the draft policy.

2.51 Two respondents commented that where a firm has invested in a new asset class it should have no impact on TMTP. One respondent commented that for the purpose of determining the level of TMTP where a firm has invested in a new asset class, it should be assumed to generate the same level of Solvency I illiquidity premium as the matching adjustment portfolio assets, which they considered would ensure there is no impact on the TMTP. This is in contrast with the PRA proposal that investments in new asset classes should be assumed to generate the same level of Solvency I illiquidity premium as the Solvency I illiquidity premium of existing assets.

2.52 The PRA has reviewed the responses and considers that it remains appropriate for TMTP to continue to recognise the difference between the Solvency I illiquidity premium and Solvency II MA, as a genuine driver of TMTP. Therefore, it is not the intention for the TMTP approach to be simplified to the extent that investment in new asset classes has zero impact on TMTP, since this would ignore genuine differences in the treatment of these assets

between the Solvency I and Solvency II regimes. Furthermore, as the MA benefit is generally more favourable than the corresponding benefit from the ICAS illiquidity premium - giving rise to a negative contribution to TMTP benefit - the respondents' proposals could result in more TMTP benefit being claimed than appropriate. The PRA also notes that the intention behind this safeguard, to freeze the relationship between the Solvency I and Solvency II treatment, helps to ensure that the legacy approach remains calculated on a consistent basis following the implementation of the policy, and to remove the need for the PRA to undertake further reviews of firms' Solvency I illiquidity premium assumptions for new investments. Therefore, having considered the responses, the PRA has decided to maintain the draft policy in this area.

2.53 One respondent requested clarification on how changes to the legacy approach could be treated. Specifically, whether changes to the Solvency II BEL methodology could be simply replicated in the Solvency 1 Pillar 2 BEL methodology in instances where the Solvency II and Solvency 1 Pillar 2 methodology were aligned prior to the change, such that it resulted in no overall change to TMTP.

2.54 The PRA considers that where aspects of a legacy approach firm's Solvency I Pillar 2 methodology are already aligned with the corresponding Solvency II methodology, then any changes to that Solvency II methodology would not be regarded as changes to the Solvency I Pillar 2 methodology (ie as the Solvency I Pillar 2 methodology is to use the Solvency II methodology), unless changes are being made to the existing alignment between Solvency I Pillar 2 and the Solvency II methodology.

Removal of the FRR test

2.55 In CP12/23, the PRA proposed to remove the financial resource requirement (FRR) test when implementing the new TMTP policy at year end 2024, with the aim of significantly reducing the complexity of calculating and reviewing the TMTP. The FRR test sets out that a firm's TMTP can be limited where necessary, so that the firm's FRR under Solvency II would not be lower than under Solvency I, as this would undermine TMTP's purpose as transitional relief at the time of the introduction of Solvency II in 2016. The PRA considered that by the proposed implementation date for the CP12/23 proposals, the prudential benefits of maintaining the test would no longer outweigh the resource costs to firms and the PRA, and that firms should take a forward rather than backward looking view to managing potential prudential risks arising from run-off of TMTP.

2.56 Fourteen respondents stated that they supported the proposals to remove the FRR test, with four also noting the removal of reliance on Solvency I models as a particular benefit.

2.57 Nine respondents commented that they would prefer the removal of the FRR test to be brought forward to year end 2023. The reasons stated were:

- that removing the test at year end 2024, as proposed, could create operational complexities;
- that HMT's risk margin reforms could lead to the test biting for more firms if the FRR test is not removed at the same time, therefore delay the effect of the risk margin reforms;
- removing the test at year end 2024 would lead to negative risk management outcomes for the interim period, which were disproportionate for a requirement that is being removed;
- year end 23 aligns with a regular TMTP recalculation point for firms;
- performing the FRR calculation over 2024 would be burdensome, as firms would have to continue to maintain legacy Solvency I models, and would be disproportionate for a requirement that would shortly be removed;
- CP12/23 does not provide rationale for why the implementation should be delayed, as removing earlier would have limited implementation time and cost; and
- the rationale for removing the FRR test set out in CP12/23 is as valid at year end 2023 as year end 2024.

2.58 The PRA has considered these responses and issued a statement on 8 December 2023 setting out that a) if firms were required to limit the TMTP due to the FRR test in their last recalculation before 31 December 2023, the PRA will consider removing the test subject to a case-by-case assessment; and b) for all other firms, the PRA no longer expects firms to carry out the FRR test when recalculating the TMTP. The PRA considers that removing the expectation to carry out the FRR test a year earlier than proposed in CP12/23 brings forward the expected reduction in resource costs for firms and the PRA, while the case-by-case assessment limits risks to PRA objectives by ensuring the TMTP remains appropriate for each firm. This case-by-case assessment is still needed as other safeguards in the overall reform package will not yet be in force. Further to the above, the PRA will maintain its draft policy, removing the FRR test in its entirety from the TMTP framework at year end 2024.

2.59 One respondent noted that the consultation had not advanced an argument for why the removal of the FRR test could not be brought forward, and noted that firms could have differing views on timing based on their circumstances.

2.60 The PRA has considered this response and has issued the statement mentioned above. In developing this approach, the PRA considered the circumstances of different firms with regards to the FRR test as well as the impact on its objectives. As a number of the additional safeguards proposed in CP12/23 would not yet be in force, the PRA decided a case-by-case assessment was still needed for firms with FRR test restrictions. The PRA will maintain its draft policy, removing the FRR test in its entirety from the TMTP framework at year end 2024.

2.61 One respondent commented that the FRR test should be maintained as it was part of the original Solvency II regime, but did not provide any evidence to suggest why the PRA's proposals were not appropriate.

2.62 As set out in CP12/23, the PRA considers that the FRR test creates significant resource costs for firms and the PRA. It is based on Solvency I calculations that have decreasing credibility, and it has idiosyncratic impacts on firms, leading to perverse incentives to manage business on a Solvency I rather than Solvency II basis. Therefore, the PRA considers that the increasing resource costs now outweigh the prudential benefits, which have reduced over time, and that the reforms to the TMTP methodology and forward-looking safeguards, such as expectations around managing TMTP run-off in the wider package of reforms, are now more appropriate. Having considered the response, the PRA has decided to maintain the draft policy of removing the FRR test from the TMTP framework at year end 2024.

Amortisation of TMTP

2.63 The PRA proposed to require all firms to amortise TMTP, so that it decreases in a consistent manner to zero by the end of the transitional period in 2032. Under the existing requirements, firms are required to amortise TMTP linearly by 1/16th each year to zero in 2032. However, firms adopt different approaches to achieve this. The proposal will ensure greater consistency in firms' approaches, to avoid a cliff-edge effect in relation to TMTP run-off, and to improve transparency in this area.

2.64 Five respondents stated their support for the proposals around the amortisation of TMTP, with two of these noting that this would help avoid the 'double run-off' effect, and two noting support for the PRA's proposal for firms to be able to apply to adopt alternative amortisation approaches.

2.65 One respondent commented that firms should be allowed to make approximations when calculating the risk margin component for the amortisation of immaterial lines of business.

2.66 Having considered the response, the PRA has amended the wording of SS17/15 to clarify that when calculating the projected risk margin and dynamic portions, firms can use a methodology that the firms' Chief Actuary considers appropriate, provided it is consistent with the calculation of Technical Provisions and the principles set out with Article 56 of the CDR.

2.67 One respondent commented that the amortisation proposals did not appear to be a requirement and that micro-managing firms' TMTP calculations could be dangerous.

2.68 The PRA notes that for both TMTP method firms and legacy approach firms, the amortisation proposals will be required either through Transitional Measures on Technical Provisions 5.2 or requirements in the written notice. The PRA notes that firms are currently required to amortise TMTP by 1/16th annually, so the PRA's proposals are consistent with the existing approach. The PRA considers that setting requirements around firms' amortisation of the TMTP will help ensure improved consistency in firms' approaches. Furthermore, the

PRA's proposal will help to avoid a cliff-edge loss of TMTP in 2032 for firms, and therefore facilitate a smooth and orderly cessation of this transitional measure. Therefore, having considered the response, the PRA proposes to maintain the draft policy in this area.

2.69 One respondent requested clarification on whether firms can maintain existing amortisation approaches.

2.70 The PRA notes that:

- firms with permission to use the legacy approach will continue to be able to maintain their existing amortisation approach, if under that approach TMTP runs-off in a consistent manner to zero by 1 January 2032; and
- firms on the TMTP method will be required to follow the amortisation approach set out in the rules, although they can apply for a waiver or modification from the required amortisation approach if the rule would result in a material financial impact, as further detailed in paragraph 3.2 of the SoP. However, any alternative approach would still be expected to achieve a consistent amortisation to zero by 1 January 2032.

Having considered the response, the PRA has maintained the draft policy in this area.

Management of TMTP run-off

2.71 The PRA proposed to introduce an expectation that firms consider risks to meeting their solvency risk appetite in the medium term due to TMTP run-off. This proposal was intended to ensure that firms prepare actively for the end of the transitional period and to manage any risks emerging from TMTP run-off.

2.72 Two respondents stated that they supported the PRA's proposed new expectations for firms around the management of TMTP run-off, with one noting that the proposals were in line with their existing approach.

2.73 Two respondents asked for the PRA to clarify expectations around the solvency risk appetite proposals and the level of analysis expected. Two respondents commented that the PRA should take a proportionate approach to new expectations and avoid additional bureaucracy.

2.74 The purpose of the policy is to ensure that firms can clearly identify when they are reliant on TMTP to meet their solvency risk appetite, and that this informs their plans to eliminate this reliance by 2032. Firms should, therefore, perform an appropriate level of analysis to consider this. The PRA considers that this expectation should not generally create additional burden, as this is something firms likely already consider as part of their ongoing risk management and capital management plans. Having considered the responses, the PRA has decided to maintain the draft policy in this area.

2.75 One respondent commented that the proposal to introduce an expectation for firms to consider risks to meeting solvency risk appetite due to TMTP run-off, was inconsistent with the requirement for firms to immediately inform the PRA as soon as it observes that the SCR would no longer be complied with without the application of the TMTP.

2.76 The PRA notes that the expectation for firms to consider the risk to meeting their own solvency risk appetite is separate to existing requirements around reliance on TMTP to meet SCR in Transitional Measures 12.1.[20] Specifically, this expectation will help to ensure that firms are actively preparing for the end of the transitional period and to manage any risks emerging from TMTP run-off. While firms are only required to hold own funds to meet SCR, firms set solvency risk appetites above the SCR as part of their risk management practices, so it is appropriate to consider how TMTP run-off impacts this. Therefore, having considered the response the PRA has decided to maintain the draft policy in this area.

2.77 One respondent asked for clarification as to which risk appetite should be used for the purposes of this proposal.

2.78 The PRA has considered this response, and notes that for the purposes of this expectation, firms should use the risk appetite for levels of capital that is set out in their risk appetite statement, as is outlined by paragraph 2.3 of SS4/18 **Financial management and planning by insurers**.

2.79 One respondent commented that creating this new expectation was redundant, as this is something firms already consider.

2.80 The PRA has considered this response, while the firms likely already consider the proposal as part of their ongoing risk management and capital management plans, the PRA still considers it important to set a clear expectation to ensure that firms prepare actively for the end of the transitional period and to manage emerging risks from TMTP run-off. Therefore, having considered the response, the PRA has decided to maintain the draft policy in this area.

TMTP calculation in each reporting period

2.81 The PRA proposed to allow firms to calculate TMTP at the final day of each reporting period and to remove the requirement for firms to seek the PRA’s permission for a recalculation. This would align TMTP calculated for regulatory purposes with most firms’ internal practices and removing recalculation approvals reduces resource costs for firms and the PRA.

2.82 Eight respondents stated that they supported the PRA’s proposals in this area, with three stating that the proposals would help reduce administrative burdens and documentation requirements.

2.83 Two respondents requested clarification on the frequency of calculations of the new TMTP approach, and whether firms could define their own reporting periods.

2.84 The PRA notes that references to 'reporting period' in the new TMTP rules relate to the period in which firms should report TMTP to the PRA, as set out in the Reporting Part of the PRA Rulebook, subject to waivers. Furthermore, the PRA clarifies that firms are free to calculate TMTP dynamically, such that it can be updated more frequently for internal purposes if desired. Having considered the responses, the PRA has amended the draft SS17/15 and SoP to clarify the above.

Removing audit committee oversight of TMTP

2.85 The PRA proposed to remove the expectation for TMTP calculations to have audit committee sign-off, and that instead TMTP calculations would be overseen by the Chief Actuary, alongside their existing responsibility for the Solvency II technical provisions. The PRA considers this level of governance to be more appropriate and proportionate, given the declining materiality of TMTP, as well as the other proposals to simplify the calculation and remove the requirement for TMTP recalculations to have the PRA's prior permission.

2.86 Nine respondents stated that they supported the proposals to remove the requirement for audit committees to sign-off TMTP calculations, with five noting that they agreed that Chief Actuary oversight of the figures was more appropriate.

2.87 One respondent commented that additional details on the nature and frequency of TMTP review by the Chief Actuary should be provided.

2.88 The PRA considers that the expectation for Chief Actuary oversight of the TMTP calculation should be carried out as part of the responsibilities of the actuarial function, in particular their responsibility for the calculation of technical provisions under Conditions Governing Business 6.1(b) and (e), which should therefore include assurance around the calculation of TMTP where applicable. The nature and frequency of this should be consistent with that of other areas of the actuarial function. The Chief Actuary is also expected to confirm annually that the TMTP has been calculated in line with the methodology the firm has permission to use and has been appropriately reduced in line with the applicable requirements. This can be done as part of the annual year end reporting process.

2.89 Two respondents commented that a requirement for firms to attest that the TMTP method remained a reasonable approximation of the full approach would be unreasonably burdensome.

2.90 The PRA has considered these responses and notes that there is no requirement within the proposals for firms using the TMTP method to attest that the TMTP method is a reasonable approximation of the legacy approach.

2.91 One respondent noted that audit committees did not previously sign-off TMTP calculations.

2.92 The PRA has considered this response, and notes that at present, firms' audit committees are expected by paragraph 7.1 of SS17/15 to oversee the TMTP calculation, provide annual confirmations to the PRA, and by paragraph 4.24 of SS6/16, to assess recalculation applications before they are submitted to the PRA. This will no longer be the case following the implementation of the proposals.

Insurance business transfers and reinsurance

2.93 The PRA proposed to introduce rules setting out how a firm must update TMTP method components following a transfer event. This proposal was designed to introduce greater consistency and transparency in how firms should update their TMTP calculations following transfer event.

2.94 Two respondents stated that they were supportive of the PRA's proposals for business transfers and reinsurance for firms using the new TMTP calculation method.

2.95 Five respondents commented that it was not appropriate to have a rule preventing additional aggregate TMTP to be generated, as there may be legitimate reasons for TMTP to increase on a transfer. Reasons stated included:

- where there is an increase in the risk margin due to loss of diversification;
- removal of another Long-Term Guarantee measure;
- if a firm has changed a risk mitigation agreement;
- acquisitions involving some restructuring such as a recapture of reinsurance; and
- difference in permissions (eg internal model) between transferring and receiving entities.

2.96 The PRA notes that the SoP allows firms to apply to the PRA to waive or modify the rule preventing additional aggregate TMTP to be generated if there is a legitimate justification. Having considered the responses, the PRA considers that where an insurance business transfer or 100% reinsurance transaction leads to a change in the firm's risk profile and a corresponding change in diversification benefit that affects the risk margin calculation, this is an example where the PRA may consider such a waiver or modification. The PRA has provided additional guidance in the SoP to clarify that the PRA will consider such a waiver or modification where the transfer event results in a change in risk profile that alters the level of diversification benefit. Otherwise, the PRA considers that examples given by respondents on why TMTP may increase on a transfer are already sufficiently reflected in the draft policy, as the TMTP method is sensitive to changes in risk margin and BEL for particular business lines. Therefore, the PRA does not propose making any other changes to the policy.

2.97 One respondent noted it would be preferable to have flexibility in the timing to update TMTP method factors, rather than being required to do so within two months of the transfer event. The respondent also noted that it could cause strain on firms if they are having to perform this update at the same time as preparing a plan for model harmonisation under the proposals in Chapter 5 of CP12/23.

2.98 The PRA has considered this response and notes that it expects that the update to the TMTP method factors (‘Z_A’, ‘Z_B’ and ‘C_0’) following a transfer event should be a straightforward calculation that should not be overly burdensome for firms. The PRA considers that two months provides firms with enough time to perform the update and ensure the TMTP method components (‘A_r‘, ‘B_r’ and ‘C_r’) is updated either within the same quarterly reporting period as the transfer event or the following one. If further time were provided for firms to perform the calculation, then TMTP could be disproportionately high and not appropriately linked to firms’ risk profile. The PRA notes that preparing a plan for model harmonisation could be a burdensome exercise; however, it does not consider that this would be affected by a TMTP factor update.

2.99 One respondent asked for clarification of expectations regarding the updating of TMTP factors at the point of business transfer and whether firms should anticipate any SCR impacts from harmonisation when carrying out the update, or whether a further update will be possible upon model harmonisation.

2.100 The PRA has considered the response and notes that the update of TMTP factors (‘Z_A’, ‘Z_B’ and ‘C_0’) following a transfer event should be based on the value of the technical provisions calculated as at the effective date of the transfer event, so SCR impacts from harmonisation should not be considered unless harmonisation has already taken place. Updates to factors are only possible following a transfer event. However, following harmonisation any SCR changes would result in change to the risk margin which would then be reflected in the TMTP amount, as the TMTP method is sensitive to changes in risk margin.

2.101 One respondent requested clarification as to whether a Change in Control would be considered a transfer event.

2.102 The PRA has considered this response and notes that a Change in Control does not come within the definition of a transfer event, since that in itself would not result in an immediate change in the firm’s risk profile and hence level of TMTP.

2.103 One respondent commented that TMTP methodology changes following a transfer event should only be considered after other factors driving a transfer, for example the circumstances of the firm, have been assessed.

2.104 The PRA has considered this response and notes that where such factors affect a firm's risk profile, this would be reflected in the TMTP calculation and updates to the TMTP method components, following a transfer event under the proposed policy. Therefore, having considered the response, the PRA has decided to maintain the draft policy in these areas.

Limiting new TMTP permissions

2.105 The PRA proposed that TMTP can only be applied to technical provisions, to which a TMTP permission related, on the proposed implementation date, and to grant new permissions to apply TMTP only in circumstances where a firm without an existing TMTP permission acquires or accepts business that already benefits from TMTP. The PRA considered these proposals consistent with the intended purpose of TMTP and that they would support firms towards full compliance with Solvency II.

2.106 One respondent commented that they support the PRA's proposal to limit granting new permissions for TMTP unless it is following a transfer event.

2.107 One respondent stated that the PRA should still consider new applications for TMTP.

2.108 The PRA has considered this response and considers that all firms that require TMTP for the purpose of transitioning to Solvency II would have already applied for the approval by this stage of the transitional. However, in order to allow for exceptional circumstances, it has amended the wording of the SoP to note that it 'expects' to only grant a new TMTP permission where a firm without TMTP acquires business which was subject to TMTP. This change acknowledges that there may be other unforeseen exceptional circumstances that arise in which the PRA will consider granting a permission appropriate.

2.109 Four respondents commented that firms should be permitted to claim TMTP on acquired books of business that did not previously benefit from TMTP. One respondent commented that firms should be permitted to claim TMTP on acquired books that fall within their existing TMTP policy and one respondent commented that the PRA should provide further flexibility for this proposal. Respondents stated the following reasons:

- the proposal could lead to operational complexities in the calculation of TMTP;
- the proposal could impact mergers and acquisition activity;
- the proposal could potentially inhibit recovery and resolution of firms in difficulty;
- the proposal could have adverse effects on the PRA's objectives;
- the proposal could particularly impact mutuals or smaller firms; and
- the proposal could impact transfer pricing.

2.110 Having considered the responses, the PRA considers that allowing firms to continue to claim TMTP on new blocks of business that did not previously benefit from TMTP would not meet the intended purpose of the proposed policies which is to support firms towards full compliance with Solvency II. Continuing to allow TMTP to be applied for the first time to books of business that are already fully compliant with Solvency II, eight years into the transitional period, would therefore not be appropriate. In addition, the PRA considers that not proceeding with this proposal may continue existing competitive distortions in the M&A market between firms with and without current TMTP permissions where firms with TMTP permissions can hold less capital for acquired business than firms without. The PRA notes it is not the purpose of TMTP to make acquisitions more attractive to firms, and it does not consider the proposal would have adverse impact on its objectives, nor hamper the recovery and resolution of firms in difficulty.

2.111 One respondent queried why the PRA was not also limiting TMIR permissions.

2.112 The PRA notes that the TMIR was out of scope for this consultation, barring the removal of branch eligibility, which was a consequential change related to changes made in Chapter 6 (Third-country branches) of CP12/23.

Removal of branch eligibility for TMTP and TMIR

2.113 The PRA proposed to remove the ability for third-country branches to use TMTP or TMIR, as a consequence of the policy proposals set out in Chapter 6 of CP12/23. The PRA does not consider it appropriate to make provision for branches to use TMTP or TMIR after the PRA's proposed implementation date, as there would be limited rationale for them to do so.

2.114 One respondent noted their support for the PRA's proposals in this area, stating that the removal of the branch eligibility was consistent with the proposed removal of requirements for branches to calculate a risk margin.

2.115 One respondent commented on the risks that could arise from third-country branches, but not specifically on the proposal.

2.116 After reviewing the response, the PRA has decided not to change the draft policy, as it does not consider the comment to be relevant to the proposals.

Other responses

2.117 One respondent commented that they supported the conclusion of the CBA that the benefits of the reform proposals outweigh the costs.

2.118 One respondent noted the PRA's analysis in the CBA and that there would likely be examples of both larger and smaller TMTPs resulting from the new TMTP method.

2.119 The PRA has considered this comment and it is consistent with paras 2.74-2.75 of CP12/23.

2.120 One respondent commented that Solvency I models are a sunk cost, and that if they are obsolete they should have already been removed.

2.121 The PRA has considered this response and notes that one purpose of the TMTP reforms is to reduce resourcing costs for firms and the PRA associated with calculating TMTP. This resourcing cost partly comes from the use of legacy Solvency I models which prior to the reform were required to calculate TMTP, despite no longer be required for other parts of the Solvency II framework. The reforms will remove reliance on Solvency I models for firms, except a small number who have permission to use the legacy approach. This will ensure that ongoing costs of maintaining legacy models are removed for the remaining years of the transitional period.

2.122 One respondent commented that if the objective of the reforms is to reduce resource overheads, it would be more effective for the PRA to stop all its activities.

2.123 The PRA has considered this response and has decided not to change the draft policy, as it considers this proposal would not be consistent with its statutory objectives, its role as a regulator, nor the requirement for it to have regard to the proportionality of its regulation.

Other minor changes to policy

2.124 The PRA has also made the following minor changes to the draft policy which were not directly driven by the feedback to further clarify particular areas:

- In rules, references to 'UK ISPVs' have been corrected to 'special purpose vehicles', in order to align the policy with how technical provisions are calculated for TMTP purposes under the existing framework, to ensure there is no change for firms in this area following the reforms;
- In the rules setting out the updates to the TMTP method components, following a transfer event, the PRA has changed the component to be updated to C_0, rather than Cr, as the amortisation figure should not change;
- Clarified Transitional Measures on Technical Provisions 2.4 that firms can only apply TMTP in respect of insurance and *reinsurance* obligations for which the *technical provisions* are subject to a *TMTP Permission* on the 31 December 2024;
- Amended the definition of 'non-dynamic portion' to include the amount of technical provisions calculated in accordance with Technical Provisions 2.5(2), rather than adding an

additional step in Chapter 4 to include such amount in C_0;

- Updated Transitional Measures on Technical Provisions 6.4 to state that a firm should provide an 'explanation' of the methods used to update the TMTP method factors (Z_A, Z_B and C_0) and any revision to the dynamic insurance and reinsurance obligations following a transfer event, rather than 'information explaining the methods', this is to further clarify what is required; and
- Adjusted the wording of Transitional Measures on Technical Provisions 6 to make the steps a firm must do following a transfer event clearer.

3: Internal models

Introduction

3.1 This chapter provides feedback to responses to Chapter 3 (Internal model) of CP12/23 which set out the PRA's proposed changes to the Solvency II internal model (IM) framework, and the proposed new IM framework for the UK. It also contains the PRA's near-final policy, as follows:

- amendments to the Glossary Part of the PRA Rulebook (Annex A of Appendix 2);
- amendments to the Solvency Capital Requirement – Internal Models Part of the PRA Rulebook (Annex F of Appendix 2);
- associated minor amendments to other Parts of the PRA Rulebook;
- a new statement of policy (SoP) – Solvency II internal models: Permissions and ongoing monitoring (Appendix 6). This SoP updates and replaces SS12/16 – Solvency II: Changes to internal models used by UK insurance firms (Appendix 10);
- a new SS – Expectations for meeting the PRA's internal model requirements for insurers under Solvency II (Appendix 7);
- updates to SS5/14 – Solvency II: calculation of technical provisions and the use of internal models for general insurers (Appendix 8);
- updates to SS15/15 – Solvency II: approvals (Appendix 9); and
- updates to SS17/16 – Solvency II: internal models – assessment, model change and the role of non-executive directors (Appendix 11).

3.2 In Chapter 3 of CP12/23 the PRA proposed to:

- streamline substantially the Solvency II tests and standards (T&S) required to be met for new IMs and changes made to IMs, while ensuring appropriate internal modelling standards are maintained;

- introduce more flexibility when the PRA grants new, and variations to, permissions to enable firms to use IMs to calculate their Solvency Capital Requirement (SCR);
- implement a range of IM permission safeguards that could be used to bring an IM that is not wholly compliant into compliance with the calibration standards, and/or mitigate the risks arising from such non-compliance in all other circumstances; and
- introduce an internal model ongoing review (IMOR) framework, building on many elements of the PRA's existing supervisory review processes.

3.3 The PRA received 20 responses to Chapter 3 of CP12/23. Respondents were generally supportive of the proposals overall, particularly the move to a more principles-based regime and the streamlining of T&S. One noted that the proposals were comprehensive and had been considered in detail. However, respondents also made a number of observations, and requests for changes and clarification, which are set out later in this chapter.

Changes to draft policy

3.4 After considering the responses, the PRA has added text to:

- the new IM statement of policy (IM SoP) – Solvency II internal models: Permissions and ongoing monitoring (Appendix 6) paragraph 2.23, stating that the PRA 'intends to determine the outcome of a complete application within 6 months from the date of receipt of the application and to provide the firm with a written notice of that determination, and will make reasonable efforts to do so.' This strengthens the previous wording to reassure firms of the PRA's intent;
- the IM SoP paragraphs 3.25 and 3.26, clarifying its expectations on negative model limitation adjustments (MLAs) and clarifying that MLAs are not expert judgements (EJs);
- the new supervisory statement (SS) 1/24 – Expectations for meeting the PRA's internal model requirements for insurers under Solvency II (Appendix 7), paragraph 2.3, explaining that splitting or combining risks already within the IM scope, or adding risks which fall within the sub-modules of risks already within the scope of the IM, may not necessarily amount to including new risks in the IM.

3.5 Additionally, the PRA is:

- removing the rule amendments to Solvency Capital Requirement – Internal Models 1 proposed in CP12/23 and reverting to the current PRA Rulebook drafting of Solvency Capital Requirement – Internal Models 1.1;
- adding a new rule 6.4 in the Solvency Capital Requirement – Internal Models Part of the PRA Rulebook (the Solvency Capital Requirement – Internal Models Part), to allow firms to make administrative changes to policies for changing an IM which do not require prior variation of permission by the PRA, and making associated consequential changes in Solvency Capital Requirement – Internal Models 6;

- adding the relevant dates to Solvency Capital Requirement – Internal Models 6.7;
- amending the numbering structure of the Solvency Capital Requirement – Internal Models Part to incorporate Commission Delegated Regulation (EU) 2015/35 (CDR) Annex XVIII as Solvency Capital Requirement – Internal Models 16B to 16G, with numbering in the usual PRA Rulebook style and making associated changes to relevant cross references;
- amending Solvency Capital Requirement – Internal Models 2.1(1) to refer to 'that *internal model*', instead of 'its *internal model*';
- amending Solvency Capital Requirement – Internal Models 5 to use the defined term '*scope*' in Solvency Capital Requirement – Internal Models 5.2 and amending Solvency Capital Requirement – Internal Models 4.1 and 4.2(1) to replace 'scope of the application' and 'scope of application' respectively with the defined term '*scope*'. The PRA also wishes to highlight that the version of the draft instrument consulted on in CP12/23 did not show the deletion of 'scope' (undefined) in Solvency Capital Requirement – Internal Models 5.1, which the PRA proposed in that CP to replace with the defined term '*scope*'. This change is now shown in the near-final rules;
- making minor drafting amendments to rules in Solvency Capital Requirement – Internal Models 3.4, 5.1, 5A.1, 5B.2 and 16A. and Group Supervision 13.1B to clarify that a firm must 'be able to carry out the relevant action upon request by the PRA';
- making drafting amendments to Solvency Capital Requirement – Internal Models 3.1, 3.2, 16A.2 and 16A.3, and the proposed definition of 'residual model limitation' in Solvency Capital Requirement – Internal Models 1.2, to remove references to a firm demonstrating appropriateness or certain matters to the PRA's satisfaction. In addition, the PRA is making changes to Solvency Capital Requirement – Internal Models 16A.2 and 16A.3 to require the firm to be able to explain and justify its choice of integration technique, and to Solvency Capital Requirement – Internal Models 16A.3 only to state that the firm may use an alternative integration technique that is appropriate;
- amending Solvency Capital Requirement – Internal Models 14.1(3) to replace the opening words 'For the purpose of demonstrating' with 'In order to be able to demonstrate';
- making minor drafting amendments to Solvency Capital Requirement – Internal Models 10.6 and 11.6A to replace 'shall' with 'must'; and
- amending the proposed definition of 'internal model residual deviation' in the Glossary Part of the PRA Rulebook.

3.6 The PRA considers that the changes do not significantly change the costs and benefits of the proposals consulted upon, and that therefore the cost benefit analysis in CP12/23 remains valid for the near-final rules. The only additional considerations relate to the addition of a new rule 6.4 in the Solvency Capital Requirement – Internal Models Part of the PRA Rulebook (the Solvency Capital Requirement – Internal Models Part) to allow firms to make administrative changes to policies for changing an IM which do not require prior variation of permission by the PRA. The benefits to firms and the PRA are the increased flexibility and

reduced administrative burden in allowing the following types of changes to be made by firms without them requiring prior variation of permission: changes to the name of the company or logo; updating titles, role descriptions or names of staff responsible for the IM; or corrections to the drafting of the text and updating numbered references. There are no additional costs, but there is a risk that firms may be tempted to change more than just administrative matters in their IM change policies. The PRA has mitigated this risk by providing examples of the sorts of changes allowed under this new rule, and ensuring that the new rule excludes changes which affect the outcome or scope of the IM change policy.

Feedback to responses

3.7 The PRA has considered the responses to Chapter 3 of CP12/23. This section sets out the PRA's feedback to those responses and its final decisions.

3.8 The sections below have been structured along the same lines as the sections of Chapter 3 of CP12/23. The responses have been grouped as follows:

- streamlining internal model tests and standards;
- widening the circumstances where the PRA can grant internal model permission;
- implementation of internal model permission safeguards;
- supervisory review process: internal model ongoing review;
- reporting amendments including the analysis of change;
- other responses;
- other changes to draft rules; and
- other minor amendments.

Streamlining internal model tests and standards

3.9 The PRA proposed to streamline the requirements where the PRA expects to grant permission for firms (and groups) to use an IM. All respondents welcomed the proposals, variously supporting the move towards a non-binary approach to model permissions and generally introducing more flexibility in granting IM permissions, the decoupling of general risk management requirements, and the aims of improving efficiency of IM permission decisions and simplifying compliance. Some respondents had additional comments which are addressed below.

3.10 One respondent welcomed the proposed streamlining and considered the reduction in the detailed provisions and focus on broader principles would improve firms' modelling of regulatory capital. However, they considered that the PRA was missing an opportunity to further reduce the burden on firms and the PRA by introducing a more agile process for granting permissions for new IM applications and changes to IM applications. They noted that the IM SoP maintained the current process for assessment of IM applications, including

completeness checks and a pre-application process. Another respondent welcomed the proposed streamlining but noted that the proposals did not bring a reduction in timelines for IM permissions, which they considered is currently onerous and resource intensive.

3.11 The PRA recognises that the changes to streamline the application process may also create additional opportunities to streamline the PRA's supervisory processes. However, the implementation of supervisory processes under the new IM framework was outside of the scope of CP12/23, and the PRA will consider this in more detail at a future date with a view to make further improvements for both firms and the PRA. Where appropriate, further details of any new supervisory approach will be communicated during 2024. Regarding the comments on pre-application engagement, the PRA notes that the pre-application engagement can be useful to both firms and the PRA, and it is not the PRA's intention to use it in all cases. In addition, the PRA considers completeness checks to be an important stage of the application process, in order to be satisfied of firms' readiness to apply and provide all the documentary evidence highlighted in the IM SoP. There is a further discussion on IM permission timelines below.

3.12 A number of respondents made the following comments on practicalities of the streamlining:

- One respondent agreed that there would be benefit of increased flexibility and a smaller number of rules for firms, but did not expect them to be particularly significant, as the high-level principles remain in place. Two other respondents similarly asked how this streamlining would lead to less reporting against the requirements or a substantive reduction in the effort required by firms. Another noted that this was a good-faith significant effort by the PRA to streamline requirements, but similarly asked about the practical effects.
- One respondent noted that the significant reduction in the quantity of IM T&S, from the existing IM T&S, was not a visible benefit unless the PRA produced an updated EIOPA self-assessment template (SAT) within the Common Application Package for IMs. The respondent considered that, in order for firms to recognise benefits from the reforms, this updated SAT should be based on the streamlined set of requirements for firms to demonstrate line-by-line compliance with. They asked the PRA to clarify its intention around compliance with the remaining requirements.
- One respondent welcomed the streamlining, but considered that, for their IM, it was currently relatively straightforward to demonstrate compliance with the requirements, but there would be one-off costs in mapping to the new requirements.

3.13 After considering the responses, the PRA has decided not to change the draft policy.

- The PRA has maintained those requirements that are necessary to ensure that only permissions for strong and robust IMs are granted. The PRA has deleted a number of

prescriptive CDR provisions, including a number of documentation requirements, and decoupled a number of other requirements from the IM permissions process, which the PRA expects will automatically result in savings for firms. Chart 5 and Appendix 11 in CP12/23 depict these proposed changes and demonstrate the new framework clearly to avoid confusion. Appendix 11 should also help in mapping the current requirements to the new requirements.
- As stated in paragraph 3.20 of CP12/23, under the Solvency II regime firms would have had to demonstrate line-by-line compliance with the SAT within the Common Application Package for IMs. Following the finalisation of the new internal model requirements, the PRA will make available an updated SAT.
- The PRA recognises there will be costs from demonstrating compliance with the updated SAT but expects these to be immaterial and one-off.

3.14 Three respondents considered that any potential reduction in the regulatory burden by the reduction in requirements would be at least partially offset by the new requirements introduced, including the Analysis of Change (AoC), the internal model ongoing review (IMOR) framework and annual attestation of compliance with internal model requirements and calibration standards. One also asked the PRA to consider if the annual attestation expectation was necessary. A further respondent noted that all of these new aspects, as well as the introduction of safeguards and model limitation adjustments (MLAs), would result in a more complex regime.

3.15 After considering the responses, the PRA has decided not to change the draft policy. The PRA does not consider that the new requirements would be overly onerous or result in a more complex regime. This is because the new IMOR and annual attestation requirements build on existing requirements where firms should already have processes in place, ie there is already a requirement for firms to ensure ongoing appropriateness of the design and operations of the IM, Solvency Capital Requirement – Internal Models 10.3, as well as reviewing the ongoing appropriateness of its specification, Solvency Capital Requirement – Internal Models 14.1(1)(a). Furthermore, the PRA understands that it is already common practice to carry out annual AoC exercises for internal management purposes. The annual attestation is covered further below in the IMOR section under Strand 3.

3.16 In addition, some respondents made comments on the structure of the new framework:

- Two respondents stated that there was potential for confusion between expectations and requirements and asked that the PRA Rulebook define these. One of these argued that expectations are effectively PRA rules.
- Another respondent welcomed the intention behind streamlining and was supportive of improving the application process for new IMs and IM changes, but did not consider that the mapping table in Appendix 11 demonstrated a material reduction in the number of

regulations that firms would need to comply with, since firms will need to meet expectations or demonstrate that an alternative approach is appropriate.
- A third said that spreading requirements across the PRA Rulebook, supervisory statements and statements of policy adds complexity to the regime.

3.17 After considering the responses, the PRA has decided not to change the draft policy, as:

- The **PRA's Policy page** explains that 'supervisory statements set flexible frameworks for firms, incorporating new and existing expectations. They focus on the PRA's expectations and are aimed at facilitating firm and supervisory judgement in determining whether they meet those expectations. They do not set absolute requirements – these are contained in rules.'
- The PRA considers its proposed streamlining of the IM tests and standards achieves a reasonable balance of maintaining robust IM standards consistent with its objectives, providing greater flexibility for granting IM permissions, and removing prescriptive requirements not considered necessary. Finally, the PRA noted in paragraph 1.3 of Appendix 6 of CP12/23 that the supervisory statement sets out the PRA's expectations under the rules in Solvency Capital Requirement – Internal Models Part; as above, they do not set absolute requirements – these are contained in the rules.
- The PRA's Policy page explains the purpose of rules and statements of policy, which form part of the PRA's policy framework.

Internal model permission timelines

3.18 Four respondents noted that, for IM permission timelines, the wording in paragraph 2.23 of the IM SoP was weaker than the wording in the existing Regulation 48 of Solvency 2 Regulations 2015. These four respondents suggested that this change in wording could lead to the PRA taking longer than six months to grant permission for IM applications. Two of these respondents acknowledged that the PRA cannot legally bind itself in a SoP, and three proposed that stronger wording be adopted in the IM SoP.

3.19 Having considered the responses, the PRA has amended paragraph 2.23 in the IM SoP to state that the PRA 'intends to determine the outcome of a complete application within six months from the date of receipt of the application and to provide the firm with a written notice of that determination, and will make reasonable efforts to do so.' A key aim of the IM reforms is to streamline the internal model requirements and improve flexibility, and as a result the PRA envisages that this would facilitate faster IM permissions (where feasible), taking no longer than six months in general. The backdrop for the proposed IM SoP is the revocation of the Solvency 2 Regulations 2015 under the Financial Services and Markets Act 2023, which means that the statutory six-month limit will no longer apply. Consistent with the transfer of detailed regulatory requirements to PRA rules and policy materials under the SRF, the SoP will set out how the PRA expects to handle applications, in accordance with the relevant

legislation and PRA rules. As acknowledged by two respondents, the PRA cannot impose an explicit legal obligation on itself to reach a decision on IM permission applications within a specific time period.

3.20 While recognising the PRA's aim to simplify and speed up the internal model change application process, one respondent commented that it was not clear how the proposed IM rule changes would achieve this for firms that wish to avoid application of a residual model limitation capital add-on (RML CAO). Another respondent noted that there were no changes to the pre-application process, and a lengthy approval process would slow down and restrict their ability to invest in productive assets. Three respondents requested clarity from the PRA on the expected timeline for each part of the IM permission process (pre-application, initial application, model changes). Two respondents also requested that the PRA publish data on the time taken for the PRA to approve IM applications, to provide transparency on the impact of the reforms. One of these respondents acknowledged that faster and smoother approval decisions could be facilitated by the wider set of circumstances under which IM permission may be granted under these reforms.

3.21 After considering the responses, the PRA has decided not to change the draft policy. The PRA notes that the proposed framework aims to improve the efficiency of decisions made in the PRA's review of IM applications, and the cost benefit analysis outlined in Chapter 3 of CP12/23 describes how the proposals are expected to improve the process. Paragraph 3.82 of CP12/23 highlights the cost savings to firms expected to arise from less onerous documentation requirements, such as the lower overhead costs when completing the SAT, and a less prescriptive framework. The PRA considers that the time taken for pre-application will depend on firm readiness in each specific case and that, where a pre-application stage is appropriate, there have been no changes to this process which would have an impact on productive investment. It is not possible to give indicative timelines on each part of the permission process, since this will depend on the complexity, firm readiness and the quality of a firm's application. The PRA's approach in providing transparency on the time taken for it to determine applications for permissions under s.138BA FSMA was out of scope for this consultation, but the PRA is consulting separately in CP 27/23 – **The Prudential Regulation Authority's approach to policy** on a range of metrics where reporting would support the secondary competitiveness and growth objective, including variations of permissions.

EIOPA Guidelines

3.22 Four respondents commented on the PRA's proposals for EIOPA guidelines. Two respondents noted that Chart 5 in paragraph 3.20 of CP12/23 does not include the EIOPA guidelines, whereas Appendix 10 still refers to the EIOPA guidelines. Two respondents requested clarification whether EIOPA guidelines on IM would be amended in due course to align with the proposed changes to tests and standards.

3.23 Work is ongoing, where applicable, to consult on transferring assimilated law into the PRA Rulebook and wider policy framework, and some EIOPA guidelines may be transferred to PRA policy material on a case-by-case basis. Until that time, the PRA would expect firms to make every effort to comply with existing EIOPA guidelines to the extent that these remain relevant, as set out in statement of policy (SoP) – **Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU**.

Widening the circumstances where the PRA can grant internal model permission

Removing the binary nature of model approvals

3.24 The PRA proposed to apply a more flexible approach to granting new, and variations to, permissions to enable firms to use IMs to calculate their SCR, using safeguards where necessary to retain high modelling standards. Seven respondents commented on the PRA's proposals to remove the binary nature of IM approvals. Respondents largely welcomed the proposals to move from a binary approval process to a permission process where the PRA additionally has the option to use safeguards, the additional flexibility that this brings and the benefit in reducing the likelihood of protracted processes with disproportionate resource burdens. However, some respondents sought clarifications in some areas.

- One respondent suggested that the consultation was insufficiently clear on the flexibility being optional for firms (ie that firms may choose not to pursue IM permission if this involved safeguards).
- One respondent asked the PRA to clarify in the SoP that there would be no requirement for firms to reapply for a waiver or modification of any of the internal model requirements after a period of time, once this has been granted by the PRA; similarly, another requested the PRA to confirm if IM waivers would be permanent or timebound.
- Finally, a respondent asked the PRA to clarify that models which meet capital standards will be granted permission without safeguards.

3.25 Having considered the responses, the PRA has decided that changes to its draft policy are not required, for the following reasons:

- The procedure for considering IM permission applications is covered in the IM SoP. Should a firm not wish to pursue an IM permission with safeguards, paragraph 2.26 in the IM SoP states that firms have the right to withdraw an application.
- Paragraph 3.23 of the IM SoP summarises the mechanism by which the PRA will remove a safeguard and paragraphs 3.34 to 3.39 summarise the approach to varying and revoking permissions; furthermore, the PRA does not anticipate that waivers or modifications will be time limited.

- The PRA considers that where all requirements are met in full (ie the calibration standards and internal model requirements) then the PRA expects to grant a permission without safeguards; this is stated in paragraph 3.33 and illustrated in Chart 6 of CP12/23.

Equivalence with EU's Solvency II

3.26 Two respondents commented on the implications of the PRA's proposals for equivalence with EU's Solvency II requirements. One respondent suggested that EU Solvency II compliant models should be deemed compliant under Solvency UK. Another respondent commented that the divergence from the EU's Solvency II regime is only going to be helpful if it leads to significant simplifications or tailoring to the UK market.

3.27 The PRA expects that models that meet current EU Solvency II requirements should materially meet UK requirements, with the exceptions of the additional AoC reporting requirement and the introduction of MLAs (to the extent that firms wish to use these). However, for the purpose of IM permissions for UK firms and groups, the PRA will continue to assess all models on a case-by-case basis and make its own determination. This is because the PRA is not able to delegate or derogate its decision making to another body, so it must independently make a decision on an application for permission (or a variation of permission), irrespective of what other regulators have decided even about the same model. Additionally, even if a model is approved by an EU regulator, its use will be different when applied, for example, just to UK entities, so it is right that the PRA makes its own assessment.

Implementation of internal model permission safeguards

Definition of model limitation adjustment

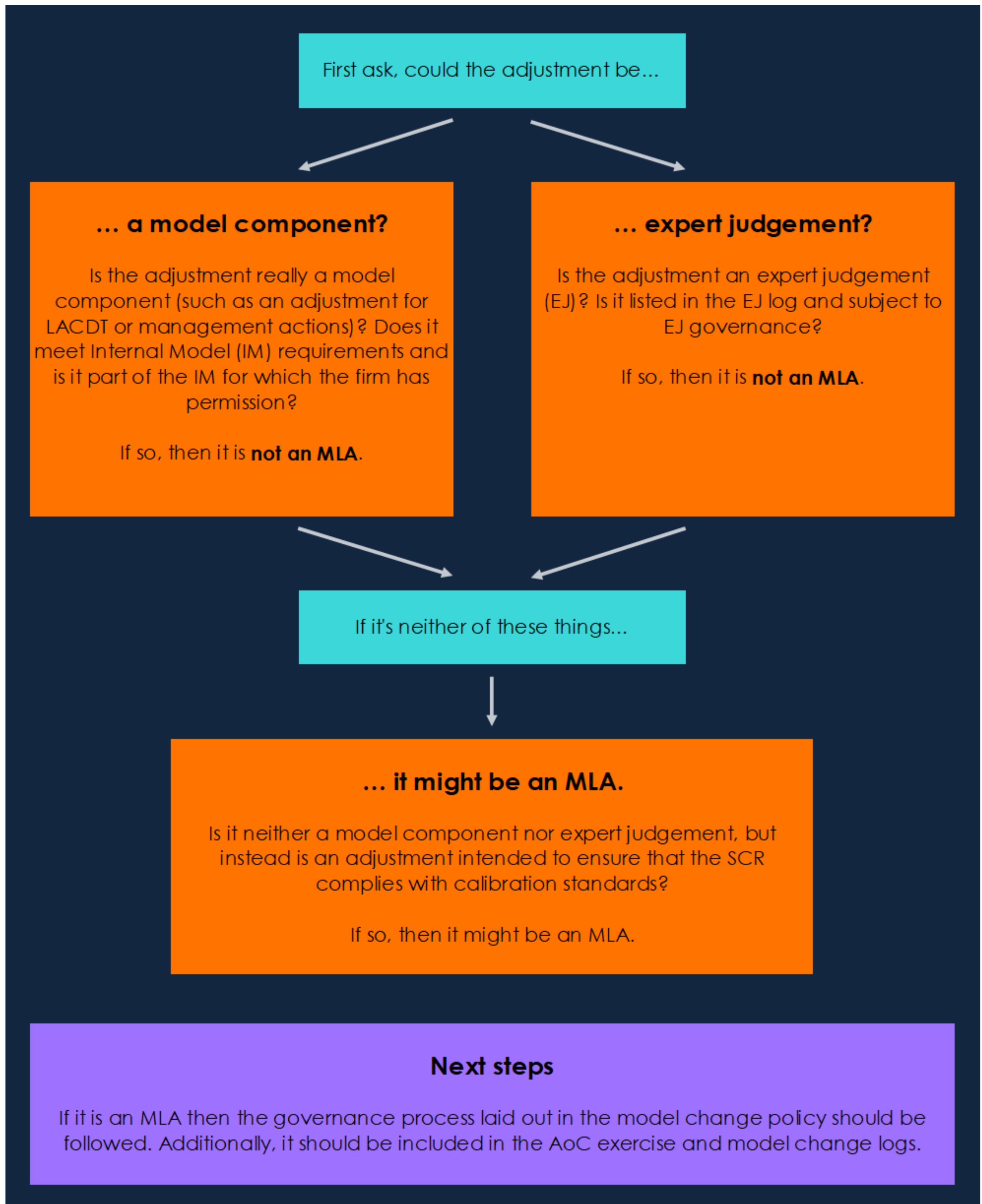
3.28 The PRA proposed to formalise existing arrangements whereby firms address residual IM weaknesses, shortcomings, or uncertainty by incorporating MLAs into their IMs to ensure compliance with the calibration standards. One respondent was supportive of the formalisation of this practice.

3.29 The PRA proposed in 3.24(c) of the IM SoP that an MLA could be applied as an adjustment to a parameter or assumption. Seven respondents requested that 3.24(c) should either be deleted or amended, on the grounds that there would be an overlap with expert judgements (EJs) on individual parameters. One respondent asked the PRA to clarify whether all EJs would be treated as MLAs, and need to be reported.

3.30 Having considered the responses, the PRA has clarified in paragraph 3.26 of the SoP that MLAs are not EJs. However, the PRA has not removed 3.24(c) as paragraph 3.24 in general is about how an MLA could be applied, and it does not mean that all parameter adjustments are MLAs. In particular, if an EJ on a parameter is captured in a firm's EJ log and is subject to governance under the firm's EJ policy, then it is considered an EJ rather than an

MLA. Firms are not obliged to use MLAs, and do not need to use this tool if their IM (including EJs) is already compliant with calibration standards. However, where an adjustment to a parameter is not already classified as an EJ or subject to existing IM governance in some other way, then 3.24(c) would ensure that the adjustment is captured within the firm's IM framework. The following diagram may help with this clarification.

Chart 1: Understanding whether an adjustment is a Model Limitation Adjustment (MLA)



3.31 One respondent additionally asked if out-of-model adjustments which do not vary by percentile would be considered MLAs. Another respondent stated that an out-of-model deterministic adjustment to allow for expense risk, for example, should neither be considered

an MLA nor lead to non-compliance with Solvency Capital Requirement – Internal Models 12.2, which requires a firm to derive its SCR directly from the probability distribution forecast generated by its IM.

3.32 After considering the responses, the PRA has decided not to change the draft policy. In some cases, an adjustment which does not vary by percentile would be considered an MLA. However, in other cases, such an adjustment could be an EJ or a model component, as described above in Chart 1. In particular, the calculation of LACDT or expense risk, for example, in another system may be considered a model component. Paragraph 3.24 of CP12/23 highlights the options available to firms in the case of non-compliance with Solvency Capital Requirement – Internal Models 12.2.

3.33 The PRA stated in paragraph 3.42 of CP12/23 that it expects firms to have plans to address the issues underlying an MLA over time.

- Five respondents argued that longer-term or indefinite MLAs should be allowed, for reasons of materiality or pragmatism.
- One respondent additionally stated that it currently sets a limit for the out of model adjustments it does not intend to model, for pragmatic reasons.
- One respondent considered that it would never be feasible or proportionate to include all MLAs in the calculation kernel.
- One respondent considered that the true-up calculation should not be captured by the MLA definition.

3.34 After considering the responses, the PRA has decided not to change the draft policy.

- Since MLAs are used to mitigate RMLs or uncertainty on a model which would otherwise not comply with calibration standards, the PRA generally considers that firms should have in place plans to address these underlying issues, rather than assuming that aspects of the model that do not meet requirements may persist indefinitely. Firms may take into consideration factors such as the size and nature of the underlying model deficiency or uncertainty, when determining the planning horizon, and this is stated in paragraph 3.29 of the SoP.
- The PRA considers that all MLAs should have associated remediation plans and considers that it would be inappropriate to set upfront thresholds of materiality for items which will not be modelled.
- The PRA has clarified above that MLAs exclude EJs, and the PRA would not expect firms to have so many MLAs that it is unfeasible to keep track of them.
- Finally, respondents may consider the diagram in Chart 1 and consider whether a model adjustment (such as the true-up calculation) is already a part of the IM for which the firm has permission, in which case it would not be an MLA.

3.35 One respondent asked for more clarity in the definition of an MLA provided in the PRA Rulebook.

3.36 The PRA has not attempted a precise definition of an MLA, and considers it more fundamental to introduce a framework to formalise arrangements whereby firms address residual IM weaknesses, shortcomings, or uncertainty, by formally incorporating MLAs into their IMs, and contribute to compliance with the calibration standards. This framework was introduced because the PRA considered that firms' use of such adjustments in their IMs under the existing framework lacked transparency and consistency in how they are applied, and consequently made it difficult for the PRA to understand the output of approved IMs. Within this framework, is up to firms to document how they plan to use MLAs in their IM change policies.

3.37 Six respondents commented further on the definition of an MLA. Two were supportive of the proposals, since current concepts such as 'out of model adjustments' and 'model overlays' are not always consistent, or clearly defined and applied.

- One requested that MLAs should not include core components of model calibration.
- Three stated that the definition was too widely framed, creating a risk that some may be treated as EJs.
- Two stated that the proposed MLA scope would be wider than for typical 'out of model adjustments' currently made by firms, or inconsistent with how firms currently use 'out of model adjustments'.
- One respondent questioned whether the PRA Rulebook definition was correct, given that calibration standards (Solvency Capital Requirement – General Provisions 3.3 and 3.4) apply to both IM and standard formula (SF) firms.
- The same respondent asked for clarification that an MLA reflecting an acquisition which has not yet been incorporated in the IM is intended to be captured by the definition.
- One respondent proposed that MLAs corresponding to long-term features and those corresponding to management loadings for RMLs should be treated differently by the PRA, and that the PRA should clarify its intention around approval and review.

3.38 After considering the responses, the PRA has decided not to change the draft policy.

- Model components are not MLAs, since these components are subject to IM governance and should meet the internal model requirements.
- The point about potential overlap with EJs is covered in the paragraphs above and Chart 1.
- The respondents did not elaborate on how firms' existing 'out of model adjustments' may be narrower or different in scope to MLAs. If this relates to the expectation that MLAs should be positive, then this is discussed in the next subsection.

- The PRA Rulebook definition states that MLAs only apply in an IM context (and therefore do not apply where the SCR is calculated using the SF).
- Unmodelled business acquisitions are intended to be captured by the definition, to allow firms to reflect a change in the firm's risk profile following a business acquisition and to avoid potentially understating the SCR.
- It is up to firms how they document their approach to using MLAs, and the governance arrangements relating to their use in their IM change policy, subject to the PRA granting/varying an IM permission covering such an IM change policy. If the firm's IM change policy also classifies the MLA as a major model change, then the firm would need to apply for a variation of permission from the PRA.

3.39 The PRA gave examples in Appendix 12 of CP12/23 of where firms might use MLAs. One respondent found these examples helpful and suggested that the PRA use more examples and case studies in future consultations. Another respondent appreciated the use of examples but requested links between the examples given and the PRA's assessment criteria.

3.40 The PRA notes the requests for more use of examples in the future. In terms of the examples in CP12/23, these examples illustrate, at a high-level, different potential scenarios where MLAs may or may not be appropriate. They were not intended to be exhaustive. Once firms have updated their IM change policies with the procedures for applying, reviewing and removing MLAs, firms should use MLAs in accordance with their IM change policies.

3.41 One respondent said that paragraphs 3.8 and 3.9 of CP12/23 presented a practical problem. Paragraph 3.8 stated that firms should consider any consequential changes to their IM change policies resulting from these proposals, in particular around MLAs, before applying to the PRA for a variation of their IM permission. Paragraph 3.9 then described the transitional rule, which allows firms that apply MLAs up to two years from the effective date of the final rules to make the consequential changes to their IM change policies to reflect MLAs. The respondent inferred that no other changes to IM change policies were therefore permitted within the two-year transitional period.

3.42 After considering the responses, the PRA has decided not to change the draft policy. Solvency Capital Requirement – Internal Models 6.7 allows firms that apply MLAs a transitional period of two years to make changes to their IM change policies, in order to document procedures for applying, reviewing and removing MLAs. If a firm makes any such changes, it must apply to the PRA before the end of the transitional period for a variation of permission in order to reflect those MLA changes to their IM change policy. Other changes to IM change policies are permitted during this time, in accordance with Solvency Capital Requirement – Internal Models 6.4 to 6.6.

3.43 One respondent noted that the formalisation of the MLA framework provided helpful clarity and requested that the governance around MLAs would be commensurate with their materiality. One respondent recommended that the PRA clarifies that only material MLAs are subject to the proposed requirements in the CP and its appendices. One respondent suggested that MLAs should be subject to existing IM governance and requirements, and that additional governance was therefore unnecessary.

3.44 The PRA considers that all MLAs should be subject to the firms' own governance arrangements (which can reflect the materiality of the MLA), which should be set out in their IM change policies. The PRA considers it to be important that firms clarify the governance around MLAs in their IM change policies because the existing framework lacked transparency and consistency across the industry.

3.45 One respondent supported the use of MLAs (among other new measures) in reducing the onerousness of IM applications and believed that there was scope for further safeguards to ensure that the majority of model approvals do not fall short of the required standards. They suggested that these MLAs should only be used in a minority of cases. They also suggested that the PRA publish a statement on the frequency of the use of MLAs, together with a process for retrospectively analysing whether the frequency was being met. They stated that the IM approval regime implemented in the UK by the PRA is one of the most highly respected regulatory approval processes that exists anywhere in the world, and would be undermined if large numbers of models were approved which fall short of the standards. Checks and balances were important in ensuring MLAs (among other new measures) were not required in most cases.

3.46 After considering the responses, the PRA has decided not to change the draft policy. The PRA agrees that firms should not use MLAs excessively. The PRA cannot provide an expected frequency with which circumstances requiring an MLA will arise, as this depends on how firms address model limitations and how other model safeguards are used (eg RML CAOs). CP12/23 states that this new framework will improve transparency and the PRA's understanding of firms' use of this tool, and the PRA will continue monitoring their use. The overall intention is for the PRA to maintain a robust IM framework, which uses appropriate safeguards, and to improve transparency around MLAs.

3.47 One respondent disagreed that an RML CAO may be applied by the PRA if the materiality of an MLA increases over time, because some MLAs may become more material as the SCR grows.

3.48 After considering the response, the PRA has decided not to change the draft policy. Table 1 in Appendix 13: 'Solvency II: Capital add-ons' of CP12/23 highlights the criteria for assessing whether a risk profile deviation is significant. In addition, paragraph 3.30 of Appendix 13 highlighted some of the factors which the PRA may consider when judging

whether an MLA is more appropriate than an RML CAO. Therefore, whether an MLA or RML CAO is more appropriate will depend on the case-specific circumstances, and the PRA may take into account how the MLA fluctuates over time relative to the firm's risk profile.

Model limitation adjustments are expected to be positive

3.49 Thirteen respondents commented on the PRA's expectation that each MLA will be (or result in) a positive increase to the SCR. Three respondents argued that negative MLAs would not necessarily lead to a reduction in overall modelling standards. Twelve respondents suggested that there were reasonable scenarios where negative adjustments to the SCR may be needed while waiting for model developments to reflect matters, such as:

- a reinsurance treaty signed close to the year end, which would reduce the SCR but due to timing issues is not reflected in the model and subsequently not in the year end SCR, or new group capital support arrangements in a similar position;
- a correction made to the final SCR because a credit protection transaction had been executed but could not yet be accurately captured within the core SCR calculation engine;
- the MLA discussed in example D of Table 3 in Appendix 12 to adjust for skew in the notched ratings of the underlying portfolio (where skew could be positive and negative);
- a recalibration that leads to a mistaken spike in capital requirements not reflective of the risk, or one-off errors that would not justify rerun of the model; and
- adjustments to reflect LACDT or Technical Provisions and management actions.

3.50 After considering the responses the PRA has clarified its expectations in paragraph 3.25 of the SoP that MLAs should be positive in most cases, and acknowledges that negative MLAs could be appropriate in rare circumstances, subject to discussion with supervisors. However, the PRA considers it is important to reiterate that the purpose of the MLA is to allow a firm to make an adjustment to demonstrate compliance with the calibration standards where there is a shortfall against the requirements, rather than to benefit from the impact of model changes before these have been through model change governance and implemented in the model. In response to the specific examples provided by firms, the PRA considers that:

- where a firm has carried out significant transactions (or put in place new group capital support arrangements) close to the year end which require formal changes to the IM, such as a reinsurance, hedging or other transaction, but the transaction occurred after the firm's year end model calibration process, firms should wait until the necessary governance and model changes, before recognising the SCR impact of this transaction, and that an MLA would not be appropriate in this case;
- similar arguments apply for the credit protection transaction;
- firms should design, build, test, validate and implement changes to their IM, rather than opting solely for a negative MLA and bypass the steps to change the model in example D

in Table 3 of Appendix 12;

- recalibration mistakes and errors should not lead to negative MLAs, for the reasons stated in the IM SoP in paragraph 3.25 (that negative MLAs could lead to a reduction in modelling standards), and the PRA considers that it is inappropriate to benefit from an SCR reduction before model change governance has been completed; and
- the LACDT adjustment or adjustments for management actions in stress, where they are already part of the IM methodology for which the PRA has granted permission, should not be considered MLAs.

Requirement safeguards

3.51 Four respondents commented on the PRA's requirement safeguard. They acknowledged and welcomed the examples provided in Appendix 12 of CP12/23, and either queried or requested further details on the practical application of requirement safeguards. Three of the four respondents commented that limiting a firm's new business activity could hinder investment and conflict with the PRA's secondary objectives (for example, if peer firms are not subject to a similar safeguard).

3.52 Having considered the responses, the PRA has decided not to change the draft policy. Appendix 12 of CP12/23 set out examples of requirement safeguards. In practice, requirement safeguards would be considered on a case-by-case basis, and if a firm desires further detail on the application of a requirement safeguard, it should engage with its supervisor. The PRA notes that a requirement safeguard in some cases could be used to limit a firm's new business activity, for example investment in a new asset class, if a firm does not yet have the capability to model the risks within these assets appropriately. However, this safeguard would be imposed in cases where a firm's IM does not meet the internal model requirements. Permitting such a firm to gain exposure to significant volumes of the new asset class in such circumstances would pose a risk to the PRA's primary objectives, as the IM would not reflect the risks run by the firm. In addition, relative to a firm that had invested in the necessary capabilities to appropriately model the risks, this would not be consistent with the PRA's secondary objective on facilitating effective competition. The PRA also notes that in granting permission to use the IM with safeguards, firms would be able to gain some initial exposure to a new asset class whilst having space to develop their IM in respect of the same, advancing the PRA's secondary objective to facilitate effective competition.

Model limitation adjustments and model change policies

3.53 Two respondents commented on the PRA's proposal that IM change policies should set out the procedures for applying, reviewing, and removing MLAs. One respondent argued that updating the model change policy and, in particular the formalisation of MLAs, will add a significant compliance burden. Another respondent recognised that the introduction, change,

or removal of an MLA, might fall within the scope of the model change policy, but suggested that other aspects forming part of the internal model methodology would not be appropriate to be included in the model change policy.

3.54 After considering the responses, the PRA has decided not to change the draft policy. MLAs are considered to be part of the IM and therefore, the introduction, change or removal of an MLA could constitute a model change and should be covered in the firm's model change policy.

Formalising model limitation adjustments

3.55 One respondent commented on the PRA's proposal to formalise MLAs. The respondent recognised the need for the PRA to ensure that MLAs are appropriate, but was unclear how formalising this framework would achieve this and how it would not result in a disproportionate burden on firms.

3.56 After considering the responses, the PRA has decided not to change the draft policy. The PRA considers that formalising MLAs addresses issues with the existing IM framework where firms' current use of such adjustments lacked transparency and consistency in how they are applied, and consequently made it difficult for the PRA to understand the output of approved IMs. Therefore, formalising MLAs will help to address these concerns, and ensure they are subject to appropriate governance within a firm and review by the PRA where needed. The PRA does not consider formalising the MLAs to be disproportionate since such adjustments are considered part of a firm's IM.

Safeguards in general

3.57 Four respondents made comments around firms' ownership of their models. One respondent agreed with the PRA's proposed use of safeguards alongside IM permissions. However:

- One of those respondents believed firms should be involved in the process of setting safeguards and that firms should be able to remove safeguards unilaterally with consent of their Board once they are satisfied some pre-specified conditions have been met.
- Three of those respondents said that PRA should not have the ability to impose safeguards unilaterally or that safeguards should be a matter for the firm to decide if they are required.
- Two of those respondents said the proposals may lead to reduced ownership of their models, and one said they could limit innovation and investment in new asset classes.

3.58 After considering the responses, the PRA has decided not to change the draft policy. The PRA agrees with the overall views of the respondents that it is of fundamental importance that firms have ownership of their models. However, the PRA considers that

safeguards should not detract from the firm's ownership of their models. Firms retain the IM methodology agreed by their Board. The PRA considers that safeguards allow potential limitations in a firm's model to be adequately rectified or mitigated, where a firm would not otherwise be permitted to use an IM, and provide greater clarity where there may be a difference in view between the PRA and the firm. Therefore, the PRA considers that safeguards would improve transparency between the firm and PRA on modelling issues and therefore supplement the firms' own modelling and risk management. While firms would be involved in the discussions on safeguards, ultimately it is the PRA that imposes them where it is necessary to retain high modelling standards; similarly, the PRA will remove them where the firm has demonstrated to the PRA that that it has remedied the identified RML.

3.59 Two respondents asked the PRA to confirm that the safeguard pathway for approvals would be voluntary and that firms could reject the option without any prejudice to their applications.

3.60 The PRA confirms that firms have the choice to pursue further model development to resolve any RMLs identified during the IM application process, instead of accepting model permission safeguards, as highlighted in paragraph 4.48 of CP12/23. The PRA would assess an application as set out in Chapter 2 of the IM SoP. If the PRA identified an RML, and the firm did not wish to accept a safeguard, then they may withdraw the application in order to address the model weakness. However, if the application is not withdrawn then the firm should consider the possibility that the PRA may not grant permission. Therefore, the PRA notes that safeguards provide greater flexibility to grant permission for models in a more pragmatic manner.

3.61 One respondent asked the PRA to acknowledge that all models had residual limitations and that RML CAOs should not be necessary where prudence has already been applied to address general model uncertainty or data limitations.

3.62 The PRA considers that if a firm meets the calibration standards and internal model requirements, then the model will not require safeguards. And where a firm has made allowances for model uncertainty or limitations within the model, the PRA will take this into consideration when deciding whether an RML CAO, or other safeguard, would be necessary.

3.63 One respondent called for consistent application of safeguards across time and across firms, to ensure the credibility of the proposed regime and for its fair and efficient functioning.

3.64 After considering the response, the PRA has decided not to change the draft policy. A PRA decision-making framework is in place to ensure that firm-specific decisions are consistent, but this is outside of the scope of this consultation.

3.65 Two respondents said that safeguards should be used exceptionally, one of whom said this is necessary so as not to significantly reduce the standards required for model approval. This respondent also called for a statement in the final guidance on the expected frequency of use of these new measures, together with a process for retrospectively analysing whether this expected frequency was being met. (These are similar comments to those made above in paragraph 3.45, in the context of MLAs.)

3.66 After considering the responses, the PRA has decided not to change the draft policy. The circumstances for imposing safeguards are set out in the IM SoP, in the section 'Safeguards to support granting or variation of model permissions'. The PRA cannot provide an expected frequency with which these circumstances will arise, as this depends on the nature of firms' models submitted in applications for permission and the models' subsequent compliance with internal model requirements. By definition, safeguards cannot result in a reduction in model standards, given they can only be used to ensure compliance with the calibration standards and mitigate non-compliance with the internal model requirements.

3.67 Two respondents said it could take many years to obtain sufficient data or expertise to meet the relevant requirements and thus remediate an RML for new classes of business. Accordingly, the PRA should find a pragmatic solution to the problems in Appendix 12 Tables 4 and 5, such as acknowledging the reasonable application of EJ in such situations. In their view, imposing a requirement safeguard limit would impair HMT's objective of long-term productive investment.

3.68 The PRA considers that its proposed safeguards will facilitate firms obtaining model permissions in respect of new risks and asset classes, including those where there may be little historic data available to calibrate the model and demonstrate that the data requirements are fully met. This will allow firms to adopt more proportionate modelling approaches than might be allowable under the current framework where initial IM applications or major model changes that are not fully compliant with the internal model requirements must be rejected. This approach therefore reduces potential regulatory barriers to investments in new asset classes. Over time this safeguard may be moderated or removed, for example as more data about the risk is collected, and the firm demonstrates to the PRA that it has remediated the RML.

3.69 One respondent did not object to the use of safeguards, such as limiting exposures while expertise was being developed, but asked the PRA why it was necessary for RMLs to be temporary if the capital loading or safeguard was sufficient and appropriate.

3.70 The PRA notes that paragraph 3.1 in the SoP states that the degree to which any model limitation can be considered residual will depend on particular circumstances, including that the limitation is temporary and capable of remediation. Some limitations may, by their nature, persist longer than others but there should be a plan in place for remediation.

3.71 One respondent asked for additional clarity over the level of disclosure in relation to capital add-ons and safeguards that the PRA intended to publish in written notices.

3.72 Paragraph 2.28 in the SoP confirms that the written notice will specify any safeguards set by the PRA. Following the changes discussed in Chapter 4 of this PS, a firm will not be required to disclose an RML CAO in its SFCR, and IM permission safeguards will not be included in the PRA's aggregate report on CAOs for significant risk deviations. The PRA continues to consider the form of publication of written notices, and will take into account any requirements in secondary legislation made under s138BA(6)(d) of FSMA.

3.73 One respondent asked if the PRA could add safeguards without a firm applying for a new permission.

3.74 The PRA will assess the ongoing model compliance as part of the IMOR framework, as stated in CP12/23; in doing so, it may identify an RML which may require an adjustment to the firm's model or SCR to ensure compliance with the calibration standards or internal model requirements or mitigate non-compliance with the internal model requirements (paragraph 5.10 in the IM SoP). Therefore, the PRA could impose safeguards without a firm applying for a variation of its existing permission.

3.75 One respondent thought the waiver process in the IM SoP, paragraph 3.6(b), would add additional administrative burden for firms, without adding significant regulatory value.

3.76 After considering the response, the PRA has decided not to change the draft policy. Paragraph 3.6 of the IM SoP states that the PRA will specify in the written notice issued to the firm (a) requirement safeguards and (b) where a safeguard is imposed that is intended to mitigate non-compliance with any internal model requirement, any applicable waivers or modification of requirements. Item (b) is a key part of the framework as it allows for greater flexibility; without it, the firm would be in breach of those requirements it is not meeting, therefore, this represents a benefit to the firm. Compared to a firm not being granted permission, a waiver or modification of the requirements does not seem to be burdensome.

3.77 One respondent argued that the scope and definition of RMLs was too wide and could in theory catch every decision, assumption and judgement in the model, and suggested it was replaced with high-level principles and expectations.

3.78 After considering the responses, the PRA has decided not to change the draft definition. The definition is sufficiently precise because the RML that is the aspect of concern would have to prevent the firm from meeting the internal model requirements or calibration standards (Solvency Capital Requirements - General Provisions 3.3 and 3.4). Paragraph 3.8 onwards in the IM SoP sets out the PRA's policy on this matter. See also the response in paragraph 2.25 above on MLAs versus EJs.

3.79 One respondent stated that firms require stability of capital requirements in order make long-term decisions, and where uncertainty is introduced through the potential for significant changes to capital requirements (eg via CAOs) as a result of the IMOR process, this could reduce appetite for certain risks – eg the retention of longevity risk or investment in newer asset classes.

3.80 After considering the responses, the PRA has decided not to change the draft policy. The new RML CAOs would relate to residual modelling issues, and therefore, be small relative to a firm's overall capital requirements. Additionally, the 1-in-200 VaR standard is not changing (Solvency Capital Requirement - General Provisions 3.4). Therefore, the PRA would not expect them to result in a materially different SCR. Accordingly, the PRA considers that it is unlikely the new rules and policy could lead to material instability of firms' internal model SCRs and reduce appetite for certain risks, compared to the previous regime.

3.81 One respondent acknowledged the intention of the PRA to simplify and add flexibility to the regime. However, they believed that there was a lack of clarity on many aspects of the reform, including the implementation processes. Furthermore, the respondent was unconvinced the reforms would result in tangible and positive outcomes; for instance, the reforms presented, in this respondent's view, a material uncertainty in their ability to achieve the modelled economics of assets, particularly new illiquid asset classes.

3.82 After considering the responses, the PRA has decided not to change the draft policy. The implementation of the supervisory processes under the new IM framework was not in scope of CP12/23 and, where appropriate, there will be further communications with industry on implementation processes during 2024. Furthermore, the reforms are intended to bring improvements to the IM framework, in terms of flexibility and burden reduction in the modelling approaches available, which in turn would allow IMs to change and adapt more quickly, as highlighted in paragraph 3.18 of CP12/23. The PRA considers that the type of uncertainty described by this respondent should not arise as a consequence of the reforms. Under the current IM framework, it is challenging for a firm to demonstrate that its model for a new illiquid asset class fully meets the internal model requirements and calibration standards. To attain approval firms would need to remediate any deficiencies in their IMs so that these are met in full. This pathway is still open for firms to pursue and firms would now have an additional option to be granted permission but with safeguards, which the PRA considers would be a benefit for firms.

3.83 One respondent agreed that the PRA's proposals should widen the use of internal models, which was in the public interest. Another respondent said that the proposal to grant permission to a firm to use an IM that had some RMLs so long as safeguards were used seemed reasonable. A third respondent said that the proposed monitoring of safeguards in paragraph 3.64 of the CP seemed broadly reasonable. They believed that the majority of monitoring should be performed by firms and only reported to PRA if an agreed threshold is

breached or expected to be breached in the near future. As part of setting any safeguards (including CAOs), they believed that PRA should agree with the firm the timescales for, and the nature of, any review.

3.84 After considering the responses, the PRA has decided not to change the draft policy in respect of the comments above around the monitoring of safeguards. Paragraph 5.12 of the IM SoP covers monitoring of safeguards including where the PRA may request from a firm a progress report setting out the measures taken, a description of the progress the firm has made on remedying RMLs for where there is an IM safeguard, and states that the PRA will discuss the timing and frequency of this report with firms. Paragraph 4.43 in Chapter 4 of this PS also covers the PRA's response to a related question on timescales for setting a CAO.

3.85 One respondent supported the principle behind the changes to enhance the flexibility of the PRA to act more proportionately with regard to model approvals, but was unconvinced that the proposals when considered in combination would achieve the overall aim of making the regime better. They believed that the additional requirements and governance surrounding RML CAOs and safeguards were unnecessary, as the existing regime had been effective in protecting policyholders. They also welcomed the PRA's proposal to publish information on its use of capital add-ons and safeguards, adding that they would encourage the PRA to use this report to explain to the industry, the public, and other users, how its use of such measures is consistent with its statutory objectives and 'have regards'.

3.86 After considering the response, the PRA has decided not to change the draft policy. While the existing IM regime has been effective in protecting policyholders, the PRA considers that it has done so at a greater cost to firms' and the PRA's resources than is optimal. As such, a key aim of these reforms is to introduce greater flexibility in the IM framework and streamline the internal model requirements in order to facilitate a broader range of IM permissions than currently allowed. The PRA envisages that if the new IM framework is implemented faithfully by both firms and the PRA, it would likely lead to reduced overall resourcing requirements. Chapter 4 of this PS covers changes to the proposed regular report on safeguards.

3.87 One respondent said the RML CAO and the 'requirement safeguard' should enable the PRA to gain comfort that granting permission, subject to safeguards, would effectively mitigate the risk that an internal model did not fully comply with the tests and standards, but believed more guidance regarding their expected use would be beneficial. They also supported the PRA's proposal to publish a report on safeguards (both RML CAOs and requirement safeguards) and CAOs on an aggregate basis.

3.88 The PRA considers that it has provided an appropriate amount of guidance during this reform, and if necessary, can seek to clarify expectations via supervisory statements after the regime becomes operational, subject to future consultation. Chapter 5 of the IM SoP covers

changes to the proposed regular report on safeguards.

Major model change process changes

3.89 Two respondents suggested that the PRA should allow minor or administrative changes to their internal model change policies that do not affect the outcome of the policy, without the need for a disproportionate level of governance, both internally and with the PRA.

3.90 After considering the responses, the PRA agrees with the suggestion and has amended the IM SoP paragraph 2.50 and will add new rule Solvency Capital Requirement – Internal Models 6.4 to the PRA Rulebook (as well as making some consequential amendments to Solvency Capital Requirement – Internal Models 6) to allow firms to make administrative changes to their internal model change policy without the need to apply to the PRA for a variation of permission. Examples of such administrative changes include: changes to the name of the company or logo; updating titles, role descriptions or names of staff responsible for the IM; or corrections to the drafting of the text and updating numbered references.

3.91 One respondent welcomed the additional flexibility around major model change (MMC) process changes. One respondent requested clarity on whether future model changes will be considered while RMLs are outstanding. Three respondents requested further clarity in the final rules and guidance on how the internal model change process will be conducted in the future relative to the current approach. Of these:

- one asked for clarification in the final rules that existing approved IMs will not be re-evaluated to a different standard;
- one asked for confirmation that there would be no retrospective consequences on firms with existing approvals, and that CP12/23 would have no impact unless there is a major model change; and
- one requested that MMC reviews are limited to only on the model component affected.

3.92 After considering the responses, the PRA has decided not to change the draft policy. The PRA may vary permissions to reflect major model changes while existing RMLs are outstanding, so long as the model together with existing safeguards – and potentially any additional safeguards needed in light of the proposed model changes – meets the calibration standards and internal model requirements, or mitigates any non-compliance with the internal model requirements. Additionally:

- Paragraph 3.8 of CP12/23 stated that the PRA does not expect firms whose IMs were approved before the reforms would need to be granted new permissions.
- Paragraph 3.8 of CP12/23 also advised firms with existing IM approvals to consider changes to IM change policies if they wish to use MLAs, and paragraph 3.10 highlighted the impact of the proposed IMOR framework for firms with existing approvals.

- The PRA may, as under the existing IM framework, review other elements of the model separate to the change being requested where it is necessary to determine that the model as a whole remains compliant.

Materiality

3.93 Two respondents requested reintroducing Article 222 of the Commission Delegated Regulation (EU) 2015/35 (CDR) on the definition of materiality.

3.94 After considering the responses, the PRA has decided not to change the draft policy. The PRA considers it would not be helpful to define 'material' as its meaning can be dependent on the context in which it is used. Therefore, the PRA considers that firms should exercise their own reasonable judgement in interpreting 'material' and that this judgement should be applied consistently over time. Firms may also wish to consider the definition of materiality in PRA Rulebook Reporting Article 4A, relevant for information to be submitted to the PRA.

Supervisory review process: internal model ongoing review

3.95 The PRA proposed to update its approach to the review and assessment of ongoing compliance of firms' IM with the internal model requirements and calibration standards, through the internal model ongoing review (IMOR) framework. Seven respondents made comments on the proposed IMOR framework. Respondents largely supported the framework, including the clarity and details, and acknowledged that it built on the existing supervisory process. One firm also agreed that the IMOR framework will help to ensure that IMs remain appropriate on an ongoing basis, and will improve the consistency and regularity of IM information gathered by the PRA in the overall supervisory process.

3.96 In addition, a number of respondents provided other comments:

- One respondent highlighted the need to apply the framework pragmatically and ensure the PRA does not raise capital requirements to an unnecessarily prudent level.
- Two respondents stated their view that the IMOR framework will increase the cost and resource associated with regulatory engagement and updating existing processes without bringing clear benefits to firms, industry, or policyholders.
- One noted the need to consider the additional work created by the proposed changes; firms with existing permissions will need to change their processes to accommodate the new proposals.
- One respondent requested further details or examples of the likely scope and form of the 'additional data submissions through the IMOR framework' noted in CP12/23.
- One respondent also welcomed the PRA's new secondary objective requiring the PRA to facilitate competitiveness and growth, subject to aligning with international standards; they

requested that the PRA regularly assess the capital levels of UK firms to ensure that the UK does not become an outlier in the international sphere.

3.97 The PRA has considered these responses and decided to not make changes to the draft policy, specifically:

- The PRA will apply the framework proportionally, aligning with international standards when they are appropriate for the UK.
- The IMOR framework is not expected to increase the cost and resource on an ongoing basis due to the framework building on existing supervisory processes, such as the PRA's use of thematic work. Similarly, the attestation expectation builds on the existing validation requirements. Furthermore, the PRA expects the proposed IMOR framework to provide significant benefit to the PRA. Specifically, the framework will provide assurance that firms' IMs remain appropriate to their risk profile and thereby advances the PRA's primary objectives.
- The PRA recognises there may be work and costs involved in adapting to the new IM framework, but expects these to be largely one-off costs.
- Examples of submissions are being considered by the PRA at present. However, the additional data submissions from firms are not expected to be onerous and the PRA will apply a proportionate approach to any such requests.
- The PRA has published consultation paper (CP) 27/23 – **The Prudential Regulation Authority's approach to policy**. Appendix 2 of this CP provides the quantitative metrics which the PRA intends to publish periodically to provide transparency around the work to facilitate competitiveness and growth, subject to aligning with international standards, and these include SCR coverage ratios.

3.98 In addition to the comments above on the overall IMOR framework, respondents also made comments on the individual strands, as set out below.

Strand 1

3.99 Three respondents supported the continued use of thematic work, with one considering it to be proportionate in terms of its scope and the level of engagement required by firms. However, one respondent requested that thematic work should not be used to identify model limitations of individual firms and apply CAOs on a blanket basis to impacted firms; instead, a process of feedback and industry discussion should be held. If necessary, firms should then be asked to update their IMs in response to findings. Additionally, one respondent expressed concerns that the PRA's communication of thematic review findings could lead to reduced investor appetite due to the uncertainty of the scale and timing of potential resulting CAOs.

3.100 After considering the responses, the PRA has decided not to change the draft policy. As stated in paragraph 3.54 of CP12/23, the PRA makes use of firm-specific ‘deep-dives’, supervisory engagement, thematic reviews, and model drift analysis to monitor IMs. The PRA would not rely on thematic reviews alone to set CAOs, but these could be used to identify emerging risks for future regulatory focus. The PRA acknowledges the points made regarding the sensitivities around communicating its findings of thematic reviews. Where appropriate, the PRA intends to communicate further about its approach to IMOR in 2024.

Strand 2

3.101 Fourteen respondents commented on the PRA’s proposals on the Analysis of Change (AoC). Respondents were largely supportive of the proposals, including the free-format nature of AoC.01, phased introduction of the requirement, and the materiality considerations outlined in Appendix 10. Respondents largely noted that the AoC is already carried out by most firms, and compared to the P&L attribution exercise, is a more effective validation tool which would provide a better insight for the purposes of IM regulation (discussed further in paragraphs 3.108).

3.102 In addition, respondents made the following comments on the AoC proposals:

- Two respondents suggested extensions to the proposals, specifically to extend the AoC to movements in Own Funds and incorporate AoC submissions into external reporting requirements.
- One respondent suggested standardising the submission.
- One respondent requested clarity from the PRA on how it will use the AoC in its supervision of firms.

3.103 The PRA has considered these responses and decided not to change the draft policy.

- Should the PRA consider changes or extensions to the AoC requirements in the future, these will be consulted upon. To reduce the reporting burden on firms, and to provide the most meaningful insight to the PRA at the current time, the PRA does not consider it necessary to implement the extensions the respondent has suggested (extending to movements in Own Funds or requiring the AoC to be reported externally).
- Given the differences between firms’ risk profiles, the PRA does not consider standardising the submission beneficial at this point in time and is mindful that standardisation would introduce additional implementation costs for firms. Upon reviewing initial submissions, the PRA will consider whether further guidance may be useful to firms.
- CP12/23 sets out the benefits of the AoC to the PRA; for example, paragraph 3.31 states that ‘submission of the AoC exercise results would also help the PRA to inform its supervisory strategy by providing insight into changes in firms’ risk exposure.

3.104 One respondent requested guidance on the level of detail required in the supporting narrative documentation, and two respondents requested further guidance on the materiality that should be applied in the AoC; noting the size of the balancing item and requesting a materiality consideration for disclosure of MLAs. Two respondents requested detail on how the PRA intends to use AoC data in its supervision of firms to help them design the reporting process for the submissions to the PRA.

3.105 After considering the responses, the PRA has decided not to change the draft policy. The PRA notes that paragraph 10.8 of the updated SS17/16 allows firms to apply their own definition of material in the AoC exercise, which should align with the definitions already used within firms' own internal exercises. All MLAs should be reported individually, regardless of materiality, because each MLA contributes to the calculation of the SCR. Furthermore, the aggregate change in MLAs should be provided in the AoC.01 template as part of firms' AoC submissions. In relation to the final response, the PRA considers that the free-format nature of the AoC.01 template allows firms to leverage their own internal AoC exercises, providing for example, the information that their Boards have found most useful. As set out above in paragraph 3.103, upon reviewing initial submissions, the PRA may consider issuing further guidance.

3.106 Three respondents supported the proposals and recognised that they already carried out AoC exercises, but highlighted additional costs in meeting the proposals, particularly the expectations for the supporting narrative documentation. One of those respondents requested that the PRA did not expand the scope of the AoC proposals over time without consulting with industry and considering the burden on firms, with changes considered only by exception or as part of longer-term reviews. The same respondent noted that the AoC would be more resource-intensive for syndicates than the existing P&L attribution exercise. They also noted that a requirement for the Society of Lloyd's to provide an aggregated market wide AoC may impose constraints on how individual syndicates prepare their analysis for Lloyd's.

3.107 The PRA has considered these responses and decided not to change the draft policy. While the PRA notes the efforts required to implement the policy proposals, particularly the expectations for the supporting narrative documentation, it envisages that this should not be onerous as firms can leverage their existing internal AoC processes and any narrative that is already prepared for that, given that most firms already complete AoC exercises. Furthermore, the PRA has proposed both a free-form template, AoC.01, and supporting documentation, to enable flexibility in how firms provide the AoC and any attached narrative, and therefore limit the reporting burden. As noted above in paragraph 3.103, upon reviewing the initial submissions, the PRA will consider whether further guidance may be useful to firms. In response to the final respondents, Lloyd's syndicates are not directly regulated by the PRA. The requirement to carry out the AoC exercise applies to Lloyd's, but exactly how

Lloyd's chooses to gather the information to carry out the AoC exercise is out of scope of the CP12/23. However, the PRA considers that the free-form format provides sufficient flexibility to suit the unique features of the Lloyd's market.

3.108 Five respondents also made comments on the proposed removal of the P&L Attribution requirement. Respondents largely welcomed this proposal and agreed that the proposed AoC would be a more useful tool than the P&L attribution exercise. One of the five respondents noted that the P&L attribution exercise had the potential to identify experience that arose and was not modelled, which is not captured by the AoC.

3.109 Having considered these responses the PRA has decided to not change the draft policy. While capturing risks not modelled in the IM was one of the aims of the P&L attribution, this exercise has not provided the PRA with sufficient, appropriate insight. Additionally, the PRA Rulebook (Solvency Capital Requirement – General Provisions 3.3) requires a firm's SCR to be calibrated to ensure that all quantifiable risks to which the firm is exposed are taken into account, therefore the onus remains on firms to monitor emerging risks and include them in their models as required.

3.110 Five respondents noted that they would continue to perform a P&L attribution exercise, or expected firms to continue doing so. Two welcomed the removal of the P&L attribution requirement, but expected to continue using it voluntarily for internal purposes. Two did not object to the introduction of the AoC requirement but noted that they would need to continue to produce the P&L attribution for Group reporting to other regulators, and therefore there is no saving in the amount of work involved for them.

3.111 Having considered these responses the PRA has decided to not change the draft policy. The PRA expects that many firms, though it recognises not all, will choose to cease production of the P&L attribution and there will be savings for these firms. Where the P&L is considered useful for firms' own validation, the PRA encourages continuation of such analysis. As explained in paragraph 3.15, the PRA is aware that the AoC exercise is completed by many firms already and therefore this proposal should not be onerous.

Strand 3

3.112 Ten respondents commented on the PRA's proposal to introduce an expectation that a firm submit an annual attestation to the PRA that it satisfies the calibration standards and internal model requirements. One respondent supported this proposal and agreed that the CRO would generally be the most appropriate individual to perform this attestation. Four of the ten respondents considered the annual attestation to be unnecessary, given the requirements and expectations of the existing IM governance and validation framework, and two of the ten respondents felt that the attestation could be delivered from current processes. Five of the ten respondents considered that it would result in additional work and burden for firms, with one of these five stating there was no clear regulatory benefit, and another stating

that it would, therefore, impact the competitiveness of the UK relative to other jurisdictions. One respondent also requested that the scope of the attestation is not extended beyond the proposed scope given this would increase ongoing costs.

3.113 Having considered the responses, the PRA has decided not to change the draft policy. The PRA notes that the new expectation is similar to the PRA's long-standing expectations for banks where internal ratings are used to calculate regulatory capital requirements.[21] It ensures that firms own, and are accountable for, meeting the calibration standards and internal model requirements on an ongoing basis, and that there is a credible plan to address any non-compliance identified by the validation. The PRA expects that the work required to perform the attestation should not go beyond the scope of the firm's IM validation and that it should not adversely impact the competitiveness of UK IM firms, given that it is already a requirement for firms to ensure that they meet calibration standards and internal model requirements on an ongoing basis. The PRA would consult on any proposed changes to the attestation in the future.

3.114 Additionally, seven of the ten respondents requested clarification over:

- The scope, timing, and format of the attestation;
- The selection of the individual that would perform the attestation;
- The split of responsibilities between the Board and the individual providing the attestation; and
- The benefits that the attestation delivers relative to the existing IM framework and PRA objectives, and how the PRA would use the attestation.

3.115 Having considered the responses, the PRA has provided the following:

- Paragraph 2.9 of the new SS clarifies the scope of the attestation. The PRA considers that the format and timing of the attestation is at the discretion of the firm.
- The PRA expects that a firm would propose an appropriate individual to provide the attestation, where in most cases this would likely be the Chief Risk Office (SMF4).
- The responsibilities of the Board would remain unchanged, and the individual's responsibilities would be in accordance with paragraph 2.10 of the supervisory statement.
- Paragraph 3.78 of CP12/23 sets out the benefits that the new attestation expectation would provide. In addition, the PRA considers that the attestation would provide greater accountability within a firm and support the IMOR framework in providing the PRA with assurance over a firm's IM, both of which advance the PRA's objectives.

Strand 4

3.116 Two respondents supported the monitoring of remedial progress on RMLs identified and the review of any safeguards set (highlighting requirement safeguards). In particular, they supported the use of multiple reporting channels to assess the ongoing validity and appropriateness of these safeguards with regards to changes in firm's risk profile, market conditions and IM changes. One of the two agreed that it would be appropriate for it to sit in the IMOR framework.

Reporting amendments including the analysis of change

3.117 The PRA proposed to make changes to the reporting templates relevant to IM firms (for example: quarterly model change reports; standard formula reporting and model drift analysis). Responses related to proposals for reporting, and any subsequent changes to PRA policy, will be covered in a future policy statement.

Other responses

Reforms overall

3.118 One respondent commented on the PRA Rulebook; they considered that the PRA Rulebook should cross-reference supervision and policy statements.

3.119 After considering the responses, the PRA has decided not to change its existing approach. The current PRA Rulebook webpage shows consultation papers, supervisory statements and policy statements in the right-hand pane under 'Related links'. Additionally, the Bank of England's **Prudential regulation publications** policy bank allows readers to search for relevant supervisory statements, say, on a particular matter. The PRA has also explained in CP27/23 that it is also working on improvements to the current PRA Rulebook, to improve its accessibility, efficiency, usability and clarity, making it easier for stakeholders to engage with the regulatory material. In the meantime, the PRA has developed its **Prudential and Resolution Policy Index** to provide easy access to relevant source materials.

3.120 One respondent suggested that the PRA should place more reliance on firms' internal model validation activities, and grant permissions based on the conclusions of these validation activities.

3.121 After considering the responses, the PRA has decided not to change the draft policy. The PRA considers that it needs to be satisfied that firms meet all of the internal model requirements and calibration standards (with or without safeguards) or any non-compliance with internal model requirements is mitigated by safeguards, not just those relating to validation. However, the more comprehensive the independent validation report is, the more it is likely that supervisors will find its conclusions useful when assessing the other requirements.

3.122 One respondent did not envisage increased regulatory burden for Lloyd's syndicates from the proposals. However, they commented that Lloyd's syndicates' models are overseen by Lloyd's rather than directly by the PRA and there may be trickle-down capital implications if the nature of the PRA's oversight of Lloyd's were to increase the regulatory burden. They suggest that the solvency regime should reflect the unique features of this market.

3.123 The PRA's intention is to retain a risk-based regime that can be applied across all firms rather than one tailored to unique features of one market. The PRA's oversight of Lloyd's was not in scope of CP12/23, and all firms with IMs are expected to comply with the new framework. The PRA has not seen arguments or evidence that Lloyd's syndicates would be disproportionately affected by these reforms.

3.124 Two respondents requested that the PRA review the operation of the new framework after a suitable period of time, analysing the impact and possibly publishing a report on the impact it has had on the PRA's objectives.

3.125 The PRA intends to keep under review the operation of the new framework as part of its policy evaluation cycle.[22] Regarding external publication, the PRA states in Chapter 4 – Capital add-ons that it will publish a report on its use of safeguards in 2027. While other aspects will also be kept under review, there are no commitments at this stage regarding publications of other review findings.

3.126 One respondent recommended that the PRA ensures that supervisory statements arising from former tests and standards are treated as genuine expectations, rather than former rules.

3.127 The PRA notes this response and highlights that supervisory statements do not set requirements; requirements are contained in rules.

3.128 One respondent stated that some of the proposed reforms should enable the UK insurance industry to remain internationally competitive, but considered that the PRA should have gone further, referring to the Matching Adjustment (MA) framework.

3.129 Reforms to the MA framework are out of scope of CP12/23 and were covered in CP 19/23 – **Review of Solvency II: Reform of the Matching Adjustment**.

3.130 One respondent considered that the PRA had not factored into its CBA the risks posed by firms' reduced ownership of their models. The same respondent did not support the PRA's conclusion in paragraph 3.87 of CP12/23, that one-off compliance costs for firms with existing IM permissions are expected to be immaterial; on the assumption that firms maintain existing processes, they argued that benefits would similarly be immaterial.

3.131 Having considered the response, the PRA does not consider that it needs to update its cost benefit analysis. Firstly, as stated in paragraph 3.58, the PRA considers that these reforms will not lead to reduced ownership of models. Secondly, paragraph 3.87 of CP12/23 relates to the costs; the benefits are contained in the preceding section, including paragraph 3.82 and the discussion regarding lower overhead costs for firms. The streamlining reforms mean that there are fewer and more principles-based internal model requirements to comply with and provide evidence against.

3.132 One respondent stated that they believed that the costs and overheads of operating an IM would increase and there would be no benefit from faster or less burdensome approvals.

3.133 After considering the response, the PRA has decided not to change the draft policy. It is unclear to which aspects this respondent is referring and the respondent has not provided new information, arguments, or data, that would justify a change in position.

3.134 One respondent noted items of additional work for firms (eg documentation of attestations and AoC) and asked if the additional burden had been quantified and is aligned to the spirit of reforms.

3.135 Having considered the response, the PRA does not consider that it needs to update its cost benefit analysis. Paragraphs 3.88 and 3.89 of CP12/23 cover the costs of attestation and AoC separately.

- The PRA does not expect the attestation expectation to be onerous, since firms are already required to comply with the validation requirements in Solvency Capital Requirement – Internal Models 14. Therefore, firms should already have a regular process in place, where the output is, for example, the IM validation report, to support the proposed attestation expectation.
- The PRA expects that most firms already complete an AoC exercise internally. Due to the free-form nature of the reporting template, the PRA expects that firms would leverage this internal exercise when carrying out the exercise required in Solvency Capital Requirement – Internal Models 13A and in the submission of the AoC exercise to the PRA. The ongoing compliance costs may be offset by the removal of the profit and loss attribution exercise.

3.136 One respondent commented on the potential for unintended consequences, including:

- safeguards and CAOs having the effect of moving firms' economic views towards the PRA's, decreasing ownership;
- decreasing modelling standards should internal model permission be granted to a large number of models with deficiencies, including the situation where safeguards were used to bypass technical discussions with the PRA; and

- uncertainty for firms if safeguards and CAOs were to be applied retrospectively and for unrelated model changes.

3.137 After considering the response, the PRA has decided not to change the draft policy.

- The purpose of safeguards is not to take ownership of firms' modelling (see response in paragraph 3.58). Including safeguards in the new IM framework means the PRA will not necessarily reject an IM application if it identifies RMLs which prevent a firm from demonstrating compliance with all the relevant requirements. If the PRA decides to grant (or vary) a model permission with appropriate safeguards, the safeguards are there to protect firms and policyholders while these deficiencies are being addressed. As an alternative to permission safeguards, firms have the option of continuing to develop their model to meet internal model requirements and calibration standards without safeguards, as is the current position under the existing framework.
- Additionally, safeguards are a pragmatic tool to bring an IM that is nearly compliant into compliance with the calibration standards or mitigate non-compliance with the internal model requirements. As stated in paragraph 3.15 of CP12/23, the PRA continues to attach significant importance to firms demonstrating high standards of internal modelling of the risks which they are exposed to, particularly where these IMs are used to determine a firm's regulatory solvency requirements.
- For model change applications, as explained in paragraph 4.15 of CP12/23, the purpose of an RML CAO (and, more generally, a safeguard) is to support granting of a variation of an IM permission for a MMC, where the application would have otherwise been rejected. As an alternative, firms will continue to have the choice to pursue further model development to resolve any RMLs identified during the IM application process, instead of accepting model permission safeguards (including an RML CAO). For any other RMLs, which are not related to the model change, the PRA expects to identify these as part of IMOR, or they may be identified at other times, for example, the firm may identify non-compliance and notify the PRA. Therefore, a model change application should not affect whether a safeguard is imposed in relation to RMLs unrelated to the model change.

Implementation of the IM framework

3.138 Fifteen respondents commented on implementation of the new IM framework. Four respondents welcomed the proposals, commenting that they had the potential to produce a more proportionate/efficient regime or else reduce application timelines and the burden on firms. One respondent stated that the proposals were helpful for firms applying for an internal model for the first time. One respondent stated that the PRA had considered the practical implications of the proposals from industry's perspective.

3.139 Five respondents requested clarity on when firms could engage with the PRA for IM changes under the new framework, including for applications currently in progress that had already been submitted to the PRA. Six respondents commented on the existing EIOPA Common Application Template (CAT) and EIOPA Self Assessment Template (SAT). These respondents queried whether these templates would be replaced with PRA versions and whether they would be simplified in any way.

3.140 The PRA will communicate with industry during 2024 regarding when it will engage with firms on applications under the new framework and on updated application templates. These aspects were not in the scope of CP12/23.

3.141 Four respondents outlined suggestions for implementation of the reforms by the PRA: a fast-track process for straightforward model change applications; a reduction in evidence/documentation requirements; creating a distinction between the requirements for a new IM compared to a MMC on an existing model in order to reduce the resources needed to complete an MMC. Three respondents noted that the impact of the IM reforms would depend on the PRA's approach in implementing them. One respondent noted that in implementation the PRA should ensure uniformity of decision making and consistency of capital requirements across firms.

3.142 The PRA acknowledges the respondents' comments and will take these into consideration when implementing the IM framework. Where appropriate, further communication about the PRA's supervisory processes will follow in 2024 before the new IM framework comes into force. Furthermore, the PRA considers that its existing proposals result in a significant streamlining of the IM framework for both firms and the PRA, and considers that further changes to its policy are not required. The PRA will continue to use its current approaches and mechanisms for maintaining consistent treatment of firms.

3.143 Eight respondents acknowledged the details provided by the PRA on implementation of the new IM framework, but requested further guidance across a variety of other topics. These included: the impact on existing approved models; whether an updated model change policy will trigger a major model change; and implementation of credit rating notches.

3.144 The PRA notes that:

- the PRA's proposals will not impact the approved status of existing models;
- transitional rule Solvency Capital Requirement – Internal Models 6.7, provides that for a period of two years after the effective date of the rule changes, a firm that applies MLAs may make changes to its model change policy solely in order to document procedures for applying, reviewing, and removing MLAs without the prior approval of the PRA for a variation of its permission. A firm making such changes must apply to the PRA within two years after the effective date of the rule changes to vary its IM permission in order to

reflect these changes. While other changes to firms' IM change policies are possible during this time (and afterwards), they will require an application to the PRA to vary the firm's permission; and

- CP19/23 discusses the interaction of the MA reforms with the IM, including credit rating notches.

Inclusion of new risks

3.145 Six respondents commented on the PRA's proposal that including new risks in the IM should be considered a MMC in firms' IM change policies. Five respondents argued that this treatment could be disproportionate for minor risks and that materiality of the risks should be considered. Three respondents suggested that firms' own model change policies should define what constitutes a new risk. One respondent went further to state that the model change policy should include associated materiality thresholds. Finally, two respondents requested the PRA to provide further clarification and guidance on these aspects.

3.146 After considering the responses the PRA has decided to make changes to paragraph 2.2 in the SS1/24 to provide greater clarity in this area. Firms may be able to demonstrate that splitting or combining risks already within the IM scope or adding any additional risk which falls within a sub-module of a risk already within the IM scope may not necessarily amount to introducing new risks.

Quantitative indicators and qualitative principles

3.147 Four respondents suggested that the PRA should publicly disclose the quantitative indicators (QIs) and qualitative principles (QPs) that it applies in its decision making on IM approval.

3.148 The PRA's application of QIs and QPs to inform its decision making on IM permission applications is outside the scope of this consultation. The PRA notes that its usage of QIs and QPs is consistent with its strategic priority to be at the forefront of identifying new and emerging risks.[23] PRA publication of QIs and QPs would risk these becoming targets rather than internal PRA tools, which could lead to firms herding around the PRA's position, rather than the QIs and QPs acting as minimum calibration and diagnostic tools. The PRA therefore does not intend to disclose these tools.

Partial internal model integration

3.149 One respondent asked if the PRA proposed to make any changes to partial internal model integration techniques.

3.150 The PRA confirms that there are no substantive changes to partial internal model integration techniques and Annex XVIII of the CDR has been transferred and restated to the PRA Rulebook). The PRA has amended the numbering structure of Annex XVIII which is set

out as Chapters 16B to 16G on integration techniques for partial internal models, in line with usual PRA Rulebook style.

3.151 Another respondent asked if undertaking specific parameters or proportionate application of the rules would be allowable for simple partial internal models.

3.152 Reform the Standard Formula, and therefore undertaking specific parameters, was out of scope of CP12/23. Furthermore, with regards to the respondent's comment on simple partial internal models, the PRA's policy on granting (or varying) permission is the same for all firms and internal models unless otherwise specifically stated.

Financial and regulatory misconduct

3.153 One respondent made comments on the risks of financial and regulatory misconduct which do not fit into another category.

- The respondent considered that changes to documentation (SSs and SoPs) were premature but useful to have as a record. Rather, they challenged the aims of the review, which they considered should have started with an assessment from first principles of internal modelling (for example, whether they are robust and acceptable approximations of reality).
- They also highlighted that IMs are not independently audited.
- They argued that loosening the regime will release capital, heightening the risk of insurer failure. The respondent expressed concerns that reforms were politically-driven decisions that increase the risk of insurers failing because capital is diverted to other investments and projects.
- They considered that the IMOR framework was redundant, and limited assessing compliance to particular dates, rather than continuously.
- They considered that the PRA would become less independent by focusing on supervisory judgement and a smaller number of principles-based requirements for IMs.
- Finally, they disagreed that having regard to HMT's recommendation letter dated December 2022 was relevant for ensuring the stability of insurers.

3.154 After considering the responses, the PRA has decided not to change the draft policy.

- The aims of the IM reforms were highlighted in paragraph 3.18 of CP12/23. These aims did not include fundamentally reviewing the case for having IMs.
- While IMs are not independently audited, the internal model validation process is required to be independent from the development and operation of the IM, according to Solvency Capital Requirement – Internal Models 14.2.
- The PRA has not sought to release capital through the proposed IM reforms, and all firms would still need to meet the same calibration standards.

- The requirement for a firm to ensure the ongoing appropriateness of the design and operation of the internal model remains in Solvency Capital Requirement – Internal Models 10.3.
- The existing Solvency II framework for IMs includes a large number of highly prescriptive and detailed provisions, originally designed to promote harmonisation of regulation and supervision across multiple EU countries, and the PRA considers that this level of prescription is unnecessary for its needs in supervising UK firms. The PRA continues to consider that high modelling standards within firms can be achieved with fewer prescriptive provisions; it is unclear why addressing these would lead to supervisory capture.
- Finally, the PRA has a legal obligation to have regard to HMT's recommendations.

Other changes to draft rules

3.155 The PRA has made the following additional amendments to the rules consulted on in Chapter 3 of CP12/23.

3.156 The PRA has not proceeded with the rule amendments to Solvency Capital Requirement – Internal Models 1 proposed in CP12/23. The PRA considers that the existing formulation of the application rule Solvency Capital Requirement – Internal Models 1.1 is appropriate.

3.157 The PRA has made amendments to Solvency Capital Requirement – Internal Models 2.1(1) to refer to 'that *internal model*' instead of 'its *internal model*' for consistency with Solvency Capital Requirement – Internal Models 2.2.

3.158 The PRA wishes to highlight that the version of the draft instrument consulted on in CP12/23 did not show the deletion of 'scope' (undefined) in Solvency Capital Requirement – Internal Models 5.1, which the PRA proposed in that CP to replace with the defined term '*scope*'. This change is now shown in the near-final rules. The PRA has also made the equivalent change to Solvency Capital Requirement – Internal Models 5.2 to use the defined term '*scope*' for consistency with use of the defined term in Solvency Capital Requirement – Internal Models 5.1 and a similar change to Solvency Capital Requirement – Internal Models 4.1 and 4.2(1) to replace 'scope of the application' and 'scope of application' respectively with the defined term '*scope*'.

3.159 In the draft rules, rules in Solvency Capital Requirement – Internal Models 3.4, 5.1, 5A.1 and 5B.2, and in Group Supervision 13.1B, set requirements on firms to carry out relevant actions upon request by the PRA. The PRA has amended these rules to clarify that a firm must be able to carry out the relevant action upon request by the PRA.

3.160 The PRA has made amendments to Solvency Capital Requirement – Internal Models 6.7 to add the relevant dates.

3.161 The PRA has made amendments to rules in Solvency Capital Requirement – Internal Models 3.1, 3.2, 16A.2 and 16A.3 and to the proposed definition of 'residual model limitation' in Solvency Capital Requirement – Internal Models 1.2. In the draft rules, 3.1 and 3.2 set out requirements to demonstrate information to the PRA's satisfaction, and 16A.2 and 16A.3 set out requirements to demonstrate appropriateness relating to partial internal model integration techniques. The definition of 'residual model limitation' refers to an aspect of the internal model that prevents the firm from demonstrating to the PRA's satisfaction that the internal model meets Solvency Capital Requirement - General Provisions 3.3 and 3.4 and all internal model requirements. The PRA has removed references in the rules and the definition of 'residual model limitation' to the firm demonstrating appropriateness or demonstrating matters to the PRA's satisfaction. In addition, the PRA has made changes to Solvency Capital Requirement – Internal Models 16A.2 and 16A.3 to require the firm to be able to explain and justify its choice of integration technique, and to Solvency Capital Requirement – Internal Models 16A.3 only to state that the firm may use an alternative integration technique that is appropriate.

3.162 The PRA has made amendments to Solvency Capital Requirement – Internal Models 10.6 and 11.6A to replace 'shall' with 'must'.

3.163 The PRA has made amendments to Solvency Capital Requirement – Internal Models 14.1(3) to replace the opening words 'For the purpose of demonstrating' with 'In order to be able to demonstrate', for consistency with Solvency Capital Requirement – Internal Models 14.1(1)(b).

3.164 In the draft rules, the PRA had proposed to include a definition of 'internal model residual deviation' in the Glossary Part. The PRA has amended the proposed definition of 'internal model residual deviation' to clarify that this means a deviation itself as opposed to meaning the PRA's determination of a deviation.

Other minor amendments

3.165 The PRA identified a typographical error in paragraph 2.2 of Appendix 8: Draft amendments to SS15/15 – **Solvency II: approvals** The PRA deleted remaining references to 'Solvency II Directive' and 'Solvency II Regulations' in the updated SS15/15 – Solvency II: approvals and permissions, in Appendix 9 of this PS.

4: Capital add-ons

Introduction

4.1 This chapter provides feedback to responses to Chapter 4 (Capital add-ons) of CP12/23, which set out the PRA's proposed reforms to the Capital add-ons (CAOs) framework. It also contains the PRA's near-final policy as follows:

- amendments to the Glossary, Solvency Capital Requirement – General Provisions, and Group Supervision Parts of the PRA Rulebook (Annexes A, E, N of Appendix 2);
- a new SoP Solvency II: Capital add-ons (Appendix 12),
- amendments to supervisory statement (SS) 4/15 – Solvency II: the solvency capital requirements (Appendix 13);
- amendments to SS12/15 – Solvency II: Lloyd's (Appendix 14); and
- amendments to SS9/15 – Solvency II: Group Supervision (Appendix 15).

4.2 In Chapter 4 of CP12/23, the PRA proposed to:

- introduce a new type of CAO as a model permission safeguard, called a residual model limitation CAO (RML CAO), to support granting of an internal model (IM) permission by the PRA (or variation of an existing permission in the case of a major model change (MMC) application) in order to ensure compliance with the relevant calibration requirements and/or mitigate non-compliance with the internal model requirements (as defined in the PRA Rulebook), where a model on its own does not meet those requirements, due to the presence of an RML;
- introduce a new approach for calculating a CAO for an IM significant risk profile deviation in exceptional circumstances, where the PRA has concerns that part, or all, of a firm's IM is inadequate, or the Solvency Capital Requirement (SCR) that the IM generates no longer appropriately reflects the firm's risk profile better than if the Standard Formula (SF) were used;
- maintain the requirement for firms to disclose CAOs set by the PRA;
- change the frequency with which the PRA reviews CAOs, from (at least) annually to on a regular basis; and
- introduce the publication of regular reports by the PRA, summarising its use of CAOs at an aggregate industry level.

4.3 The PRA received 22 responses to Chapter 4 of CP12/23 reflecting constructive and helpful engagement by the industry and other interested parties with the consultation process. The PRA has carefully considered all of these in detail and, as a result, has made

some changes to the policy as set out in this chapter. Respondents also made a number of observations and requests for clarification, and some were supportive of the PRA’s proposals, particularly of the intended use of RML CAOs to facilitate faster IM permissions by enabling permission to be granted for IMs with residual model limitations, referred to in CP12/23 as moving away from the binary nature of IM approvals. As CP12/23 set out, the PRA’s proposal to introduce a new type of CAO, an RML CAO, formed a key part of a package of proposals to support the PRA’s new flexible approach; to grant permission to use a full or partial IM to calculate all or part of the SCR, and to vary an existing permission for a full or partial IM. The PRA’s proposals broadly reflected the existing assimilated law applicable to CAOs, which has been in place since the start of Solvency II in 2016. For avoidance of doubt, the PRA is not intending the CP12/23 proposals on CAOs to be a mechanism to structurally increase capital held by firms.

Changes to draft policy

4.4 After considering the consultation responses received, the PRA has made some changes to its proposed policy on CAOs. Specifically:

- Firms will not need to disclose RML CAOs separately in their Solvency and Financial Condition Reports (SFCRs) and the PRA will not include safeguards in its summary report on CAOs for significant deviations.
- In order to maintain an appropriate level of transparency, the PRA will publish a summary report on its use of safeguards in 2027, covering how the tools have been used in the intervening period.
- The PRA has updated the near-final statement of policy - Solvency II: Capital add-ons (Appendix 12) (the ‘CAO SoP’) to explicitly allow for the possibility of setting a CAO which moves dynamically.

4.5 Firstly, the PRA Rulebook has been amended to allow firms to not disclose the amount of an RML CAO separately, and rather include it in the amount of the SCR calculated using its internal model and the reported SCR split by risk modules. Template S.25.04.21 and its relevant instructions have been amended to give firms the option, following discussion with supervisors, to split the RML CAO among the notional SCR of the risk modules so that RML CAOs are not separately identifiable within firms' reporting templates. The amended rules and instructions will be included in a separate PS for reporting, as explained in Chapter 1.

4.6 Secondly, the PRA has considered the importance of a transparent approach relating to how the PRA is imposing CAOs. The PRA had proposed in CP12/23 to publish regular summary reports at an aggregate industry level summarising its use of CAOs and IM permission safeguards (ie RML CAOs and requirement safeguards). After considering the responses, IM permission safeguards will not be included in the regular summary report which will now only include CAOs for significant deviation. However, the PRA will publish a

summary report on its use of safeguards in 2027, which will include retrospective statistics on the prior use of safeguards. The aggregation of these statistics will be done at a sufficiently low level of granularity to ensure anonymity of individual firms.

4.7 Thirdly, the PRA has also updated the CAO SoP to explicitly allow for the possibility of setting a CAO which moves dynamically in line with certain outputs calculated by a firm. While CAOs have in the past been applied as a fixed amount, the PRA acknowledges that in certain circumstances a dynamic amount may be more appropriate to reflect how the underlying risk deviation varies over time eg due to changes in the business and economic conditions.

4.8 Finally, the PRA has made three additional minor changes.

- Firstly, there is a change to the glossary definition of 'internal model residual deviation' in the PRA Rulebook, to clarify that the deviation exists independently and is not created by the PRA's determination.
- Secondly, paragraph 2.8 of the CAO SoP has been amended in order to clarify that the factors in paragraph 2.2 may be used to determine whether a deviation is residual, in the same way the PRA would identify whether a deviation is significant for the purposes of setting a significant risk profile deviation (SRPD) CAO.
- Thirdly, paragraph 2.1 of Appendix 13: Updated SS4/15 – Solvency II: the solvency capital requirements, has been corrected to remove an incorrect reference, 'to waive or modify Own Funds 2.5 - 2.7'. The reference, 'to waive or modify Own Funds 2.5 – 2.7', was introduced in a section relating to use of undertaking specific parameters. This reference is incorrect, since 'undertaking specific parameters' is relevant to the SF, and Own Funds 2.5 to 2.7 relate to ancillary own funds. This change did not result from a response.

4.9 The PRA has decided not to change the draft policy in other areas. Notably, a number of respondents considered that CAOs (for both significant deviations and RMLs) should be agreed between the PRA and firms. The PRA considers this would not be appropriate. CAOs support the PRA's primary objectives of safety and soundness and policyholder protection, and therefore it is the PRA's responsibility to use the tool when needed. The PRA did not consult on a change in approach to setting significant deviation CAOs, and there were no new arguments to support such a change. Additionally, there were a number of responses relating to how the PRA will implement and supervise firms under the new CAO framework in the near term, rather than on the policy framework itself. The PRA is considering implementation matters separately and will communicate its approach ahead of the reforms taking effect.

4.10 The PRA considers that the changes above do not have a significant impact on the cost benefit analysis presented in CP12/23, and that there will be some positive impacts for firms. There will be a reduction in costs for firms in not having to disclose RML CAOs, and dynamic

CAOs are beneficial in ensuring the CAO continues to be appropriate for the firm's risk profile. CP12/23 highlighted that the benefits of disclosure of RML CAOs would include effective market discipline and transparency, therefore there is a drawback to giving firms the option to not disclose. However, the PRA does not consider these costs to be significant because these CAOs relate to residual model limitations. Additionally, the PRA is planning to mitigate some of these costs through its publication of a summary report on its use of safeguards in 2027, maintaining an appropriate level of transparency. The cost benefit analysis presented in CP12/23 therefore remains valid for the near-final rules. The PRA does not consider that the impact of the near-final rules will have a significantly different impact on mutuals relative to the impact of the draft rules on mutuals.

4.11 In carrying out its policy making function, the PRA is required to have regard to several matters, as set out in Chapter 4 of CP12/23. In CP12/23, the PRA explained how it had had regard to the application of these matters in relation to the proposed policy. The PRA has considered the 'have regards' where it is proposing changes and considers the following to be most relevant:

- Proportionality (FSMA regulatory principles): the PRA considers that not disclosing RML CAOs could lead to the application of a less burdensome and more proportionate regime for IM firms, without unduly affecting their safety and soundness, or the protection of policyholders.
- Competitiveness, growth in the interests of consumers and businesses, smart regulatory reform, and sustainable growth (HMT recommendation letter and FSMA regulatory principles):
  - The change to disclosure of RML CAOs would prevent potential disclosure of intellectual property about internal models, relieve senior management from having to explain RML CAOs to the market, and avoid potential share price volatility. It would also allow small firms to compete more effectively with larger peers, on the assumption that they have fewer resources for IM development and access to external consultancy support, and are therefore more likely to attract IM safeguards. The PRA also considers that it would support international competitiveness and growth of the UK economy in the medium- to long-term by helping more small firms to be granted permission to use IMs faster.
  - Enabling CAOs to change dynamically would support competition because the approach ensures the SCR (including the CAO) is better aligned to the firm's risk profile as the business and economic conditions change over time, and does not give rise to unfair advantages or disadvantages relative to other firms.

Feedback to responses

4.12 The PRA has considered the responses received to Chapter 4 of CP12/23. Feedback to the responses has been grouped as follows:

- transfer of current CAO-related requirements;
- a new capital add-on to facilitate internal model permissions where residual limitations remain;
- methodologies for calculating capital add-ons;
- group capital add-ons;
- ongoing monitoring, reporting, and removal of capital add-ons; and
- other responses.

Transfer of current CAO related requirements

4.13 The PRA proposed in CP12/23 to base the material in the new CAO SoP broadly on the current CAO related requirements within assimilated law. Respondents made a number of general comments on CAOs and these are detailed in this section. The PRA also proposed to introduce a new type of CAO to address RMLs that lead to an internal model residual deviation, and comments on RML CAOs are in the next section.

General comments on capital add-ons

4.14 Three respondents called for fairness and transparency to firms when the PRA sets CAOs, one of whom was otherwise supportive of broader use of CAOs in order to facilitate more efficient model changes. They said that the CAO set should be agreed between the firm and the PRA, the reason for the CAO should be clearly articulated, the methodology and basis for the calculation should be clearly defined and agreed (collaboratively) between the firm and the PRA, and the PRA should be required to provide clarity on the steps a firm has to take to remove the CAO (including triggers), with the steps being well-defined and achievable. Transparency was needed to ensure a level playing field, in the view of one of these respondents.

4.15 After considering the responses, the PRA has decided not to change the draft policy. CAOs support the PRA's primary objectives of safety and soundness and policyholder protection, and therefore it is the PRA's responsibility to use the tool when needed. The CAO SoP details the process for the PRA setting a CAO in section 5, which remains largely unchanged from the Solvency II framework. As stated in paragraph 5.3 of the CAO SoP, the PRA will consider any information provided by the entity or entities before taking its decision on whether to set a CAO. Additionally, paragraph 5.8 states that the decision of the PRA will be sufficiently detailed to enable the firm to understand what measures are needed or what deficiencies need to be remedied in order to have the CAO removed. Also, paragraph 5.9 states that the PRA will inform the firm of the methodology for calculating the CAO. In summary, the processes for setting, including determining how to calculate, a CAO are largely unchanged from Solvency II requirements. These already allow the PRA to consider

relevant information from the firm to inform the determination of any CAO, and place an onus on the PRA to adequately explain the approach it has taken, what measures are needed, or what deficiencies need to be remedied in order to have the CAO removed.

4.16 Four respondents commented on firms' ownership of their models. Of these, three respondents made a general point about firms being in the best position to manage their risks, suggesting the PRA should not degrade this principle through CAOs. The fourth said that the PRA should consider firms' own safeguards before setting a CAO.

4.17 After considering the responses, the PRA has decided not to change the draft policy. The PRA does not consider that CAOs detract from firm's ownership of their IMs. Firms retain the methodology agreed by their Board, with a CAO imposed as an overlay. Section 2 of the CAO SoP details the circumstances for setting CAOs, which states that the PRA will consider all relevant factors when making an assessment of SCR risk profile deviations.

4.18 One respondent said that CAOs were not always the answer to model limitations, that the PRA should avoid going back to an individual capital guidance (ICG) approach under the Individual Capital Adequacy Standards (ICAS) regime, and that using safeguards for faster IM permissions may mean that the PRA has not reached full understanding of an issue.

4.19 After considering the response, the PRA has decided not to change the draft policy. The PRA agrees that CAOs are not always the answer to model limitations. To that end, a range of other tools were proposed in CP12/23, including model limitation adjustments (MLAs) and requirement safeguards. The use of RML CAOs by their nature relate to residual model limitations and hence represent a pragmatic way to support the granting of IM permissions in a streamlined manner. In circumstances where firms consider that the PRA's understanding of the firm's model is not appropriate, firms will have an opportunity to respond to the PRA's notification of its intent to set a CAO, as detailed in paragraph 5.3 of the CAO SoP. Where an RML CAO relates to model applications, firms retain the right to withdraw the application, as discussed in the new IM statement of policy – Solvency II internal models: Permissions and ongoing monitoring (Appendix 6) (IM SoP).

4.20 One respondent commented on Implementing Technical Standard ('ITS') 2015/2012 as they related to CAOs, and said that ITS 2015/2012 appears not to have been carried across. Two respondents called for the PRA to reinstate or retain Recital (2) which allows firms to provide reasons to the regulator against setting a capital add-on.

4.21 After considering the response, the PRA has decided not to change the draft policy. These elements were substantively retained within the proposed policy materials. The ITS 2015/2012 Articles were broadly incorporated in Chapters 5 and 6 of the CAO SoP and the subject of Recital (2) was covered by paragraph 5.3 of the CAO SoP.

4.22 Five respondents said that CAOs should be used sparingly and as a last resort.

- One respondent said that over-reliance on CAOs could potentially lead to a general weakening of modelling standards.
- One respondent said that RML CAOs are likely to lead to the risk of more add-ons overall, and their application becoming commonplace which could damage investor confidence. They said broader use of CAOs should come with guardrails to ensure they are used sparingly. Another respondent was supportive of the proposals put forward by the PRA but expected the need for any capital add-on to remain an exception and not to become the norm, expressing the concern that, should CAOs become a common measure implemented by the PRA, this would also be to the detriment of international competitiveness.
- Another respondent said a more frequent application of CAOs should require the PRA to evidence that the potential marginal benefit to policyholder protection would be enough to justify all the other negative impacts on the secondary statutory objectives of economic growth and international competitiveness and associated increased bureaucracy. They said a substantial increase of the use of CAOs could be understood as a poor regime design.
- One respondent was supportive of RML CAOs, but believed that there was scope for further safeguards, to ensure that the majority of IM permissions do not now fall short of the required standards. They called for guidance on the expected frequency of use of the new measures, together with a process for retrospectively analysing whether this expected frequency was being met, and that the CAOs were used proportionately and consistently between firms.

4.23 After considering the responses, the PRA has decided not to change the draft policy.

- The PRA does not expect the use of significant deviation CAOs to change materially. RML CAOs could be used comparatively more frequently, depending on the quality of IMs, in order to support the overall intention for a more flexible approach to granting model permissions, for example to use them as a pragmatic tool to bring an IM that is nearly compliant into compliance with the calibration standards. As stated in paragraph 3.15 of CP12/23, the PRA continues to attach significant importance to firms demonstrating high standards of internal modelling of the risks which they are exposed to, particularly where these IMs are used to determine a firm’s regulatory solvency requirements.
- The PRA considers that introduction of RML CAOs would not damage investor confidence and competitiveness, particularly as their use is intended to help expedite IM permission and would reflect PRA confidence that the model, together with the RML CAO, met the required standards. Given this, and the above point that the PRA does not expect the use of significant deviation CAOs to change materially, the PRA considers that the reforms will not have negative impacts on the secondary statutory objectives of economic growth and

international competitiveness. However, discussed below in paragraph 4.93 in a related point, the PRA has made changes around disclosures of RML CAOs.
- The PRA recognises that there could be more CAOs set in the future due to the introduction of a new type of CAO (the RML CAO). However, the PRA does not consider that more CAOs are an indication that the regime is not working as intended. The PRA would not generally perceive an RML CAO (as a means of expediting or facilitating IM permissions) as a negative indicator on the firm's risk management.
- The primary purpose of RML CAOs is to allow firms to benefit from a more flexible and streamlined permission process, as the PRA will consider permission for models that are not fully compliant alongside an RML CAO (or other safeguard as appropriate). The circumstances for imposing RML CAOs are set out in the IM SoP, in the section 'Safeguards to support granting or variation of model permissions'. The PRA cannot provide an expected frequency with which these circumstances will arise, as this depends on the nature of firms' models submitted in applications for permission and the model's subsequent compliance with IM requirements.

4.24 Four respondents commented on the frequency of the PRA's review of CAOs.

- One respondent considered that the requirement to review CAOs yearly provided more certainty for firms (rather than on a regular basis).
- One respondent asked if the PRA could commit to reviews at least once a year if a firm requested it.
- One respondent requested that the PRA agree with firms an appropriate schedule for reviews of CAOs.
- One respondent suggested that the PRA should agree with firms an appropriate review frequency for RML CAOs and their associated triggers for recalculation and removal, as there was otherwise a risk of an inappropriate level of RML CAO being applied, even if this is expected to be remediated in the short to medium term. The respondent was concerned around the change of frequency from (at least) annual to 'on a regular basis'.

4.25 After considering the responses, the PRA has decided not to change the draft policy. The PRA considers that there should be flexibility regarding the timing of reviews depending on case-specific circumstances, including the materiality of the CAO (as explained in paragraph 4.28 of CP12/23) as well as the size and risk of the company and the external environment. The rationale for this change was to allow supervisory resources to be used in a proportionate and efficient manner. The possibility for CAOs to vary dynamically upon recalculation (as described below) may also mitigate the need for as frequent reviews of CAOs. The PRA will review a case put forward by a firm that demonstrates that the

underlying issues giving rise to the CAO have been addressed or partially addressed. Paragraph 6.4 of the CAO SoP states that the PRA will consider information provided by the firm when deciding whether to maintain, vary or cancel such a requirement.

4.26 One respondent asked whether CAOs could be set as a percentage of SCR, rather than as an absolute amount, expressed in millions of pounds. They argued that such an approach could be more appropriate in specific circumstances, as it would move in line with the exposure and avoid the interaction effects of other risks.

4.27 After considering the response, the PRA agrees that it is desirable to have the flexibility for CAOs to respond dynamically to changes over time in the business and economic environment. To that end, the PRA has amended the CAO SoP, clarifying that the PRA may express the CAO with reference to outputs calculated by the firm such as those derived from the firm's IM, SF, or balance sheet calculations. For example, the PRA may express the CAO as a proportion of the pre (or post) diversified SCR prior to application of the CAO. In cases where the CAO is specified dynamically, the PRA expects the firm to calculate the amount of additional capital that it is required to hold in accordance with the dynamic formula set by the PRA. The PRA expects to also specify the frequency and timings for when this amount should be recalculated, and to review these recalculations regularly.

4.28 One respondent asked the PRA to consider the timing implication of CAOs on Lloyd's syndicates' annual capital setting process.

4.29 After considering the response, the PRA has decided not to change the draft policy. The PRA considers that aligning supervisory reviews with Lloyd's own process is outside the scope of CP12/23. However, in relation to entities in the Lloyd's market, the PRA would liaise with Lloyd's as it does generally under its published co-operation agreement.

4.30 Four respondents commented on distinctions between different CAOs or requested clarity on definitions:

- One respondent was unclear on how CAOs for a deviation of less than 10% would differ from RML CAOs.
- The same respondent found the introduction of additional SCR adjustments (RML CAOs and MLAs) to add unnecessary complexity. They requested that definitions of the different types of CAOs and MLAs should be included in one place (CAO SoP or PRA Rulebook).
- One respondent did not believe there is a need to introduce the new class of RML CAOs. They said they found it hard to understand the distinction between an RML CAO and a CAO, as currently anticipated by Article 37 of the Solvency II Directive, and also found it hard to understand the content in section 2 of Appendix 13 of CP12/23 about the size of SCR deviation that might lead to a CAO.

- One respondent requested additional clarity over the circumstance that would qualify as a sufficiently large deviation in assumption to warrant the imposition of a CAO, and said that RML CAOs should not be treated with the same degree of PRA oversight and intervention as significant risk profile deviation CAOs.
- One respondent asked for clarity around the definition of 'risk profile deviation', in particular on when a change in the business constitutes a risk profile deviation and how the quantitative thresholds in paragraph 4.11 of CP12/23 will be calculated (with what granularity, and whether diversified or undiversified).

4.31 After considering the responses, the PRA has decided not to change the draft policy.

- Regarding the comments about how RML CAOs differ with existing CAOs – including where these are imposed for a deviation of less than 10% – RML CAOs are different, since:
  - they can be applied for deviations that are determined to not be significant;
  - they will not need to be disclosed by firms; and
  - the PRA will grant IM permission where RMLs remain subject to appropriate safeguards in place eg an RML CAO. In contrast, the PRA will not grant permission for an IM with a significant deviation, regardless of its size, consistent with the statement in CP12/23 that the reforms are not intended to lower modelling standards.
- In response to the query around the need to introduce the new class of RML CAOs, this is because RML CAOs can be applied for residual model limitations, whereas existing CAOs may be imposed only for significant risk profile deviations.
- Regarding the query around circumstances which would qualify as a sufficiently large deviation in assumption to warrant the imposition of a CAO, paragraphs 2.2 to 2.9 of the CAO SoP set out the factors relevant to the assessment of any SCR risk profile deviation. In addition, paragraphs 3.1 and 3.1 of the IM SoP set out further relevant considerations regarding when the PRA will consider imposing an RML CAO. The PRA has largely transferred and restated the Solvency II CAO framework covering significant deviations, which has been in place since 2016 and no changes were proposed to the definition or thresholds for a significant risk profile deviation. As is the case under the existing framework, a risk profile deviation that is less than 10% of the SCR may still be considered significant, as outlined in Table 1 in the CAO SoP.
- Regarding the comment about RML CAOs and MLAs introducing unnecessary complexity, the PRA continues to consider that formalising MLAs addresses issues with the existing IM framework. Firms' current use of such adjustments lacks transparency and consistency in how they are applied, which can make it difficult for the PRA to understand the output of approved IMs. Formalising the MLAs will help to address these concerns, ensuring they are subject to appropriate governance within a firm, and where necessary, review by the

PRA. Secondly, the intention behind these reforms is to introduce a range of tools which the PRA could use to achieve more flexible and streamlined internal model permissions, compared to the current framework. This is expected to lead to a widening of the circumstances where the PRA can grant IM permission in combination with safeguards. Regarding the feedback that definitions should be included in a single place, the PRA's approach is to include all relevant definitions in the PRA Rulebook, and ensure that policy documents such as supervisory statements or SoPs refer to the PRA Rulebook.

- Regarding comments around oversight and intervention, the PRA notes that an RML CAO is intended to mitigate the effect of non-compliance with the internal model requirements, and/or ensure compliance with the calibration standards. The PRA will therefore treat it with an appropriate level of oversight and intervention.

4.32 One respondent said it was broadly supportive of the new approach regarding use of CAOs and asked if there would be immediate CAOs for models already approved which have limitations.

4.33 The PRA stated in paragraph 4.17 of CP12/23 that RML CAOs would be an option available in the future, including for firms with existing permissions, where the supervisory review process reveals deviations in a firm's risk profile or deficiencies in its models. But in all other circumstances where the PRA has not raised concerns in accordance with the supervisory review process, the PRA does not currently intend to set RML CAOs for existing approved IMs.

4.34 Two respondents requested that in deciding whether to impose a risk profile deviation CAO, the PRA take into account prudence in one area to offset weakness in another area.

4.35 After considering the responses, the PRA has decided not to change the draft policy. Article 283 of the Solvency II CDR, which is now reflected in the CAO SoP, considers the offsetting point and outlines approaches for setting risk profile deviation CAOs. Specifically, it states that prudence in one area should not be offset against weakness in another area in calculating CAOs, save for a limited set of circumstances.

4.36 One respondent asked the PRA to consider whether there were specific circumstances where a CAO might be negative.

4.37 After considering the responses, the PRA has decided not to change the draft policy. The respondent did not provide new information, arguments or data that would justify a change in approach to calculating a CAO, and so the PRA has not considered the proposal for negative CAOs further.

4.38 Two respondents asked if decoupling risk management articles meant that IM firms should not expect CAOs for significant deviations in the system of governance.

4.39 The PRA stated in paragraph 3.23 of CP12/23 that decoupled articles would not be assessed during the IM permission process, but would remain requirements elsewhere in the PRA Rulebook. Therefore, the PRA clarifies that a significant deviation in the system of governance from these requirements could still lead to a CAO.

4.40 One respondent asked what would happen in cases such as those in Appendix 12 of CP12/23, where a significant deficiency was identified which cannot be classed as 'residual' and hence covered by an RML CAO.

4.41 The PRA assumes that this question relates to Example A in Table 2 (of Appendix 12 of CP12/23), where the deviation cannot be classed as residual, as the risk profile of the firm deviates significantly from the assumptions underlying the SCR. In this example, the PRA would then consider use of alternative measures, such as significant risk profile deviation CAOs.

4.42 One respondent stated that the regime was being strengthened for new assets and would disincentivise firms to invest in the real economy, which runs counter to the objectives of the wider Solvency II reforms. They thought that setting of a CAO via a model change would take well over six months, by which time it is likely that the investment opportunity would be lost.

4.43 After considering the responses, the PRA has decided not to change the draft policy. Respondents did not provide evidence that the regime is being strengthened for new assets as a result of IM reforms, which are general to IMs rather than specific to asset classes. Moreover, it is not the intention of the PRA to impose CAOs for fully compliant models in order to take the SCR beyond its view of the 1-in-200 level, which remains unchanged following these proposals. Models that are fully compliant and which would therefore be approved under the current framework would continue to be granted permission under the new framework without the need for CAOs. Rather, the aim of RML CAOs is to facilitate more flexible and streamlined model permissions, under which IMs which are not fully compliant can be granted permission for use with safeguards. These models would currently have been rejected under the Solvency II regime. Paragraph 3.68 in Chapter 3 of this PS also makes the point that safeguards will facilitate firms obtaining model permissions in respect of new risks and asset classes, include situations where there is little historic data available. Regarding timeframes for model change, the PRA has not sought to change policy in this area. The process for setting a CAO could be completed in significantly shorter time than six months, so the PRA considers that investment opportunities would not be impacted as a consequence of these reforms.

4.44 One respondent considered there was a contradiction between the stipulation that firms can only apply MLAs to correct for deficiencies in compliance against the calibration standards, and that the PRA can apply CAOs to correct for deficiencies in other IM tests and

standards. In their view, total capital requirements (including CAOs and MLAs) should be set to ensure that firms' capital requirements are calibrated to an appropriate 1-in-200 level given their risk profile, and setting CAOs for reasons unrelated to the overall strength of the calibration was therefore inappropriate. They believed other supervisory tools would be better suited to such situations. They also asked the PRA to retain a qualitative materiality threshold (as currently exists in Article 222 of the CDR).

4.45 After considering the responses, the PRA has decided not to change the draft policy. The PRA generally expects that CAOs would be used to ensure compliance with the 1-in-200 calibration standards, as it is not the PRA's intention for the SCR to be calibrated at beyond the 1-in-200 level contemplated by the calibration standards, and therefore the PRA would consider any relevant MLAs which form part of a firm's IM when setting a CAO (see Example B in Table 5 of Appendix 12 of CP12/23). RML CAOs may also be used to remedy uncertainty about whether the calibration standards are met, and to mitigate the non-compliance with internal model requirements, as shown in Example C in Table 5 of Appendix 12 of CP12/23. The use of an RML CAO in this example would be used alongside a waiver or modification of the rules which are not being met. Similarly, the existing Solvency II framework sets out broader considerations for when CAOs can be imposed for significant deviations as regards the system of governance, and these have been replicated in the CAO SoP. Finally, paragraph 3.94 in Chapter 3 of this PS explains why the PRA has not retained the definition in Article 222 of the CDR.

4.46 One respondent said that while they were comfortable with the level of PRA judgement in the current CAO process, the introduction of safeguards would introduce additional judgment, which could risk hindering a streamlined and efficient application process.

4.47 After considering the response, the PRA has decided not to change the draft policy. The PRA considers that the new safeguards support a more flexible IM permission framework, allowing the PRA and firms to better recognise model limitations and provide a greater range of tools to grant IM permission. The PRA does not consider that this flexibility will slow down the application process.

CAOs and exceptional circumstances wording

4.48 Nine respondents suggested that CAOs should remain an exception and some were concerned that their use by the PRA could become more widespread under the new framework.

- Two respondents were supportive of the proposal but requested that the use of CAOs should not become the norm. Six respondents raised the point that the 'exceptional circumstances' wording in Directive Article 37(1) or the sense of 'exceptional' in Recital 27 had not been transposed into UK legislation or PRA rules. Of these respondents, one recognised that this was not a policy change in CP12/23 but rather reflects the framework

post the Implementation Period Completion Date (IPCD).[24] Of these respondents, another believed that the 'exceptional circumstances' wording had been previously transposed into UK regulations implicitly via the reference to Article 37 in SS4/15 (rather than in the form of express wording) and queried why the words 'exceptional circumstances' do not appear in Appendix 13 of CP12/23 other than in relation to the new alternative approach envisaged by paragraph 3.10 of that Appendix.

- One respondent said that CAOs under the current regime should only be applied by the regulators in 'exceptional circumstances' and no significant deviation of the assumptions underlying the SCR calculations from the risk profile would be assumed for a deviation less than 10% (with significance always being assumed at 15% or more). They asserted that paragraph 2.2 of Appendix 13 of CP12/23 would allow the PRA to consider a deviation of less than 10% as significant, which it said did not fit with PRA's intention to streamline the process for IM permissions.
- In addition, one of the respondents above said it was unclear how materiality and proportionality would be considered in determining the circumstances where a CAO can be imposed and this could 'lower the bar' relative to the existing regime.

4.49 After considering the responses, the PRA has decided not to change the draft policy. The PRA considers that the 'exceptional circumstance' concept in Article 37 is primarily reflected in the finite situations then specified by the Directive (SF significant risk profile deviation, IM significant risk profile deviation, significant system of governance deviation, and significant risk profile deviation following the application of the matching adjustment, volatility adjustment or transitional measure). The PRA notes that the CAO SoP maintains this finite list of circumstances under which the PRA would consider imposing a CAO (bar RML CAOs). To the extent that the 'exceptional circumstances' wording was doing more prior to IPCD, the PRA considers it was seeking to reflect that CAOs are a 'measure of last resort' per Recital 27 of the Directive. The PRA interprets this as the last thing that the PRA does to ensure the SCR reflects the risks to which the firm is exposed. This approach continues to be reflected in the PRA's policy since:

- paragraphs 2.4 to 2.7 of the CAO SoP note that when deciding whether to impose a SRPD CAO, relevant considerations include whether requiring a firm to develop an IM is ineffective or inappropriate or that the adaptation of the model by the firm to better reflect its risk profile has failed within an appropriate timeframe;
- paragraph 2.11 of the CAO SoP notes that the PRA may consider setting a governance CAO where it determines that the application of other measures is in itself unlikely to sufficiently improve the deficiencies within an appropriate timeframe;
- there remains a finite list of circumstances under which the PRA would consider imposing a CAO;

- the PRA policy will be that CAOs (barring RML CAOs) are imposed for deviations that are ‘significant’, and the PRA needs to consider that they are, in accordance with the criteria previously in CDR Articles 276-278, which were brought into the CAO SoP;
- the imposition of CAOs via section 55M of FSMA requires the PRA to act, as a matter of public law, rationally and proportionately;
- it is already the case under the existing framework that there may be certain circumstances under which the PRA might consider a deviation of less than 10% to be significant. Article 276 of the CDR provides a range of factors that the PRA could take into account when determining whether a deviation was significant, and a deviation can be considered significant based on these factors alone. Paragraph 2.2 of Appendix 13 of CP12/23 is merely repeating these pre-existing factors. This is in addition to the circumstances (CDR Article 279) where the CAO must be considered to be significant eg if the deviation exceeds 15%. Moreover, firms should see a corresponding benefit in widening the circumstances where the PRA can grant IM permission in combination with safeguards; and
- the PRA continues to attach significant importance to firms demonstrating high standards of internal modelling of the risks to which they are exposed, particularly where these IMs are used to determine a firm’s regulatory solvency requirements, as stated in paragraph 3.15 of CP12/23.

CAOs for elements of Technical Provisions and interaction with HMT objectives

4.50 Two respondents queried why CAOs may be imposed in respect of certain elements of the technical provisions, including the matching adjustment (MA), volatility adjustment (VA) and transitional measures, on the basis that a firm has to apply to the PRA for permission to use these measures and the technical provisions are subject to external audit. One of these respondents said the PRA should set out more clearly the circumstances under which it could use CAOs for these elements of technical provisions, so that firms can understand the implications of this proposal. They said that if the circumstances are not set out clearly, it could be seen as implementing the PRA’s original MA ideas ‘via the back door’.

4.51 The Solvency II framework already includes a provision for the PRA to set a CAO where there has been a significant risk profile deviation following the application of the MA, VA or transitional measures (Article 37(1)(d) of Directive 2009/138/EC and SII CDR Article 278). SII CDR Article 278 has been transferred and restated in paragraphs 2.12 and 2.13 of the CAO SoP and the circumstances for setting CAOs in paragraph 2.1 of the CAO SoP largely replicate (with the exception of RML CAOs) the circumstances set out in Article 37 as referenced in SS4/15. Significant deviations (from the assumptions underlying those adjustments to the relevant risk-free rate and transitional measures) may develop over time after permission has been granted, which justify a CAO but do not justify revoking the permission. Therefore, the PRA was not proposing to make policy changes in this regard.

4.52 Three respondents commented on the PRA's proposals regarding the interaction of the new type of CAO with HMT's objectives for the Solvency II review. All three considered that the PRA was introducing new circumstances for setting capital add-ons, in relation to transitional measure on technical provisions (TMTP) and MA. Two did not consider that these should be termed 'capital' add-ons. The other considered that there was a conflict with HMT's reform objectives and this had not been highlighted in CP12/23.

4.53 The PRA has considered these responses but does not propose to make changes to the policy. The Solvency II framework already includes a provision to apply a capital add-on in circumstances where there is 'significant deviation from the assumptions underlying MA, VA or transitional measures (Article 37(1)(d) of Directive 2009/138/EC (referred to in SS4/15) and SII CDR Article 278(1)). The PRA considers there is no compelling reason to change its policy in this respect, including in light of HMT's objectives for the Solvency II review. In particular, the second of HMT's objectives for the review is to protect policyholders and ensure the safety and soundness of firms. As noted in the government's **Call for Evidence**,[25] a robust, proportionate regulatory regime for insurance firms is necessary not only to advance its objectives around safety and soundness of firms, but also to underpin a vibrant insurance sector and to support long-term investment in productive assets. The PRA considers that provisions to apply a CAO are important tools to ensure adequacy of technical provisions and hence that these objectives are met.

4.54 Two respondents requested that the PRA allow firms to comment further on CAOs imposed in response to significant risk profile deviation following the application of the MA, VA or transitional measure, after they have seen the proposals in consultation paper (CP) 19/23 – **Review of Solvency II: Reform of the Matching Adjustment**, since there are potential interactions between these CAOs and the forthcoming matching adjustment proposals.

4.55 After considering the responses, the PRA considers that respondents would have had the opportunity to provide further comments via CP19/23, on matters where the MA and IM reforms may interact. In addition, as noted in both CP12/23 and CP19/23, the PRA is not proposing any changes to the framework on the use of CAOs for the MA. Therefore, no additional consultation period is necessary on this specific matter.

A new capital add-on to facilitate internal model permissions where residual limitations remain

4.56 Three respondents were supportive of the PRA's proposals to introduce RML CAOs. Specifically:

- One respondent was supportive of the proposal to move from a binary approval process to a permission process, where the PRA has the option to grant an IM permission subject to

requirement safeguards or a RML CAO. They believed that the RML CAO should enable the PRA to gain comfort that granting permission, subject to safeguards, will effectively mitigate the risk that an internal model does not fully reflect the firm's risk profile.

- One respondent broadly supported the PRA's proposals, in particular the proposal to introduce new RML CAOs as one form of safeguard, the proposed methods by which RML CAOs can be calculated, and the proposals for ongoing monitoring, reporting and removal of CAOs.
- One respondent noted that the increased flexibility provides an increased opportunity for the PRA to set RML CAOs at its discretion, not only at the point of granting new permissions or changes to existing permissions, but also through the IMOR process and supervisory review process more generally. They also noted that the PRA does not expect that the use of RML CAOs would result in materially higher levels of capital requirements.

4.57 Six respondents commented on what they saw as the need for transparency and collaboration when the PRA imposes a CAO for RMLs:

- One respondent said it would be helpful for the PRA to provide more clarity on the process for agreeing RML CAOs and the balance of responsibilities between firms and the PRA in doing so. They asked that PRA's communication to firms should meet the IM documentation standard. They said that the PRA will need to explain how the CAO behaves in stress so that firms can model how the CAO changes over time in their ORSAs as well as part of stress and scenario testing. They said clear criteria for removal of the CAO should be clearly defined in advance, and firms should have an option for independent review.
- One respondent said alternative assumptions used to determine an RML CAO should be made transparent to the firm at a detailed level, given a firm's own assessment is subject to internal governance and independent model validation.
- Three said transparency and clarity in bilateral and collaborative discussions will be key, including on the process, quantum and rationale for the add-on (which should be risk-sensitive), and steps to be taken to remove it, which for RML CAOs they thought might be less than a year. One of these said that given a firm must be able to implement any imposed CAO, the PRA should work with the firm collaboratively to not cause undue operational issues, and another said it was not clear how firms will remedy the perceived limitation, leading to RML CAOs potentially being in place for long periods.
- One respondent said there must be a clear rationale for the application of CAOs, and a clear pathway for their removal, as in their view an excess of new RML CAOs could increase UK firms' SCRs, reduce their international competitiveness and increase related costs.

4.58 After considering the responses, the PRA has decided not to change the draft policy.

- CAOs support the PRA's primary objectives of safety and soundness and policyholder protection, and therefore it is the PRA's responsibility to use the tool when needed. The CAO SoP details the process for the PRA setting a CAO in section 5, which remains largely unchanged from the Solvency II framework – please refer to paragraph 4.15 onwards for responses around this theme. This should address the respondents' request for clarity and transparency on the process for agreeing RML CAOs, including quantum and rationale for the add-on, and the balance of responsibilities between firms and the PRA. Sections 5 and 6 of the CAO SoP should also address respondents' comments regarding process around setting and removing a CAO, engagement with the firm, as well as alternative methodologies for setting an RML CAO. On this latter point, paragraph 5.9 of the CAO SoP explains that the PRA will inform firms of (inter alia) the methodology for calculating CAOs. Where the PRA is considering setting RML CAOs for initial or model change applications, firms will have the option to continue development instead of being granted permission with a safeguard. Dispute resolution is covered separately below.
- IM documentation standards are for firms rather than PRA. Similarly, it is a matter for firms, rather than PRA, to determine how their balance sheet would move in stress for the purposes of the ORSA. As stated in paragraph 5.9 of the CAO SoP, the PRA will inform the firm of the methodology for calculating the CAO.
- The timescales provided in Table 1 of Appendix 12 of CP12/23 were indicative of how long it might take a firm to remedy the situation in particular cases, but this is in the firm's control. Implementing CAOs should not cause operational issues, given that they are additions to the SCR.
- The PRA considers that RML CAOs would not increase UK firms' SCRs relative to the appropriate 1-in-200 level – thus reducing international competitiveness – as explained in paragraphs 4.23 and 4.60 below.

4.59 Three respondents commented on subjectivity of capital modelling and the need for firms to own their models and underlying calibrations. They said that RML CAOs, particularly if they become widespread, will lead to the firm no longer owning its model and calibrations but these becoming PRA judgements, and the SCR could overshoot the 1-in-200 level. One of these respondents requested clarity from the PRA on how it intends to use its new powers over firms' IMs.

4.60 The PRA considers it to be very important that firms continue to own their internal models and calibrations. The PRA considers that this would be the case under the proposals, as firms could retain the IM methodology agreed by their Board alongside a safeguard such as an RML CAO. The PRA considers that safeguards allow potential limitations in a firm's model to be adequately rectified or mitigated, where a firm would not otherwise be permitted to use an IM, and provide greater clarity where there may be a difference in view between the PRA and the firm. Therefore, the PRA considers that safeguards would improve transparency

between the firm and PRA on modelling issues and therefore supplement the firms' own modelling and risk management. To the extent that RML CAOs would facilitate the granting of a firm's IM permission, the PRA considers this would be preferable to a firm remaining on the SF. Regarding the comments around 'overshooting', the PRA does not consider the SCR would overshoot the 1-in-200 level as a result of the RML CAO. As noted above, the PRA generally expects that CAOs would be used to ensure compliance with the 1-in-200 calibration standards – which remain unchanged. It is not the PRA's intention for the SCR to be calibrated at beyond the 1-in-200 level contemplated by the calibration standards and one of the purposes of the reforms to the internal model framework, including RML CAOs, is to allow greater flexibility in how the 1-in-200 calibration standard is met in order to gain IM permission. In other words, a firm could provide a fully compliant model which would attract no safeguards, or it could have an RML CAO such that when combined with the model it meets the 1-in-200 standard.

4.61 One respondent thought that a cleaner solution would be to use supervisory judgement to grant permission for models that are not fully compliant.

4.62 The PRA wishes to clarify that under the current framework, IM requirements and calibration standards must be met in full in order to grant IM permission. It would not be possible to simply exercise supervisory judgement to grant permission to use non-compliant IMs without this posing an unacceptably high risk to the PRA's primary objectives. However, the proposed IM reforms provide a framework that supports more streamlining of IM permission processes, a more principles-based approach and removal of the binary nature of approval process. Therefore, the proposed IM safeguards will allow greater flexibility within the IM framework for firms with models that are sound but not fully compliant to be granted IM permission in combination with a safeguard that mitigates or rectifies the non-compliance.

4.63 Three respondents identified RML CAOs with a return to Individual Capital Guidance (ICG) under the former Individual Capital Adequacy Standards regime. The drawback of that approach was, in their opinion, a lack of transparency over rationale and quantum of the CAO.

4.64 The PRA considers that the aim of the RML CAO is not a return to ICG, but rather to reflect ways in which the PRA considers the existing Solvency II IM regime can be improved to introduce greater flexibility in IM permissions and reduce overall levels of resources spent by firms and the PRA on discussing IM permissions. Paragraph 5.9 of the CAO SoP states that the PRA will inform the firm of the reasons for setting the CAO and the methodology for calculating it.

4.65 Six respondents contrasted use of RML CAOs for firms with existing model approvals relative to firms seeking IM permission for the first time:

- One respondent asked for clarity around how RML CAOs would be used for firms with existing model approvals.
- Two respondents considered that the use of RML CAOs was not appropriate for existing internal models that have already been approved.
- One respondent agreed that a new power to apply RML CAOs could potentially facilitate a faster model permission process for new application, but saw limited benefit for most firms that already have an IM.
- One respondent expressed concern that a firm with existing IM permissions could be discouraged from making major model changes, as they could become subject to RML CAOs. They said the PRA should ensure consistency in this area between those who are applying for an initial IM permission and those that have established IMs and are applying for major model changes.
- One said they agreed with the PRA's assessment that the use of RML CAOs is likely to be of greater benefit to smaller firms seeking IM permissions for the first time, however, they considered that this is how model approvals are currently already granted and that the benefit is already reflected in the current regime. They agreed with the PRA's assessment that an RML CAO is likely to be a more efficient approach than not granting IM permissions, but they considered other CAO options were available to the PRA.

4.66 After considering the responses, the PRA has decided not to change the draft policy.

- The PRA's approach to how RML CAOs would be used for firms with existing model approvals is set out above.
- Regarding the comments from respondents who queried, or saw limited benefit in, CAOs for firms that already have an approved internal model, the PRA notes firstly that RML CAOs should benefit firms that have an existing approved model but that are planning for a major model change. RML CAOs (or other safeguards as appropriate) support the overall intention for a more flexible approach to granting model permissions, for example to use them as a pragmatic tool to bring an IM that is nearly compliant into compliance with the calibration standards. Second, the PRA may detect through the IMOR process an RML, as a result of which the model is not fully compliant. Rather than revoking the model, the firm is able to maintain its permission to use the internal model, alongside a safeguard such as an RML CAO.
- Regarding the comment about firms being discouraged from applying for major model change applications, the PRA does not consider that introducing RML CAOs should lead to this. As explained in paragraph 4.15 of CP12/23, the purpose of an RML CAO is to support granting of an IM permission, or a variation of an IM permission for a MMC, which would have otherwise been rejected. And firms would continue to have the choice to pursue further model development to resolve any RMLs identified during the IM application process, instead of accepting model permission safeguards (including an RML CAO). For

all other RMLs, which are not related to the model change, the PRA expects to identify these as part of IMOR, as firms are under a duty to comply with the internal model requirements. Therefore, a model change application should not affect whether an RML CAO is imposed in relation to RMLs unrelated to the model change.

- Regarding the last comment above, the PRA notes that models can currently only be approved if they meet all requirements in full, therefore it is not correct that the benefits introduced under the reforms consulted on already exist in the current framework. The PRA notes the respondent's comment that other CAO options are available, however it is was not clear which other options this is in reference to, and no evidence was provided to support the case that these would be better alternatives than the PRA's proposals. In particular, PRA considers it would not be appropriate to grant model permission alongside a significant risk profile deviation CAO, as granting permission to use a model which has a significant deviation could lead to a lowering of modelling standards.

4.67 While appreciating the RML CAO regime could help improve efficiency, one respondent was concerned that the easier pathway may result in RML CAOs being applied in situations where PRA may have previously reached a clean approval decision, and believed that an MLA should be considered as the first option. The view was echoed by another respondent who said where relevant MLA should be considered initially.

4.68 After considering the responses, the PRA has decided not to change the draft policy. The PRA considers that it has addressed the point regarding whether an MLA may be an appropriate alternative to an RML CAO in paragraph 3.30 of the IM SoP. That paragraph states that an MLA may indeed be an appropriate alternative in certain circumstances. Additionally, models that meet all the relevant IM requirements can be granted permissions without use of safeguards; This does not prevent the use of RML CAOs to support more flexible IM permissions in other cases.

4.69 Two respondents said there appears to be a blurring of the boundary between an internal model residual deviation and a significant risk profile deviation in Table 1 in the CAO SoP.

4.70 The PRA considers that the comment on Table 1 in the CAO SoP highlights that whether a risk profile deviation is significant is not only quantitative, and it also depends on the qualitative factors set out in paragraph 2.2. This replicates the current approach to determining whether a deviation is significant under the Solvency II framework.

4.71 One respondent disagreed with the PRA's assessment that the reforms proposed in this chapter, and the chapter outlining changes to IMs, would reduce compliance costs associated with applications for IM permissions, given the costs of RML CAOs. They considered that the PRA had possibly not factored in the opportunity cost and the cost of capital of RML CAOs.

4.72 After considering the responses, the PRA has decided not to change the draft policy. As discussed in paragraph 1.38 of CP12/23, the PRA considered whether the use of RML CAOs would result in materially higher levels of capital requirements, but concluded that the proposed reforms would not change the 1-in-200 calibration standard for IM firms. Rather they would introduce flexibility for an IM firm to meet its requirement directly with its model calibration, or to allow residual limitations to be addressed through the combination of model and RML CAO. The PRA considers the additional flexibility introduced by RML CAOs may lead to more proportionate and pragmatic IM permission outcomes where a model has residual limitations, and this may outweigh any potential compliance costs.

4.73 Two respondents generally supported use of RML CAOs as a pragmatic internal model safeguard and to streamline IM permissions process. However, they believed there was a need for appropriate checks and balances to ensure appropriate use, including strengthening PRA's accountability for its decisions. They said:

- there was a risk that supervisors may be under pressure to give RML CAOs to look 'strong';
- the PRA should apply RML CAOs consistently and only to new MMCs for the component within scope of the MMC, in order to avoid firms being put off applying for MMCs; and
- RML CAOs should not become sticky and difficult to remove.

4.74 After considering the responses, the PRA has decided not to change the draft policy. The process for reviewing and removing CAOs is set out in section 6 of the CAO SoP, which includes considering information submitted by the firm and the reasons for setting the CAO. Additionally, the PRA has a robust supervisory decision-making framework which is applied consistently across all insurance firms, and the application of CAOs would therefore be subject to appropriate internal governance, review and challenge. In addition, the IMOR process will allow the PRA to undertake thematic reviews and compare firms' models across peer groups, facilitating a consistent approach to identifying deviations in firms' models over time. As explained in paragraph 4.66, a model change application should not affect whether an RML CAO is imposed in relation to RMLs unrelated to the model change; the proposed reforms introducing the new RML CAOs should not therefore put firms off applying for a MMC.

4.75 One respondent disagreed with the case in example B in Table 4 in Appendix 12 of CP12/23, where the PRA would hypothetically set a safeguard because an investment in a new illiquid asset class has limited relevant data for modelling, meaning that there is a breach in IM requirements. They were of the view that a new and complex asset class, where data is limited, should be capable of being incorporated into the model with methods/assumptions set using (prudent) expert judgements which make allowance for the data limitations. The calibration standards and IM requirements would then be considered to have been met.

4.76 After considering the responses, the PRA has decided not to change the draft policy. The example gives the reason that simply holding extra capital does not imply that there is compliance with internal model requirements and in particular the statistical quality standards.

4.77 One respondent said that updating aspects of the model that have been mandated by the PRA, as part of a regular calibration cycle, or in response to a change in market conditions or risk exposures of the firm, could become problematic, and an RML CAO may introduce additional (potentially unwarranted) volatility to firms' balance sheets.

4.78 After considering the responses, the PRA has decided not to change the draft policy. The PRA does not expect the use of RML CAOs to result in a material increase in the SCR, for the reasons set out in paragraph 4.16 of CP12/23, and the calibration standard will remain at the existing 1-in-200 level. The respondent has not provided evidence to substantiate their concerns around how an RML CAO could introduce balance sheet volatility. By their nature, RML CAOs are for residual issues, and so at the point of application, it is not expected to lead to undue volatility in a firm's SCR.

4.79 One respondent believed that the PRA's expectation that use of RML CAOs could result in more firms seeking and obtaining permission to use an IM had been assessed relative to the status quo, rather than relative to a position where the SF was calibrated appropriately for the majority of firms.

4.80 The PRA clarifies that in carrying out CBA, it is required to compare the costs and benefits of its proposals against the status quo, rather than a hypothetical situation (which in this case is a reformed SF regime).

Methodologies for calculating capital add-ons

New CAO methodology with reference to the Standard Formula

4.81 The PRA set out proposals on methodologies for calculating CAOs. Ten respondents commented on the PRA's proposed methodology which would enable it to set a CAO in reference to the Standard Formula in exceptional circumstances:

- Seven respondents felt that this method would not reflect the risk profile of the firm, particularly (in the view of one respondent) for annuity providers. And two of these requested more clarity on how this would be applied and what would be regarded as exceptional circumstances.
- One respondent was concerned that this approach might lead to an unintuitive and inappropriate dynamic over time as the difference between the SF SCR and internal model SCR changes while the CAO is in place (for example the difference could reduce due to change in risk profile/economic conditions while the deficiency remains as material). In addition, they were concerned it could increase the complexity of SCR forward-looking

projections and the calculation of the SCR under stress. They preferred the CAO be calculated in a simple way and was maintained at a level proportionate to the deficiencies in the model it is intended to safeguard against.

- One asked if an MLA could be more appropriate than calculating a CAO with reference to the SF.
- One respondent asked why it would be appropriate to determine RML CAOs using the new methodology with reference to the SF. They added that, although the PRA had set out the reasons and the methodology for calculating the quantum of the RML CAO in paragraph 2.28(b) of the IM SoP and paragraph 5.9 of the CAO SoP, the PRA had not set out how it concluded that there was a deviation from the SCR. In their view, the PRA should map CAOs back to the precise rule which it considers is not met, or how the PRA had arrived at the specifications referred to in paragraph 5.9.

4.82 Having reviewed the responses, the PRA does not propose to make changes to this policy, but paragraph 2.8 of the CAO SoP has been modified to include a clarification, as discussed below. Taking each of the above points in turn:

- The PRA considers that this methodology is intended to expand the potential ways in which a CAO could be calculated by the PRA, to be used in cases where the PRA has concerns that part or all of the firm's IM is inadequate, or the SCR that the IM generates no longer appropriately reflects the firm's risk profile better than if the SF were used. In the specific cases referred to in the IM SoP and CAO SoP, it was the calibration standards that had not been met. In such cases, the CAO would be set as proportion of the difference between the SCR calculated using a firm's IM and the SCR that would be calculated if: the firm's IM permission was varied so that model components with significant limitations reverted to calculating the SCR using the SF; or the firm's IM permission was revoked so that it was required to calculate its entire SCR using the SF. The proportion chosen would reflect the strength of concerns around the extent to which the firm's IM reflects its risk profile, as well as the extent to which the firm's risk profile was significantly different to that underlying the SF calibration. In addition, the PRA considers that setting a CAO in reference to the SF could be used in advance of the PRA considering more significant supervisory actions such as to revoke IM permission or vary it through reducing scope of the IM. No single CAO method can work in all circumstances.
- As set out in paragraph 6.3 of the CAO SoP, the PRA will review the CAO on a regular basis. The PRA will consider whether it is appropriate to set a CAO that varies dynamically, as set out above. These points should address respondents' concerns around inappropriate dynamic emerging over time. The PRA disagrees with the respondent that a CAO calculated in this way would increase complexity of projecting the SCR, particularly if the CAO were expressed as a fixed amount. And if it were expressed as a proportion of

internal model SCR, the CAO could be projected on the basis of the firm's SCR projections.

- The PRA considers that MLAs are not appropriate where the risk profile deviation is significant. In such cases, the PRA considers that a requirement imposed by the PRA to hold more capital is necessary (rather than an adjustment by the firm), given the risk to modelling standards and safety and soundness. Therefore, the PRA does not consider that an MLA would be a possible alternative to determining the CAO with reference to the SF.
- In response to the final point, an RML CAO would not be applied in the manner described in paragraph 3.11 of the CAO SoP. Paragraph 3.11 relates to an approach for calculating a CAO for IM significant risk profile deviations, rather than an RML. In response to the question as to how the PRA concludes there has been an internal model residual deviation, the PRA will assess if the risk profile of the firm deviates from the assumptions underlying the SCR, in particular the calibration standards: Solvency Capital Requirement – General Provisions 3.3 to 3.4 and the internal model requirements: Solvency Capital Requirement – Internal Models 10 to 16A. The PRA would identify a deviation, as well as the extent of that deviation (ie considering the factors in paragraph 2.2 of the CAO SoP), for the purposes of setting an RML CAO in the same way it would for the purposes of setting a significant risk profile deviation CAO. If, giving consideration to the extent of that deviation based on the aforementioned factors, the PRA concludes that the deviation does not constitute a significant risk profile deviation, but rather an IM residual deviation, the PRA will consider setting an RML CAO. Paragraph 2.2 of the CAO SoP has been modified so as to clarify these points. As set out in paragraph 2.28 of the IM SoP and in paragraphs 5.1 to 5.9 of the CAO SoP, the PRA would inform the firm of the reasons for imposing a RML CAO (as well as any other safeguards), the PRA's expectations as regards a firm's remediation of the RMLs underlying those safeguards, and, where relevant, an expected timeframe for remediation.

4.83 One respondent asked for clarity on 'exceptional circumstances' in the context of a new alternative method for calculating CAOs for IM significant risk profile deviations.

4.84 The PRA considers that paragraphs 3.11 and 3.12 of the CAO SoP set out the 'exceptional circumstances' where the PRA has concerns that part, or all, of the firm's IM is inadequate, or that the SCR that the IM generates no longer appropriately reflects the firm's risk profile better than if the SF were used.

4.85 One respondent expressed concern that the PRA could revoke a firm's IM permission so that it was required to calculate its entire SCR using the SF.

4.86 The PRA notes that under the existing framework, in accordance with paragraph 3.4 of SS4/15, PRA may require the firm to revert to calculating the SCR in accordance with the SF. This is, therefore, not a new policy or change proposed in CP12/23.

CAO methodology with reference to other firms

4.87 Three respondents commented on the PRA's proposals relating to the determination of CAOs for risk profile deviations by comparison to other firms' SCR. Given the bespoke nature of each firm's IM methodologies, calibrations, and exposures, the respondents felt this could lead to inappropriate SCR outputs and should hence be used only in the most exceptional circumstances.

4.88 The PRA notes that there is no change to the policy here, as determination of CAOs for risk profile deviations by comparison to other firms' SCR is already allowed for within the CDR, Article 283(5). The PRA would carefully assess similarities between firms, and take into account differences in their risk profiles and business models. The PRA considers that this would be just one factor that it would take into consideration in its overall derivation of the CAOs. Paragraph 3.7 of the CAO SoP stated that PRA will only use this approach if the alternative approaches (as stated in paragraph 3.5 of the CAO SoP) for calculating the SCR of the firm are insufficient. The PRA will maintain open dialogue with firms about its approach to determining a CAO as it does under the existing framework.

Group capital add-ons

4.89 The PRA proposed to delete group CAO material from SS9/15 – Solvency II: Group supervision and restate it in the CAO SoP. The PRA also proposed to consolidate guidelines 23 to 27 from the EIOPA Guidelines on group solvency which relate to Group CAOs into the CAO SoP, to provide groups with more clarity on the PRA's approach. One respondent welcomed the PRA's comment to seek to avoid any double counting of CAOs to address the same deviation at individual entity and group levels. They asked the PRA to clarify its expectations around the application of CAOs at Group level, and the operation of any Own Funds restrictions at Group level, to reflect solo entity Own Funds, so as to be clear that the CAO need not be accounted for twice – once in the SCR and again in the Own Funds restriction (where relevant).

4.90 The PRA clarifies that a CAO set at a solo level would increase the solo SCR, but not affect own funds. The impact of the solo SCR on Group own funds availability is set out in SS9/15 5A.2B. In principle, firms should not consider the solo SCR as restricting the availability of own fund items or assets at the level of the group. Additionally, CP12/23 did not propose policy changes regarding treatment of own funds restrictions at the group level.

Ongoing monitoring, reporting and removal of capital add-ons

4.91 The PRA proposed to make changes in how it reviews CAOs over time. The PRA also set out proposals on disclosure of the new RML CAOs within firms' SFCRs, as well as publication of regular reports at an aggregate industry level summarising its use of CAOs.

Disclosure of RML CAOs

4.92 Five respondents commented on the PRA's proposals regarding disclosure of RML CAOs within firms' SFCRs, and on the PRA's proposal to publish a regular report.

- Two respondents considered that RML CAOs should not be disclosed as it would put pressure on listed firms, and would risk revealing proprietary and sensitive information.
- One respondent asked whether any CAOs subject to dispute resolution should be disclosed.
- One respondent considered that publishing the aggregate report would lead to pressure on firms to disclose their own RML CAO, leading to senior management distraction and share price volatility.
- One supported disclosure of CAOs in the SFCR but did not support disclosure of RML CAOs in the SFCR, as in their view it did not appear to be proportionate to the non-significant nature of the adjustment. This respondent also supported the PRA's intention to publish aggregate reports of CAOs applied in the industry, which it welcomed as a key accountability measure to ensure that the PRA's approach supported its objectives and 'have regards', to ensure the UK remains internationally competitive in particular.

4.93 After considering the responses the PRA has decided to make changes. Given the lower materiality of RML CAOs and their intended function as a tool to enable quicker approval of IMs, the PRA agrees that a requirement to disclose an RML CAO within a firm's SFCR is disproportionate and may be open to misinterpretation by users. The PRA Rulebook (Reporting 3.6 and 3.6A) will be amended to allow firms to not disclose the amount of an RML CAO separately and rather include it in the amount of the SCR calculated using its internal model and the reported SCR split by risk modules. Template S.25.04.21 and its relevant instructions have been amended to give firms the option, following discussion with supervisors, to split the RML CAO among the notional SCR of the risk modules so that RML CAOs are not separately identifiable within firms' reporting templates. The amended rules and instructions will be included in a separate PS for reporting, as explained in Chapter 1. Finally, the PRA has made changes to the CAO SoP relevant to this chapter and the IM SoP, to state that the PRA intends to publish a regular aggregate report on the use of significant deviation CAOs only; this report will exclude the use of RML CAOs. However, in order to maintain an appropriate level of transparency, the PRA will publish a summary report on its use of safeguards in 2027, covering how various safeguards have been used in the intervening period.

Other responses

Dispute resolution other than tribunal

4.94 Six respondents commented on the mechanism for resolving disagreements between firms and the PRA on the application of safeguards, should firms wish to dispute the outcomes of the PRA's assessments.

- Each of these respondents requested a new dispute resolution mechanism for RML CAOs other than that provided in Section 55Z3 of FSMA (for a firm to refer the matter to a tribunal).
- Four respondents specifically requested the ability to conduct an independent review (eg through an independent body such as an actuarial consultancy or independent expert) or appeals process for disagreements to be resolved, although one of these was generally supportive of a regime that allows for broader use of CAOs in order to facilitate more efficient model changes.
- One respondent noted it was unclear how Tribunals would in practice arbitrate on what are highly technical matters.
- Additionally, one respondent requested the PRA stated expressly in the final policy that it would make use of its internal control functions (such as the Supervisory Oversight Function or Independent Evaluation Office) to mitigate the risk of inconsistent application of safeguards across firms or over time.
- One respondent requested further detail on the process before setting the safeguard.

4.95 After considering the responses, the PRA has decided not to change the draft policy. The PRA holds responsibility for IM permissions, thus use of an independent or third party in the permissions process would be inconsistent with the PRA's regulatory responsibilities. The PRA generally considers that an RML CAO will be imposed using a voluntary requirement and, in the case of an application for an IM permission or a major model change, the firm will have the choice to improve its model before being granted an IM permission or variation of an IM permission for a major model change, so that the model is fully compliant and a safeguard is not needed. FSMA provides the overall architecture in which the PRA operates and the imposition of CAOs (via section 55M of FSMA) requires the PRA, as a matter of public law, to act rationally and proportionately. The FSMA structure includes the powers that may be necessary for the PRA to apply CAOs. That includes detailed procedural provisions on the use of those powers, including appeal rights. It also requires the PRA to publish a SoP on how it makes decisions under those powers, which the PRA has done. After considering the responses, the PRA does not consider that a different approach to the detailed legislative structure that the PRA operates in is required for RML CAOs; to do so would add complexity and cost, as well as decrease flexibility in model permissions. Finally, the PRA has a robust decision-making framework where a supervisory decision to set a safeguard would be referred to the appropriate independent decision-making committee within the PRA,

depending on category of the firm and type of decision being made. The PRA's internal functions and processes are also subject to review by the PRA's Supervisory Oversight Function, or the Bank's internal audit function.

Other minor amendments

4.96 The PRA amended the Glossary and Internal Models Part of the PRA Rulebook. One respondent suggested drafting changes to the PRA Rulebook to improve clarity on the glossary term 'internal model residual deviation'.

4.97 Having considered the response, the PRA has altered the glossary term 'internal model residual deviation' to clarify that the deviation exists independently and is not created by the PRA's determination.

4.98 The PRA identified a typographical error in Appendix 14 of CP12/23 - Draft amendments to SS4/15 – Solvency II: the solvency and minimum capital requirements. The reference, 'to waive or modify Own Funds 2.5 – 2.7', was introduced in a section relating to use of undertaking specific parameters. This reference is incorrect, since 'undertaking specific parameters' is relevant to the SF, and Own Funds 2.5 to 2.7 relate to ancillary own funds. Therefore, the PRA has deleted this reference in Appendix 13 of this PS - Updated supervisory statement 4/15 Solvency II: the solvency capital requirements.

5: Flexibility in calculating the Group SCR

Introduction

5.1 This chapter provides feedback to responses relating to the proposals in Chapter 5 (Flexibility in calculating the Group SCR) of CP12/23. It also contains the PRA's near-final policy as follows:

- amendments to the Glossary and Group Supervision Part of the PRA Rulebook (Annex A and N of Appendix 2);
- amendments to supervisory statement (SS) 9/15 – Solvency II: group supervision (Appendix 15); and
- a new statement of policy (SoP) – The PRA's approach to insurance group supervision (Appendix 16).

5.2 In CP12/23 the PRA proposed to:

- allow a group temporarily to add the results of two or more different calculation approaches when calculating the consolidated group SCR (eg Internal Models (IM) and IM; or IM and standard formula);

- allow a UK group's overseas sub-group SCR to be included in the consolidated group SCR under Method 2, thereby allowing diversification benefits between the Method 2 entities within that sub-group; and
- transfer and restate certain group supervision regulations from the SII Commission Delegated Regulations 2015/35 (CDR) and the Solvency 2 Regulations 2015 that are revoked under FSMA 2023 into the Glossary and Group Supervision Part and the proposed new SoP – The PRA's approach to insurance group supervision, in order to give effect to the proposals above and make consequential changes to SS9/15.

5.3 The PRA received 18 responses to Chapter 5 of CP12/23. Respondents generally welcomed the PRA's proposals but made a number of observations and requests for clarification which are addressed in this chapter.

Changes to draft policy

5.4 Following consideration of the respondents' comments, the PRA has made changes to the near-final rulebook. A summary of the changes is set out below:

- the PRA has added Group Supervision 16.3 to transfer the definition of significant transaction from CDR article 377(1) which clarifies that significant transactions are those that would materially influence the solvency or liquidity position of the group.
- the PRA has modified the Rulebook definition of significant branch proposed in CP12/23, removing reference to third country insurance undertaking, third country reinsurance undertaking or a Gibraltarian insurance undertaking.
- the PRA has added Chapter 8D on own funds items that are free from encumbrances, in place of the rules proposed at 8A.3 and 8B.3 in CP12/23.

5.5 Following consideration of the respondents' comments, the PRA has also made changes to the near-final SoP. A summary of the changes is set out below:

- the PRA has added paragraph 5.6 to the new SoP – the PRA's approach to insurance group supervision, allowing firms a temporary modification for 6 months to create a clear and realistic plan to integrate multiple calculation approaches. Further details of this change are set out in the following sections;
- the PRA has modified wording within the Group Supervision statement of policy so that paragraphs 3.9 – 3.11 refer to ancillary own funds for intermediate insurance holding companies; and
- the PRA has made various minor changes for consistency and clarity.

5.6 The PRA considers that changes to the near-final PRA rules and changes to the near-final SoP provide clarification and are not significant enough to materially alter the cost benefit analysis presented in CP12/23. The PRA considers allowing a group up to six months after an acquisition to create a plan to integrate any internal models would create additional

flexibility by better recognising the differences in nature between firms and ensure a firm had sufficient time to assess the most appropriate approach to model integration. This allows firms to better use the proposal and realise the competition, competitiveness and growth benefits outlined in CP12/23.

5.7 In addition, the PRA has made a number of clarificatory amendments. A summary of the amendments is set out below:

- Changes to the definitions within the PRA Glossary;
- Removing references to EU directives and replacing with references to relevant UK law or descriptions of activities; and
- Using the PRA Glossary defined term when referring to derivatives.

Feedback to responses

5.8 The PRA has considered the responses received to Chapter 5 of CP12/23. Feedback to the responses have been grouped as follows:

- providing a clear and realistic plan to integrate multiple calculation approaches;
- transfer and restatement of regulation 45;
- intragroup transactions for multiple calculation approaches;
- definitions;
- tiering limits;
- transfer and restatement of Group Supervision 9.4;
- the treatment of capital issued by intermediate holding companies;
- consolidation approach for Method 2 for an overseas sub-group;
- time period of modification for multiple calculation approaches;
- assumptions underlying the models for multiple calculation approaches;
- scope of external and internal audits;
- remaining EU references following the transfer and restatement;
- other methods waivers;
- requirements to use Method 2 for overseas sub-groups;
- clarification on implementation;
- additional reforms to Method 1 and D&A waivers;
- FSMA 138BA powers;
- financial and regulatory misconduct; and
- minor changes for consistency and clarity.

Providing a clear and realistic plan to integrate multiple calculation approaches

5.9 The PRA proposed to allow a group to add the results of two or more calculation approaches (eg Internal Model (IM) and IM or IM and Standard Formula) when calculating the consolidated group SCR. In assessing whether the temporary use of more than one calculation approach may be permitted, the PRA's assessment would be based on certain factors including the requirement for the firm to submit a clear and realistic plan to develop a group internal model for the purposes of the group solvency calculation.

5.10 One respondent noted groups will be unable to create a clear and realistic plan to integrate internal models as the depth of knowledge required to create a credible plan for integration is unlikely to be available prior to a change in control (CiC) for an M&A transaction.

5.11 Having considered the response, the PRA agrees that it is appropriate to allow additional time for firms to prepare a realistic plan to integrate their calculation approaches. Accordingly, the PRA has made changes to the proposals in CP12/23. These changes are set out in the near-final SoP – the PRA's approach to insurance group supervision. In summary, the PRA will grant firms a temporary modification for six months to create a clear and realistic plan to integrate the calculation approaches. During this period, firms would be allowed to use multiple calculation methods when calculating the group SCR if they met all the other safeguards set out in the near-final SoP. Within six months, a firm will be required to submit their plan and upon satisfactory review by the PRA, will be granted a two-year modification.

5.12 The PRA has considered that in practice, obtaining sufficient data and expertise to create an integration plan would not be available at the point of the CiC application. The PRA considers that allowing a period of six months for a group to provide a clear and realistic plan will likely result in higher quality and more accurate plans.

Transfer and restatement of Regulation 45

5.13 The PRA proposed to transfer and restate certain group supervision regulations from the SII CDR and the Solvency 2 Regulations 2015 that will be revoked under the Financial Services and Markets Act (FSMA) 2023 into the Glossary and Group Supervision Part and the proposed new SoP – The PRA's approach to insurance group supervision.

5.14 Four respondents asked for clarification on the transfer and restatement of Regulation 45 of the Solvency 2 Regulations 2015 (itself a transposition of Solvency II Directive article 226) into the new Group Supervision statement of policy (SoP) on Group Supervision (3.9 – 3.11). Responses suggested that 3.9 to 3.11 should refer specifically to ancillary own funds, rather than eligible own funds, for clarity and in line with the text of Article 226 of the Solvency II Directive which regulation 45 originally transposed.

5.15 Having considered the responses the PRA has made a change to the proposals in CP12/23 clarifying within the Group Supervision SoP that paragraphs 3.9 – 3.11 refer to ancillary own funds for intermediate insurance holding companies. Although Regulation 45 refers to eligible own funds it is limited by Regulation 44 to take into account only ancillary own fund items. The PRA further clarifies that no policy change has taken place as a result of the transfer and restatement of Regulation 45, this change is to ensure the policy intent from article 226 and Regulation 45 are maintained.

Intragroup transactions for multiple calculation approaches

5.16 The PRA proposed that when assessing whether the temporary use of more than one calculation approach may be permitted it would, among other factors, consider whether intra-group transactions between group entities that are not covered by the same group SCR calculation approach would not be significant in terms of either volume or value of transactions.

5.17 Two respondents noted that the materiality of intra-group transactions should be assessed against their material impact on the Group SCR rather than in terms of volume or value of transactions.

5.18 Having considered the responses, the PRA has made a change to the proposals in CP12/23. Consistent with CDR A377, the PRA considers that significant transactions are those that would materially influence the solvency or liquidity position of the group or of one of the firms involved in these transactions. The PRA has added Group Supervision 16.3 to transfer and restate CDR A377(1). The PRA, therefore, clarifies that it would consider the volume and value of transactions as well as transactions that alter the group SCR. This restates CDR article 377 (1).

5.19 The PRA has amended the definition of intra-group transaction to make it more consistent with the approach set out in the Onshored Solvency II Directive. In the Solvency II Directive, the definition of intra-group transaction is any transaction where a re/insurance undertaking relies on other undertakings in the group to fulfil an obligation. In CP12/23 the PRA included in the definition of intra-group transaction limb (2) which referred to regulated entities within the group. The PRA considers that to maintain a transfer and restatement approach the definition should refer to an intra-group transaction relied on by a solvency II insurance undertaking, to be consistent with the approach in the Directive. The PRA has amended Group Supervision 16.2(1) to remove the description of an intra-group transaction, as this is now set out in the definition.

Definitions

5.20 The PRA proposed several definitions within the PRA Glossary including that of a significant branch which were taken from the CDR.

5.21 One respondent suggested clarifications to several definitions within the glossary where wording was derived from EU directives and delegated acts.

5.22 Having considered the response, the PRA has made a change to the PRA Glossary definition of a significant branch proposed in CP12/23. The PRA considered a change to the definition to provide clarity following the end of the EU withdrawal period by referring to a branch of a non-UK insurer, whereas before the EU withdrawal period the definition would have applied to the branch of a UK insurer in another member state. However, this change would have had the unintended consequence of excluding branches of UK firms and branches in Gibraltar. The PRA has, therefore, removed reference to third country insurance undertaking, third country reinsurance undertaking or a Gibraltarian insurance undertaking within the definition which were added for clarity following the end of the EU withdrawal period. Instead, the PRA will rely solely on the rest of the current definition which refers to a GWP threshold greater than 5% for a branch to be considered significant.

5.23 The PRA has not made a change to the definition of part specific terms ‘third country insurance undertaking’ and ‘third country reinsurance undertaking’, choosing to keep part specific terms that exclude Gibraltarian insurance undertakings. This achieves the PRA’s aim of no policy change through the transfer and restatement by recreating the definition used in the Solvency 2 Regulations 2015.

Tiering Limits

5.24 The PRA proposed to allow a group temporarily to add the results of two or more different calculation approaches when calculating the consolidated group SCR.

5.25 One respondent asked for clarity on how the Solvency II tiering limits interact with the proposal.

5.26 Having considered the response, the PRA has made no change to the proposals in CP12/23. The PRA considers the group solvency calculation involves determining the amount of eligible group own funds and the group solvency capital requirement, then calculating the surplus. The proposal in CP12/23 is specific to the group solvency capital requirement, aiming to make a group’s SCR a more accurate representation of the groups risk profile when performing M&A activity. It does not address group own funds hence own funds would be calculated as normal, with the group solvency capital requirement affecting tiering limits in the same way as it does currently.

Transfer and restatement of Group Supervision 9.4

5.27 The PRA proposed to transfer and restate certain group supervision regulations from the SII CDR and the Solvency 2 Regulations 2015 that will be revoked under FSMA 2023 into the Glossary and Group Supervision Part and the proposed new SoP – The PRA's approach to insurance group supervision. As part of this exercise, CDR article 330(3) and 330(4) on the availability at group level of the eligible own funds of related undertakings was partially transferred to 9.4A and 9.4B which each list several types of own funds that are assumed not to be available to cover the group solvency capital requirement. The own fund items are presented in separate lists as the assumption of non-availability can be overturned for those in 330(3) but not for those in 330(4).

5.28 One respondent suggested the drafting of Group Supervision 9.4 to 9.4B may not achieve its intended purpose and suggested several drafting changes. The respondent suggested that Group Supervision 9.4A and 9.4B could be combined into one list as the drafting suggested that the assumption of non-availability for items in both rules could be overturned. The respondent's interpretation would represent a change in policy by allowing the assumption of availability to be overturned for items in 9.4B.

5.29 Having considered the responses the PRA has made no change to the proposals in CP12/23. The distinction between the own fund items in Group Supervision 9.4A and 9.4B preserves the distinction from assimilated law, in keeping with the PRA's aim for no policy change from the transfer and restatement. Within the SoP, the PRA clarifies this distinction at 3.12 and has clarified this again within SS9/15 5B.1 where items in 9.4B are presumed not to be available in any case.

5.30 Separately, the PRA has removed reference to 'diversification benefits' at 9.4D and replaced it with 'diversification effects' for clarity by referring to the defined term.

The treatment of capital issued by intermediate holding companies

5.31 One respondent highlighted the treatment of capital items issued by intermediate holding companies. The respondent noted that if a group parent is acquired, it becomes an intermediate holding company of a group and capital that was previously deemed available would then be subject to an availability assessment that may disqualify the capital.

5.32 Having considered the response, the PRA has made no change to the proposals in CP12/23. The PRA considers that its proposals in CP12/23 were focused on the group solvency capital requirement not the availability of group own funds. In considering this response the PRA would look to incorporate this area in future policy development.

Consolidation approach for Method 2 for an overseas sub-group

5.33 The PRA proposed to allow a UK group's overseas sub-group SCR to be included in the consolidated group SCR under Method 2. Where a firm applies to use this proposal, a group using Method 2 to calculate the group SCR may be allowed to include in the group solvency calculation the local capital requirements calculated for its overseas sub-group and the local eligible own funds. This measure will be available if that sub-group is subject to group supervision and HM Treasury determine that the prudential regime of the third country is equivalent.

5.34 Two respondents questioned the requirements within the proposal to use Method 2 for an overseas sub-group. Specifically, requiring the use of local figures for capital resources and requirements for the sub-group. The respondents noted that not all jurisdictions apply a consolidation approach and so consolidated figures may not be available on a local basis.

5.35 Having considered the response, the PRA has made no change to the proposals in CP12/23. The PRA considers that the purpose of the policy is to permit a better reflection of the position of the sub-group and for this purpose looking at the sub-group as a consolidated entity may be preferable and more consistent with the additional flexibility provided in this proposal.

Time period of modification for multiple calculation approaches

5.36 The PRA proposed that where it allows the temporary use of more than one calculation approach, the modification would usually be granted for a period of two years while a single group IM (or group-specific parameters) is under development.

5.37 Three respondents noted that delivering a new consolidated internal model within the 2-year time period would be challenging.

5.38 Having considered the response, the PRA has made no change to the overall two-year time period which it considers to be sufficient for a group to develop a single approach. However, it has also included a 6-month period following an acquisition to allow firms to develop a clear and realistic plan to integrate multiple calculation methods. The PRA may also consider granting a further extension taking into account the group's specific circumstances for example, if the work involved in integrating models following a large and complex transaction mean that it is appropriate to go beyond the two-year period.

Assumptions underlying the models for multiple calculation approaches

5.39 In assessing whether the temporary use of more than one calculation approach may be permitted, the PRA's assessment would be based on the certain factors including, whether, where the PRA allows a group to add two or more different calculation approaches, each

separate calculation would continue to reflect the material risks to which the group was exposed, and whether the assumptions underlying those separate calculations would not deviate significantly from the assumptions underlying the overall group SCR calculation for that group.

5.40 One respondent questioned the need for assessing if the assumptions underlying the acquired internal model deviate significantly from the existing internal model if both models are already PRA approved.

5.41 Having considered the response, the PRA has made no change to the proposals in CP12/23. The PRA considers that this factor ensures the firm is responsible for ensuring that the use of a combination of calculation approaches would be appropriate in its specific case.

Scope of external and internal audits

5.42 The PRA proposed to temporarily allow a group to add the results of two or more different calculation approaches when calculating the consolidated group SCR for example internal model and standard formula.

5.43 Two respondents asked for clarification on whether an internal model group acquiring a standard formula entity would require the newly acquired standard formula entity to be subject to an internal or external audit.

5.44 Having considered the response, the PRA has made no change to the proposals in CP12/23 but confirms that in line with External Audit 2.2(4), where an IM group acquires a SF firm the resulting consolidated group SCR is out of scope of the external audit. This position would not be expected to change with the introduction of S.25.04, replacing S.25.01, S.25.02 and S25.03. The PRA does not publish guidance on the scope of internal audits and considers it is up to firms to determine the scope of their internal audits.

Remaining EU references following the transfer and restatement

5.45 The PRA proposed to transfer and restate certain group supervision regulations from the SII CDR and the Solvency 2 Regulations 2015 that will be revoked under FSMA 2023 into the Glossary and Group Supervision Part and the proposed new SoP – The PRA's approach to insurance group supervision.

5.46 Three respondents asked for clarification relating to remaining references to the Commission Delegated Regulation within the PRA Rulebook.

5.47 Having considered the response, the PRA has updated the definition of non-regulated undertaking carrying out financial activities and updated Group Supervision 10.1A, 11.1A(5) and 11.2A(3), and Group Supervision SoP 6.5B to remove references to EU directives and

insert the appropriate UK reference. The PRA clarifies that cross references will also be revisited as part of a consultation later in the year or will be updated in the rules at the point they are made.

Other methods waivers

5.48 The PRA proposed to transfer and restate certain group supervision regulations from the SII CDR and the Solvency 2 Regulations 2015 that will be revoked under FSMA 2023 into the Glossary and Group Supervision Part and the proposed new SoP – The PRA's approach to insurance group supervision.

5.49 One respondent queried why references to 'other method' waivers had been removed and wanted clarification on whether this policy remained unchanged.

5.50 Having considered the response, the PRA has made no change to the proposals in CP12/23 but clarifies that other method waivers continue to be considered and may be granted by the PRA. The PRA's approach to insurance supervision document confirms this policy.

Requirements to use Method 2 for overseas sub-groups;

5.51 The PRA proposes that certain other factors would also be taken into account in assessing whether to give permission for the overseas sub-group's group SCR to be used in the consolidated group SCR. This included a materiality assessment where Method 2 should be compared with Method 1 using the aggregated group eligible own funds and the aggregated group SCR calculated in accordance with UK solvency rules.

5.52 Two respondents believed that requiring a firm to calculate both Method 1 and 2 to show they were broadly equivalent would be overly burdensome and prevent adoption of the proposal.

5.53 Having considered the response, the PRA has made no change to the proposals in CP12/23. The PRA considers that this factor is suitable and not overly burdensome as it is already required for deduction and aggregation (D&A) waivers where an applicant's sub-groups calculate both Method 1 and 2. The PRA must be able to make a comparison between methods using a common reference point, and considers that this approach has worked well for D&A waivers. It is also consistent with Method 1 being the default method.

Clarification on implementation

5.54 Four respondents asked for clarification around equivalence decisions, the impact of the proposals on groups with Lloyd's managing agents and the consolidation of EEA subsidiaries into the Solvency UK balance sheet.

5.55 Having considered the response, the PRA has made no change to the proposals in CP12/23 but clarifies that the policy does not make changes relating to how equivalence decisions are made and Lloyd's managing agents cannot take advantage of these proposals. The majority of rules under Solvency II apply to Solvency II firms. However, Lloyds managing agents are treated as non-financial / non regulated entities while the Lloyds market is considered a single Solvency II firm which subsumes the members. The PRA further clarifies that a group can continue to consolidate its EEA subsidiaries using Method 1 and then calculate group SCR and group own funds using UK solvency rules. Alternatively, a group can apply to the PRA for use of a Deduction & Aggregation waiver in relation to the EEA subsidiary. Upon PRA approval of the D&A waiver the firm can continue to use the requirements in the relevant jurisdiction for local solo SCR and own funds.

Additional reforms to Method 1 and D&A waivers

5.56 Three respondents asked for further reforms to Method 1 calculations with no specific focus, the duration and process of D&A waivers and allowing diversification effects between an overseas sub-group and the UK part of the group.

5.57 Having considered the response, the PRA has made no change to the proposals in CP12/23. However, the PRA will consider the feedback on how Method 1 could be improved to suit the UK market in future policy making.

5.58 The PRA clarifies it will retain the discretion to decide the duration of waivers when considering any application, being proportionate and risk based in its decision. The PRA also clarifies that it will not allow diversification effects between overseas sub-groups and the UK part of the group.

FSMA 138BA Powers

5.59 The PRA proposed that where it allowed flexibility in calculating the group SCR, it would be exercising its power under section 138BA of FSMA 2000, as inserted by FSMA 2023 to give or vary a permission to modify the PRA Rulebook.

5.60 One respondent commented on the difficulty in forming a view of the PRA's proposals in this area without sight of a draft of HMT's legislation in relation to flexibility in the calculation of the group SCR. The respondent stated that the PRA's powers to modify rules under 138BA only apply if HMT makes regulations that govern applications. They said this amplifies their general point raised about industry needing another opportunity to provide feedback when the further CPs and relevant legislation have been published.

5.61 The PRA recently published **CP3/24**, which sets out the PRA's general approach to rule permissions under s138BA. While the PRA's use of s138BA relies on the **secondary legislation** from HMT, which includes provision on general procedural matters that

requires further consideration by the PRA, it does not provide any specific regulations in relation to the final policy on the calculation of the group SCR for firms to consider. The specific criteria the PRA will consider in deciding whether to grant permissions in relation to the calculation of the Group SCR were consulted on as part of CP12/23 for respondents to provide comments and are set out in the near-final SoP included in this PS. The general point raised about respondents needing another opportunity to provide feedback is addressed in Chapter 10 of this PS – General points raised by respondents.

Financial and regulatory misconduct

5.62 The PRA considered that the proposals to allow flexibility in calculating the group SCR represent a proportionate approach to safety and soundness and policyholder protection.

5.63 One respondent commented on the impact the proposals might have on financial and regulatory misconduct. The respondent highlighted the risks of overseas parents and cross border supervision, competitiveness and M&A activity within the insurance market and broker conduct.

5.64 Having considered the response, the PRA has made no change to the proposals in CP12/23. The PRA's primary objectives are promoting the safety and soundness of firms and securing policyholder protection, which the PRA considers these proposals support.

Minor changes for consistency and clarity

5.65 The PRA amended the Glossary and Group Supervision Part of the PRA Rulebook, amended supervisory statement (SS) 9/15 – Solvency II: group supervision and introduced a new SoP – The PRA's approach to insurance group supervision.

5.66 One respondent suggested several grammatical changes to improve clarity. They also suggested numerous drafting changes to the PRA Rulebook, SS and SoP to improve clarity, particularly where wording has been derived from EU directives and delegated acts and disagreed with their transfer and restatement into PRA policy. Some suggested drafting did not relate directly to the draft policy under consideration.

5.67 Having considered the response, the PRA has made some minor grammatical changes to the near-final rules, SoP and SS.

5.68 Where suggested drafting edits have not been taken forward in changes to the PRA Rulebook, SS or SoP this is because the PRA considers the drafting consulted on CP12/23 achieves the intended purpose of no policy change.

5.69 The PRA has not provided feedback to the areas of the response that did not relate directly to the draft policy under consideration, but may consider the points raised in further policy development.

6: Third-country branches

Introduction

6.1 This chapter provides feedback to responses relating to Chapter 6 (Third-country branches) of CP12/23, which set out proposals to remove the rules that require international insurers operating in the UK through a branch presence ('third-country branch undertakings') to calculate branch capital requirements, as well as other consequential amendments. It also contains the PRA's near-final policy, as follows:

- amendments to the Glossary Part of the PRA Rulebook (Annex A of Appendix 2);
- amendments to the Third Country Branches Part of the PRA Rulebook (Annex K of Appendix 2);
- amendments to the Insurance – Supervised Run Off Part of the PRA Rulebook (Annex L of Appendix 2);
- amendments to the Run-Off Operations Part of the PRA Rulebook (Annex M of Appendix 2); and
- updates to supervisory statement (SS) 44/15 – Solvency II: third-country insurance and pure reinsurance branches (Appendix 18).

6.2 In CP12/23, the PRA proposed to:

- remove the requirements for third-country branch undertakings to calculate and report branch capital requirements; and
- consequentially remove the requirements for third-country branch undertakings to:
  - establish and report a branch risk margin for the purposes of ongoing supervision; and
  - hold assets in the UK to cover the branch SCR.

6.3 The PRA received 23 responses to Chapter 6 of CP12/23, six of which had no comments. Where respondents did provide comments, the majority generally welcomed the PRA's proposals. Some respondents made a number of observations and requests for clarification which are set out in the following section of this chapter. Several respondents raised comments outside of the scope of the proposals.

Changes to draft policy

6.4 The PRA has made some minor changes to SS44/15, including in response to feedback, as follows:

- removing the reference to 'Branch Guideline 25' in paragraph 3.3 of SS44/15, given that Guideline 25 would no longer be relevant following implementation of the proposals in Chapter 6 of CP12/23;
- removing the reference to 'at the branch level (Guidelines 17 and 26)' in paragraph 4.1A (formerly 3.2) of SS44/15;
- inserting Guideline 6 (1.25) into the table of remaining relevant Branch Guidelines in Appendix 1 of SS44/15 (and removing it from the mapping table in Appendix 19 of this PS), given that the PRA considers this Guideline is still relevant and may consider including it in the PRA Rulebook as part of a future consultation; and
- inserting a footnote in Appendix 1 to clarify which of the remaining Branch Guidelines are relevant for the PRA to implement, thus providing more clarity.

6.5 These amendments are discussed in more detail in the 'Feedback to responses' section of this chapter.

Implementation

6.6 The Overview of Applicable Branch Guidelines mapping table (set out in Appendix 19 of this PS) and additional changes to SS44/15 (Appendix 18 of this PS) were also consulted on as part of Chapter 7 (Reporting and disclosure) of CP12/23 and may change to reflect the outcome of Chapter 7 of CP12/23 and any changes to the associated rules and policy materials. This will be covered by near-final PS3/24 – Review of Solvency II: Reporting and disclosure (Phase 2) (due to be published later in February 2024). For transparency, the PRA has highlighted in blue (otherwise unchanged) the proposed changes arising from Chapter 7 of CP12/23 in Appendix 18 and Appendix 19 of this PS.

6.7 Similarly, further changes to SS44/15 were also consulted on as part of CP21/23 – **The PRA's approach to the authorisation and supervision of insurance branches**. For transparency, the PRA has highlighted in yellow (otherwise unchanged) the proposed changes arising from CP21/23 in Appendix 18 of this PS. However, the amendments could be subject to change, given that the PRA is still considering responses to that CP.

Feedback to responses

6.8 The PRA has considered the responses received to Chapter 6 of CP12/23. Feedback to the responses have been grouped as follows:

- branch assets;

- security deposit;
- clarifications regarding SS44/15;
- branch guidelines;
- competition and competitiveness;
- scope of proposals;
- implementation;
- cost benefit analysis;
- glossary;
- policyholder protection;
- financial stability;
- legal entity valuation;
- availability of capital;
- winding-up process;
- out of scope responses; and
- reporting.

Branch assets

6.9 The PRA proposed to remove the requirement for third-country branches to calculate and report a branch SCR and MCR, as well as the requirement to establish a branch risk margin for the purposes of ongoing supervision.

6.10 One respondent noted that there appeared to be an absence of any requirement for third-country branches to cover branch liabilities. Another respondent noted that the PRA's proposals do not mention a requirement that UK third-country branch eligible assets need to exceed UK liabilities, while another suggested there is no requirement for third-country branches to cover its technical provisions with assets. The latter two respondents highlighted that these are requirements for Swiss general insurers and asked the PRA to confirm whether this was a drafting oversight.

6.11 One respondent noted that the removal of branch capital requirements implies that there is no requirement for branch own funds to be positive, and thus creates an incentive for firms to attribute no assets to the UK branch. The respondent queried whether this was the PRA's intention, given that there is continued emphasis on branch assets in SS44/15 and the **Guidelines on the supervision of branches of third-country insurance undertakings** ('Branch Guidelines').

6.12 The PRA clarifies that in accordance with Rule 6.1 of Annex K in Appendix 2 third-country branch undertakings must establish adequate provisions to cover the insurance and reinsurance obligations assumed by the third-country branch undertaking in the UK. The PRA

clarifies that, in this context, 'establishing provisions to cover' means to 'calculate and hold assets'. Rule 6.1B of Annex K in Appendix 2 further stipulates that the insurance and reinsurance obligations must be calculated using the branch best estimate of liabilities (or where applicable, the market value of financial instruments). Consequently, the PRA confirms that third-country branch undertakings are required to calculate and hold assets covering the branch best estimate of liabilities. As set out in SS44/15, only those assets that are available to pay the claims of branch policyholders in the event of a winding-up should be included in the calculation.

6.13 With regard to Swiss general insurers, the PRA clarifies that different requirements apply pursuant to the Agreement between the United Kingdom of Great Britain and Northern Ireland and the Swiss Confederation on Direct Insurance other than Life Insurance ('the UK-Swiss Direct Insurance Agreement').[26]

6.14 One respondent noted that if there is a requirement for branch assets to cover branch liabilities, it would be helpful to indicate, in the case of composite branches, whether the measure applies separately to each of the general and long-term insurance arms of the business.

6.15 The PRA confirms that Composites 2 and 3 of the PRA Rulebook continue to apply to third-country branch undertakings, as set out in Third Country Branches 11.1.

6.16 One respondent asked the PRA to clarify that a notional allocation of legal entity eligible assets to the UK branch is acceptable, given that assets are likely to be managed at the legal entity level, and branch assets often represent a subset of assets that are eligible.

6.17 The PRA confirms that a notional allocation of legal entity assets is acceptable, but that assets should only be allocated to the branch where they would be available to pay branch policyholders in a winding-up scenario.

6.18 Another respondent suggested the PRA revisit the requirement of notional asset allocation to the third-country branch, given that the adequacy of the level of assets is monitored at the legal entity level.

6.19 Having considered this response, the PRA has decided not to revisit the requirement of notional asset allocation to the third-country branch, given that it requires third-country branch undertakings to ensure there are sufficient assets available to pay branch policyholders in the event of a winding-up, and thus contributes to securing an adequate degree of policyholder protection.

Security deposit

6.20 In Chapter 10 (Currency redenomination) of CP12/23, the PRA proposed to redenominate from EUR to GBP the amount that a third-country branch undertaking must hold as a security deposit with a UK CRD institution ('security deposit'), and to specify the GBP amounts in the Third Country Branches Part.

6.21 Two respondents asked the PRA to clarify whether third-country branch undertakings would still be required to hold a security deposit. Two respondents recommended that the PRA considers removing the requirement, given that it would not reduce policyholder protection but would support the PRA's secondary competition and competitiveness objectives. Two respondents also asked the PRA to clarify why it is proposing to retain it as a requirement.

6.22 Having considered these responses, the PRA confirms that third-country branch undertakings will continue to be required to hold a security deposit in the UK, of the amount specified in Rule 3.3 of the Third Country Branch Part (see Annex K of Appendix 2). The PRA considers this to be appropriate for several reasons, including that it can provide a minimum amount of assets in the UK to cover financial penalties or redress more broadly. The PRA also reminds firms that Branch Guidelines 19 and 20 are relevant in the context of the requirement to hold a security deposit in the UK.

Clarifications regarding SS44/15

6.23 As part of the proposals in Chapter 6 of CP12/23, the PRA proposed several amendments to SS44/15, including deleting paragraph 3.2 and restating it as paragraph 4.1A.

6.24 One respondent noted that paragraph 4.1A appeared to contradict the PRA's proposals to remove the requirement to calculate branch solvency calculations and suggested that the PRA should amend the paragraph to acknowledge that entity solvency and insolvency priority would satisfy the branch financial soundness rule. Another respondent suggested that the text of paragraph 4.1A and references to branch assets in the Branch Guidelines should be underpinned in the PRA Rulebook.

6.25 As set out in the PRA's proposed draft statement of policy (SoP) – **The PRA's approach to insurance branch authorisation and supervision** there are several criteria that the PRA considers to be relevant in the context of safety and soundness of the branch, and these are assessed at authorisation and as part of ongoing supervision.[27] Where the PRA's assessment of these criteria finds the firm to be outside of risk tolerance, the PRA may consider further action. The PRA had retained the reference to Guidelines 17 and 26 of the Branch Guidelines in paragraph 4.1A, given that they contain details regarding branch accounts and availability of branch assets, which the PRA considers will continue to be

relevant in the context of the financial soundness of the branch, despite removal of branch capital requirements. However, having considered these responses, the PRA has decided to amend paragraph 4.1A of SS44/15 to remove the reference to 'at the branch level (Guidelines 17 and 26)' to avoid ambiguity, given that Appendix 1 of SS44/15 also sets out which Guidelines continue to be relevant. The PRA also confirms that the remaining Guidelines will be revisited and considered for transfer to the PRA Rulebook or other policy material, as part of a future consultation. As part of this, the PRA will consider whether the definition of branch assets needs underpinning in the PRA Rulebook.

Branch guidelines

6.26 The PRA proposed to transfer and restate several Branch Guidelines in the PRA Rulebook or supervisory statements.

6.27 One respondent asked for clarification on the difference between the following tables in CP12/23: Appendix 1 of Appendix 19 (Draft amendments to SS44/15 – Solvency II: third-country insurance and pure reinsurance branches) and Appendix 20 (Overview of Applicable Branch Guidelines). The respondent further suggested that the PRA should consider moving the Guidelines into its own supervisory documentation rather than having firms refer to an external source.

6.28 Another respondent noted the PRA's analysis that some of the Branch Guidelines were no longer relevant following the UK's exit from the EU and suggested that this should not have an effect on the capital sufficiency safeguards associated with insurance products and services sold to UK customers.

6.29 The PRA clarifies that Appendix 1 of SS44/15 sets out the Guidelines that will continue to be relevant following implementation of the removal of branch capital requirements. Given that SS44/15 expects firms to continue to comply with the Guidelines that are relevant to them, the PRA included this as an appendix to SS44/15 to ensure clarity on an ongoing basis.

6.30 Conversely, the Overview of Applicable Branch Guidelines, as was set out in Appendix 20 of CP12/23 (Appendix 19 of this PS), shows a mapping table of the Guidelines that the PRA chose to set out (or not set out) in rules or expectations in SSs, to supplement the proposals in CP12/23. Some of the Guidelines were only relevant in the context of the UK's membership of the EU and have since become redundant, and the PRA therefore considers that these specific Guidelines do not advance its safety and soundness or policyholder protection objectives. The PRA confirms that the remaining Guidelines will be revisited and considered for transfer into the PRA Rulebook or other policy material as part of a future consultation.

Competition and competitiveness

6.31 In CP12/23, the PRA explained that the proposal to remove branch capital requirements would allow it to continue to advance its primary objectives, while also facilitating entry into the UK, facilitating effective competition and enhancing the UK's competitiveness.

6.32 One respondent noted that the proposals may create a risk of arbitrage where it is preferable for firms to domicile overseas with a branch in the UK, rather than domicile in the UK with an overseas branch. The respondent recommended that the PRA monitors this risk but did not see it as significant. Another respondent argued that overseas companies could come to the UK and benefit from 'light touch' treatment, and that it is the PRA's job to stop the public from engaging with these firms.

6.33 One respondent suggested that the proposals could have implications for UK firms and how they compete globally, whereby the burden of operating through a branch is reduced relative to alternative means. The respondent noted that this could affect a group's decision about which platform to operate through in the UK, leading to a drain of capital from UK markets.

6.34 The PRA considers that there are appropriate safeguards in its third-country branch regime to secure an appropriate degree of policyholder protection. For example, as set out in SS2/18 – **International insurers: the Prudential Regulation Authority's approach to branch authorisation and supervision**, the PRA will only authorise third-country branches where the home jurisdiction's supervisory regime is deemed to be broadly equivalent. Furthermore, the PRA considers that the competition impact in retail markets is likely to be immaterial and that there are appropriate safeguards with regard to ensuring effective competition. As set out in SS2/18, the PRA expects third-country branches to have under £500 million of insurance liabilities covered by the Financial Services Compensation Scheme (FSCS) when operating as a branch and may consider authorisation as a subsidiary as an alternative where this is not the case.

6.35 The PRA also considers that there are additional safeguards arising from CP21/23 – **The PRA's approach to authorisation and supervision of third-country insurance branches**, including the proposed approach to third-country branch reinsurance arrangements, and the size of the branch compared to the undertaking. The PRA is currently considering responses to this consultation.

6.36 One respondent suggested that foreign branches of UK firms should be able to benefit from the same treatment overseas that the UK is proposing for foreign branches operating in the UK, as this would increase competitiveness of UK firms and avoid a framework where foreign firms are able to compete in the UK on more favourable terms than UK firms can compete overseas.

6.37 The PRA notes that it is possible that some UK firms would face restrictions in their ability to operate through an overseas branch since some other jurisdictions, most notably the EU, impose local capital requirements on third-country insurance branches. However, the PRA clarifies that it has no direct control over the capital requirements that may be imposed by other regulators on the foreign branches of UK firms. The PRA considers that it is able to balance this issue by only authorising third-country branches where the home jurisdiction's supervisory regime is deemed to be broadly equivalent, and also requiring third-country branch undertakings to maintain adequate worldwide financial resources (which includes accounting for the activities of the branch) in any case. It also expects third-country branches to maintain under £500 million of FSCS-protected liabilities and may consider subsidiarisation to be appropriate where this is not the case, thus creating an indicative threshold for operating in the UK via a branch. The PRA continues to consider that its proposals would facilitate greater competition in the markets for insurance services, and that the proposals would also enhance the international competitiveness and growth of the UK as a safe and attractive place to do insurance business.

Scope of proposals

6.38 The PRA set out that the proposals in Chapter 6 of CP12/23 were relevant to all third-country branch undertakings, except Swiss general insurers, and all third-country insurance undertakings seeking authorisation to operate as a branch in the UK.

6.39 One respondent asked the PRA to confirm whether European Economic Area (EEA) subsidiaries are considered to be in scope of Chapter 6 of CP12/23, given that there are varying definitions of 'third-country'. Another respondent requested further clarity on how the proposals apply to existing branches.

6.40 The PRA confirms that the proposals in Chapter 6 of CP12/23 and near-final policy as set out in this PS chapter, apply to all third-country branch undertakings (except Swiss general insurers) as defined in the PRA Rulebook, including any insurers that already have a branch established in the UK.[28] This includes UK branches of insurers headquartered in the EEA.

Swiss general insurers

6.41 The PRA set out that the proposals in Chapter 6 of CP12/23 were relevant to all third-country branch undertakings, except Swiss general insurers. Two respondents noted the interaction between the Solvency II reforms and the UK-Swiss Direct Insurance Agreement.

6.42 The PRA confirms that different requirements apply to Swiss general insurers, pursuant to the **UK-Swiss Direct Insurance Agreement** These requirements are set out under the Non-Solvency II Firms Sector of the PRA Rulebook. The UK-Swiss Direct Insurance

Agreement is the responsibility of HMT, and the PRA has not commented further in this PS.

Implementation

6.43 The PRA proposed to implement the third-country branch proposals on 31 December 2024, along with the majority of reforms covered by this PS.

6.44 One respondent asked the PRA to consider whether there is a mechanism for implementing the proposals earlier than the end of 2024 to provide benefits to firms as early as possible.

6.45 Having considered this response, the PRA confirms that the implementation date for the near-final rules is 31 December 2024, due to the dependency on changes to branch capital reporting requirements which are scheduled for implementation on the same date.

Cost benefit analysis

6.46 Within Chapter 6 of CP12/23, the PRA set out the costs and benefits of its proposal to remove branch capital requirements, the requirement to establish a branch risk margin, and the requirement to hold assets in the UK to cover the branch SCR.

6.47 One respondent suggested that in addition to the costs and benefits set out in Chapter 6 of CP12/23, there would also be a one-off implementation cost and ongoing costs of the additional annual reporting requirements that the PRA is proposing for third-country branches.

6.48 The PRA clarifies that the costs and benefits of the additional reporting requirements proposed for third-country branches were set out in the cost benefit analysis section of Chapter 7 of CP12/23.

Glossary

6.49 As part of Chapter 6 of CP12/23, the PRA proposed to amend the definition of 'third country insurance undertaking' and 'third country reinsurance undertaking' to remove references to Solvency II Directive, in light of the UK's withdrawal from the EU.

6.50 One respondent noted that, under the UK's approach, a reinsurance undertaking is considered to be a type of insurance undertaking, which differs from the approach taken in the Solvency II Directive, whereby an insurance undertaking only encompasses direct insurance. Consequently, the respondent suggested that the definition of 'third country reinsurance undertaking' could be amended so that is becomes an extension of the definition

of 'third country insurance undertaking', rather than repeating certain details. Related to this, the respondent further suggested that the text throughout the PRA Rulebook could be simplified at various points, by deleting references to 'reinsurance undertaking'.

6.51 Having considered this response, the PRA has decided not to update the PRA Rulebook in line with the suggestions. The PRA considers that the necessary amendments were made to the PRA Rulebook to effect the reforms as proposed in CP12/23; however, it may consider the points raised as part of any future amendments to the PRA Rulebook, given that it would be easier to complete once the finalised PRA Rulebook amendments resulting from the Solvency II reforms have been published.

Policyholder protection

6.52 The PRA proposed to remove the requirement for third-country branches to calculate and report branch capital requirements, and consequentially remove the requirement to hold assets in the UK to cover the SCR and the requirement to establish a branch risk margin. The PRA noted that as part of its existing third-country branch regime, it expects the whole entity to meet Threshold Conditions, as well as relevant PRA rules and have sufficient financial resources. It further noted that it expects third-country branches to comply with the Branch Guidelines that are relevant to them.

6.53 One respondent noted that these proposals do not add to security for policyholders, and queried how the PRA ensures that its expectations are met so that policyholders are adequately protected.

6.54 The PRA considers that the branch capital requirements, and the branch risk margin, offer limited protection for branch policyholders beyond entity-level regulatory requirements. The PRA therefore considers that the proposals represent a proportionate approach to policyholder protection given that a branch cannot fail independently of the third-country insurance undertaking. Furthermore, branch capital requirements do not guarantee policyholder protection in a winding-up scenario given that assets held in the UK to cover the SCR are not ring-fenced. Consequently, the PRA considers that the removal of these requirements allows it to continue to advance its primary objectives, while also facilitating competition and competitiveness of UK markets.

6.55 The PRA confirms that there are several safeguards within its third-country branch regime to ensure adequate policyholder protection, including requiring third-country branch undertakings to have adequate worldwide financial resources in accordance with Third Country Branches 13.1, and being satisfied that UK policyholders are given the appropriate priority in a winding-up scenario.

6.56 Moreover, the PRA recently consulted on a draft statement of policy (SoP) – **The PRA's approach to insurance branch authorisation and supervision** regarding its overall approach to third-country insurance branches, including how it supervises third-country branches on an ongoing basis.[29] The **PRA's approach to insurance supervision** document further sets out the PRA's approach more generally.

Financial stability

6.57 The PRA noted that the existing safeguards in its third-country branch regime constitute an appropriate level of oversight for the PRA to assess a firm's risk to financial stability in the UK.

6.58 One respondent requested that the PRA clarifies how it assesses these risks.

6.59 The PRA confirms that it considers several factors, as set out in SS2/18, including the significance of the UK operations of the third-country branch compared to the amount of business within other jurisdictions, the availability of substitute products that would offer a policyholder a similar level of protection, and the level of connectivity of a branch in the industry it operates in.

Legal entity valuation

6.60 The PRA noted that the proposals in Chapter 6 of CP12/23 would continue to advance firm safety and soundness, given that the valuation of the legal entity's assets and liabilities (including those of the branch) would be carried out at the level of the third-country undertaking, which the PRA needs to be satisfied is based in a broadly equivalent regime.

6.61 One respondent suggested that valuation at the legal entity level does not make sense given that capital adequacy relies on client monies and policyholder interests being adequately protected, such that they remain intact even after the firm has failed. The respondent suggested that the PRA should operate as if there were no supervision overseas, given that valuations and liabilities are a complex area.

6.62 The PRA clarifies that its supervisory powers reflect the differences in how a firm is structured; insurance subsidiaries are subject to the PRA's solo insurance regime given that they are separate legal entities from the parent. In contrast, third-country branches form part of the legal entity headquartered abroad. This means that responsibilities for the prudential supervision of branches are split between the supervisor where the insurer is headquartered (the home supervisor) and the PRA (the host supervisor).

6.63 As set out in SS2/18, when considering applications for authorisation as a third-country branch, the PRA needs to be satisfied that the third-country branch undertaking is capable of being effectively supervised by the home supervisor. The methods that the PRA uses to

assess this are discussed in the newly proposed SoP, as consulted on within CP21/23 – **The PRA's approach to authorisation and supervision of third-country insurance branches**. The PRA is currently considering responses to this consultation.

6.64 The PRA considers that the safeguards in its approach to authorising and supervising third-country branches advances the PRA's safety and soundness and policyholder protection objectives. For example, as set out in SS2/18, when considering applications for a third-country branch, the PRA needs to be satisfied that the home prudential regime is broadly equivalent to the UK, and this includes assessing whether UK policyholders of the firm will be given an appropriate priority in an insolvency. Furthermore, third-country branch undertakings must comply with Investments 3.1 of the PRA Rulebook which specifies that assets must be invested in the best interests of policyholders, and as set out in SS44/15, only those assets that are available to pay the claims of branch policyholders in the event of a winding-up should be included in the calculation of branch assets.

Availability of capital

6.65 The PRA proposed to remove branch capital requirements given that third-country insurance undertakings are required to adhere to home state prudential requirements, and as such, the PRA considered it was not proportionate to continue to impose separate capital requirements on the branch, particularly as it cannot fail independently of the legal entity. The PRA further noted that the primary safeguard for protecting policyholders from being treated less preferentially in a winding-up scenario is the PRA's approach to branch authorisation, including assessing whether the home jurisdiction's prudential regime is broadly equivalent.

6.66 One respondent noted that vicarious liability of the head office is now accepted in many jurisdictions, and any capital that exists overseas is irrelevant if that reserved capital cannot be accessed; therefore, the only capital that can be taken into account is that which is accessible in the UK.

6.67 The PRA confirms that, as set out in SS44/15 – **Solvency II: third-country insurance and pure reinsurance branches**, only those assets that are 'available' to pay the claims of branch policyholders in the event of a winding-up should be included in the calculation of branch assets. Furthermore, the PRA considers that branch capital requirements do not guarantee policyholder protection in a winding-up scenario given that assets held in the UK to cover the SCR are not ring-fenced.

6.68 The PRA further considers that it is important to consider the capital adequacy of the whole undertaking, given that the third-country branch cannot fail independently. As such, in accordance with Third Country Branches 13.1, third-country branch undertakings are required to have adequate worldwide financial resources. Furthermore, the PRA considers

that its proposal to introduce the new legal entity reporting template, as set out in Chapter 7 of CP12/23, would provide it with an appropriate understanding of the adequacy of the whole entity's financial resources.

Winding-up process

6.69 The PRA noted that the primary safeguard for protecting policyholders from being treated less preferentially in a winding-up scenario is the PRA's approach to branch authorisation, including assessing whether the home jurisdiction's prudential regime is broadly equivalent.

6.70 One respondent noted that bankruptcy laws differ by jurisdiction, and often, those appointed for administration are only interested in recovering assets in their own territory. The respondent further noted that the PRA does not feature in the winding-up process and so a broadly equivalent prudential regime should not be a factor; instead, if authorisation and supervision of branches is successful, policyholder interests will be protected from the failure of the insurer.

6.71 The PRA notes that bankruptcy laws can differ by jurisdiction. However, it considers that there are adequate safeguards in place in its policy approach to maintain policyholder protection. For example, when considering whether to authorise a branch, the PRA must be satisfied that UK policyholders will receive the appropriate priority in a winding-up scenario. Furthermore, as set out in SS44/15, only those assets that are available to pay branch policyholders in a winding-up scenario should be included in the calculation of branch assets. Lastly, within Chapter 7 of CP12/23, the PRA proposed to retain the requirement for third-country branch undertakings to triennially submit a narrative report analysing how the home jurisdiction's winding-up laws apply to the firm. The PRA considers that this would continue to give it appropriate oversight of any significant developments regarding how UK policyholders would be treated in the event of a failure.

Out of scope responses

6.72 The PRA received general comments from respondents that did not directly relate to the proposals in Chapter 6 of CP12/23:

- one respondent questioned the scope of the FSCS;
- one respondent suggested that the availability of the PRA's modification by consent (MbC) for reporting non-UK risks highlights a lack of clarity on the branch perimeter; and
- one respondent noted their understanding that the Bank of England may be planning to convert foreign banks operating as branches in the UK into subsidiaries, and that this may give rise to a potential inconsistency in treatment of insurance and banking branches.

6.73 The PRA has not provided feedback given that these comments do not directly relate to the proposals but may consider them as part of future policy development.

6.74 One respondent noted that the use of the term ‘policyholder’ in paragraphs 3.3 and 6.7 of SS44/15 suggests that the PRA expects reinsurance claims of third-country branch undertakings to have priority over general creditors, and thus queried the use of the term given that this is not the case under UK legislation. Another noted that policyholders are those with claims on the legal entity, and that capital securing policyholders ought to be considered as client assets.

6.75 While this comment is out of scope, the PRA considers it helpful to confirm that policyholders are those with direct claims under a contract of insurance, and that it does not expect reinsurance claims of third-country branch undertakings to have priority over general insurance creditors, in accordance with the Insurers (Reorganisation and Winding Up) Regulations 2004. The PRA may consider amending paragraph 3.3 of SS44/15 as part of future policy development.

6.76 One respondent asked the PRA to confirm that there will be no expectation for EEA subsidiaries of UK groups to comply with Solvency UK, and that they will be permitted to consolidate into the group’s balance sheet using their current methodology. The PRA has provided feedback in Chapter 5 (Group SCR) of this PS (see paragraph 5.55).

Reporting

6.77 Within the responses to Chapter 6 of CP12/23, the PRA received several comments that related to the proposals in Chapter 7 of CP12/23. Feedback to these responses will be provided in PS3/24 – Review of Solvency II: Reporting and disclosure (Phase 2), due to be published later in February 2024.

7: Mobilisation

Introduction

7.1 This chapter provides feedback to responses relating to the proposals in Chapter 8 (Mobilisation) of CP12/23. It also covers the transfer and restatement of Articles 248 to 253 of the **onshored Commission Delegated Regulation (EU) 2015/35** (SII CDR) into the PRA Rulebook, resulting in:

- amendments to the Minimum Capital Requirement Part of the PRA Rulebook; and
- amendments to the Composites Part of the PRA Rulebook.

7.2 In Chapter 8 of CP12/23, the PRA proposed to introduce an optional mobilisation stage for new insurers with the aim of facilitating entry into UK insurance markets.

7.3 Under the proposals in the chapter, mobilisation would be an optional stage for up to 12 months, beginning at the point of authorisation, during which a new firm would operate with business restrictions while it completes the final aspects of its development. The PRA would apply proportionate regulatory requirements to firms that choose to go through a mobilisation stage, which includes a proposal to lower the absolute floor to the Minimum Capital Requirement (MCR floor) to £1 million for the purpose of mobilisation.

7.4 To ensure it can modify rules to lower the MCR floor for firms choosing mobilisation, the PRA included, as part of its mobilisation proposals, the transfer and restatement of Articles 248 to 253 of the onshored SII CDR into the PRA Rulebook.

7.5 The PRA has considered the feedback to responses relating to Chapter 8 of CP12/23 with the Financial Conduct Authority (FCA). Any firm that wants to be an insurer (which includes the activities of effecting contracts of insurance or carrying out contracts of insurance) must have PRA authorisation. The PRA may only agree to authorise a firm if the FCA has provided its consent for the firm to be authorised. With respect to mobilisation, key assessments and decisions will also be taken jointly with the FCA.

7.6 The PRA received 12 responses to Chapter 8 of CP12/23. The respondents broadly supported the PRA's proposals to establish a mobilisation stage for new insurers, including the proposal to lower the MCR floor for firms entering mobilisation. Some respondents suggested changes to the restrictions on business during mobilisation, to the length of the mobilisation stage, or to the minimum expectations for firms in mobilisation. Five respondents had no comments on the proposals.

7.7 The PRA received some responses that did not relate directly to the draft policy under consultation. As explained in Chapter 1 of this PS, the PRA has not provided feedback to these responses but may consider the points raised in further policy development.

Changes to draft policy

7.8 The PRA has not made any changes to the draft rules it consulted on within Chapter 8 of CP12/23. The PRA has provided further comments on the responses to the draft policy in the 'Feedback to responses' section below.

Implementation

7.9 The PRA will publish information and guidance on the mobilisation regime, which will reflect the approach set out in this policy statement (PS), by 31 December 2024.

Feedback to responses

7.10 The PRA has considered the responses received to Chapter 8 of CP12/23. Feedback to the responses has been grouped as follows:

- mobilisation restrictions;
- the length of the mobilisation stage;
- expectations and requirements during mobilisation; and
- other responses.

Mobilisation restrictions

7.11 The PRA proposed that in order to manage the additional risks posed by a mobilisation phase, it would restrict the nature, scale, and complexity of business that firms can write during the mobilisation stage using its powers under Part 4A of FSMA (mobilisation restrictions). The PRA said it would consider the precise details of these mobilisation restrictions on a case-by-case basis, but that firms would generally only be permitted to write policies that cover short-term and short-tail risks and produce a cumulative net exposure below a maximum limit set individually for firms. CP12/23 included an example of a starting position for the mobilisation restrictions, whereby firms would be limited to effecting contracts of insurance to the extent that:

- after effecting the contract, the firm's total net exposure remains below an aggregate sum insured/assured of £50,000;
- the contracts are short-term, with a maximum policy term of two years; and
- only policies on a 'claims-made' basis, and no liability insurance, are permitted, such that firms are not exposed to large or long-tail risks in respect of potential claims.

7.12 Three respondents suggested the PRA should consider implementing the mobilisation restrictions differently, so that firms are able to write a greater variety and volume of business during the mobilisation stage. One respondent said the restrictions, particularly the two-year policy term limit, would be unsuitable for long-term insurers and could not be overcome by heavy use of reinsurance. Another respondent said that restricting firms to effecting policies on a 'claims-made' basis would prevent firms from issuing most personal line products. The respondents said the restrictions would detract from the appeal of the mobilisation stage, and suggested the PRA should be more flexible with its framework.

7.13 The PRA has decided not to modify its draft policy after considering these responses. As stated in CP12/23, the PRA will consider the precise details of individual mobilisation restrictions on a case-by-case basis. The purpose of these restrictions will be to ensure that firms do not write a material amount of business during mobilisation, if any, and only write policies that expose them to short-term or short-tail risks, or that would result in a very limited

overall potential net exposure. The PRA considers this approach to be appropriate given that firms will be entering mobilisation at an earlier stage in their development, before they have full operational capabilities, and will therefore pose greater potential risks to the PRA's policyholder protection objective during this phase. The PRA would not expect the restrictions to prevent firms from applying for authorisation through mobilisation, regardless of whether their business after mobilisation will focus on long-term or general insurance, but all applicants should recognise that they would not be growing their business in terms of written policies during the mobilisation stage. Notwithstanding the impact of the restrictions, the PRA considers that mobilisation would benefit new entrants by enabling them to finish building out their resources and setting up their operations with the added confidence that comes with an authorisation.

7.14 One respondent said the PRA should exclude firms from having exposures to complex products and derivatives during the mobilisation stage.

7.15 After considering this response, the PRA has decided not to modify its draft policy. The PRA expects that firms would be prevented from writing complex insurance business during mobilisation, as a result of the mobilisation restrictions described in CP12/23. The PRA also notes that firms will need to comply with the Prudent Person Principle (PPP) during mobilisation, as set out in the Investments Part of the PRA Rulebook. The PPP requires firms to properly identify, measure, monitor, manage, control and report on the risks of the assets they invest in, and to take appropriate account of these risks in the assessment of their overall solvency needs. Firms must also invest in assets that are appropriate to the nature and duration of their insurance liabilities and, if investment risks are not borne by policyholders, the PPP requires that firms should avoid investing in derivatives and quasi-derivatives and should pursue prudent diversification in line with other conditions set out in Investments 5.2.

The length of the mobilisation stage

7.16 The PRA proposed that mobilisation could last up to 12 months, though firms can exit sooner if they meet all the relevant requirements.

7.17 Three respondents suggested the PRA should allow the mobilisation stage to last longer than 12 months. One respondent questioned whether 12 months was long enough for firms to finish building out their business and noted there were similar start-up schemes that give firms three years to demonstrate they can meet full regulatory requirements. Another respondent said the PRA should allow firms in mobilisation to execute well-defined business plans over a longer period, rather than requiring firms to meet certain requirements within precise timeframes. A third respondent said the PRA should be flexible by allowing mobilisation to last longer than a year where new entrants demonstrate good progress but cannot meet a hard 12-month deadline.

7.18 After considering these responses, the PRA has decided not to modify its draft policy. Generally, the PRA considers that it is reasonable to expect that firms spend no longer than 12 months in mobilisation, given that applicants should only have a short list of activities they need to complete before they can meet full regulatory requirements. The proposed 12month mobilisation period is also consistent with the mobilisation period for banks, which has been in effect since 2013. However, the PRA understands that there may be some limited circumstances that are truly beyond a new insurer's control that may have a bearing on their ability to exit mobilisation within the 12-month period. New insurers in mobilisation should therefore discuss with the PRA and the FCA at the earliest opportunity if they believe there are exceptional circumstances which mean they may not meet this timeline, bearing in mind that the PRA and the FCA will not normally allow new insurers to remain in mobilisation beyond a 12-month period.

Expectations and requirements during mobilisation

7.19 The PRA proposed to lower the MCR floor to £1 million for firms during the mobilisation stage, noting that it would be appropriate considering the restricted nature, scale and complexity of firms in mobilisation.[30] The PRA did not propose any further changes to capital requirements in mobilisation.

7.20 One respondent said that a £1 million MCR floor could still represent a significant investment for new insurers. The respondent said the PRA should set the level of the MCR floor on a case-by-case basis, following a careful assessment of the risk of each applicant's proposed business model. Where a firm applying for mobilisation is simple and presents a low risk, the respondent suggested the PRA could apply a MCR floor below £1 million. Similarly, where the applicant is more complex and poses a higher risk, the PRA could set the MCR above £1 million.

7.21 The PRA has decided not to modify its draft policy after considering this response. The PRA notes that all firms should present a low risk to policyholders during mobilisation, due to the restrictions on their business. The PRA expects that an MCR floor of £1 million will ensure that capital demands are low enough to benefit firms in mobilisation, while also being high enough to ensure that firms have a realistic prospect of meeting regulatory requirements for their proposed business models within 12 months. Fixing the MCR floor at £1 million also guarantees consistency in the mobilisation framework, improving transparency for prospective applicants.

7.22 One respondent said the PRA should offer more flexibility to new entrants over the types of capital that are eligible to meet regulatory requirements. For instance, the respondent said it would be helpful if the PRA allowed start-ups to meet regulatory capital requirements in the

early stages of their development using financing arrangements provided through venture capital. The PRA could then allow firms to adapt over time to meet capital eligibility requirements.

7.23 The PRA has decided not to modify its draft policy after considering this response. Rather than relaxing capital eligibility requirements, the PRA proposed in CP12/23 to lower the MCR floor to support new firms with capital demands during the early stages of their development. However, the PRA considers it is important for firms in mobilisation to meet these lower capital requirements with a sufficient quality of capital, particularly given that firms in mobilisation may be at a higher risk of failure than more established firms.

7.24 Table 4 of CP12/23 described the minimum expectations for firms in mobilisation and explained that the PRA may have different expectations depending on a firm's proposed business model. CP12/23 also confirmed that firms would be required to meet any FCA expectations in this area.

7.25 One respondent said the minimum expectations for mobilisation set out in Table 4 were broadly the same as the existing requirements for newly authorised insurers. The respondent noted that applicants would need to weigh up the benefits of any simplifications provided against the added expectation of producing a mobilisation plan. The respondent also said the lower MCR floor would be more beneficial for firms if they were able to write a more material amount of business in mobilisation.

7.26 The PRA has decided not to modify its draft policy after considering this response. The PRA considers that restrictions on the amount of business permitted during mobilisation decrease the risks that firms can pose to the advancement of the PRA's objectives and enable the PRA to adapt regulatory expectations accordingly. The PRA expects that a lower MCR floor would be beneficial for firms during mobilisation. In addition, the PRA's other expectations would be more proportionate, and therefore more beneficial, for firms that choose the mobilisation route. For example:

- the PRA might only expect firms to have key 'guiding minds' at the point of authorisation, rather than having all key senior management staff in place; or
- in relation to risk management structures or IT infrastructure, the PRA might expect firms to have near-final frameworks or plans for implementation at the point of authorisation, rather than having fully developed systems in place.

The PRA would not generally consider it appropriate to modify its expectations further, given that firms should only be using mobilisation to complete the final stages of their development and should therefore be able to demonstrate at the point of authorisation that they are able to meet minimum regulatory requirements. The proposed approach in Table 4 is also largely consistent with the approach taken for banks entering a mobilisation stage.

7.27 One respondent commented that the PRA should take a more flexible approach towards new firms, as this would be more beneficial than any of the individual proposals set out in Chapter 8 of CP12/23. Specifically, the respondent suggested the PRA should consider waiving the application of an insurance holding company definition for new entrants in accordance with the approach confirmed in PS6/22. The respondent said the PRA should provide further guidance to firms in circumstances where they cannot take a flexible approach within its authorisation framework.

7.28 The PRA has decided not to modify its draft policy after considering this response. The PRA seeks to take a flexible and proportionate approach to regulating insurers, subject to ensuring its policies are consistent and transparent, and continue to advance its objectives. Firms can apply to the PRA to request a waiver or modification to aspects of the insurance holding company definition, in line with the approach confirmed in **PS6/22** and set out in **supervisory statement 9/15**. The PRA will assess these applications on a case-by-case basis, in accordance with the usual statutory tests. Firms can access detailed guidance about the PRA's approach to new firms on the **webpage for the New Insurer Start-Up Unit** (NISU), which forms part of the PRA's work to improve and streamline the authorisation process. As noted in paragraph 7.9, the PRA will also publish information and guidance about mobilisation on its website. The PRA also welcomes discussions with potential new applicants considering applying for authorisation and/or use of the mobilisation phase.

7.29 One respondent suggested firms may require extra resources to satisfy regulatory requirements during mobilisation, which could put further strain on their capital position and impact their ability to attract staff.

7.30 The PRA has decided not to modify its draft policy after considering this response. As set out in CP12/23, the PRA would expect regulatory requirements to remain proportionate for firms in mobilisation, considering the restrictions on their business. Noting that new firms may face challenges while completing the build out of their business in mobilisation, the PRA would encourage firms to include appropriate levels of contingency in their plans.

Other responses

7.31 The PRA did not propose any specific measures in CP12/23 relating to disclosures about firms entering a mobilisation stage.

7.32 One respondent encouraged the PRA to report on the number of firms entering mobilisation each year.

7.33 The PRA considers that this response relates more broadly to the PRA's policy on disclosures, rather than the specific proposals for the mobilisation regime set out in Chapter 8 of CP12/23. The PRA is currently consulting on a range of operational metrics relating to the

PRA's new competitiveness and growth objective, and these include **proposed metrics relating to applications for new firm authorisations**.

7.34 The PRA proposed to transfer and restate Articles 248 to 253 of the SII CDR into the PRA Rulebook to ensure it can modify the rules to lower the MCR floor for firms in mobilisation. At the point of transfer, the PRA proposed to remove a reference in existing rules to the MCR being calibrated at an 85% confidence level over a one-year period because it would be redundant following the proposed transfer and restatement of the full MCR calculation. However, to ensure it is clear there is no change in the intended calibration of the MCR, the PRA proposed to insert a reference to the 85% confidence level within the glossary definition of the MCR in the PRA Rulebook.

7.35 One respondent questioned the value of retaining a reference to the 85% confidence level within the glossary definition of the MCR because it is only a design aim for the prescribed MCR formula. The respondent said the proposed rules would not require a reference to the 85% confidence level, given the rules would include the MCR formula itself.

7.36 The PRA acknowledges that firms are required to follow the prescribed MCR formula when calculating the MCR, meaning the proposed rules would arguably be sufficient without a reference to the 85% confidence level underlying the design of the formula. However, the PRA considers that the 85% confidence level provides important additional transparency and clarity about the intended purpose and calibration of the capital requirement. As noted in CP12/23, the PRA also considers that maintaining the reference to the 85% confidence level contributes to a sense of continuity in MCR requirements following the transfer and restatement of the relevant SII CDR Articles into the PRA Rulebook. Therefore, the PRA has decided not to change its draft policy after considering this response.

7.37 The PRA said it considered that its mobilisation proposals could have a positive impact on sustainable economic growth in the UK by improving ease of entry, which may increase the number of insurers operating in UK insurance markets and promote competition.

7.38 One respondent suggested the PRA should develop measures to facilitate entry for new insurers, but that such measures should not continue once firms have entered insurance markets, because facilitating growth is not necessary for public protection.

7.39 The PRA is required to have regard to a number of factors when developing new policy, including the FSMA regulatory principles and aspects of the government's economic policy, which includes the need to facilitate sustainable economic growth, and growth in the interests of consumers and business. The PRA also has a secondary objective relating to the UK's competitiveness and growth, which it considers alongside its primary objectives on safety and

soundness and policyholder protection. As explained in CP12/23, the PRA considers that its mobilisation proposals could have a positive impact on growth while continuing to advance the PRA's primary objectives.

8: Thresholds

Introduction

8.1 This chapter provides feedback to responses relating to the proposals in Chapter 9 (Thresholds) of CP12/23. It also contains the PRA's final policy through amendments to the Insurance General Application Part of the PRA Rulebook (Appendix 2).

8.2 In Chapter 9 of CP12/23, the PRA proposed to increase two of the Solvency II thresholds that determine whether a firm is regulated under Solvency II or the non-Directive firm (NDF) sector rules (the 'Solvency II thresholds'). The PRA proposed to increase the following thresholds and redenominate them from EUR to GBP:

- a firm's gross written premium income — the threshold would change in the PRA Rulebook from €5 million to £15 million; and
- firm and group technical provisions — the thresholds would change in the PRA Rulebook from €25 million to £50 million.

8.3 The PRA did not propose changes to the other thresholds, or any other rules, in Insurance General Application 2.3, except to redenominate the thresholds for reinsurance operations from EUR to GBP in line with the proposals set out in Chapter 10 (Currency redenomination) of CP12/23.

8.4 The PRA received 16 responses to Chapter 9 of CP12/23. Respondents generally welcomed the proposals to increase the Solvency II thresholds relating to size, but several respondents requested further changes or increases in the Solvency II thresholds and one respondent suggested the PRA consider leaving the size thresholds at their current levels. Five respondents had no comments on the proposals.

8.5 The PRA received some responses that did not relate directly to the draft policy under consultation. As explained in Chapter 1 of this Policy Statement (PS), the PRA has not provided feedback to these responses but may consider the points raised in further policy development.

Changes to draft policy

8.6 After considering responses to Chapter 9 of CP12/23, the PRA has decided to make changes to draft policy, which will be reflected in the near-final rules relating to the Solvency II thresholds.

8.7 The PRA has increased the threshold relating to gross written premium income to £25 million, which is a further increase of £10 million compared with the CP12/23 proposals. It has increased the technical provisions thresholds to £50 million, in line with the CP12/23 proposals.

8.8 The PRA has increased the Solvency II thresholds for reinsurance operations described at Insurance General Application 2.3(5)(a). The changes mean that a firm will be subject to Solvency II if its business includes reinsurance operations exceeding £2.5 million of its gross written premium income, or £5 million of its gross technical provisions rather than £530,000 or £2.4 million, respectively, as proposed in CP12/23.

8.9 Further details on the changes to draft policy, as well as an assessment of their impact, are set out in the 'Feedback to responses' section below.

Implementation

8.10 In accordance with Insurance General Application 2.6, firms would only be exempted from Solvency II at the point of implementation if they have not exceeded any of the revised Solvency II thresholds for three consecutive years and do not expect to exceed any of the Solvency II thresholds in the following five years.

8.11 If a firm has fallen out of scope of Solvency II, it will be subject to the prudential regime for non-Directive firms without the need for an application to the PRA. However, the PRA encourages firms to notify their supervisors of any expected change in their status as a Solvency II or non-Directive firm. As explained in CP12/23, new and existing firms that do not exceed the thresholds described in this PS will be able to apply for a voluntary requirement (VREQ) to operate within Solvency II if they prefer.

8.12 Some respondents requested additional measures to increase the proportionality of the prudential rules applicable to small insurers, in addition to the higher thresholds and streamlined reporting requirements proposed as part of the Solvency II Review. After implementing the Solvency II Review, the PRA may consider further measures to increase the proportionality of the regime for smaller insurers, following similar efforts to simplify the prudential framework for smaller banks and building societies.[31]

Feedback to responses

8.13 The PRA has considered the responses received to Chapter 9 of CP12/23. Feedback to the responses has been grouped as follows:

- Solvency II thresholds relating to size;
- Solvency II thresholds relating to types of business; and
- Other responses.

8.14 Where decisions have resulted in significant changes to the draft policy, the PRA has provided an updated cost benefit analysis (CBA) and statement of the impact on mutuals below, along with an explanation for why the PRA considers the final policy is compatible with its objectives and have regards.

Solvency II thresholds relating to size

8.15 The PRA proposed to increase, and redenominate from EUR to GBP, the threshold relating to gross written premium income in the PRA Rulebook from €5 million to £15 million, and to increase the threshold relating to firm and group technical provisions in the PRA Rulebook from €25 million to £50 million. Firms that do not meet the Solvency II thresholds are able to operate under the NDF sector rules, which are generally characterised by simpler regulatory requirements — including simpler capital standards, reporting forms, and governance requirements.

8.16 One respondent said the PRA should increase the thresholds for entry into Solvency II by a much greater margin than proposed in CP12/23. The respondent presented evidence about the expected impact of increasing the size thresholds further, asserting that more than 99% of UK insurance activity would remain in scope of Solvency II under a range of alternative calibrations for the thresholds. The respondent said the percentage of insurance activity covered by Solvency II was lower in the EU. The respondent also queried whether the PRA had specific concerns about closed book firms, based on their amount of assets rather than their premium income. Conversely, another respondent said that increasing the thresholds would weaken the quality of publicly available data on the insurance sector by enabling firms to move outside of Solvency II, which has greater disclosure requirements than the NDF sector rules. The same respondent said the PRA should take account of the impact of previous changes in the level of the thresholds when considering its policy.

8.17 Having considered the responses, the PRA has decided to increase the gross written premium income threshold by a further £10 million compared with the CP12/23 proposals, to £25 million, while maintaining the technical provisions thresholds at £50 million, as set out in CP12/23. The PRA considers that – while the Solvency II size thresholds complement one another – the thresholds for technical provisions are a better indicator of the potential risks to

the PRA's primary objectives of safety and soundness than the gross written premium threshold, because technical provisions measure the overall amount required by insurers to settle obligations towards policyholders. Gross written premium income is a simpler measure based on annual premiums written in any one year, which may be a more volatile measure and which may not always correspond to the aggregate risks posed by firms. On this basis, and after considering the evidence provided in response to CP12/23, the PRA considers that raising the gross written premium income threshold by a further increment and maintaining the increase in the technical provisions threshold in line with the CP12/23 proposals, could result in a more proportionate application of Solvency II without increasing materially the risks to the PRA's primary objectives. The PRA also considers that its final policy will further support the PRA's secondary objectives, as they relate to competition and UK growth in the medium to long term, by enabling smaller firms to write more business under relatively simpler prudential rules, which may be more proportionate for them considering their size.

8.18 The PRA expects that the changes to draft policy will give more small firms the option of operating under the NDF sector rules. As highlighted in CP12/23, the PRA notes that there are potential risks associated with giving larger firms the option of operating outside of Solvency II, because of the simpler prudential regulation and generally lower capital standards applicable under the NDF sector rules compared with Solvency II. The PRA considers that enabling firms with higher premium income, rather than higher technical provisions, to move out of Solvency II, will still advance its primary objectives because the risks to safety and soundness and policyholder protection are not materially higher from the final policy compared with the risks from the proposals in CP12/23.

8.19 As noted above, the PRA has made these changes after considering the evidence in support of a further rebalancing of the Solvency II thresholds beyond the changes proposed in CP12/23. However, the PRA considers that further increases to the gross written premium income threshold beyond these levels, or increasing the technical provisions thresholds beyond the levels set out in CP12/23, could increase the risks to the PRA's primary objectives on safety and soundness and policyholder protection and result in a disproportionate application of prudential rules generally intended only for the smallest UK firms. This is because the PRA considers that firms with more than £50 million in technical provisions or £25 million in gross written premium income are large enough to warrant closer regulatory scrutiny than is possible under the current NDF regime.

8.20 In line with one respondent's comments, the PRA acknowledges that a broader application of Solvency II is generally beneficial for the quality of data available on the UK insurance industry. Though the final policy will enable a greater number of firms to operate outside of Solvency II, the PRA does not expect that the changes will lead to a significant deterioration in data coverage — given the NDF sector will continue to represent a relatively

small proportion of the overall UK insurance market. The PRA also notes that key accounting and balance sheet metrics, including on premium income and asset size, will continue to be available for NDFs on a comparable statistical basis to Solvency II.

8.21 In CP12/23, the PRA assessed the impact of its proposals to increase the Solvency II thresholds relating to size compared with leaving them unchanged in line with the current Solvency II rules and legislation. The CBA concluded that the proposals would give nine more firms an option to operate under the NDF sector rules, accounting for about £77 million in annual gross written premiums for life and non-life business at year end 2021 and £53 million in technical provisions. Using the same baseline, the PRA expects that its final policy will give a total of about 15 firms an option to move out of Solvency II, accounting for about £187 million in annual gross written premiums for life and non-life business at year end 2021 and £86 million in technical provisions. The firms would be excluded from Solvency II based on their premium income and technical provisions. The PRA did not consider asset size in its analysis, given that asset size does not feature as part of the thresholds described at Insurance General Application 2.2.

8.22 The PRA considers that there would be no material change to the costs and benefits of the final policy compared with those identified in the CBA for the draft proposals in Chapter 9 of CP12/23. The PRA expects there may be slightly larger benefits from the final policy because NDFs will have an opportunity to grow and increase their premium income further within a proportionate prudential regime characterised by generally lower compliance costs. The PRA also expects that the costs may be slightly higher in respect of the risk to policyholders from enabling small firms to carry out more business under the NDF sector rules, through expansion of the scope of a prudential regime designed to apply only to the smallest UK firms at the point of implementation in 2016. However, as noted above, the PRA considers that these risks are limited by its decision to limit the increase in the gross premium income threshold to a further £10 million and to maintain the technical provisions thresholds in line with the proposals in CP12/23. There would also be no change to the current levels of protection provided for policyholders by Financial Services Compensation Scheme.

8.23 The PRA considers that the factors set out in Chapter 9 of CP12/23 on how it had regard to developing the proposals, remain the most relevant matters in relation to the final policy on the size thresholds. In particular, the have regards analysis in Chapter 9 of C12/23 relating to proportionality, competitiveness, growth in the interests of consumers and businesses, smart regulatory reform, and sustainable growth remain the most significant when considering these changes.

8.24 The PRA considers that the changes to draft policy will not have a significantly different impact on mutuals compared with non-mutuals. As stated in CP12/23, the PRA considers that mutuals are more likely than non-mutuals to fall below the final Solvency II thresholds and

therefore benefit from greater flexibility in future about whether to adopt the NDF regime, given that more than half of small firms operating near the thresholds are mutuals.

Solvency II thresholds relating to types of business

8.25 The PRA proposed to redenominate the thresholds for reinsurance operations described at Insurance General Application 2.3(5)(a) from EUR to GBP, in line with the proposals set out in Chapter 10 of CP12/23.

8.26 One respondent said that, rather than just redenominating the thresholds as proposed in CP12/23, the PRA should increase the thresholds for reinsurance operations so that the thresholds remain in line with increases in the Solvency II thresholds relating to the overall size of a firm.

8.27 Having considered the response, the PRA has decided to increase the thresholds for reinsurance operations in line with increases in the size thresholds, as set out in the section on 'changes to draft policy'. The changes mean that a firm will be subject to Solvency II if its business includes reinsurance operations exceeding £2.5 million of its gross written premium income, or £5 million of its technical provisions — rather than £530,000 or £2.4 million, respectively, as proposed in CP12/23. The PRA did not propose any significant changes to the reinsurance thresholds as part of CP12/23. However, the PRA agrees with the respondent and considers that the thresholds for reinsurance operations should retain the calibration they originally had under Solvency II legislation, such that an NDF of any size is permitted to accept reinsurance for up to 10% of its overall business, as expressed in terms of gross written premium income and technical provisions.

8.28 The PRA considers it prudent to continue to restrict the level of reinsurance operations permitted under the NDF sector rules, given the NDF sector rules are not designed to regulate the specific risks that firms take on when accepting reinsurance. However, the PRA does not expect that increasing the thresholds for reinsurance operations will raise the risks to its primary objectives of safety and soundness and policyholder protection, because NDFs will still be limited to only a small amount of accepted reinsurance, capped at 10% of their overall business in terms of size.

8.29 The PRA assessed in CP12/23 that its draft proposals to increase the Solvency II thresholds relating to size would enable nine more firms to operate under the NDF sector rules. As noted above, the PRA expects its final policy on the size thresholds will enable 15 more firms to become NDFs. The changes to the draft policy on the thresholds for reinsurance operations will not have any further impact on the number of firms that will have an option of moving out of Solvency II based on the year end 2021 data used in the CBA for Chapter 9 of CP12/23, although the higher threshold could allow firms more flexibility in the future.

8.30 The PRA considers that the final policy on thresholds for reinsurance operations could benefit small firms because it improves the proportionality of regulation by increasing these thresholds in line with the other increases being made to the size thresholds (that are described above).

8.31 The PRA considers that the factors set out in Chapter 9 of CP12/23 on how the PRA had regard to developing the proposals remain the most relevant matters in relation to the final policy on the thresholds for reinsurance operations. In particular, the have regards analysis in Chapter 9 of C12/23 relating to proportionality remains the most significant when considering these changes.

8.32 Besides the Solvency II thresholds mentioned at paragraph 8.2, the PRA did not propose changes to any of the other Solvency II thresholds in Insurance General Application 2.3.

8.33 Three respondents said the PRA should also consider changing or removing the Solvency II threshold described at Insurance General Application 2.3(5)(b), which requires firms to apply Solvency II if more than 10% of their gross written premium income or technical provisions comes from reinsurance operations. One respondent noted that application of this threshold would require all pure reinsurers to apply Solvency II, which the respondent said was not the case under the current regulation. Another respondent said the threshold is not risk-based and means that new or small insurers could be captured by Solvency II, even if they accept a very small amount of reinsurance. A third respondent noted that, while in run-off, a direct insurer could exceed the 10% threshold if it has accepted reinsurance on longer-running contracts compared with contracts for the rest of its business.

8.34 Having considered the responses, the PRA has decided to maintain the threshold at Insurance General Application 2.3(5)(b), stating that firms must comply with the Solvency II firms sector rules if their reinsurance operations account for 10% or more of their gross written premium income or technical provisions. The PRA did not consult on changes to this threshold because, as stated above, it considers it prudent to restrict the level of reinsurance operations permitted outside of Solvency II given the alternative prudential regime was not designed to regulate the specific risks that firms take on when accepting reinsurance. The PRA also notes that it has decided to increase the thresholds for reinsurance operations in line with increases in the size thresholds, as set out in the section on ‘changes to draft policy’, which may allay some of the specific concerns presented by respondents.

8.35 One respondent said the PRA should consider enabling the Solvency II thresholds to vary according to a firm’s business model, or whether a firm is open to new business or not.

8.36 The PRA has decided not to modify its draft policy after considering this response. The PRA considers that the Solvency II thresholds are already designed to be sensitive to the risks posed by different business models, by restricting levels of accepted reinsurance and excluding certain types of insurance (covering liability, credit, and suretyship risks) from regulation under the NDF sector rules. The PRA also considers that the current rules distinguish between open and closed businesses, given that firms are required to consider the thresholds based on whether they have exceeded any of them for three consecutive years, or whether they expect to exceed any of them in the following five years.

8.37 One respondent said some of the PRA's threshold rules are not risk-based, including the exclusion of any liability, credit, or suretyship business from regulation under NDF sector rules. The respondent suggested the PRA operate with more discretion to disapply different aspects of the thresholds through a less formal process than a modification by consent or a waiver request.

8.38 The PRA has decided not to modify its draft policy after considering this response. The PRA considers that Solvency II is the appropriate regime for regulating risks arising from liability, credit or suretyship business. Regarding the proposal for the PRA to apply a more discretionary approach to disapplying aspects of the thresholds, the PRA notes that it cannot change the application of its rules, including the thresholds, unless it does so via the formal regulatory powers that have been conferred on it through legislation. This is also consistent with FSMA regulatory principles, which require the PRA to exercise its functions as transparently as possible.

Other responses

8.39 One respondent said the PRA should increase the Solvency II thresholds annually in line with inflation.

8.40 Having considered the response, the PRA has decided not to change its draft policy contained in CP12/23. The PRA considers that the thresholds set out in the final policy are appropriate at the current time. The PRA recognises that there may be arguments for some fixed regulatory values in the PRA Rulebook to increase periodically in line with inflation and will consider any further policy in this area after implementing the Solvency II Review.

8.41 One respondent said the PRA would need to produce detailed assessment of what would be required by firms to adopt the NDF sector rules.

8.42 The PRA has decided not to modify its draft policy after considering this response. It is the responsibility of firms to ensure they can understand and comply with the applicable rules in the PRA Rulebook. As noted above, if a firm has fallen out of scope of Solvency II, it will be subject to the NDF sector rules without the need for an application to the PRA, albeit those

firms have the option to continue being supervised under Solvency II. However, the PRA encourages firms to notify their supervisors of any expected change in their status as a Solvency II or non-Directive firm.

8.43 Two respondents said the PRA should consider removing the audit requirement for NDFs or creating an option for the requirement to be waived.

8.44 Having considered the response, the PRA notes that it is beyond the scope of the proposals in Chapter 9 of CP12/23. In this chapter, the PRA proposed changes to the thresholds determining whether a firm is regulated under Solvency II or the NDF sector rules. The PRA did not propose any changes to the applicable rules themselves. As noted in paragraph 8.12, the PRA may consider further measures to improve the proportionality of the regime for smaller insurers after implementing the Solvency II Review, following similar efforts to simplify the prudential framework for smaller banks and building societies.

8.45 One respondent noted that adopting a new prudential regime may require considerable effort and some cost. However, the respondent said there were various reasons why smaller firms might want to move out of Solvency II, including because they would benefit from simpler and more proportionate NDF rules, and they would no longer be treated as Public Interest Entities (PIEs) under UK legislation. Another respondent noted that moving thresholds can create unintended issues for the firms affected.

8.46 The PRA acknowledges that there could be costs from switching to a new prudential regime, but likewise considers that there would also be benefits for smaller firms moving out of Solvency II. Ultimately, this is a trade-off that will need to be made by each of the firms that may be affected, given that they have the option to be supervised under Solvency II if they so choose. The PRA has considered this feedback and has decided not to modify its draft policy. The definition of a PIE is set out in the Companies Act 2006, which cannot be amended by the PRA. Further, the PRA notes that the definition of a PIE in s519A(1)(c) Companies Act 2006 refers to a person who would be an insurance undertaking as defined in Article 2(1) of the Insurance Accounts Directive, as that article had effect immediately before 31 December 2020, and does not directly refer to the PRA's rules, as those may be amended from time to time.

8.47 In CP12/23, the PRA set out that the proposals in Chapter 9 apply to all firms, for the purpose of determining whether they are subject to any of the provisions of the Solvency II firms Sector of the PRA Rulebook.

8.48 One respondent noted that the proposals applied to all firms and asked the PRA to clarify whether third-country branches were always subject to Solvency II, regardless of the size of their businesses.

8.49 The proposals in Chapter 9 of CP12/23 result in amendments to the Solvency II thresholds set out in the Insurance General Application Part, which applies to all firms for the purposes of determining whether they are a UK Solvency II firm.[32] The Third Country Branches Part sets out how the Solvency II firms Sector applies to third-country branch undertakings.

9: Currency redenomination

Introduction

9.1 This chapter provides feedback to responses relating to the proposals in Chapter 10 (Currency redenomination) of CP12/23. It also contains the PRA's near-final policy as follows:

- amendments to the Insurance General Application of the PRA Rulebook (Annex B of Appendix 2);
- amendments to the Minimum Capital Requirement Part of the PRA Rulebook (Annex C of Appendix 2);
- amendments to the Third Country Branches Part of the PRA Rulebook (Annex K of Appendix 2);
- amendments to the Insurance – Supervised Run Off Part of the PRA Rulebook (Annex L of Appendix 2); and
- amendments to the Run-Off Operations Part of the PRA Rulebook (Annex M of Appendix 2).

9.2 In Chapter 10 of CP12/23, the PRA proposed to redenominate monetary values within the Solvency II firms Sector of the PRA Rulebook from EUR to GBP, using the average daily GBP/EUR spot exchange rate covering the 12-month period prior to 31 December 2020. The monetary values that were proposed for redenomination were set out in Table 5 of CP12/23.

9.3 The PRA received 14 responses to Chapter 10 of CP12/23. Six respondents had no comments, while most other respondents welcomed the PRA's proposals. Some respondents made a small number of observations and requests for clarification, which are addressed in the following section of this chapter.

Changes to draft policy

9.4 As a result of comments made by respondents to Chapter 10 of CP12/23, there have been no changes made to the draft policy set out in Chapter 10. Separately, in Chapter 9 (Thresholds) of CP12/23, the PRA intended not to propose an increase to the Solvency II thresholds for reinsurance operations described in Insurance General Application 2.3(5)(a),

but instead sought to redenominate them from EUR to GBP in line with the methodology set out in Chapter 10 of CP12/23. However, following consideration of respondents' comments to Chapter 9 of CP12/23, the PRA has decided to increase the Solvency II thresholds relating to reinsurance operations from the values consulted on as part of Chapter 10 of CP12/23. Therefore, the threshold for the amount of reinsurance operations in relation to:

- gross written income premiums will increase from £530,000 to £2.5 million; and
- technical provisions will increase from £2.4 million to £5 million.

Feedback to responses

9.5 The PRA has considered the responses to Chapter 10 of CP12/23. Feedback to the responses has been grouped as follows:

- implementation;
- references to the Commission Delegated Regulations (CDR); and
- proposed methodology.

Implementation

9.6 The PRA proposed to redenominate from EUR to GBP the absolute floor of the minimum capital requirement (MCR) within the Minimum Capital Requirement Part.

9.7 One respondent requested confirmation that the redenomination from EUR to GBP of the absolute MCR floors and the associated GBP values, as proposed in CP12/23, would be implemented in December 2024.

9.8 The PRA confirms that all redenominated values, including the absolute MCR floor values, are intended to be implemented on 31 December 2024. However, as set out in the 'Changes to draft policy' section of this chapter, the Solvency II thresholds for reinsurance operations relating to gross written income premiums and technical provisions have been increased following feedback from respondents to Chapter 9 of CP12/23. Table 1 sets out the PRA's near-final rules and associated GBP thresholds and monetary values that are intended to be implemented on 31 December 2024:

Table 1: GBP thresholds and monetary values for implementation on 31 December 2024

Relevant PRA rule	Summary	Permission type	GBP (£)
Minimum Capital Requirement 3.2	Absolute floor for the MCR for firms with various permissions	General insurers (excluding business classes 10-15)	2,400,000
		General insurers (including classes 10-15)	3,500,000
		Life insurers	3,500,000
		Pure reinsurers	3,500,000
		Pure captive reinsurers	1,200,000
Insurance – Supervised Run Off 1.2	Threshold for a material transaction	All	18,000
Run-Off Operations 1.2	Threshold for a material transaction	All	18,000
Insurance General Application 2.3(5)(a)(i) and 2.3(5)(a)(ii)	Solvency II threshold: amount of reinsurance operations in relation to gross written premium income	All	2,500,000
	Solvency II threshold: amount of reinsurance operations in relation to technical provisions	All	5,000,000

References to CDR

9.9 The PRA transferred several MCR-related provisions from the CDR, and restated them in the PRA Rulebook.

9.10 One respondent noted that some of the MCR-related provisions that had been transferred into the PRA Rulebook still contained references to CDR articles, and requested clarification as to whether these cross-references will be revisited in the PRA’s consultation that is expected in 2024.

9.11 As outlined in paragraph 1.43 of this PS, the PRA confirms that cross-references will be revisited as part of its expected consultation to transfer the remaining firm-facing Solvency II requirements into the PRA rulebook and other policy materials in Q2 2024. If cross-references remain following publication of the aforementioned consultation, the PRA will look to remove these as soon as it is practical, given that the PRA does not intend to retain references to EU legislation over the long term.

Proposed methodology

9.12 The PRA proposed to redenominate the monetary values within the PRA Rulebook from EUR to GBP using the average daily GBP/EUR spot exchange rate covering the 12-month period prior to 31 December 2020, given that this was the date that EU law ceased to apply in the UK.

9.13 One respondent argued that the cessation of EU law is an arbitrary point in time for considering the application of exchange rates and proposed that the PRA should instead use year end 2022 data which they argued was, at the time of consultation, the best available data for determining the exchange rate.

9.14 Having considered this response, the PRA has decided not to revisit the exchange rate used. The PRA does not see year end 2020 as an arbitrary date given that it is the date that EU law ceased to apply in the UK – the same date that the MCR floors were last updated in line with inflation figures. As part of the CBA in Chapter 10 of CP12/23, the PRA found that the year end 2020 exchange rate would have a negligibly different impact on firms when compared to the year end 2022 exchange rate. Furthermore, if the PRA was to use as an alternative the latest date at the point of making the final policy as opposed to year end 2020, this would create uncertainty for firms as the PRA would be unable to confirm the exchange rate used until the day of implementation.

9.15 One respondent suggested that the PRA could consider denominating in both EUR and GBP, given that EUR data is often commercially required in any event.

9.16 The PRA considers that denominating monetary values in only GBP is appropriate, given that it is the UK's domestic currency and the main reporting currency of most PRA-regulated firms. Furthermore, denominating values in both currencies would require fixing separate EUR and GBP monetary values in the PRA Rulebook. The PRA considers that this would not be appropriate, as it would create opportunities for regulatory arbitrage due to fluctuations in exchange rates.

10: General points raised by respondents

Introduction

10.1 This chapter sets out the PRA's feedback to any relevant, general points raised in response to Chapter 1 (Overview) of CP12/23 or other general areas that are not aligned to the specific proposals in the CP and the PRA's final decisions, where applicable.

10.2 The PRA received 30 responses that raised general points in this respect, which covered a number of areas. Some of the overarching supportive comments received are set out in the summary of responses in Chapter 1 of this PS. The remaining general comments are addressed in this chapter.

Feedback to responses

10.3 The PRA has considered the general responses received to CP12/23 and has set out its feedback below. The responses have been grouped into the following topics:

- consultation period;
- implementation of the Solvency II reforms;
- requests for further opportunity to provide feedback on the PRA's reforms;
- cross-references to assimilated law and guidelines; [33]
- engagement with the PRA on the Solvency II reforms; and
- comments outside of the scope of CP12/23.

Consultation period

10.4 In CP12/23, the PRA provided a two-month consultation period for the relevant chapters in this PS, while also making clear that the PRA would consider requests for more time. Four respondents commented on the length of this consultation period, raising the following points:

- three respondents said the two-month consultation was challenging or insufficient, with two noting the complexity of the material covered in CP12/23, including the appendices;
- three respondents also noted that the publication of CP12/23 overlapped with the summer period and half-year reporting; and
- three respondents felt there was an increased chance stakeholders could miss areas of feedback or misinterpret the content of the proposals, however two of these understood the length of the consultation period and supported the drive to implement the reforms as soon as possible.

10.5 With these points in mind, three respondents asked the PRA to be flexible with receiving late or further feedback and to continue to listen to industry after the deadline, while the remaining one respondent noted they would remain available to discuss anything they had potentially misunderstood.

10.6 The PRA appreciates the two-month consultation period was an acceleration of its usual consultation timeframe, and that the consultation took place over the summer period. The shorter consultation period for CP12/23 was driven by the overall timetable for the Solvency II review and reflected a number of factors:

- the PRA's desire to give firms certainty as soon as possible about the final Solvency II reforms, with sufficient time to prepare for the changes at year end 2024;
- feedback from firms asking for early certainty on the final reporting templates and to publish them as soon as possible in 2024 (which are dependent on the substantive reforms to the other areas of CP12/23); and
- many of the reform areas in CP12/23 had already been subject to significant stakeholder discussions, including through HMT's Solvency II **Call for Evidence** and **Consultation** to which industry stakeholders had already provided feedback and which informed the proposals in CP12/23.

10.7 The PRA provided flexibility to all respondents that requested more time to respond, consistent with the approach it had set out in paragraph 1.63 of CP12/23 where it stated that the PRA would consider any representations from stakeholders asking for further time to assess the proposals. The PRA considered all responses to CP12/23 that it received in finalising this PS, including a small number of responses that were received beyond the consultation deadline, and so considers that firms were given adequate opportunity to respond to CP12/23.

10.8 Two respondents also said the PRA should consider longer deadlines for the remaining Solvency II consultations, with a minimum period of three months. The PRA has since published the second planned consultation, **CP19/23**, with a three-month consultation period (which has now closed). For the final Solvency II consultation to transfer remaining firm-facing Solvency II requirements from assimilated law into the PRA Rulebook and policy materials, the PRA will also take this feedback into account when considering the appropriate consultation period.

Implementation of the Solvency II reforms

10.9 In CP12/23, the PRA consulted on an implementation date of 31 December 2024 for the proposed reforms covered in this PS.[34] Responses relating to the implementation of specific reforms are addressed in the relevant chapters of this PS. However, eight respondents also commented on general implementation considerations.

10.10 Of those eight, two respondents supported or otherwise considered the overall implementation timeline to be appropriate. Three respondents said the timeline was too short or unduly tight. They highlighted a number of challenges, suggesting firms may find it difficult to implement all the reforms by 31 December 2024. These challenges included operational issues such as the time needed to change and test systems and processes, dependencies on software providers being able to provide updates, and potential resourcing issues, including the availability of specialist resources that may need to be recruited. They suggested giving more time between the publication of the PS and implementation to allow firms to understand and make the changes.

10.11 Conversely, some respondents asked for an earlier implementation of some of the proposals, in particular the elimination of the Financial Resources Requirement (FRR) test in the TMTP calculation.

10.12 The PRA has considered the responses and points raised in relation to the implementation date of 31 December 2024. It has decided not to change the implementation timeline for the reforms covered by this PS – with the exception of the earlier implementation of some of the reforms, which as noted above was requested by a number of respondents. [35]

10.13 The PRA considers that by publishing the majority of the Solvency II reform proposals in June 2023, firms would have had sight of the substance of the draft proposals and draft rules 18 months ahead of the reforms coming into force. Furthermore, between the publication date of this PS and the 31 December 2024 implementation date, firms will have 10 months to make their final preparations for the reforms covered in this PS.

10.14 The PRA also notes that firms' year end reporting for 2024 is generally not required until at least February/March 2025,[36] which may provide some additional time for firms to finalise the reporting reforms set out in CP12/23. Overall, the PRA considers that these timeframes are consistent with its general understanding of the amount of time that firms would require to implement reforms of this nature.

10.15 The PRA appreciates that many of the implementation issues will be firm specific. If firms experience challenges or issues, such as the examples raised in response to CP12/23, firms should continue to engage with their supervisory teams or the Firm Enquiries team[37] if they do not have a named supervisor.

10.16 Four respondents said further clarity and information is needed or would be helpful to successfully implement the reforms. One of these respondents commented that CP12/23 took an uneven approach to implementation, with some points considered in detail and others lacking clarity. The remaining three suggested a clear timetable or detailed roadmap would be useful to allow firms to take the necessary steps for implementation, including for planning

purposes, analysing the requirements, and testing and implementing solutions. Two of the respondents expressed concern at the lack of opportunity to discuss implementation with the PRA at roundtable events during the consultation period. These respondents said that further explanation and engagement would have been useful for industry's understanding and for providing useful feedback to the consultation. One of these respondents also said they would like to work with the PRA to ensure satisfactory outcomes in relation to implementation.

10.17 Following publication of this PS setting out the PRA's final policy, the PRA intends to engage further with industry and provide further information to support the preparation and implementation of the Solvency II reforms in the run up to them taking effect, including matters relating to implementation both on 'day one' on 31 December 2024 and beyond. Further information is expected to be made available on the PRA **Solvency II** webpage throughout 2024.

10.18 In CP12/23, the PRA also explained that it envisaged a phased implementation of the reforms between the risk margin (RM), Matching Adjustment (MA) and other areas. The PRA worked with HMT to align the PRA Rulebook with HMT's legislation to implement its RM reforms by 31 December 2023 (which is now in force).[38] As set out in CP12/23 and CP19/23, the PRA is also still planning to have final policy in place on the MA to enable implementation of HMT's MA provisions by the end of June 2024 (subject to the Government's legislative timetable and responses to CP19/23), with all other changes taking effect on 31 December 2024.

10.19 While one respondent specifically supported the phased approach, two respondents noted their opposition to frequent ad-hoc changes and expressed a strong preference for a long lead time into a single point of implementation. They considered that a phased implementation would be expensive and resource intensive.

10.20 The PRA has considered the points raised in relation to the phased implementation of reforms. Overall, the PRA's phased implementation of Solvency II reforms is consistent with HMT's expected legislative timetable.[39]

- The majority of the PRA's reforms relating to the Solvency II review will be implemented at a single point, on 31 December 2024, including all reforms covered in this PS.
- The earlier implementation date of the MA provisions in June reflects the date set out in HMT's **statutory instrument (SI) covering legislative reforms to the MA** The PRA's corresponding reforms have been designed to allow firms that use the MA to take advantage of these MA reforms in advance of 31 December 2024.
- Likewise, the earlier implementation at 31 December 2023, of a subset of the reforms, was requested by some stakeholders and is expected to be beneficial to them. The earlier implementation of risk margin reforms at this date also reflected the date set out in HMT's **SI covering legislative reform to the risk margin** Any specific points raised around

implementation in response to CP19/23, including in relation to the costs and benefits of the earlier implementation date for the reforms to MA, will be considered and addressed when finalising the policy in that area.

10.21 One respondent also encouraged the PRA to publish a summary of the main themes arising from responses to the CP in advance of this PS, and to publish the final PS as soon as possible, to ensure that industry has time to understand and implement the reforms.

10.22 The PRA has published its feedback to consultation responses and the final policy as soon as possible, within this PS. The PRA also released a **statement** at the end of 2023 to comment on certain issues earlier, where there was a significant need to do so. Firms should continue to engage with the PRA on the implementation of Solvency II reforms throughout 2024.

Requests for further opportunity to provide feedback on the PRA's reforms

10.23 The publication of CP12/23 marked the first of the three planned PRA consultations on policy material arising from the Solvency II review (CP12/23, CP19/23, and the upcoming consultation on transferring remaining firm-facing Solvency II requirements into the PRA Rulebook and policy materials).

10.24 In response to this phased approach, two respondents said there needs to be further opportunity for industry to provide additional feedback on the package of Solvency II reforms as a whole, before policy is finalised, to allow all interactions and dependencies between consultations, legislation and rules to be properly considered.

10.25 The PRA has considered the responses provided but has decided not to change or add to the overall consultation plans for the Solvency II review for the following reasons:

- the PRA designed each of the CPs to be as standalone as possible (when considered with any corresponding legislation), so interested stakeholders would have a chance to comment at each key consultation stage;
- interested stakeholders will also be sighted on all the reforms, interactions and dependencies across CP12/23, CP19/23 and the transfer of Solvency II requirements into the PRA Rulebook by Q2 2024 – stakeholders will then have the opportunity to provide further comments in response to the forthcoming consultation on the transfer of Solvency II requirements; and
- by that time, the PRA expects that stakeholders will be sighted on the corresponding legislation covering the Solvency II reforms and the legislation relating to the use of s138BA of FSMA.

Cross-references to assimilated law and guidelines

10.26 The PRA proposed to transfer across several provisions from the existing **onshored Commission Delegated Regulation (EU) 2015/35** (SII CDR) and the Solvency 2 Regulations 2015 to the PRA Rulebook and policy materials, as part of the proposed reforms in CP12/23. Two respondents noted that some of the provisions that had been transferred into the rules still contained references to SII CDR articles and requested clarification as to whether these cross-references will be revisited.

10.27 When making the final rules and issuing final policy material arising from this PS, cross references to assimilated law will be updated to refer to those requirements as they have been absorbed into the PRA's rules or other parts of the overall framework. In the near-final rules included in this PS, such references have been highlighted in square brackets and will be updated when the rules are made. If the revocation of the relevant provisions has not been commenced by the time these rules are due to come into force on 31 December 2024, they would be made with the cross-references to the assimilated law as it stands. The PRA would then update these as consequential changes as and when that assimilated law is revoked and replaced. Further clarity will be provided in the planned consultation paper on the transfer of the remaining firm-facing Solvency II requirements.

10.28 One respondent also noted that different chapters in CP12/23 took different approaches to EIOPA guidelines, as some were transferred across to PRA policy materials or otherwise considered as part of the CP, while others were not. Two respondents recommended the PRA adds further explanation to confirm that EIOPA guidelines would be amended in due course to align with proposed changes (one suggested the PRA provides a full consideration of EIOPA guidelines as an alternative, if preferred).

10.29 To ensure clarity for certain reforms within CP12/23, the PRA considered it was necessary to consolidate the specific guidelines mentioned in the relevant chapters, or otherwise to confirm the guidelines that would no longer be relevant. For all other EIOPA guidelines, the PRA intends to consult separately on the transfer (where appropriate) into PRA policy materials in the future as part of its commitment to streamline the current framework into a single Rulebook,[40] as explained in Chapter 1 of this PS. Until such time as the remaining guidelines are transferred, firms are reminded that the PRA expects them to continue to make every effort to comply with the existing EIOPA Guidelines and Recommendations that are applicable, to the extent these remain relevant as at the end of the transition period, as confirmed by the **PRA's statement of policy**. Links to the relevant Guidelines are also available in the PRA's **Prudential and Resolution Policy Index** organised by topic areas.

Engagement with the PRA on the Solvency II reforms

10.30 Throughout this consultation process, and the wider Solvency II review process, the PRA has endeavoured to ensure an appropriate level of engagement with firms. Ten respondents to CP12/23 provided comments related to this level of engagement. Notably, seven respondents provided positive feedback on the level of constructive engagement provided by the PRA through roundtables, Subject Expert Groups and bilateral conversations. Some asked for a continuation of engagement in future, including for specific topics, which the PRA will consider going forward.

10.31 One respondent also noted that they would have welcomed even more engagement and pointed out that longer time periods between publication of PRA materials and the corresponding roundtables would allow firms more time to consider proposals before discussing them.

10.32 The PRA will consider this when planning future policy consultations.

10.33 A further respondent expressed concern with the level of engagement on topics other than the proposed reforms to the risk margin, matching adjustment and reporting.

10.34 The PRA has sought to engage with industry stakeholders across a wide range of topics in CP12/23, and in a variety of ways. For example, in addition to the topics mentioned by the respondent above, the PRA held industry roundtables on reforms to the internal model framework, including capital add-ons, and TMTP. Furthermore, the PRA engaged with the **Insurance Practitioner Panel** on the topics covered in CP12/23. The PRA also engaged with industry bodies on other topics, such as thresholds and mobilisation, and held bilateral meetings to discuss various topics as requested by different stakeholders.

10.35 In any case, the PRA will consider this feedback in its future for how it can take forward its engagement plans with industry stakeholders. The PRA also commented at the Association of Financial Mutuals Annual Conference 2023 on its desire to engage further with mutual insurers generally.[41]

10.36 One further respondent raised comments related to the level of engagement made with policyholders and the ability for policyholders to make informed responses to the proposals. Some of the comments relating to policyholders overlapped with the remit of the Financial Conduct Authority and are not within the scope of CP12/23.

10.37 The PRA aims to engage a diverse range of stakeholders, including civil society groups,[42] and notes that anyone, including policyholders, is welcome to respond to the PRA's consultations. As set out in **CP27/23 – The Prudential Regulation Authority's**

approach to policy, the PRA recognises that civil society stakeholders can face resource constraints and has proposed to proactively engage these groups in future, and to make them aware of consultations where their views and expertise may be valuable.

Comments outside of the scope of CP12/23

10.38 A number of respondents made a number of general comments that the PRA considers do not relate directly to the proposals in the CP. However, the PRA has sought to provide clarity in response to some of these issues below, where appropriate.

10.39 Two respondents noted that they previously raised several items to HMT and/or the PRA during the Solvency II review that have not been covered in CP12/23, for example model drift, contract boundaries and a greater emphasis on proportionality.

10.40 The PRA's reforms are in line with the scope that was confirmed following the Government's Call for Evidence and the Solvency II review consultation. Suggestions around making the regime more proportionate were also considered by the PRA when developing the proposals in CP12/23, which the PRA considers did have a focus on proportionality. The PRA will consider this feedback when considering plans for future policy development.

10.41 Another respondent noted that the PRA should consider the international regulatory position, including the EU and other major economies.

10.42 The PRA considered international standards when developing the policy set out in CP12/23. Furthermore, as confirmed in the CP, the PRA specifically considered whether the proposals facilitated the international competitiveness of the UK economy and its growth in the medium to long term, subject to alignment with international standards, as part of the PRA's new secondary growth and competitiveness objective.

10.43 The PRA received two responses commenting on the drafting and formatting of CP12/23. Both respondents gave positive feedback on the clarity of policy proposals and the comprehensive materials, with one respondent also highlighting the charts and examples as being useful for illustrating the proposals. However, one respondent also provided the following comments on the background and structure of the CP:

- further explanation of the legal backdrop would be useful for respondents without a legal or regulatory background, so they could understand the context of the reforms and provide more focused feedback; a short primer on the purpose and use of SSs and SoPs would have been useful;
- only showing new, amended, or deleted text in SSs and SOPs makes it onerous for respondents to cross-refer to original text; a greater level of context is needed; and
- as well as publishing separate documents, the PRA should publish a single collated document when publishing consultation papers (including appendices) with embedded

navigation structure.

10.44 The PRA will consider these comments when publishing consultations in the future. Information about the prudential policymaking framework at the PRA, including the purpose of the PRA Rulebook, SSs, and SoPs, can be found on the Bank of England's **Policy** webpage. The further information provided in CP27/23 – **The Prudential Regulation Authority's approach to policy** and the accompanying approach document, **The Prudential Regulation Authority's approach to policy** may also be helpful to add clarity and understanding of our approach to policymaking.

10.45 One respondent also noted that the transition to Solvency UK presents an opportunity to simplify the approach to managing and evidencing regulatory compliance but noted that requirements are still contained in both the PRA Rulebook and supervisory statements under the proposed structure. The respondent recommended that as part of the planned 2024 consultation the PRA brings forward proposals to consolidate all regulatory requirements into the PRA Rulebook.

10.46 The PRA recognises the need for firms to have clarity on what the requirements that apply to them are. The PRA considers that SSs and SoPs can both be useful supplements to the Rulebook to provide transparency to firms on the PRA's approach and supervisory expectations. In **CP27/23**, published in December 2023, the PRA confirmed its intention to move to a new approach to the PRA Rulebook in the future. It intends for the Bank of England's website to host the PRA Rulebook and this would include functionality to search both rules and other related PRA policy material (such as SSs and SoPs) in one place. Chapter 6 of the accompanying approach document to CP27/23, **The Prudential Regulation Authority's approach to policy** sets out the PRA's current sources of regulatory material and its approach and intentions for the future.

10.47 One respondent commented that CP12/23 refers to the subsequent consultation paper for September 2023, in relation to proposals for life insurers relating to the MA. The respondent noted that the MA is relevant to some non-life insurers especially those with Periodical Payment Order (PPO) liabilities.

10.48 The PRA notes that its proposed reforms to the MA were set out in CP19/23, which is relevant to all UK Solvency II firms, the Society of Lloyd's and its members and managing agents, and insurance and reinsurance undertakings that have a UK branch (third-country branch undertakings) where they are applying or have applied to use the MA. Chapter 3 of CP19/23 discusses proposed reforms relating to the liabilities eligible to be held within an MA portfolio.

10.49 One respondent asked for clarification on wording in HMT's SI relating to the treatment of potential and settled PPO liabilities.

10.50 The final version of HMT's SI has since been laid and came into force on 31 December 2023. The PRA has published a **statement** to assist firms in their approach to calculating the RM.

10.51 One respondent also made several comments relating to issues that the PRA considers to be beyond the scope of CP12/23 and/or the PRA's remit, such as financial conduct related matters and other regulatory issues, which the PRA will therefore not be addressing.

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1. Further details of the PRA's policymaking framework, including the purpose of rules, SSs, and SoPs, can be found on the Bank of England's **Policy** webpage.
2. Retained EU law that continues to apply in the UK was renamed to 'assimilated law' by section 5 of the **Retained EU Law (Revocation & Reform) Act 2023**
3. The PRA implemented a first phase of reforms to insurance supervisory reporting requirements in PS29/21 – **Review of Solvency II: Reporting (Phase 1)**.
4. PS3/24 – **Review of Solvency II: Reporting and disclosure phase 2**.
5. **The Insurance and Reinsurance Undertakings (Prudential Requirements) (Risk Margin) Regulations 2023** came into force on 31 December 2023.
6. Specifically, amendments to Article 312 (deadline for submitting supervisory reports) of the Commission Delegated Regulation (EU) 2015/15 and to Regulation 54 (transitional measure on technical provisions) of the Solvency 2 Regulations 2015.
7. Sections 138J (5) and 138K (4) of FSMA.
8. In paragraph 1.45 in Chapter 1 (Overview) of CP12/23, the PRA explained that it expected the impact of the proposed reforms on mutuals to be no different from the impact on other firms, with the exception of the proposal to increase the threshold at which firms are required to enter the Solvency II regime, given small firms are more likely to benefit from the proposed changes, which remains applicable.
9. Sections 138J (3) and 138J (4) of FSMA.
10. Section 138J(2)(d) FSMA
11. As proposed in **CP3/24 – The Prudential Regulation Authority's approach to rule permissions and waivers**. The PRA proposes to publish a final SoP in June 2024.
12. See **The Financial Services and Markets Act 2000 (Disapplication or Modification of Financial Regulator Rules in Individual Cases) Regulations 2024**
13. See 'Details' section: **Statutory guidance Draft Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations**
14. For further information please see **Transitioning to post-exit rules and standards**.
15. CP27/23 – **The Prudential Regulation Authority's approach to policy** , Chapter 6
16. This was referred to as the 'new TMTP method' in CP12/23 but is referred to as the 'TMTP method' in near-final rules and policy materials.

17. A 'double run-off' effect refers to a situation where the natural run-off of the TMTP business, combined with an adjustment made for the purposes of amortisation, would result in an excessive degree of amortisation beyond what would be needed to ensure that TMTP reduces linearly to zero by 2032.

18. As defined in the rule instrument – see MA-eligible insurance and reinsurance obligations.

19. Only with respect to the obligations covered by the transfer event that are MA eligible in respect of that firm.

20. This will be Transitional Measures on Technical Provisions 7.1 under the new framework.

21. See SS11/13 - **Internal Ratings Based (IRB) approaches**, October 2021, paragraphs 5.2-5.3.

22. CP 27/23 – **The Prudential Regulation Authority's approach to policy**

23. **Prudential Regulation Authority Business Plan 2023/24 | Bank of England**

24. IPCD is defined in the EU (Withdrawal Agreement) Act 2020 as 31 December 2020 at 11pm.

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

26. **UK-Swiss Agreement on Direct Insurance other than Life Insurance** 2019.

27. PRA consultation paper 21/23 – **The PRA's approach to authorisation and supervision of third-country insurance branches**, October 2023. The PRA is currently considering responses to this consultation.

28. Gibraltar-based insurers are not in scope of these proposals as they are subject to specific transitional arrangements until such time as the Gibraltar Authorisation Regime is in force. In the interim, Interpretations 2.8 continues to apply for such firms.

29. PRA consultation paper 21/23 **– The PRA's approach to authorisation and supervision of third-country insurance branches**, October 2023. The PRA is currently considering responses to this consultation.

30. The PRA proposed to redenominate the MCR floor from EUR to GBP in Chapter 10 (Currency redenomination) of CP12/23. Based on these proposals, and without modification, the MCR floor would be £3.5 million for life insurers and £2.4 million for general insurers (or £3.5 million where they cover general insurance business classes 10 to 15).

31. Please see: **Solvency UK: Maintaining the momentum - speech by Gareth Truran**, September 2023.

32. Insurance General Application 1.1.

33. Retained EU law that continues to apply in the UK was renamed to 'assimilated law' by section 5 of the Retained EU Law (Revocation & Reform) Act 2023

34. Chapter 11 (Administrative amendments to PRA rules) of CP12/23 was an exception to this with an implementation date of 31 December 2023 to align with HMT's risk margin reforms, as confirmed in PS19/23.

35. See Chapter 3 (TMTP) for further details and the PRA's statement in December 2023: **Solvency II Review – considerations for year-end 2023**

36. Exact dates vary by firm and are confirmed by the firm's supervision teams. This will be considered further as part of the separate PS on reforms to reporting and disclosure requirements resulting from CP12/23 and CP14/22.

37. For firms that do not have a named supervisor, they can contact our Firm Enquiries team at **PRA.FirmEnquiries@bankofengland.co.uk** or by phone on +44 (0)20 3461 7000.

38. Administrative amendments to PRA rules were finalised in **PS19/23**. The PRA also issued a **statement** on 8 December 2023 to assist firms with implementation of the RM calculation, in light of HMT's regulations.

39. See explanatory notes in HMT's **Draft Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations - GOV.UK (www.gov.uk)**

40. CP27/23 – **The Prudential Regulation Authority’s approach to policy**, Chapter 6.

41. **The feeling is Mutual − speech by Shoib Khan**, October 2023.

42. ‘Civil society’ refers to non-industry groups and individuals such as charities, non-governmental organisations, consumer advocacy groups and academics.

Appendices

Appendix 1: Near-final changes to PRA rules and policy materials (PDF)

Appendix 2: PRA Rulebook: Solvency II Reform Instrument 2024 (PDF)

Appendix 3: Updated supervisory statement 17/15 – Solvency II: transitional measures on risk-free interest rates and technical provisions

Appendix 4: Statement of policy – Permissions for transitional measures on technical provisions and risk-free interest rates

Appendix 5: [Deleted in its entirety] supervisory statement 6/16 – Maintenance of the ‘transitional measure on technical provisions’ under Solvency II

Appendix 6: Statement of policy – Solvency II internal models: Permissions and ongoing monitoring

Appendix 7: Supervisory statement 1/24 – Expectations for meeting the PRA's internal model requirements for insurers under Solvency II

Appendix 8: Updated supervisory statement 5/14 – Solvency II: calculation of technical provisions and the use of internal models for general insurers

Appendix 9: Updated supervisory statement 15/15 – Solvency II: approvals and permissions

Appendix 10: [Deleted in its entirety] supervisory statement 12/16 – Solvency II: Changes to internal models used by UK insurance firms

Appendix 11: Updated supervisory statement 17/16 – Solvency II: internal models – assessment, model change and the role of non-executive directors

Appendix 12: Statement of policy – Solvency II: Capital add-ons

Appendix 13: Updated supervisory statement 4/15 Solvency II: the solvency capital requirements

Appendix 14: Updated supervisory statement 12/15 Solvency II: Lloyd’s

Appendix 15: Updated supervisory statement 9/15 – Solvency II: Group Supervision

Appendix 16: Statement of policy – The PRA’s approach to insurance group supervision

Appendix 17: Mapping table of assimilated law (PDF)

Appendix 18: Updated supervisory statement 44/15 – Solvency II: third-country insurance and pure reinsurance branches

Appendix 19: Overview of applicable Branch Guidelines (PDF)

Note: All content for this PS is included on this webpage. If you would like a PDF version of the PS, please use the button available below.

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