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Statement regarding the prudential treatment of banks' significant investments in insurance companies for firms that are regulated by the PRA

The PRA intends to require banks to deduct from Common Equity Tier 1 (CET1) significant investments in insurance companies above threshold allowances under its implementation of CRD IV/CRR[1]. This will apply both to banking groups with an investment in an insurance company and to solo banks with an investment in an insurance company.[2]

The rationale for this approach is that we consider deduction of significant investments to be necessary to prevent the multiple use of the same capital resources in different parts of the financial system. Deduction is the most effective way to ensure that for banks with significant investments in insurance companies there is sufficient capital of the right quality to support risks in both the bank and the insurer. The deduction of significant investments made by the bank in the insurer helps to ensure that both regulated entities are properly capitalised and limits the risk of contagion and reliance on free transfer of capital, which may not be possible in practice. The issue of potential double-gearing is explained in more detail in the attached annex.

CRD IV/CRR permits national authorities to apply an alternative risk-weighting approach to deduction where the bank and insurer are supervised as part of a conglomerate.[3] As a matter of general policy, the PRA does not intend to exercise this discretion to allow banks to use this alternative approach.

The existence of a threshold allowance under CRD IV/CRR [4] mitigates the impact of the deduction by allowing a significant portion of investments in financial sector entities to be risk-weighted. In practice, this threshold gives some allowance for diversification within the financial system and the fact that the insurer would normally maintain capital above its minimum requirements.

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[1] Consisting of the directive 'on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms' (CRDIV) and the regulation 'on prudential requirements for credit institutions and investment firms' (CRR).
[2] The PRA intends that the prudential treatment outlined in this statement will also apply to banks' holdings of Additional Tier 1 (AT1) and Tier 2 own funds instruments issued by insurance companies in which the bank has a significant investment. The rationale is the same for holdings of CET1, AT1 and Tier 2 instruments. Under CRDIV/CRR, such holdings of AT1 and Tier 2 instruments will be deducted from the bank's own AT1 and Tier 2 items, respectively. These deductions from the bank's AT1 and Tier 2 items are not subject to threshold allowances.
[3] See CRR Art. 46(1). "Conglomerate" is defined under Directive 2002/87/EC.
[4] See CRR Art 45(1)(b).

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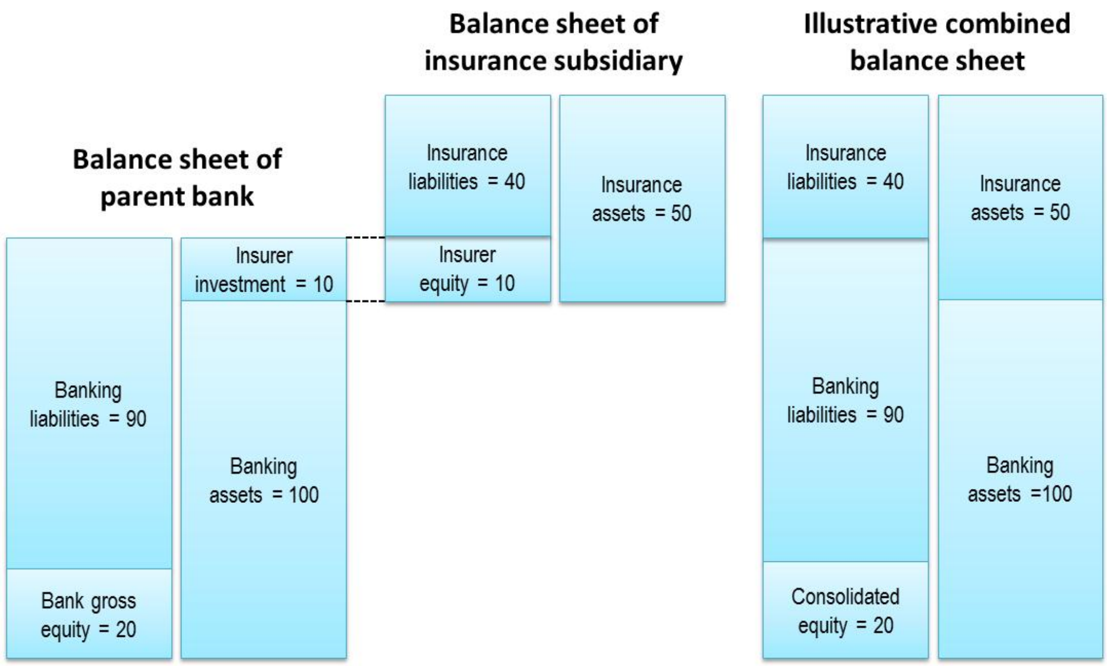
Annex: How the same capital could be used by both the bank and the insurer in the absence of deduction when a bank owns an insurer

1. Key principle: in general, a banking group containing two (or more) regulated entities should contain no less capital than those same entities would be required to hold, in aggregate, if they were separate standalone firms. There should be no unfair competitive advantage to a group.

2. If a bank decides to buy the equity in an insurance company, making itself the parent of the insurance company, there is a danger that losses in the insurance subsidiary would lead directly to losses in the equity of the parent bank. That is because the parent would incur a loss on its investment in the insurer. Unless the parent bank has sufficient equity to absorb potential losses in both the bank and the insurance subsidiary, it may not be able to sustain these losses.

3. For this reason, every £1 of equity claim on the insurance company should be backed by £1 of equity held by the parent bank. The regulatory rules for banks do not allow banking and insurance assets and liabilities to be added together in a simple way (as we would do with a bank subsidiary). Instead, we should assess the capital position of the bank by deducting from its capital its claim on the equity of the insurance company and comparing the remaining capital to its banking assets.

A simple example of how capital could be used by both the bank and the insurer in the absence of deduction when a bank owns an insurer



4. Looking at the balance sheet of the parent bank it appears that there is 20 of equity supporting banking risks. But, in fact, this is not the case because the bank has an investment of 10 in the insurer's equity. In practice, losses suffered by the insurer will lead directly to losses in the bank's equity. In other words, the 20 of equity on the bank's balance sheet is really supporting both banking risks and insurance risks (i.e. 100 + 50). This is evident from the illustrative combined balance sheet of the group.