



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Consultation Paper | CP5/15

# Solvency II: applying EIOPA's Set 1 Guidelines to PRA-authorized firms

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Responses are requested by Thursday 19 March 2015.

Please address any comments or enquiries to:

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## 1 Introduction

1.1 This paper consults on a draft supervisory statement setting out the Prudential Regulation Authority's (PRA's) expectations of firms in relation to the European Insurance and Occupational Pensions Authority's (EIOPA) Set 1 Solvency II Guidelines ('the Guidelines') published on 2 February 2015.<sup>(1)</sup>

1.2 This consultation is relevant to all UK firms within the scope of Solvency II and to the Society of Lloyd's.

1.3 It is the PRA's responsibility to make every effort to comply with EIOPA Guidelines<sup>(2)</sup> and its intention is to comply with all of the Set 1 Guidelines. The PRA will be taking full account of the Guidelines in its ongoing supervision of the new Solvency II regulatory framework. The PRA expects firms to comply with all of those Set 1 Guidelines that apply to them in a proportionate manner, in accordance with the principle set out in the Solvency II Directive.<sup>(3)</sup>

1.4 Those Guidelines on which the draft supervisory statement provides further commentary are:

- ancillary own-funds;
- classification of own-funds;
- ring-fenced funds;
- treatment of related undertakings, including participations;
- loss-absorbing capacity of technical provisions and deferred taxes; and
- group solvency calculation.

1.5 Those Guidelines that apply exclusively to supervisory authorities will be integrated into the PRA's internal supervisory approach. They do not form part of this consultation paper. These are: the Guidelines on the operational functioning of colleges; methodology for equivalence by national supervisory authorities; and the supervisory review process.

## 2 Statutory obligations

2.1 In determining general policy, the PRA must, so far as is reasonably practicable, act in a way that advances its general objective to promote the safety and soundness of PRA-authorised firms and its insurance objective of contributing to securing an appropriate degree of policyholder protection.

2.2 The main objective of Solvency II, as set out in Article 27 of the Solvency II Directive, is the protection of policyholders and beneficiaries. In advancing the prudential strength of the regulatory regime, the Solvency II Directive will also promote the safety and soundness of insurers. This is consistent with the PRA's statutory objectives.

2.3 In establishing its practices and procedures, the PRA has had regard to the Regulatory Principles.<sup>(4)</sup> One of the Regulatory Principles is that regulators should exercise their functions as transparently as possible. The PRA has followed this principle by publishing this draft supervisory statement in order to provide greater clarity for firms about its supervisory expectations in the context of the new regulatory regime.

2.4 The PRA has a statutory requirement to state whether the impact on mutuals would be significantly different from the impact on other firms. This draft supervisory statement confirms that the PRA does not expect the Guidelines to have any significant differential impact on mutuals.

## 3 Economic impact

3.1 The PRA considers that the burden imposed by its proposed approach to compliance with EIOPA's Guidelines to be proportionate to the benefits. Using its own resources proportionately, the PRA has relied on EIOPA's Impact Assessment of Set 1 of the Guidelines,<sup>(5)</sup> on which EIOPA has consulted, to inform its view. EIOPA's impact assessment suggests that the Guidelines should promote a consistent application of Solvency II requirements thereby supporting policyholder protection, and they should not create material incremental costs, relative to the requirements of the Solvency II Directive and the Solvency II Regulations.<sup>(6)</sup> Moreover, the PRA is proposing a proportionate approach to compliance with the Guidelines. In view of these considerations, the PRA approach to the Guidelines should also facilitate effective competition.

## 4 Equality and diversity

4.1 The PRA may not act in an unlawfully discriminatory manner. It is required under the Equality Act 2010<sup>(7)</sup> to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. The PRA has assessed the equality and

(1) EIOPA Set 1 of Solvency II Guidelines: <https://eiopa.europa.eu/regulation-supervision/guidelines>.

(2) Article 16(3) of Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/79/EC: <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1423647191984&uri=CELEX:32010R1094>.

(3) Recital 19 of the Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (Text with EEA relevance): <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1424081200354&uri=CELEX:32014L0051>.

(4) Section 3B of the Financial Services and Markets Act 2000 (FSMA): [www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga\\_20000008\\_en.pdf](http://www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga_20000008_en.pdf).

(5) Revised Impact Assessment on the EIOPA Solvency II Guidelines: [https://eiopa.europa.eu/Publications/Consultations/EIOPA\\_EIOPA-BoS-14-225\\_Impact\\_Assessment\\_GL%20\\_set\\_1.pdf](https://eiopa.europa.eu/Publications/Consultations/EIOPA_EIOPA-BoS-14-225_Impact_Assessment_GL%20_set_1.pdf).

(6) Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (Text with EEA relevance): <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1423757927325&uri=CELEX:32015R0035>.

(7) Equality Act 2010: [www.legislation.gov.uk/ukpga/2010/15/pdfs/ukpga\\_20100015\\_en.pdf](http://www.legislation.gov.uk/ukpga/2010/15/pdfs/ukpga_20100015_en.pdf).

diversity implications of the Guidelines in this consultation and does not expect them to have any direct or indirect discriminatory impact under the Equality Act.

## **5 Next steps**

5.1 This consultation closes on Thursday 19 March 2015. Views are welcomed on the proposals made in this CP and responses should be sent to [CP5\\_15@bankofengland.co.uk](mailto:CP5_15@bankofengland.co.uk).

## Draft supervisory statement Solvency II: applying EIOPA's Set 1 Guidelines to PRA-authorised firms

### 1 Introduction

1.1 This draft supervisory statement is addressed to all UK firms that fall within the scope of Solvency II, and to the Society of Lloyd's, in relation to the European Insurance and Occupational Pensions Authority's (EIOPA's) Set 1 Solvency II Guidelines<sup>(1)</sup> ('the Guidelines') published on 2 February 2015.

1.2 This supervisory statement expands on the Prudential Regulatory Authority's (PRA's) general approach set out in the PRA's Approach to Insurance Supervision.<sup>(2)</sup> By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the Regulatory Principles<sup>(3)</sup> and relevant provisions of the Legislative and Regulatory Reform Act 2006.<sup>(4)</sup>

1.3 The PRA is not aware that there would be any significant differential impact on mutuals in respect of the Guidelines, taking into account their proportionate application.

1.4 The content of this supervisory statement is not expected to have any direct or indirect discriminatory impact under the Equality Act 2010.<sup>(5)</sup>

1.5 The PRA has consulted with the Financial Conduct Authority (FCA) on this draft supervisory statement.

### 2 Compliance with the Guidelines

2.1 It is the PRA's responsibility to make every effort to comply with EIOPA Guidelines<sup>(6)</sup> and its intention is to comply with all of the Set 1 Guidelines. The PRA will be taking full account of the Guidelines in its ongoing supervision of the new Solvency II regulatory framework. The PRA expects firms to comply with all of the Guidelines that apply to them in a proportionate manner, in accordance with the principle set out in the Solvency II Directive.<sup>(7)</sup>

2.2 This draft supervisory statement also provides further commentary on certain Guidelines where additional considerations, largely set out in previous PRA consultation papers and supervisory statements, should be taken into account by firms.

2.3 Those Guidelines on which further commentary is provided are:

- ancillary own-funds;
- classification of own-funds;
- ring-fenced funds;
- treatment of related undertakings, including participations;
- loss-absorbing capacity of technical provisions and deferred taxes; and
- group solvency calculation.

### 3 Ancillary own-funds (Guidelines 1–6)

3.1 These Guidelines complement the Regulation in respect of the criteria for the approval of and the application procedures for ancillary own-funds (AOF). Firms should refer to the checklist for AOF applications issued as Appendix 1 of CP 23/14<sup>(8)</sup> and consider its relationship with the AOF Guidelines when preparing their applications.

3.2 Guidelines 5 and 6 identify the need for firms and the PRA to monitor on an ongoing basis the ability of an AOF item to satisfy the criteria for approval. Firms should engage with their usual supervisory contact at an early stage in the case of any changes which might affect the status or loss-absorbing characteristics of an approved AOF Item.

### 4 Classification of own-funds (Guidelines 1–26)

4.1 These Guidelines are organised in several sections. The PRA highlights a number of specific considerations and links with PRA previous publications.

#### Guidelines relevant to specific Tiers (Guidelines 1–12)

4.2 Sections 1 to 3 set out considerations relating to items and features determining classification for Tier 1, Tier 2 and Tier 3 respectively.

(1) EIOPA Set 1 of Solvency II Guidelines: <https://eiopa.europa.eu/regulation-supervision/guidelines>.

(2) PRA's approach to insurance supervision: [www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf](http://www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf).

(3) Section 3B of the Financial Services and Markets Act 2000 (FSMA): [www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga\\_20000008\\_en.pdf](http://www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga_20000008_en.pdf).

(4) Legislative and Regulatory Act 2006: [www.legislation.gov.uk/ukpga/2006/51/contents](http://www.legislation.gov.uk/ukpga/2006/51/contents).

(5) Equality Act 2010: [www.legislation.gov.uk/ukpga/2010/15/pdfs/ukpga\\_20100015\\_en.pdf](http://www.legislation.gov.uk/ukpga/2010/15/pdfs/ukpga_20100015_en.pdf).

(6) Article 16(3) of Regulation (EU) No. 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/79/EC: <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1423647191984&uri=CELEX:32010R1094>.

(7) Recital 19 of the Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) (Text with EEA relevance: <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1424081200354&uri=CELEX:32014L0051>).

(8) PRA Consultation Paper CP23/14, 'Solvency II approvals', October 2014; [www.bankofengland.co.uk/pr/Pages/Publications/cp/2014/cp2314.aspx](http://www.bankofengland.co.uk/pr/Pages/Publications/cp/2014/cp2314.aspx).

4.3 Firms should follow these Guidelines when designing and classifying their capital instruments and the PRA expects this compliance to be reflected in firms' submissions of pre-issuance notifications.<sup>(1)</sup>

4.4 In CP 24/14<sup>(2)</sup> the PRA sets out its expectations relating to terms permitting the call of an instrument prior to five years from date of issue. These will be relevant in respect of Guideline 15 on call options predicated on unforeseen changes and the paragraphs referred to within that Guideline.

### Guidelines relevant to all Tiers (Guidelines 13–20)

4.5 Section 4 contains Guidelines relevant in respect of all Tiers. Firms should follow the approach set out in these Guidelines in order to ensure compliance with the Solvency II Regulations.<sup>(3)</sup>

4.6 The PRA sets out in CP24/14<sup>(4)</sup> its expectations as regards a broad scope for the term 'redemption' in line with Guideline 13.

4.7 Guideline 14 sets out the considerations relevant to encumbrance. Firms should identify the substance and not the form of arrangements and connected transactions when considering the potential impact on the quality of capital. Firms should consider SS8/14<sup>(5)</sup> on the use of subordinated guarantees in the light of Guideline 14.

4.8 In relation to Guideline 18, firms should observe the approach to supervisory approval of redemption set out in this Guideline both as regards the nature of the information to be submitted and the timescales which should apply. The PRA will adapt its approach to the review of potential redemptions in line with Guideline 18.

4.9 In considering whether an instrument includes an incentive to redeem as described in Guideline 19, firms should provide a reasoned basis for the choice of coupon structure and any other provision that might suggest an economic basis for redemption. Firms should include this information as part of their pre-issuance notification.

### Guidelines relating to items not on the lists of own fund items (Guidelines 21–26)

4.10 Section 5 covers the approach to the approval of items not on the lists of own-funds in the Solvency II Regulations. Firms should engage with their usual supervisory contact at an early stage if they consider the development of an own-fund item not on the lists.

## 5 Ring-fenced funds (Guidelines 1–17)

5.1 These Guidelines complement the Solvency II Regulations regarding ring-fenced funds (RFF).

### Identification of RFF (Guidelines 1–4)

5.2 Guidelines 1 to 4 describe the characteristics of RFF together with details of arrangements, restrictions and types of business which are generally inside or outside the scope of the RFF regime. Firms should follow the approaches set out in these Guidelines in determining whether they need to recognise RFF. In particular, the PRA draws the attention of firms to paragraph 1.13 of Guideline 3 which makes clear that all restrictions in place at the time of calculation of the Solvency Capital Requirement (SCR) should be taken into account, irrespective of the time period for which those restrictions apply.

5.3 In CP22/14<sup>(6)</sup> the PRA sets out its expectation that each with-profits fund would constitute a RFF.

5.4 Firms with matching adjustment portfolios should also comply with Guidelines 6 to 17.

### Materiality (Guideline 5)

5.5 Firms should follow Guideline 5 paragraph 1.17 when assessing whether a RFF is not material and to document their assessment. Firms should send such assessments to their usual supervisory contact.

5.6 Where a RFF is not material firms should adhere to paragraph 1.16 of Guideline 5.

### Identification of assets and liabilities in RFF (Guidelines 6–8)

5.7 Firms should follow Guidelines 6 to 8 in determining the assets and liabilities within the scope of RFF. The PRA's approach to with-profits business, as set out in the Rules and draft supervisory statement in CP22/14, will apply to those firms which have with-profits funds and their treatment as

(1) The current process is set out in [www.bankofengland.co.uk/pr/Pages/supervision/activities/capitalinstruments.aspx](http://www.bankofengland.co.uk/pr/Pages/supervision/activities/capitalinstruments.aspx). The PRA consulted on new rules to maintain pre issuance notification in *PRA Consultation Paper CP16/14*, 'Transposition of Solvency II: Part 3', August 2014; [www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp1614.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp1614.pdf).

(2) See section 2 in Appendix 7 on quality of capital instruments in *PRA Consultation Paper CP24/14*, 'Solvency II: further measures for implementation', November 2014; [www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp2414.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp2414.pdf).

(3) Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) Text with EEA relevance: <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1423757927325&uri=CELEX:32015R0035>.

(4) See paragraph 3.1 in Appendix 7 on quality of capital instruments in *PRA Consultation Paper CP24/14*, 'Solvency II: further measures for implementation', November 2014; [www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp2414.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp2414.pdf).

(5) *PRA Supervisory Statement SS8/14*, 'Subordinated guarantees and the quality of capital for insurers', August 2014; [www.bankofengland.co.uk/pr/Documents/publications/ss/2014/ss814.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/ss/2014/ss814.pdf).

(6) *PRA Consultation Paper CP22/14*, 'The PRA's approach to with-profits insurance business', October 2014; [www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp2214.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp2214.pdf). See Appendix 2 section 2.

RFF. The PRA notes that Guideline 8 will be of particular relevance to with-profits funds.

### Calculations and reporting in respect of RFF (Guidelines 9–15, and 17)

5.8 Firms should follow Guidelines 9 to 13, and 17 in carrying out the calculations required by the Solvency II Regulations in respect of the:

- notional SCR for the purpose of calculating any required adjustment to own-funds;
- notional SCRs to be aggregated for the purpose of standard formula calculations for RFF and matching adjustment portfolios;
- calculation of the SCR as a whole for internal model firms; and
- reporting of the SCR by risk module by standard formula firms.

5.9 On Guideline 14, firms should engage with their usual supervisory contact at an early stage in order to discuss what evidence the PRA would need in order to be satisfied with the proposed methodology.

## 6 Treatment of related undertakings, including participations (Guidelines 1–9)

6.1 These Guidelines complement the Solvency II Regulations regarding related undertakings, including participations. They cover the identification of related undertakings and their treatment both for capital resources and capital requirements purposes.

### Identification (Guidelines 1–2)

6.2 Guidelines 1 and 2 address the identification of related undertakings and participations. Firms should consider both shareholdings and the existence of dominant or significant influence when identifying related undertakings. This should not be considered a static assessment; firms should have in place procedures to identify and update their position where there are changes to shareholdings or the relationship between the firm and other entities, which might lead to the creation, or removal of, dominant or significant influence.

6.3 Firms should consider both direct and indirect holdings when identifying related undertakings.

### Strategic participations (Guideline 3)

6.4 The Solvency II Regulations sets out tests a firm must be able to meet before an equity investment in a related undertaking can be considered strategic. Firms should follow Guideline 3 when seeking to demonstrate that these tests are met and be able to provide credible supporting evidence as set out in paragraph 1.26 of the Guideline. In particular, the PRA draws firms' attention to the need to demonstrate that the

value of the equity investment is likely to be materially less volatile than other equities. Firms should justify the selection of equities used for comparison.

### Adjustment to own-funds to reflect value of holdings in financial and credit institutions (Guidelines 4–6)

6.5 Firms should observe Guidelines 4 and 5 which support the carrying out of the calculations required by Article 68 of the Solvency II Regulations. Where a deduction from own-funds is necessary, and where a straightforward application of Article 68(5) is not possible, firms should follow Guideline 6 to identify the Tier of own-funds to which the adjustment should apply.

### SCR calculations in respect of related undertakings (Guidelines 7–9)

6.6 Guidelines 7 to 9 set out how firms should reflect related undertakings in their SCR calculations, whether those calculations are performed using the standard formula or an internal model. When applying the standard formula to related undertakings and participations, firms should have regard to the relevant assumptions underlying the standard formula.<sup>(1)</sup> The PRA regards the assumption that the value of an equity investment cannot fall below zero as particularly relevant where a related undertaking is valued on the adjusted equity method; or where any commitment by an insurance firm to provide support to a related undertaking is not captured by the counterparty default module. In addition, when a firm has identified a related undertaking where it does not hold an equity investment or its holding is a relatively small percentage, firms should consider whether the equity investment is representative of its exposure to that related undertaking.

6.7 In relation to paragraph 1.40 of Guideline 9, firms should also refer to a draft supervisory statement in CP3/15<sup>(2)</sup> where a firm calculates its solo-level SCR using an internal model.

## 7 Loss-absorbing capacity of technical provisions and deferred taxes (Guidelines 1–22)

7.1 These Guidelines provide guidance on how firms should calculate loss-absorbing capacity of technical provisions (LACPT) and deferred tax (LACDT) in both the solo and group SCR calculation using the standard formula.

7.2 The PRA has identified additional considerations in respect of certain of the LACDT Guidelines (Guidelines 6–14).

(1) Published by EIOPA 30 July 2014: [https://eiopa.europa.eu/Publications/Standards/EIOPA-14-322\\_Underlying\\_Assumptions.pdf](https://eiopa.europa.eu/Publications/Standards/EIOPA-14-322_Underlying_Assumptions.pdf).

(2) PRA Consultation paper CP3/15, 'Solvency II: transitional measures and the treatment of participations', January 2015; [www.bankofengland.co.uk/pradocuments/publications/cp/2015/cp315.pdf](http://www.bankofengland.co.uk/pradocuments/publications/cp/2015/cp315.pdf).

### Adjustment for the loss-absorbing capacity of deferred taxes — calculation (Guidelines 6–9)

7.3 These Guidelines address how firms should value the loss-absorbing capacity of deferred tax at a solo level. It covers the appropriate level of granularity which firms should apply to the calculation, valuation principles to be used and addresses the extent to which undertakings can use group relief. The PRA expects firms to comply with these Guidelines and to refer to SS2/14<sup>(1)</sup> which sets out further details regarding PRA expectations in relation to group relief and the need to avoid inappropriate set-off.

### Adjustment for the loss-absorbing capacity of deferred taxes — recognition (Guidelines 10–14)

7.4 These Guidelines address how firms should value the loss-absorbing capacity of deferred tax at a solo level. In complying with these Guidelines firms should also refer to SS2/14, in particular in respect of:

- double counting of deferred tax liabilities;
- assumptions regarding the post shock environment;
- projection horizons;
- contract boundary assumptions; and
- risk margin.

## 8 Group solvency (Guidelines 1–27)

8.1 These Guidelines are aimed at clarifying the Solvency II Directive requirements on the calculation of group solvency, including the scope of group supervision, the level(s) at which groups are supervised and the approach to calculating group solvency.

8.2 The PRA has additional comments in respect of the following Guidelines on the scope of group supervision and the level of which groups are supervised (Guidelines 1–6).

8.3 Firms are responsible for providing guidance to related undertakings and ensuring the accuracy and completeness of information from related undertakings. Where the ultimate parent is not an authorised firm, the entity will nonetheless take responsibility for these matters. If necessary, the PRA will use its power of direction over the ultimate parent to ensure that this occurs.

### Parent insurance or reinsurance undertaking, insurance holding company or mixed financial holding company headquartered in a third country (Guideline 5)

8.4 Guideline 5 states that supervisory authorities do not need to apply group supervision at the ultimate level of the European Economic Area (EEA); instead, they can apply group supervision solely at the level of the ultimate parent located in a third country if that country operates a regime deemed equivalent to Solvency II, where this would result in a more efficient supervision of the group. The PRA has transposed the Solvency II Directive to apply the requirements necessary for it to exercise group supervision at the ultimate EEA level although the PRA may grant waivers. If, therefore, a firm considers that it would be appropriate for group supervision to be exercised solely at the level of the ultimate third-country parent, it should inform its usual supervisory contact as soon as practicable.

(1) PRA Supervisory Statement SS2/14, 'Solvency II: recognition of deferred tax', April 2014; [www.bankofengland.co.uk/pr/Pages/publications/solvency2recognitionss.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/solvency2recognitionss.aspx).