



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP16/19

Solvency II: Group availability of subordinated liabilities and preference shares

July 2019



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The response will be assessed to inform our work as a regulator and central bank, both in the public interest and in the exercise of our official authority. We may use your details to contact you to clarify any aspects of your response.

The consultation paper will explain if responses will be shared with other organisations (for example, the Financial Conduct Authority). If this is the case, the other organisation will also review the responses and may also contact you to clarify aspects of your response. We will retain all responses for the period that is relevant to supporting ongoing regulatory policy developments and reviews. However, all personal data will be redacted from the responses within five years of receipt. To find out more about how we deal with your personal data, your rights or to get in touch please visit bankofengland.co.uk/legal/privacy.

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Responses are requested by Monday 21 October 2019.

Please address any comments or enquiries to:

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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) sets out its proposed approach to the determination of the availability of subordinated liabilities and preference shares in group own funds, and its expectations of firms in presenting relevant analysis to the PRA. The Appendix sets out proposed amendments to Supervisory Statement (SS) 9/15 ‘Solvency II: Group supervision’¹ to reflect the proposed approach.

1.2 This CP is relevant to all insurance firms within the scope of group supervision under the Solvency II Directive² and to the Society of Lloyd’s.

Background

1.3 In March 2015, the PRA published SS3/15 ‘Solvency II: the quality of capital instruments’³ which clarified the PRA’s expectations of the quality of capital instruments, including instruments intended to count towards group own funds.

1.4 In July 2018, the PRA published CP15/18 ‘Solvency II: Group own funds availability’⁴ which set out the PRA’s proposed approach to the determination of the availability of group own funds and its expectations of firms in presenting relevant analysis to the PRA. The PRA’s consideration of responses to the CP were set out in Policy Statement 9/19 ‘Solvency II: Group own funds availability’⁵ and included in an updated version of SS9/15.

1.5 Further to these publications, the proposals in this CP would clarify the PRA’s expectations of firms seeking to demonstrate that the Solvency II assumption that subordinated liabilities and preference shares are not available to meet losses elsewhere in the group⁶ is inappropriate in a firm’s specific case.

Implementation

1.6 The PRA intends that the proposals in this CP would take effect on publication of the final policy. The proposals would not apply to determinations of availability the PRA has previously made.

Responses and next steps

1.7 This consultation closes on Monday 21 October 2019. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP16_19@bankofengland.co.uk.

1.8 The proposals set out in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA has assessed that the proposals will not be affected in the event that the UK leaves the EU with no implementation period in place.

¹ March 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-group-supervision-ss>.

² 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).

³ <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-the-quality-of-capital-instruments-ss>.

⁴ <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-group-own-fund-availability> (page 2 of 2).

⁵ March 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-group-own-fund-availability> (page 1 of 2).

⁶ As stated in in Article 330(3) of the 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.

2 Proposals

2.1 The PRA assesses group own funds availability based on the criteria set out in Article 330 of the Delegated Regulation⁷ which includes the assumption that subordinated liabilities and preference shares are not effectively available to cover the group solvency capital requirement (SCR). Solvency II makes provision for firms to demonstrate to the satisfaction of the PRA that this assumption is inappropriate and therefore exclude such own fund items when calculating the amount of non-available own funds exceeding the contribution to the group SCR in line with Article 330(5) of the Delegated Regulation.

2.2 Subordinated liabilities and preference shares create legal obligations on the issuing entity to the holders of the instruments. Furthermore, the issuing entity would not normally have legal obligations in relation to losses arising in related insurance and reinsurance undertakings. This would therefore restrict the ability of subordinated liabilities and preference shares to absorb all types of losses arising elsewhere in the group.

2.3 This CP proposes that, for a firm to satisfy the PRA that the own funds items are available to cover the group SCR, the firm would need to demonstrate that these own funds are available to absorb losses anywhere in the group.

2.4 The PRA considers that a firm may demonstrate this as follows:

- Each insurance and reinsurance undertaking in the Solvency II group has the right to claim against the issuing entity if that insurance or reinsurance undertaking is wound up and there is a shortfall for its policyholders and beneficiaries. This includes any insurance and reinsurance undertakings acquired by the group after the issuance of the subordinated liabilities or preference shares. Further, the right of the related insurance and reinsurance undertakings to claim on the issuer does not significantly increase group risks, including the level of complexity when winding up and contagion risk for issuing entities that are insurance or reinsurance undertakings.
- The legal obligations of the issuing entity to the holders of the subordinated liabilities and preference shares, including coupon payments, are subordinated to any claims made by related insurance and reinsurance undertakings that are being wound up.

2.5 The PRA considers that where a firm provides guarantees to related undertakings for this purpose, this would significantly increase risks in the group because of certain features that are present in most groups. This CP proposes that the firm providing the guarantee would need to demonstrate that these risks are not significant in its particular case.

2.6 The PRA would assess the level and volume of risks and the possible risks of contagion in the group due to the intra-group guarantees. The PRA would expect a firm to demonstrate that the intra-group guarantees would not significantly increase the level of complexity when winding up the group to the detriment of orderly exit. The PRA would also expect a firm to demonstrate that the intra-group guarantees would not significantly increase contagion risk for the issuing entity, where

⁷ 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.

this is an insurance or reinsurance undertaking, by exposing the solvency of the issuing entity to losses in the related insurance and reinsurance undertakings.

2.7 The PRA considers that the features that increase the impact of intra-group guarantees on these risks include, but are not limited to, the following:

- the issuing entity is an insurance or reinsurance undertaking;
- there are multiple insurance and reinsurance undertakings in the group;
- the issuing entity is a subsidiary of an entity that either has related insurance or reinsurance undertakings or is an insurance or reinsurance undertaking; and
- there are significant intra-group transactions, both in terms of volume and value.

2.8 As these features are present in most groups, the PRA would not consider it appropriate for most groups to use intra-group guarantees to make subordinated liabilities and preference shares effectively available to absorb losses anywhere in the group. The PRA would expect a firm to consider any other relevant group-specific features that increase group complexity.

2.9 These proposals would only apply to future determinations of the availability of subordinated liabilities and preference shares to a group.

3 The PRA's statutory obligations

3.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to consult when setting its general policies and practices.⁸ In doing so, it is required to comply with several statutory and public law obligations. The PRA meets these obligations by providing the following in its consultations:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective⁹, insurance objective¹⁰ (if applicable), and secondary competition objective;¹¹
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles;¹² and
- a statement as to whether the impact of the proposed policy will be significantly different to mutuals than to other persons.

⁸ Section 2L of FSMA.

⁹ Section 2B of FSMA.

¹⁰ Section 2C of FSMA.

¹¹ Section 2H(1) of FSMA.

¹² Section 2H(2) and 3B of FSMA.

3.2 The PRA should have regard to aspects of the Government's economic policy as recommended by HM Treasury.¹³

3.3 The PRA is also required by the Equality Act 2010¹⁴ to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.4 The proposals in this CP relate to the PRA's approach to determining whether the assumption of non-availability of subordinated liabilities and preference shares is inappropriate for a group. The proposals will clarify the PRA's expectations of firms and help firms better understand and comply with existing requirements.

3.5 Some firms may incur some costs if they restructure in order to satisfy the PRA that the use of intra-group guarantees does not significantly increase risks in the group. However, these costs are incurred only when firms wish to demonstrate that the assumption of non-availability of subordinated liabilities and preference shares is inappropriate in their particular case. The PRA does not expect such costs to be significant as it has received very few requests for these determinations.

Compatibility with the PRA's objectives

3.6 The PRA believes that the proposals in this CP are compatible with the PRA's statutory objectives to promote the safety and soundness of PRA-authorized firms; and in the context of insurance, to contribute to policyholder protection. The proposals clarify the PRA's expectations for firms undertaking availability of own funds assessment for subordinated liabilities and preference shares. Through the proposals, the PRA aims to ensure effective protection of policyholders anywhere in a Solvency II group. The proposals provide clarity on the PRA's approach to the assessments for consistency of application.

3.7 The PRA's secondary objective is to facilitate effective competition between providers of PRA-regulated activities. The PRA expects that the proposals will facilitate effective competition by:

- ensuring the genuine availability of own funds to absorb losses anywhere in the group;
- ensuring that making subordinated liabilities and preference shares available through the use of intra-group guarantees does not result in significant risks to the group; and
- facilitating consistent understanding of the availability assessment of subordinated liabilities and preference shares.

Regulatory principles

3.8 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Four of the principles are of particular relevance to this consultation:

- (i) The PRA should use resources in the most efficient and economic way. By providing clarity on its approach to assessing availability of subordinated liabilities and preference shares, the PRA

¹³ Section 30B of the Bank of England Act 1998.

¹⁴ Section 149.

anticipates that firm assessments would more effectively demonstrate their availability, resulting in more efficient engagement with their supervisor.

- (ii) A burden or restriction which is imposed on a person should be proportionate to the benefits, which are expected to result from the imposition of that burden. The proposals would reduce the resource burden on firms in understanding the assessments and in engagements with their supervisors. Further, the proposals would apply to availability assessments made on and after the date of publication of the revised supervisory statement. This would reduce the burden on firms that have already obtained a determination by the PRA.
- (iii) The PRA should exercise its functions in a way that recognises differences in the nature and objectives of different PRA-authorized firms. The proposals in this CP recognises that the use of intra-group guarantees to make subordinated liabilities and preference shares available may be appropriate for certain PRA-authorized firms.
- (iv) The PRA should exercise its functions as transparently as possible. Through these proposals, the PRA would make clear to firms its approach to assessing availability of subordinated liabilities and preference shares.

Impact on mutuals

3.9 The PRA considers that the impact of the proposed rule changes on mutuals is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

3.10 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.¹⁵

3.11 The aspects of the Government's economic policy most relevant to the proposals in this CP are:

- (i) Competition.
- (ii) Better outcome for consumers.
- (iii) Innovation.
- (iv) Competitiveness.

3.12 Aspects (i) and (ii) have been considered in the 'Compatibility with the PRA's objectives' and 'Regulatory principles' sections above.

Innovation

3.13 The PRA, through the proposals in this CP, recognises differences in the nature and objectives of business models and allows for innovation in raising capital while approaching treatment of subordinated liabilities and preference shares in proportion to a firm's specific circumstances.

15 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at <https://www.bankofengland.co.uk/about/people/prudential-regulation-committee>.

Competitiveness

3.14 The proposals in this CP would ensure robust policyholder protection at group level by ensuring that capital reflected in the group solvency calculation would be available in the event of losses anywhere in the group. Together with aspect (ii) and (iii) above, this would maintain the UK as an attractive domicile for internationally active financial institutions.

Equality and diversity

3.15 The PRA considers that the proposals does not give rise to equality and diversity implications.

Appendix: Draft amendments to Supervisory Statement 9/15 ‘Solvency II: group supervision’

This appendix outline proposed amendments to SS 9/15 ‘Solvency II: group supervision’.

Underlying indicates new text and striking through indicates deleted text.

...

5B Regulatory determination on the availability of group own funds

...

5B.1A Subordinated liabilities and preference shares are among own fund items treated as in 5B.1 (i). Where the PRA is the group supervisor, for a firm to satisfy the PRA that the own funds items are available to cover the group SCR, the firm needs to demonstrate that these own funds items are available to absorb losses anywhere in the group. The PRA considers that a firm may demonstrate this as follows:

- Each insurance and reinsurance undertaking in the Solvency II group has the right to claim against the issuing entity if that insurance or reinsurance undertaking is wound up and there is a shortfall for its policyholders and beneficiaries. This includes any insurance and reinsurance undertakings acquired by the group after the issuance of the subordinated liabilities or preference shares. Further, the right of the related insurance and reinsurance undertakings to claim on the issuer does not significantly increase group risks, including the level of complexity when winding up and contagion risk for issuing entities that are insurance or reinsurance undertakings.
- The legal obligations of the issuing entity to the holders of the instruments, including coupon payments, are subordinated to any claims made by related insurance and reinsurance undertakings that are being wound up.

5B.1B The PRA considers that intra-group guarantees used for this purpose increase certain risks in a group. The PRA would assess the level and volume of risks and the possible risks of contagion in the group due to the intra-group guarantees. The PRA would expect a firm to demonstrate that the intra-group guarantees do not significantly increase the level of complexity when winding up the group. The PRA would also expect a firm to demonstrate that the intra-group guarantees do not significantly increase contagion risk for issuing entities that are insurance or reinsurance undertakings by exposing the solvency of the issuing entity to losses in the related insurance and reinsurance undertakings.

5B.1C The PRA considers that features that increase the impact of intra-group guarantees on these risks include, but are not limited to, the following:

- (i) the issuing entity is an insurance or reinsurance undertaking;
- (i) there are multiple insurance and reinsurance undertakings in the group;
- (ii) the issuing entity is a subsidiary of an entity that either has related insurance or reinsurance undertakings or is an insurance or reinsurance undertaking; and

(iii) there are significant intra-group transactions, both in terms of volume and value.

5B.1D As these features are present in most groups, the PRA expects that for most groups it will not be appropriate to use intra-group guarantees to make subordinated liabilities and preference shares effectively available to absorb losses anywhere in the group. Further, the PRA would expect a firm to consider any other relevant group-specific factors that increase group complexity.

5B.1E Where own fund items are not specifically identified in Article 330 of the Delegated Regulation, the firm should assume that these own fund items are available to cover the group SCR. The PRA may require the firm to provide an assessment of availability of the own fund items which the PRA will consider to determine whether the PRA agrees with the analysis.