

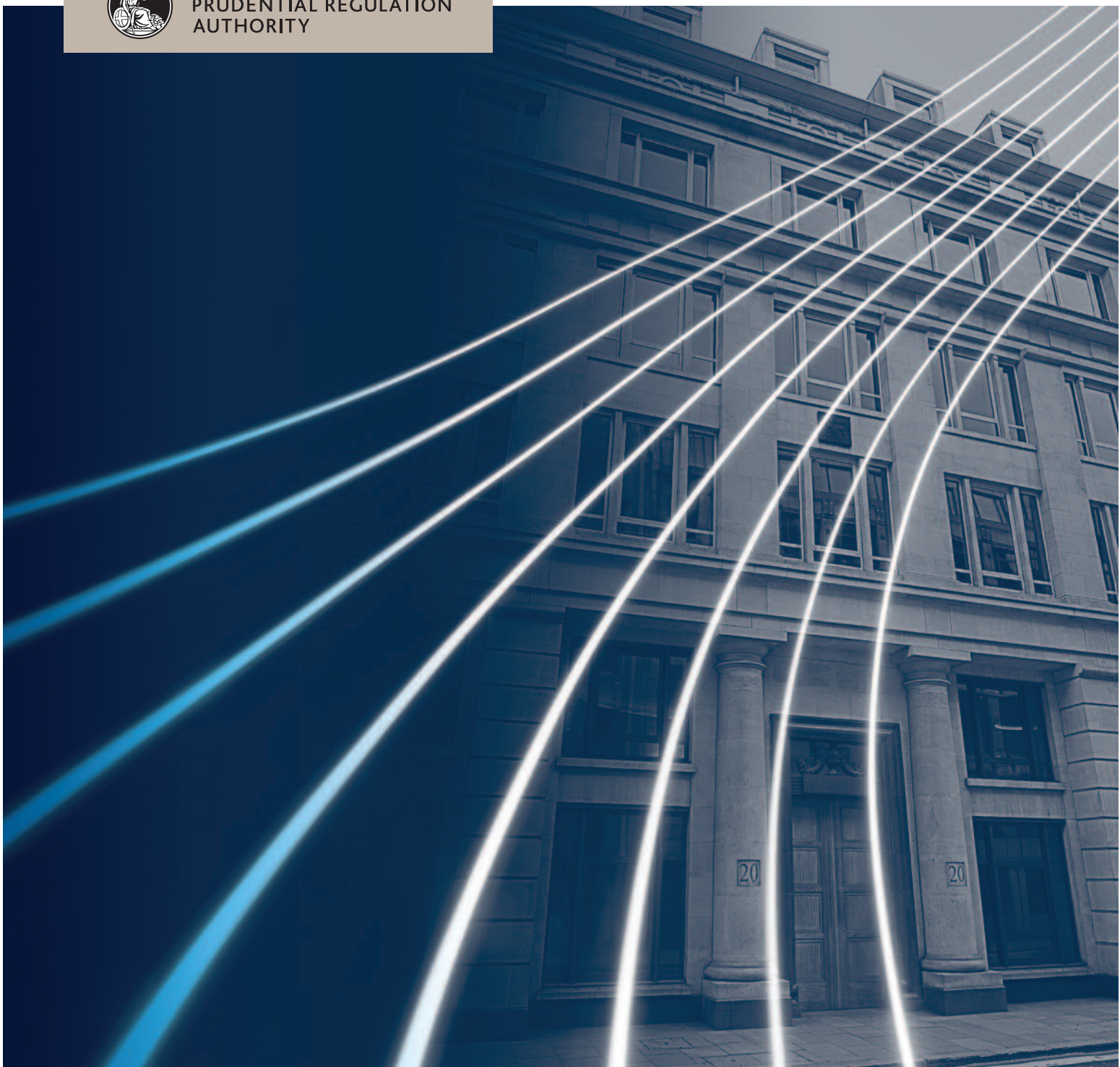
Policy Statement | PS2/15

Solvency II: a new regime for insurers

March 2015



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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This policy statement contains the final rules and supervisory statements to implement Solvency II.

Foreword by the Governor



Mark Carney
Governor

From 2016, insurers in the United Kingdom will operate under a new regulatory regime. Solvency II is about improving protection for policyholders and creating a safer and more resilient sector.

It is difficult to appreciate just how revolutionary Solvency II is for the prudential framework in Europe. This will be the first time that we have had a truly harmonised, risk-based, forward-looking and transparent regime for insurers.

Insurers enable households and businesses to shoulder burdens they could not otherwise bear. Their longer-term investment horizon builds the resiliency of our financial system and provides finance that enhances the productive potential of the UK economy.

It is precisely because they provide these critical functions that insurers must be robustly supervised.

At the heart of the insurance business model is the pricing and trading of risk. When done well, this enables an economy to prosper. When done poorly, an insurer can quickly find itself in financial distress. If the industry underperforms, the economy will suffer.

The failure of an insurance firm can have many causes and many difficult impacts. It is vital for the continued orderly functioning of a modern economy that its insurance sector is resilient to adverse events.

It is now widely accepted that risk-based capital requirements and transparent valuation practices are an important element of maintaining the resilience of insurers. This is what Solvency II introduces.

Our task now is to ensure a robust implementation of the new regime. The Bank of England has been at the forefront of global thinking on insurance regulation — a tradition that we will maintain as we move through the early years of the new framework.

A handwritten signature in black ink, appearing to read 'M Carney'. The signature is fluid and cursive, with a long horizontal stroke at the end.

March 2015

Foreword by the Chief Executive



Andrew Bailey

CEO, PRA Deputy Governor, Prudential Regulation

In 2002, my former colleague, Paul Sharma, led a comprehensive review into reforming the insurance sector following the failure of several firms under the old regime.

The Sharma Report marked the beginning of the long process towards Solvency II. It remains a valuable resource for anybody trying to understand why insurers fail, and how to avoid it.

Thirteen years after Paul's report, we are at the point of introducing the new regime. Given the long road, it is notable that Solvency II retains the original coherence: assets and liabilities are valued using market-consistent methods, and capital requirements are set to ensure that firms can withstand a forward-looking, one in two hundred year stress.

In the United Kingdom, the insurance market today faces many challenges, including a low interest rate environment, climate change risks, and the recent reforms to the annuity market.

To meet those challenges, a robust regulatory regime is required. We know from the experience of 2008 that well-capitalised insurers enable the sector to withstand unforeseen shocks.

The United Kingdom, almost uniquely among its European peers, has operated a risk-based and market-consistent framework for some time. Other countries have pursued a variety of approaches, and the European framework has become fragmented over the last few decades.

That is why Solvency II is a welcome modernisation of prudential requirements, many of which have been left untouched since the 1970s. It removes the existing patchwork of national regulatory regimes and multiple European directives, and replaces them with a single rulebook.

Having the same standards applied consistently across Europe is a fundamental principle of Solvency II. It helps ensure that regulation is not arbitrated and the risks that this presents to policyholders.

I am committed to working closely with firms to ensure a smooth transition to the new regime. Solvency II must be applied proportionately, with the emphasis on substance over form, if we are to maintain our focus as a forward-looking and judgement-based regulator.

I am pleased to say we have an effective and constructive relationship with the UK insurance industry, which remains supportive of the Solvency II framework. The new regime will not be perfect, but it is a welcome step in the right direction.

A handwritten signature in black ink that reads "Andrew Bailey". The signature is written in a cursive, slightly slanted style.

March 2015

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1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback on the responses received in relation to consultations to implement the Solvency II Directive (the Directive). These consultations were:⁽¹⁾

- CP16/14: Transposition of Solvency II: Part 3;
- CP22/14: The PRA's approach to with-profits insurance business;
- CP23/14: Solvency II approvals;
- CP24/14: Solvency II: further measures for implementation; and
- CP3/15: Solvency II: transitional measures and the treatment of participations.

1.2 This PS contains the final rules and supervisory statements following the consultations above. It will be of interest to all UK Solvency II firms and to Lloyd's. In addition, Chapter 13 of this PS will be of interest to UK firms with with-profits business that are not within the scope of Solvency II.

Feedback to responses

1.3 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to have regard to any representations made to the proposals in the consultation, and publish an account, in general terms, of those representations and its response to them.

1.4 Where relevant, this PS groups similar topics into the same chapter. Each chapter includes policy feedback commenting on the most significant issues raised by respondents and noting those areas where the PRA is making a substantive change to the proposals contained in the consultations. Where an issue is not explicitly addressed, the PRA is maintaining the policy approach set out in the consultations.

1.5 Where changes to proposals since consultation materially alter the original cost benefit analysis, this is considered in the individual chapters of this PS.

1.6 The final rules to implement Solvency II are contained in Appendix 1, and the supervisory statements are in Appendix 2. National specific templates and log files are contained in Appendix 3, which can be found on the PRA's website.

1.7 In addition to changes to PRA rules, transposing the Directive into UK law requires amendments to statutory legislation, and minor amendments to the FCA Handbook. Firms should also be aware that the PRA is making amendments to the accountability regime for senior managers of insurance firms, which transpose or are closely related to the implementation of certain Solvency II governance requirements.

(1) These consultation papers can be accessed at www.bankofengland.co.uk/pr/Pages/solvency2/updates.aspx.

2 The matching adjustment

2.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of the matching adjustment (MA). The responses did not raise any issues that would require a change to the proposals detailed in the consultation.

2.2 The PRA followed an 'intelligent copy-out' approach to the transposition of the MA. Respondents supported this approach, and specifically welcomed the omission of any prescribed list of eligible assets for the purpose of meeting the MA eligibility criteria.

2.3 A few responses expressed concern about the analysis of the costs and benefits associated with the MA. In particular, the analysis was interpreted by some as implying that the PRA intends to 'benchmark' the Solvency II requirements against the existing regulatory regime. This was not the PRA's intention. The cost benefit analysis of a policy is usually performed relative to the existing baseline in order to understand the potential future impact of that policy only.

3 The volatility adjustment

3.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of the volatility adjustment (VA).

3.2 Respondents welcomed the PRA's approach to intelligent copy-out of the Directive.

3.3 Some responses focused on matters outside the scope of the consultation, particularly in relation to the supervisory approval power for the VA proposed in HM Treasury's (HMT's) consultation on corresponding statutory legislation to implement Solvency II.⁽¹⁾ This matter remains the responsibility of HMT, which has decided to exercise the Member State option for supervisory approval of the VA in the United Kingdom.⁽²⁾

3.4 In light of HMT's decision, the PRA has published a draft supervisory statement outlining its approach to supervisory approval for the VA, to give firm's further clarity on the process. The consultation closes on 20 April 2015.

(1) www.gov.uk/government/consultations/solvency-ii-resolving-the-remaining-policy-issues-for-uk-transposition/solvency-ii-resolving-the-remaining-policy-issues-for-uk-transposition.

(2) www.legislation.gov.uk/uksi/2015/575/contents/made.

4 Risk management for the long-term guarantees measures

4.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of certain risk management requirements. The responses did not raise any issues that would require a change to the proposals detailed in the consultation.

Liquidity plan

4.2 A respondent asked for additional clarification on the nature of the liquidity plan as it relates to the long-term guarantees (LTG) measures.

4.3 More detail on the PRA's expectations of the liquidity plan in relation to the MA was provided in Paul Fisher's letter of 15 October 2014.⁽¹⁾ The liquidity plan must project the cash in and out-flows for those assets and liabilities that are subject to either the MA or the VA. As the liquidity plan forms part of a firm's own risk management, it should be tailored to suit the specific risk profile of each firm's business. The PRA will not prescribe either the content or format of a firm's liquidity plan.

Risk-free rate term structure

4.4 The respondent also queried the need for certain rules relating to the extrapolation of risk-free interest rate term structures, as the extrapolation methodology used to construct the term structure is not subject to a firm's

discretion but is instead prescribed by the European Insurance and Occupational Pensions Authority (EIOPA).

4.5 EIOPA is mandated under Article 77e of the Directive to publish certain technical information on a quarterly basis, including for each relevant currency, the relevant risk-free interest rate term structure to calculate the best estimate. It is only where such technical information is adopted by the Commission in implementing acts that the information will be binding directly on firms.

4.6 The extrapolation methodology or its parameters as published by EIOPA may change over time. It is important for firms to understand the sensitivity of their balance sheet to all critical assumptions, whether or not those assumptions are made by the firm itself or in reliance on technical information published by EIOPA.

4.7 Firms should note that the glossary definition of 'relevant risk-free interest rate term structure' contemplates the expectation that the relevant risk-free interest rate term structure will be specified in implementing acts adopted by the Commission (under Article 77e of the Directive) and, in that case, that is the rate that firms must apply.

(1) www.bankofengland.co.uk/pradocuments/solvency2/matchingadjustmentletteroct2014.pdf.

5 Transitional measures

5.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of certain transitional measures, and indicated its future intention to consult on additional transitional measures. In CP3/15, the PRA consulted on proposed rules to implement the transitional measures on risk-free interest rates and technical provisions. Together, these consultations cover the full set of Solvency II transitional provisions.

5.2 Respondents welcomed the consultation on transitional measures, noting that transitional measures are vital for ensuring a smooth transition to the new regime. The clarification of the transitional rules for firms in run-off and the PRA's adoption of the transitional measure specific to group internal models were welcomed.

5.3 A respondent proposed that the transitional measures for Tier 2 own funds be extended to cover dated Tier 2 capital as well as lower Tier 2 capital. Under GENPRU 2.2 all dated Tier 2 capital falls within lower Tier 2 capital and no change is therefore required to the rule in Transitional Measures 4.2.

5.4 Respondents agreed with the PRA's view that Pillar 2 technical provisions are the most appropriate starting point for the transitional deduction to technical provisions. However,

several respondents expressed concern about the concept of an EU minimum level of technical provisions, and said that this introduced additional complexity to the calculation and that more guidance would be needed to ensure consistent calculation of this minimum across firms. Respondents also requested more information about the application process itself, including the content required and the criteria that will be used for decision by the PRA. Respondents asked for more clarity about how the transitional deduction to technical provisions and the transitional measure on the risk-free rate would be supervised on an ongoing basis. Particular concern was expressed about 'parallel running' of old and new regimes. Respondents requested that the approach taken by the PRA be pragmatic to minimise any unnecessary resource burden on firms.

5.5 Since the publication of CP3/15, HM Treasury has decided to transpose the substance of the transitional measure for technical provisions via amendments to statutory legislation.⁽¹⁾ In doing so, HM Treasury has simplified the approach by including a specific reference to INSPRU 7 in the current PRA Handbook. The PRA has therefore amended its proposed rules (and its supervisory statement) to reflect this.

(1) Financial Services and Markets (the Solvency 2 Regulations 2015).

6 External credit rating assessments

6.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of external credit rating assessments. The responses did not raise any issues that would require a change to the proposals detailed in the consultation.

6.2 A respondent was concerned that the requirements for firms relating to reducing over-reliance on external credit assessment institutions when they use external credit rating assessment in the calculation of technical provisions and the solvency capital requirement (SCR) will be expensive and challenging to complete within the reporting deadlines. In addition, the respondent considered the requirement to be unnecessary, given firms are unlikely to have greater knowledge of the credit risk in their investments than external experts.

6.3 The Directive requires that firms must assess the appropriateness of external credit assessments as part of their risk management by using additional assessments wherever practicably possible in order to avoid any automatic dependence on external assessments. This is a maximum-harmonising provision of the Directive and therefore the PRA may not deviate from the requirement in its transposition of the provision into the PRA Rulebook.

7 Groups

7.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of groups. Since the publication of CP16/14 the PRA issued CP23/14 on 15 October 2014 and CP24/14 on 21 November 2014. Together, these consultations covered certain aspects of groups and notification of intragroup transactions, 'approvals' under Solvency II, and the extent of the insurance group (where approval would be required to exclude certain entities from the scope of group supervision).

Notification of intragroup transactions

7.2 Some respondents said that draft rules in CP16/14 (in particular, 16.2 of the Group Supervision Part of the PRA Rulebook) left it open to judgement as to what 'significant', 'very significant' and 'as soon as practicable' meant.

7.3 The rules in question transpose Articles 244 and 245 of the Directive. Those articles do not specify the meaning of 'significant', 'very significant' or 'as soon as practicable'. In line with the PRA's intelligent copy-out approach, the PRA does not intend to provide further prescription in the PRA Rulebook regarding the definition of these terms.

7.4 Firms should note that Article 244(3) requires each group supervisor, after consulting the other supervisory authorities in the group, to impose appropriate thresholds based on solvency capital requirements, technical provisions, or both. The PRA is not implementing this provision via PRA rules, because the Directive requires group-specific judgements and consultation. Insurance groups should therefore agree the thresholds for regular reporting bilaterally with their group supervisor.

7.5 The PRA judges that 'as soon as practicable' is widely understood in this context. In addition, firms should be aware of the PRA's Fundamental Rule FR7, 'A firm must deal with its regulators in an open, co-operative and timely way and must appropriately disclose to the PRA anything relating to the firm of which the PRA would reasonably expect notice'.⁽¹⁾ For very significant intragroup transactions, therefore, the PRA expects to be notified before the transaction is entered into rather than afterwards.

(1) Available at http://media.fshandbook.info/Handbook/FundamentalRulesv1_PRA_20140619.pdf.

8 Insurance special purpose vehicles

8.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of insurance special purpose vehicles (ISPVs).

8.2 While it was recognised that the approach proposed by the PRA was pragmatic, some respondents questioned why the PRA was not applying transitional provisions in respect of existing ISPVs. However, as stated in paragraph 8.6 of CP16/14, existing ISPVs will be able to maintain their current permissions as allowed for under the transitional provisions introduced in Solvency II.

8.3 Respondents also questioned whether the PRA's approach would lead to significant additional costs, and whether other Member States were adopting a similar approach. The PRA has decided that the most effective way to ensure that existing ISPVs can benefit from the Solvency II regime for ISPVs is to ensure that the PRA rules are equivalent to the relevant Solvency II Regulations (Delegated Acts and

Implementing Technical Standards). In order to adopt the simplest and most transparent approach the PRA has decided to apply the Solvency II Regulations rather than looking to maintain a set of rules equivalent to them. As a result, the PRA does not consider that the adoption of its proposals will create level playing field issues with regimes in other Member States, nor that existing ISPVs will be exposed to significant additional costs.

8.4 A respondent questioned whether there was certainty as to the treatment of an ISPV in the group solvency calculation. Compliance with the Solvency II Regulations for ISPVs, or compliance with a Member State's equivalent regime, is a pre-requisite for the exclusion of the ISPV from that calculation. Any ISPV entitled to apply Rule 3.1 in the Insurance Special Purpose Vehicles Part of the PRA Rulebook will be excluded from the group solvency calculation, as specified in Article 329 of the Solvency II Regulations.

9 Third-country branches

9.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of third-country branches. Responses focused on how branch assets and liabilities would be identified, the reporting requirements for branches, and requirements for branches carrying on only reinsurance business.

Identification of branch assets and liabilities

9.2 Some respondents suggested that the proposals did not cover the identification of branch assets and branch liabilities. The rules proposed by the PRA are modelled on the provisions in the Directive that they implement. These provisions do not provide further prescription on the allocation of branch assets and branch liabilities to the branch when calculating the branch SCR. Therefore, at present the PRA does not propose any changes to the rules concerning the identification of branch assets and branch liabilities. This leaves a certain degree of discretion to insurers as to how to categorise assets and liabilities, within the boundaries of the Solvency II framework. The PRA expects insurers to take a realistic and prudent approach when making this determination.

Reporting requirements

9.3 A small number of respondents were concerned that the timetable for introducing reporting requirements was unclear; questioned the scope for these to be waived (particularly if the branch carries on only reinsurance business); and wished to better understand whether the PRA would require information on the whole third-country insurance undertaking's financial position that differed from that provided to the home regulatory authority.

9.4 The timetable for introducing reporting requirements is as provided in the PRA's rules, which apply PRA rules and transitional provisions on reporting to third-country branches. Rule 9 in the Third-Country Branches Part of the PRA Rulebook has now been amended to clarify which of the reporting rules for Solvency II firms apply to third-country branches and with what modifications. In addition to this, firms may look to the EIOPA Guidelines for details of how PRA rules on reporting may be interpreted.⁽¹⁾ In particular, the PRA understands it is likely that EIOPA will not expect the first returns (as at 1 January 2016) to be submitted using XBRL reporting formats and the PRA may take this approach also. As regards information on the whole third-country insurance undertaking, consistent with SS10/15,⁽²⁾ provided that undertaking's home regime is broadly equivalent to the

Solvency II regime, the PRA would expect to receive only information extracted from that provided to the home regulatory authority. The format of this information can be agreed bilaterally with a firm's usual supervisory contact.

Requirements for branches carrying on only reinsurance business

9.5 Some respondents questioned the need to have as extensive requirements for branches carrying on only reinsurance business, while other respondents supported extending Solvency II requirements to such branches as proposed in CP16/14.

9.6 The PRA will consider applications to waive requirements for branches carrying on only reinsurance business since these do not stem from EU Directive obligations. The PRA expects that it will remain necessary to receive information on the whole insurance undertaking's financial position, a basic level of branch-level reporting, and to be satisfied that if the undertaking were to fail, then branch policyholders would receive an appropriate level of protection. However, as reinsurance creditors do not receive preferential treatment under Solvency II or UK insolvency legislation (they rank equally with ordinary creditors unlike direct policyholders' claims which have priority), tend to be sophisticated businesses and are not protected by the Financial Services Compensation Scheme, the PRA may be more readily satisfied that the criteria for granting waivers will be met. Firms in this situation should raise the matter directly with their supervisory contact. However, the PRA intends to introduce the general rules for branches carrying on only reinsurance as proposed in order that such matters are given proper consideration simultaneously with implementing Solvency II.

Branch asset ring-fencing

9.7 A respondent was concerned that some of the proposals could be regarded as introducing ring-fencing of branch business. The proposed rules do not require any ring-fencing of branch assets. Indeed, the requirements relax what was previously in the PRA's rules concerning the localisation of branch assets. It is possible that if EIOPA's Guidelines on branch supervision are made in their present form, branch assets of branches which are subject to a winding-up regime

(1) Available at https://eiopa.europa.eu/Publications/Consultations/EIOPA_EIOPA-CP-14-048_GL_Third_Country_Branches.pdf.

(2) PRA Supervisory Statement SS10/15, 'Third-country branches', March 2015; www.bankofengland.co.uk/pradocuments/publications/ss/2015/ss1015.pdf.

which does not adequately protect policyholders may need to be reserved for the exclusive benefit of branch policyholders in order to be counted towards the branch solvency requirements. However, the PRA expects that most major jurisdictions are likely to operate a winding-up regime which provides appropriate and fair protection for all policyholders.

9.8 A respondent also commented that as part of the proposed requirement for the whole third-country insurance undertaking to have adequate worldwide financial resources, the exclusion for this purpose of any surplus assets held within the United Kingdom or the European Economic Area (EEA), could be regarded as a type of ring-fencing.

9.9 The PRA has decided to delete the proposed Third-Country Branches 13.2 concerning restrictions in calculating worldwide financial resources from the final rules as it is not strictly necessary and could lead to confusion.

Future policy development

9.10 The PRA intends to consult in the summer of 2015 on the adoption of EIOPA's Guidelines for branch supervision, once these have been finalised. If the PRA proposes to comply with the Guidelines, this will determine more precisely which branch assets should be included in the branch solvency calculation and which liabilities those assets should cover. The inclusion of assets will depend upon the way in which they are distributed under the relevant winding-up regime to ensure that policyholders receive the appropriate degree of protection which Solvency II demands. The PRA may update the supervisory statement now being introduced (see Appendix 2.10).

10 Surplus funds

10.1 In CP16/14 the PRA consulted on proposed rules and a draft supervisory statement addressing the calculation of surplus funds for Solvency II firms carrying on with-profits business. The responses did not raise any issues that would require a change to the proposed rules. In light of feedback, the PRA has made three additions (in paragraphs 3.3–3.6) to the surplus funds supervisory statement in order to enhance clarity. These amendments do not signal a change in policy intent.

10.2 Respondents raised many specific questions on this complex policy area; further detail on the consultation and the issues raised in responses is provided below. Comments on with-profits definitions received in relation to CP16/14 and CP22/14 are addressed in Chapter 13, With-profits, of this PS.

Consistency with Solvency II

10.3 A respondent felt that the proposals were not consistent with Article 76(2) of the Directive, which requires the value of technical provisions to reflect the transfer value of insurance obligations to another firm.

10.4 Article 91 of the Directive allows for surplus funds to be authorised under national-specific legislation. Surplus funds identify amounts that should not be treated as insurance liabilities and hence should not be included within the best estimate component of a firm's technical provisions as specified in Article 78(3) of the Directive.

10.5 A respondent felt the proposed surplus funds calculation would make it difficult for firms to comply with Articles 23 and 236 in the Solvency II Regulations, which set out requirements for future management actions at the solo and group levels.

10.6 Future management actions need to be taken into account in the determination of technical provisions under Solvency II when a firm's solvency position is calculated. Surplus fund calculations identify amounts that are not included in the best estimate component of a firm's technical provisions at that time and can be seen as part of the process of determining technical provisions overall. Bearing in mind the relationship between the calculations it is difficult to see why compliance with Articles 23 and 236 of the Solvency II Regulations is problematic.

Consistency of the calculation with a firm's legal obligations

10.7 Some firms have said that the specific arrangements governing the operation of their with-profits fund(s) place them in a different position to other firms, and this should result in a different treatment of surplus funds. Those respondents felt that the proposals did not recognise the contractual and legal obligations of some firms, and noted that, as firms in general are subject to a legal obligation (eventually) to distribute all or part of the residual inherited estate to with-profits policyholders, those amounts should be included now in the value of with-profits policy liabilities.

10.8 The PRA recognises that each with-profits fund is different, but considers that the calculation of surplus funds is sound and capable of operating consistently with the various arrangements governing UK with-profits funds. In formulating a calculation for surplus funds, the PRA has sought to promote consistency in the preparation of Solvency II technical provisions, capital resources and capital requirements across UK with-profits firms. The surplus funds rules also recognise the loss-absorbing capital arising in relation to closed with-profits funds and mutuals.

10.9 The PRA does not consider that the prescribed calculation of surplus funds is inconsistent with a firm's legal obligation or expectation to distribute some or all of its with-profits assets (including any residual inherited estate) to with-profits policyholders over time. The surplus funds rules in fact recognise the timing issues created by future distributions of inherited estate: amounts that have not already been made available for distribution at the valuation date should not be treated as insurance liabilities for the purposes of calculating Solvency II technical provisions even if, over the course of time, the firm might expect to distribute the entire estate. These amounts retain loss-absorbing capacity and are therefore surplus funds. However, as and when further amounts within the inherited estate are subsequently made available for distribution, they should be recognised as insurance liabilities and would then cease to be considered surplus funds. The existence of the required calculation of surplus funds does not therefore preclude a firm transferring a with-profits fund's residual inherited estate to a third party in connection with any future transfer of the associated with-profits liabilities, in order for the firm to meet any legal requirements or expectations in respect of that inherited estate.

Interaction of with-profits and shareholder own funds

10.10 Some respondents suggested that including potential future distributions from the inherited estate as surplus funds rather than as insurance liabilities would result in what was described as mixing of own funds contributed by with-profits funds and shareholder own funds. It was asserted that this could result in a less transparent, and potentially misleading or inappropriate overall presentation of a firm's own funds.

10.11 A mandatory surplus funds calculation will lead to a more consistent approach across UK with-profits firms, and a clearer presentation of restricted own funds within a with-profits fund. The PRA considers the current approach by some, but not all, firms which treats all potential future distributions as insurance liabilities to be less transparent, because those amounts can in fact be reduced in adverse circumstances. That approach could lead to a significant reduction in the SCR stemming from a loss-absorbing capacity of technical provisions calculation based on the inclusion of the estate within the value of future discretionary benefits. The surplus funds calculation will require a firm to consider the amounts that have been made available for distribution to policyholders at the valuation date; this clearly demarcates amounts to be treated as insurance liabilities from those that function as loss-absorbent own funds. The identification of surplus funds as a separate own funds item will also add to the transparency of the presentation.

Implications for calculations under Solvency II

10.12 Some respondents commented that for internal model firms, calculation of (non-zero) surplus funds will necessitate the calculation of a notional SCR for the ring-fenced fund (RFF) constituted by a with-profits fund, which will introduce unnecessary complexity and additional cost into Solvency II preparations.

10.13 The requirement to calculate a notional SCR for a RFF does not apply to internal model firms merely because of the calculation of surplus funds. Where an internal model firm has restricted own funds in a with-profits fund, the firm will be required to calculate a notional SCR to determine the adjustment (if any) for restricted own funds in respect of the RFF constituted by the with-profits fund. In some cases the calculation of surplus funds may be the only source of restricted own funds. Where this occurs the PRA considers that any additional costs relating to the calculation of a notional SCR are outweighed by the benefits afforded by the identification of any restricted own funds and a clearer understanding of the risks to which the with-profits fund is exposed.

10.14 Another respondent commented that internal model firms may experience a 'leakage' of restricted surplus funds because of inconsistencies between the Solvency II calculation of the notional SCR for a with-profits fund and the

contribution of that fund to the entity level SCR. This situation is not caused solely by the calculation of surplus funds for with-profits funds, and can arise in any case if the RFF contribution to the entity level SCR is materially less than the fund's notional SCR. Where this is the case, a firm must be able to justify the reason for such reduction, including the recognition of diversification effects.

10.15 A respondent commented that the PRA's expectation that each with-profits fund will be treated as a RFF under Solvency II would severely reduce the benefit of treating surplus funds as Tier 1 capital in a mutual, and would place mutual firms at a significant competitive disadvantage. The respondent also challenged the PRA's assertion that its proposals will not have a disproportionate impact on those firms.

10.16 It is not clear whether these comments relate to surplus funds or to the Solvency II RFF regime. However, the PRA considers that the surplus funds rules provide an important source of capital for mutual firms, potentially enabling certain firms to meet capital requirements under Solvency II. The surplus funds calculation is consistent with the PRA's approach to with-profits insurance business (see Chapter 13), and these requirements — in addition to adding greater transparency — should allow mutual insurers to operate, without impact on competition, under the same rules as proprietary insurers under the Solvency II regime.

10.17 The PRA's expectation in relation to with-profit funds and the RFF regime applies regardless of whether a firm is a mutual or proprietary firm. It is the identification of one or more funds as separate with-profits funds that generates the requirement to consider each of them in the context of the Solvency II RFF regime and thus determines their treatment. This is a more general point and unrelated to the subject of surplus funds. RFF considerations for a mutual will also depend on whether the firm has taken steps to determine the interests of with-profits policyholders separately from those of members, as described in SS1/14.⁽¹⁾

The treatment of planned enhancements

10.18 Several respondents felt that paragraph 10.13 in CP16/14 on planned enhancements contradicted other statements within the consultation paper, proposed Surplus Funds rules and draft supervisory statement. Some respondents felt that the treatment of planned enhancements was unclear, while others interpreted it as instructing firms to include within their Solvency II technical provisions amounts reported as planned enhancements under the current regime.

(1) PRA Supervisory Statement SS1/14, 'Mutuality and with-profits funds: a way forward'; www.bankofengland.co.uk/pradocuments/publications/policy/2014/mutuality114.pdf.

10.19 The CP16/14 text was intended to explain the PRA's rationale for removing the concept of planned enhancements because of past differences in interpretation and application. It was not the intention to imply that firms can or should include within Solvency II technical provisions all amounts currently reported as planned enhancements. To clarify the matter, the sentence in paragraph 10.13 of CP16/14 which states 'In both cases, such amounts would fall within the scope of technical provisions under Solvency II' should be read as 'In both cases, without the requirements relating to the calculation of surplus funds, such amounts would fall within the scope of technical provisions under Solvency II'. Paragraphs 3.5 and 3.6 of the supervisory statement provide clarity on the amounts which firms should include within benefits payable as they relate to the prospective calculation and calculation of future policy-related liabilities, and indicate that the PRA would not expect a firm to include within benefits payable potential, eventual distributions from the estate.

The surplus funds calculation methodology

10.20 Some respondents welcomed the changes and improvements in clarity introduced since the FSA's CP12/13, and were supportive of the aim of defining the concept of surplus funds in order to promote consistency in its treatment. However, some respondents felt that the proposed methodology was too rigid, that the rules prescribing the calculation should be removed and firms should be given the freedom to value with-profits benefits in line with the high level requirements of the Directive in relation to future discretionary bonuses that firms expect to make. Other respondents were in favour of a principles-based approach to allow for the specific circumstances of a with-profits fund to be taken into account, otherwise warning that the surplus funds rules may lead to a change in the way that with-profits funds are managed.

10.21 The objective of consistency of presentation in respect of surplus funds would not be met if the calculation were free-form or if firms were given such discretion in the calculation as to lead to inconsistent outcomes. The PRA considers that greater transparency may have positive benefits for the way that with-profits funds are managed.

10.22 A respondent said that surplus funds should exclude the capital requirements associated with a firm's non-profit business written within a with-profits fund. It would be inappropriate to bring a capital requirement of this nature within the scope of the surplus funds calculation; once calculated surplus funds are treated as own funds and thus are available, subject to any necessary adjustment in relation to their restricted nature, to meet a firm's SCR.

10.23 A respondent felt that Surplus Funds 3.1 in the Surplus Funds Part of the PRA Rulebook should allow for shareholder

transfers as a liability in a proprietary firm, while another requested clarification on which future shareholder transfers should be included within the item listed in Surplus Funds 3.1(5). A further suggestion was to include reference to future shareholder transfers already included in the value of with-profits policy liabilities.

10.24 The Solvency II Regulations indicate that the value of future transfers attributable to shareholders shall be treated as unrestricted own fund items. The EIOPA guidelines on RFFs⁽¹⁾ provide additional clarification that shareholder transfers are part of the excess of assets over liabilities, and are not a liability within a RFF.

10.25 The PRA considers that only future shareholder transfers that are defined with reference to future discretionary benefits payable to policyholders should be excluded from surplus funds. The amounts required to be excluded from surplus funds do not therefore include transfers to shareholders arising from potential, eventual distribution of any residual inherited estate.

The calculation of 'with-profits policy liabilities'

10.26 A respondent suggested the use of the Solvency II term 'technical provisions' instead of 'with-profits policy liabilities', and that the PRA's approach would create conflict for firms because Solvency II requires separate calculation of guaranteed benefits and discretionary benefits which form part of technical provisions. One respondent suggested that the cost of capital risk margin component of the Solvency II technical provisions should be taken into account within the calculation of surplus funds.

10.27 'With-profits policy liabilities' and Solvency II technical provisions are different concepts. 'With-profits policy liabilities' is a PRA-defined concept that facilitates the calculation of surplus funds and also identifies the amounts to be taken into consideration by a firm to comply with With-Profits 2.1. This calculation is different to the calculation of technical provisions required by the Solvency II Regulations. Therefore the calculation of 'with-profits policy liabilities' should not create any conflict or difficulty, particularly given the fact that it draws on existing methodology used in the current INSPRU regime. The risk margin component of the Solvency II technical provisions is not relevant to the calculation of surplus funds — a position which the PRA stated in paragraph 10.15 of CP16/14.

10.28 A respondent voiced concern over the need to justify the use of the prospective calculation methodology set out in Surplus Funds 3.4, instead of the retrospective calculation in Surplus Funds 3.3.

(1) Available at eiopa.europa.eu/Publications/Consultations/EIOPA_EIOPA-BoS-14-169-Final_Report_RFF.pdf.

10.29 Surplus Funds 3.2 specifies the circumstances where a firm can use the prospective calculation methodology in order to calculate the value of its with-profits policy liabilities, and paragraph 3.1 of the supervisory statement provides clarification. The prospective approach can be used if valuation under Surplus Funds 3.3 does not adequately reflect the value of some or all of such liabilities, or if the firm can demonstrate that valuation under Surplus Funds 3.3 is impracticable.

10.30 A respondent felt that the prospective calculation was inconsistent and difficult to apply because the future discretionary benefits component of benefits payable in Surplus Funds 3.5(3) refers back to the retrospective calculation.

10.31 Paragraph 3.7 of the supervisory statement now makes it clear that where a firm uses the prospective calculation methodology to value some or all of its with-profits policy liabilities, it is not required to perform a retrospective calculation in order to calculate the future discretionary benefits component of benefits payable as referred to in Surplus Funds 3.5(3).

10.32 A respondent was concerned by the reference to 'permanent enhancements' in Surplus Funds 3.3(3) and suggested reverting to earlier text referring to enhancements intended to be permanently included in pay-outs, even if the firm retains the right to reduce the enhancements in extreme circumstances.

10.33 The current wording captures the PRA's policy intent. Permanent enhancements in Surplus Funds 3.3(3) is intended to capture amounts previously added to with-profits policy liabilities which a firm expects to be permanent at the time of the surplus funds calculation (ie to apply in all but the most extreme adverse circumstances). Any change in the additions that are considered permanent over time should be reflected in subsequent calculations of surplus funds. A new paragraph 3.4 has been added to the supervisory statement to clarify this point.

10.34 A respondent requested clarification on the reference to 'miscellaneous surplus' within Surplus Funds 3.3(4): 'any past miscellaneous surplus (or deficit) which has been allocated', and whether or not previous allocation of the inherited estate is one such source of surplus. Miscellaneous surplus is intended to capture surplus or deficit arising from the experience of the with-profits fund, that may have been allocated to the value of with-profits policies prior to (or on) the valuation date. Examples include mortality or expense experience (relative to expectations) or profits or losses arising from non-profit business within the with-profits fund. A new paragraph 3.5 has been added to the supervisory statement to clarify this point.

11 Cancellation of dividends on ordinary shares

11.1 In CP16/14, the PRA consulted on proposed rules to implement Directive provisions in respect of the cancellation of dividends. There have been no subsequent changes to the policy consulted on in CP16/14.

11.2 Responses to the consultation focused on three areas:

- consistency with the Directive and the requirements of the Solvency II Regulations;
- the interaction between the Solvency II requirements and national law; and
- the expectation that firms review their Articles of Association.

11.3 Some respondents felt that the proposed rules went beyond the Solvency II requirements or that the rules were unnecessarily onerous for firms.

11.4 The mandatory dividend cancellation feature which Article 71(1)(l)(i) of the Solvency II Regulations requires in order for a basic own-fund item to be classified as Tier 1 is not restricted to the period before a dividend is declared. It was therefore necessary to identify a mechanism that would make cancellation of a dividend after declaration possible, consistent with the Solvency II Regulations. Given the importance of ensuring that firms are able to classify their ordinary shares as Tier 1 capital under Solvency II, the PRA does not consider that the mechanism identified by the PRA (a review, and where appropriate amendment of Articles of Association) would be excessively onerous for firms.

11.5 Some respondents questioned whether the PRA's proposals would unnecessarily place UK firms at a competitive disadvantage.

11.6 Article 71 of the Solvency II Regulations requires that either the legal or contractual arrangements governing the basic own-fund item or the national legislation must allow for dividend cancellation if the SCR is breached or payment would result in a breach. The PRA understands that a number of Member States already have relevant provisions in national law that address this issue and others are planning to include such provisions in their transposition of Solvency II. Therefore, the PRA does not expect firms to be disadvantaged by the approach described in CP16/14.

11.7 In addition, respondents challenged the requirement to be able to cancel dividends after declaration, arguing that:

- it was not necessary since declared dividends are deducted when calculating the reconciliation reserve; and/or
- insurers already notify the PRA of a planned dividend distribution, and any potential adverse impact on solvency would be raised by the PRA at this stage.

11.8 Article 70(1)(b) of the Solvency II Regulations requires the total excess of assets over liabilities to be reduced by foreseeable dividends. While the point at which a dividend is foreseeable is not defined, EIOPA Guidelines⁽¹⁾ makes it clear that undertakings should consider a dividend or distribution to be foreseeable at the latest when it is declared or approved by the board. It may therefore be foreseeable, and therefore deductible, earlier than this in some circumstances. However, this requirement in Article 70 does not negate or in any way overrule the mandatory requirements as to features of Tier 1 capital, listed in Article 71(1)(l)(i).

11.9 Similarly while insurers may well notify the PRA of a planned dividend distribution, and any potential adverse impact on solvency may well be raised by the PRA at that stage, this does not negate the requirement for Tier 1 capital to comply with these mandatory Tier 1 features.

(1) Classification of own funds, Guideline 2, paragraph 1.23(a).

12 Reporting – national specific templates

12.1 In CP16/14 and CP24/14, the PRA consulted on proposed rules to implement Directive provisions in respect of national specific templates (NSTs). The feedback received by the PRA included both technical comments on the detail of the templates, and broader comments on thematic issues. These thematic issues are addressed below, and detail of individual changes are detailed in **Table A** at the end of this chapter. The final templates and log files are in Appendix 3.

Alignment of data with EIOPA definitions

12.2 Much of the technical feedback received related to definitions in the NSTs. The PRA has now clarified that profit and loss account items are to be completed on an accounting basis (with the exception of deposit accounting, which is not permitted). The balance sheet information within the revenue account template (NS.05) is to be provided on an accounting basis. However, for the business model analysis templates, information about balance sheet items is to be reported on a Solvency II basis. The detailed approach to completing templates has been made clear in the log files.

Granularity of data

12.3 Some respondents said the information being requested in the NSTs was more granular than in the EIOPA templates. This was particularly the case for three templates: NS.05 — Revenue Account — Life; NS.07 — Business Model Analysis (non-life); and NS.10 — Projection of Future Cashflow. On NS.05, respondents commented on the additional granularity of information requested compared to the current regulatory returns.

12.4 In light of the feedback to the consultation, the revised NS.07 template now contains reduced granularity of information for future years 2 and 3. The split by distribution channels is now only required at a total level for written premiums and unearned premium provision.

12.5 On NS.10, some respondents asked for a materiality threshold to be applied. At this stage the PRA does not believe an appropriate threshold can be defined until submissions are returned. Therefore the PRA will instead review this template following submission of information in 2017 and propose changes where needed. The PRA intends to introduce a regular review of all NSTs, with the first review being completed within three years.

Duplication of information

12.6 Respondents questioned whether the forward-looking information prescribed in the business model analysis templates (NS.06 and NS.07) could instead be obtained from information captured in the Own Risk and Solvency Report (ORSA). The feedback stated that much of this information is likely to be included in firms' annual ORSA report. However, the PRA has decided to retain these templates as:

- forward-looking information contained in the ORSA will be received at different times and different formats making comparison across the market difficult;
- for smaller firms, template data will allow better and more efficient use of resources both for the PRA and for the insurers themselves; and
- in pursuing the PRA's role as a forward-looking regulator, the PRA will need forward-looking data of this nature. This NST will allow supervisors to understand how the solvency capital position, firm performance and business mix is expected to evolve over a number of years.

12.7 Respondents also identified that the rigid date for regulatory reporting may not fit with some firms' planning cycles. The PRA does not propose to alter the submission date but will take into account that there may be differences between business plan projections in the ORSA and in the NSTs due to this. The information for future years should be consistent with the firm's most recent business plan approved by its Board at the reporting date.

The costs and benefits of national specific reporting

12.8 Some respondents felt the cost benefit analysis of completing the additional NSTs did not sufficiently capture the incremental costs of reporting requirements.

12.9 To supplement the cost benefit analysis contained in the consultation, the PRA asked the Association of British Insurers (ABI) to provide a quantitative assessment of the incremental cost of national specific reporting. It was estimated that the incremental cost of national specific reporting represents an increase of between 5% and 10% on the cost of implementation of Solvency II reporting as a whole. For a solo insurer this is estimated to be between £12,500 and £50,000 and for a group between £100,000 and £800,000. The most significant additional cost is in relation to NS.07 for which the

PRA has engaged further with a number of affected firms and has decided to amend the template, as detailed above, to reduce the cost to firms.

12.10 Based on the results of cost benefit analysis for CP11/12, the PRA expects ongoing incremental costs to be approximately 10% of one-off costs.

12.11 Taking into account the proposed changes, the PRA continues to believe that the costs of the proposal are proportionate to the benefits. Information specific to the UK market is a critical source of supervisory intelligence, and enables the PRA to meet its statutory objectives.

Private reporting

12.12 A respondent asked whether the reporting will be public or private. The PRA can confirm that all NSTs submitted to the PRA are submitted privately.

Format of reporting

12.13 A respondent asked whether the national specific reporting should be in XBRL to match the rest of the reporting suite. The PRA expects to move to XBRL reporting but has decided to remain with our proposal to use Excel due to the requirement for additional systems and taxonomy changes to do so. The PRA will consult on any changes to reporting format in due course and will give the industry sufficient lead time to make system changes.

Timing of reporting

12.14 A respondent asked about the timing of the national specific reporting. The NSTs proposed as part of CP16/14 are annual, and the deadlines are aligned with the submissions for the reporting required under the relevant Implementing Technical Standard. The first report will be for results as at year-end 2016.

Unit of currency

12.15 One respondent asked for clarity on unit of currency. In line with reporting templates adopted under the relevant Implementing Technical Standard, the unit of currency will be pound sterling. Where firms' internal systems round figures to the nearest thousand or where business plan figures are rounded to higher denominations, these will be acceptable for the purpose of NSTs.

Table A Changes made to individual templates

Number	Template name	PRA feedback
NS.01	With-profits value of bonus	The template has been altered to include a minor amendment to make the calculation basis clear and remove the requirement to report funds subject to special apportionment rules.
NS.02	With-profits assets and liabilities	No amendments made.
NS.03	Material pooling arrangements	No material amendments. The only comments from the undertakings which would have to submit this template were requests for clarification, so there are some changes to wording in the log file. Other commentators made remarks that were relevant if the PRA were supervising pools, whereas the template reiterates that the PRA is only concerned with the effect of pooling arrangements on the reporting undertaking.
NS.04	Assessable mutuals	No material amendments.
NS.05	Revenue account (life)	Questions were received regarding the accounting basis for definition of premiums. Log file modified to state that firms must use the EEC definition of premiums in accordance with 91/674/EEC. Minor amendment to identify overhead expenses to be consistent with the latest published quantitative reporting template (QRT).
NS.06	Business model analysis (life)	Feedback received on the use of template to gather forward-looking data and alignment with the business planning cycles. A minor amendment proposed to identify corporate pensions premiums separately from individual pensions premiums for new business.
NS.07	Business model analysis (non-life)	Feedback received on the use of the template to gather forward-looking data and the granularity of the data request. Definitions of premiums written, premiums earned, claims incurred, and expenses incurred to follow that in S.05 — the premiums, claims and expenses QRT. Breakdown by distribution channel (for the lines of business where this split is applicable — income protection, personal motor, personal property) is only required for years Y and Y+1.
NS.08	Business model analysis — financial guarantee insurers	The template has been adjusted to remove potential overlaps with NS.07. Some commentators asked why more granular data is needed. The PRA requires this information in order to model potential claim scenarios. The undertakings which would have to submit this template currently submit a simple formulaic model to the PRA's specification, and they will no longer be required to calculate or submit this. Minor changes have been made to the schedule of securities covered to better align it with current reporting, in accordance with feedback.
NS.09	Best-estimate assumptions for life insurance risks	A respondent asked for a transitional for this template over five years. Firms only show experience where they have carried out analysis on a consistent basis and should complete the template on a best efforts basis. At a minimum, firms should include one year's experience for the first reporting period at year-end 2016.
NS.10	Projection of future cash flows (best-estimate — non-life: sub-classes)	No material amendments made.
NS.11	Non-life insurance claims information (general liability sub-classes)	No material amendments made.
NS.12	The Society of Lloyd's solvency capital requirement	Some minor amendments made to improve clarity.
NS.13	The Society of Lloyd's minimum capital requirement	Some minor amendments made to improve clarity.

13 With-profits

13.1 This chapter is relevant to all firms that write⁽¹⁾ with-profits insurance business within the United Kingdom, whether or not they are within the scope of Solvency II. In CP22/14, the PRA consulted on proposals to delete the PRA-designated rules in the Conduct of Business Sourcebook chapter 20 (COBS 20) and to replace them with three new prudential rules addressing:

- assets required to be held within with-profits funds;
- affordable and sustainable distribution strategies; and
- clarity on support arrangements.

13.2 These rules were intended to provide a sharper focus to the PRA's with-profits regulatory regime, so that firms are clear on the respective roles and requirements of the PRA and the Financial Conduct Authority (FCA) in this area. The PRA also consulted on a draft supervisory statement which set out its expectations in respect of firms carrying out with-profits business.

13.3 In the light of feedback to the consultation, the PRA has made amendments to the definitions of 'with-profits fund' and 'with-profits policy liabilities', and to the supervisory statement in order to clarify the material regarding affordable and sustainable distribution strategies. The PRA is not making any further changes to its proposals for the regulation of with-profits insurance business. The amendments do not signal a change in policy intent.

13.4 Comments on the calculation of 'with-profits policy liabilities' are addressed in Chapter 10, Surplus funds, of this PS.

Assets in the with-profits fund

13.5 A number of respondents said that With-Profits 2.1 in the With-Profits Part of the PRA Rulebook should require firms to maintain assets within a with-profits fund sufficient to cover the following amounts:

- any non-profit liabilities held within a with-profits fund;
- any capital requirements to meet non-profit liabilities;
- the present value of future shareholder transfers;
- planned enhancements from surplus funds; and
- for Solvency II firms, the with-profit's funds 'share' of the risk margin associated with the firm's with-profits business.

13.6 With-Profits 2.1 requires a firm to hold sufficient assets within a with-profits fund to cover the 'with-profits policy liabilities' of the fund. The rule will apply to both UK Solvency II firms and non-Directive firms. The rule is sharply focused in line with PRA objectives and its rationale is to protect the security of discretionary benefits of with-profits policyholders, which are in part derived from the assets held within the fund.

13.7 None of the additional items mentioned in responses would fall within the focus or policy intent of the PRA rule. As an investment of the with-profits fund, non-profit business should already be taken into account in determining with-profits policy liabilities; otherwise the with-profits fund and with-profits policyholders should not be exposed to such business. Nor should the rule bring in Solvency II items related to the measurement of solvency such as capital requirements or the risk margin, which apply to the position of the firm as a whole. Finally future shareholder transfers and surplus funds (which may include amounts reported as planned enhancements under the current regime) represent own-fund items and not liabilities.

13.8 A respondent raised the difference between PRA and FCA proposals regarding the level of assets that firms must maintain within with-profits funds.

13.9 With-Profits 2.1 and the FCA COBS 20.1A.5R rule are different because they are tailored to advance the different objectives of each regulator. The rules are consistent with each regulator's policy objectives and responsibilities under the Memoranda of Understanding (MoU).⁽²⁾ In this rule the PRA is primarily concerned with safety and soundness and ensuring that a firm is able to pay expected discretionary benefits to with-profits policyholders, while the FCA's rule goes further to protect liabilities arising out of a firm's regulatory duty to treat customers fairly. The rules are consistent and designed to work together, and the PRA and FCA worked closely to ensure that the rules are compatible. Firms need to consider their compliance with both rules.

(1) By referring to firms that write with-profits business, the PRA intends for this to capture not only firms which actively write new with-profits business, but also firms with closed with-profits funds.

(2) The With-profits MoU between the FCA and PRA is available at www.bankofengland.co.uk/about/Documents/mous/mouwithprofits.pdf. The FCA and PRA also have a general MoU which is available at www.bankofengland.co.uk/about/Documents/mous/moufcapra.pdf.

Distribution strategies

13.10 A respondent commented that With-Profits 3.1(1) and paragraph 4.1 of the supervisory statement suggest that definitive statements can be made when, at times, this will not be possible, thereby creating risk of non-compliance. The respondent suggested those statements be revised to reflect the expectation or likelihood of being correct, rather than being accurate under all circumstances.

13.11 With-Profits 3.1 requires a with-profits firm's distribution strategy to be affordable at the outset and sustainable over time. If circumstances change then the rule requires a firm to take action to alter the strategy so that it is affordable and sustainable, either through management actions, or some other plan. As such the PRA does not consider that the rule is absolute or that compliance is difficult or uncertain.

13.12 Some respondents questioned the wording in paragraph 4.1 of the draft supervisory statement, pointing out that any increase in bonus rates would have an adverse impact on a firm's safety and soundness, and would accelerate the transfer of profits outside the with-profits fund. One respondent suggested qualifying this as a 'significant negative impact', while another suggested the statement be clarified to apply only where any acceleration of distributions would be inconsistent with treating customers fairly (TCF).

13.13 Paragraph 4.1 of the supervisory statement has been amended to reflect the intent set out in paragraph 2.12 of CP22/14 in respect of distributions which could have a 'significant negative impact' rather than simply a 'detrimental impact'. TCF considerations in relation to distributions to with-profits policyholders are relevant to the FCA's objectives, and its rules and guidance aim to address this issue.

13.14 A respondent suggested the wording of paragraph 4.2 of the draft supervisory statement is incorrect because any distribution from a with-profits fund will accelerate the transfer of profits outside a with-profits fund.

13.15 The PRA has amended paragraph 4.2 to clarify its expectations. The intent behind paragraph 4.2 of the supervisory statement is to prevent firms from using aggressive distribution strategies which increase shareholder distributions while posing increased risk to benefit security and the safety and soundness of the firm. This provision is intended to complement FCA rules and guidance on distributions which are focused on TCF considerations.

13.16 A respondent queried how the PRA plans to assess affordability and sustainability of distributions, as well as any potential adverse effects on the safety and soundness of a firm or policyholder benefit security.

13.17 It is for a with-profits firm to demonstrate to the PRA that its strategy for distributions is affordable and sustainable, having regard to the circumstances of the with-profits fund.

13.18 A respondent suggested that the PRA require Solvency II firms to compare their technical provisions with asset shares, if available, for their with-profits policies to demonstrate how they are managing their bonuses. The respondent also suggested that firms could include this information in their ORSAs to ensure their obligations under FCA rules are met.

13.19 The PRA expects that such firms would consider making such a comparison if relevant to its circumstances. Firms should also be aware that the FCA has set out conduct rules and guidance on with-profits distributions which will apply to both Solvency II and non-Directive firms.

Support arrangements

13.20 Respondents suggested that there are differences between the PRA and FCA rules regarding support arrangements including disclosure requirements; both regulators should use a common approach and identify and justify any differences.

13.21 With-Profits 4.1 and FCA rule COBS 20.2.34AR are consistent with the statutory objectives and policy intent of each regulator. The PRA focus is on clarification of the terms and conditions governing support arrangements and any restrictions on a firm's use of those arrangements as they relate to the measurement of solvency. It is the FCA rule which includes requirements for policyholder disclosure documents, consistent with its objectives.

13.22 A response suggested that firms and the PRA should take account of any court schemes in determining the support available to with-profits funds, which is in line with the policy intent behind With-Profits 3.1. The PRA expects firms to identify and clarify any arrangements which provide support to a with-profits fund, irrespective of the method by which such support is instituted.

Definition of 'with-profits fund'

13.23 Several responses encouraged further harmonisation of the definitions proposed by the PRA and FCA. The PRA and FCA have continued to work together on shared definitions and both regulators now intend to use the same definition, largely based on the definition proposed in CP22/14.

13.24 Some respondents questioned whether the definition should include reference to the inherited estate, working capital, risk margin, capital requirements or discretionary mutual member benefits and whether the proposed definition would work for a mutual firm with a single common fund.

13.25 The definition identifies the items for which the cash flows contribute to or reduce the amount of the fund. References to the items suggested are unnecessary or in the case of risk margin and capital requirements inappropriate for the reasons already set out in paragraph 13.7. The PRA considers that discretionary member benefits within a single fund mutual firm would fall under outgoings item (7) of the proposed definition, provided those benefits are permitted in accordance with FCA requirements. To clarify this point the PRA has amended outgoings item (8) of the definition so that it refers more generically to 'transfers' rather than 'transfers to shareholders'.

13.26 It was suggested that the definition does not recognise historical non-profit business which is not written for the benefit of with-profits policyholders, but which was written before or alongside the with-profits business using the fund's original capital. The PRA considers that issues relating to non-profit business written on the basis described are relevant to the FCA's objectives.

13.27 A respondent suggested that the new rules and definitions restrict mutual firms' flexibility to retain a single common fund even if this would be in the best interests of both members and policyholders. In addition, the respondent felt the PRA and FCA proposals prejudice the outcome of the mutual capital issue by encouraging single fund mutuals to separate members and with-profits policyholders' interests, as described in FCA PS14/5⁽¹⁾ and PRA SS1/14⁽²⁾. The respondent also commented that the proposals will therefore have a disproportionate impact on mutuals.

13.28 Notwithstanding the respondent's concern, the PRA's approach to with-profits provides a robust prudential regulatory framework intended to cover all types of with-profits firm, both proprietary and mutual. The PRA does not expect that the impact of the proposals in CP22/14 in isolation will have a disproportionate impact on mutual firms, because the provisions are similar to existing rules and guidance and are designed to complement FCA provisions. To address the underlying concern raised in this response, an amendment has been made in the definition of 'with-profits fund' to bring transfers to members within the scope of that definition.

Other definitions relevant to with-profits

13.29 A respondent commented that the definition of 'with-profits policyholder liabilities' would require non-Directive firms to make provision for future policy-related liabilities and to apply a valuation methodology which is inconsistent with the requirements and practice under the current regime. The PRA has amended the definition in light of this feedback.

13.30 A respondent felt that the definition of 'with-profits assets' proposed in CP16/14 was too narrow, and should be

expanded to include any negative technical provisions for non-profit policies within a with-profits fund. Another suggestion was that the definition as proposed and allowance for profitable non-profit business written within a with-profits fund could lead to with-profits assets being higher than the total assets within the fund.

13.31 The PRA considers that should the technical provisions for non-profit business within a with-profits fund be negative overall, a firm can recognise all the value of the non-profit business assets within the assets of the with-profits fund, and that the definition of 'with-profits assets' covers this scenario. Furthermore, any profit on non-profit business previously allocated to with-profits policies should be included in the calculation of with-profits policy liabilities.

Other comments

13.32 A respondent stated that the need to keep separate accounting records for each with-profits fund, as set out in Section 6 of the draft supervisory statement, would be onerous for smaller mutual firms. The PRA notes that all with-profits firms should already be complying with this requirement, which currently features in INSPRU 1.5.23R. Furthermore, in FS14/1⁽³⁾ the FCA signalled its intent to import this requirement into COBS 20.1A.6R. The PRA intends to retain this section of the supervisory statement, as it considers it necessary for firms to identify amounts available for distribution to with-profits policyholders in different funds.

13.33 A respondent suggested that the cost of having to comply with different PRA and FCA requirements should be reflected in the cost benefit analysis. The PRA does not expect that firms will incur significant additional costs in complying with both PRA and FCA requirements because the rules in CP22/14 and FS14/1 are not supplementary or additional, but complementary. The new rules codify and clarify practices that firms are expected to adhere to in complying with the current UK with-profits regulatory regime.

(1) Available at www.fca.org.uk/your-fca/documents/policy-statements/ps14-05.

(2) PRA Supervisory Statement SS1/14, 'Mutuality and with-profits funds: a way forward'; www.bankofengland.co.uk/prs/Documents/publications/policy/2014/mutuality114.pdf.

(3) Available at www.fca.org.uk/news/feedback-statements/fs14-1-solvency-ii-cobs-rule-changes.

14 Appointment of actuaries

14.1 In CP24/14, the PRA consulted on proposed rules relating to the appointment of actuaries, to align the PRA Rulebook with the Directive. The rules require the appointment of an external actuary to the Chief Actuary function by firms which do not have the relevant internal capability available.

14.2 Some respondents said the requirement to appoint an external actuary may be onerous for firms, particularly for small general insurance firms writing largely short-tail business. Having considered these responses, the PRA notes that most such firms should already have an internal claims reserving capability, along with other relevant expertise, which, depending on the nature, scale and complexity of the risks, will often be sufficient to meet the criteria in Actuarial Function 6.1 of the Conditions Governing Business Part of the PRA Rulebook. This can be supplemented for reporting or other purposes by some form of external review, where necessary.

14.3 The PRA is also of the view that the Chief Actuary function could be performed by an individual in another group company, provided that the individual meets the relevant requirements in Conditions Governing Business 6, and the Fitness and Propriety Part of the PRA Rulebook, along with the Solvency II Regulations. The wording of Actuaries 2.1 has been amended accordingly to provide for this.

14.4 In each case, this would include the need for clear lines of responsibility, the ability to address any conflicts of interest, appropriate knowledge of the UK regulatory and business environment including professional standards relevant to this role, the availability of suitable resource to fulfil this role, and oversight of the role by the board of the firm.

14.5 A respondent queried the use of the phrase 'vacancy of the office of the actuary'. In the context of Actuaries 2.1, this phrase in Actuaries 2.3 and 2.4 was intended to mean that the firm did not have an individual in place who meets the requirements in Conditions Governing Business 6. The wording of Actuaries 2.3 and 2.4 has been amended accordingly.

14.6. The PRA was asked about the relationship between the Chief Actuary role and other controlled functions within the firm.

14.7 Where the firm (or group) does not have an internal individual with the relevant capability for the Chief Actuary role, then this individual will almost certainly by definition have to be an external actuary, and this is the person that the PRA would then expect to see being assessed as suitable for the Chief Actuary function.

14.8 In that scenario, the PRA would expect that the external actuary should normally report to another senior individual who is in one of the Controlled Functions, so that both individuals fall to be assessed (by both firms and PRA) as being fit and proper, albeit that the skills needed for the oversight role could be different. Any potential conflicts of interest that might arise through this oversight role would need to be managed in accordance with the Solvency II Regulations.

14.9 In relation to the oversight of any outsourced key function, the PRA would expect a person within the firm to be designated with overall responsibility for the outsourced key function. This could include a director of the firm, even in circumstances where the directors and other individuals performing key functions are actually employed by a group service company. A director will be considered to be 'within the firm' for these purposes as the board is ultimately responsible for compliance with the Directive.

Appendices

Appendix 1: PRA Rulebook

- 1 PRA Rulebook instruments PRA 2015/9 to PRA 2015/31, available at www.bankofengland.co.uk/pr/Pages/publications/ps/2015/ps215.aspx
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Appendix 2: Supervisory Statements

- 2.1 Supervisory Statement 1/15 'Insurance – General application', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss115.aspx
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- 2.2 Supervisory Statement 2/15 'Solvency II: own funds', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss215.aspx
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- 2.3 Supervisory Statement 3/15 'Solvency II: the quality of capital instruments', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss315.aspx
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- 2.4 Supervisory Statement 4/15 'Solvency II: the solvency and minimum capital requirements', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss415.aspx
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- 2.5 Supervisory Statement 5/15 'Solvency II: the treatment of pension scheme risk, available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss515.aspx
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- 2.6 Supervisory Statement 6/15 'Solvency II: the internal model treatment of participations', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss615.aspx
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- 2.7 Supervisory Statement 7/15 'Solvency II: supervision of firms in difficulty or run-off', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss715.aspx
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- 2.8 Supervisory Statement 8/15 'Solvency II: composites', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss815.aspx
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- 2.9 Supervisory Statement 9/15 'Solvency II: group supervision', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss915.aspx
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- 2.10 Supervisory Statement 10/15 'Solvency II: third-country branches', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss1015.aspx
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- 2.11 Supervisory Statement 11/15 'Solvency II: regulatory reporting and exemptions', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss1115.aspx
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- 2.12 Supervisory Statement 12/15 'Solvency II: Lloyd's', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss1215.aspx

Please note: On 18 August 2016 the appendices to PS2/15 were updated to include links to the documents on the Bank of England's website.

2.13 Supervisory Statement 13/15 'Solvency II: surplus funds', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss1315.aspx

2.14 Supervisory Statement 14/15 'With-profits', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss1415.aspx

2.15 Supervisory Statement 15/15 'Solvency II: approvals', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss1515.aspx

2.16 Supervisory Statement 16/15 'Solvency II: conditions governing business', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss1615.aspx

2.17 Supervisory Statement 17/15 'Solvency II: transitional measures on risk-free interest rates and technical provisions', available at www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss1715.aspx

Appendix 3: National specific templates and log files

3 National specific templates and log files, available at www.bankofengland.co.uk/pr/Pages/regulatorydata/insurance/reporting.aspx
