

Supervisory Statement | SS2/15

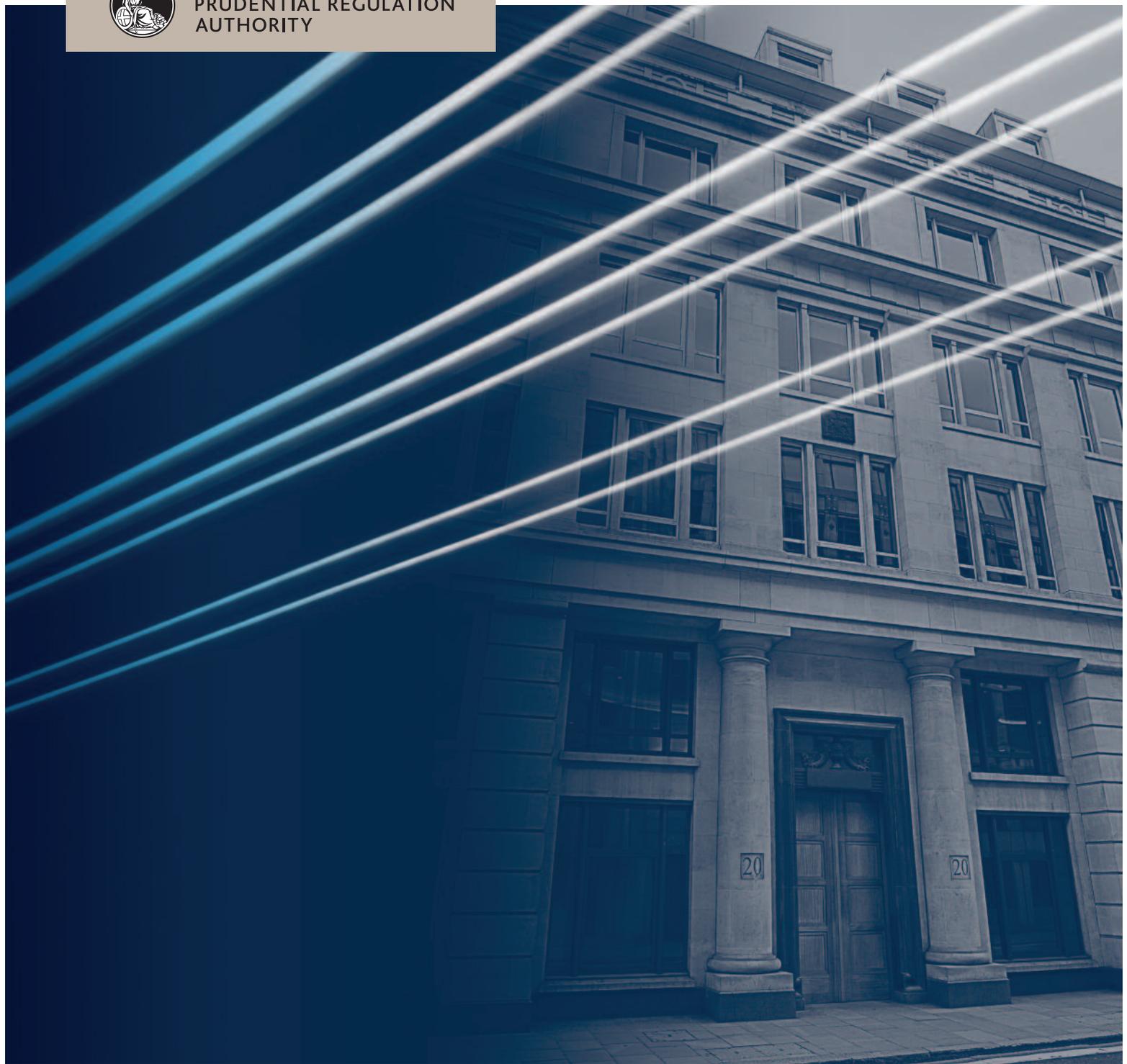
Solvency II: own funds

Appendix 2.2

March 2015



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



30 September 2019: This SS was updated, please see
<https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-own-funds-ss>

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1 Introduction

1.1 This supervisory statement is addressed to UK Solvency II firms and to Lloyd's, whether they are assessing the quality of their existing own funds and/or intending to issue new own fund items under Solvency II.

1.2 This statement sets out the Prudential Regulation Authority's (PRA's) expectations of firms in relation to own funds on the following topics in particular:

- (a) ancillary own funds and Article 96 of the Solvency II Directive;
- (b) the transitional measures for own funds;
- (c) the right to cancel (or defer) dividends or other distributions; and
- (d) pre-issuance notification.

1.3 Firms should read this statement alongside all relevant European legislation as well as the Own Funds Part of the PRA Rulebook. In particular, among other relevant provisions:

- (a) Articles 62 to 67 of the Solvency II Regulations set out requirements relating to applications for the approval of ancillary own funds and their assessment;
- (b) Articles 80 and 81 of the Solvency II Regulations set out the adjustments that must be made to own funds to reflect the lack of transferability of ring-fenced funds that can only be used to cover losses arising from a particular segment of liabilities or from particular risks;
- (c) Articles 69 to 78 of the Solvency II Regulations set out a list of own funds items and the criteria for classifying them as Tier 1 own funds, Tier 2 own funds or Tier 3 own funds.
- (d) For the purposes of Own Funds 4, Article 82 of the Solvency II Regulations set out the applicable limits regarding the proportion of Tier 1 own funds, Tier 2 own funds and Tier 3 own funds which can be included in a firm's eligible own funds to cover the firm's solvency capital requirement (SCR) and minimum capital requirement (MCR).
- (e) For the purposes of Own Funds 3.1, in connection with the classification of an item as ordinary share capital in Tier 1 own funds, a firm must assess whether that item of basic own funds satisfies all relevant criteria for that classification in the Solvency II Regulations. For example, a firm must assess whether the item ranks after all other claims including other classes of share capital in the event the firm is wound up.

1.4 This statement expands on the PRA's general approach as set out in its insurance approach document⁽¹⁾ and the Own Funds Part of the PRA Rulebook. By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the Regulatory Principles and relevant provisions of the Legislative and Regulatory Reform Act 2006. This statement is not expected to have any direct or indirect discriminatory impact under existing UK law.

1.5 This statement has been subject to public consultation⁽²⁾ and reflects the feedback that was received by the PRA.

2 Ancillary own funds and Article 96 of the Solvency II Directive

2.1 The PRA does not envisage approving an amount under Own Funds 2.5(1) or a method under Own Funds 2.5(2) unless it is satisfied that the amount approved or determined using the approved method reflects the loss absorbency of the item of ancillary own funds and is based on prudent and realistic assumptions. Therefore, where an item of ancillary own funds has a fixed nominal value the amount of that item that can be included in a firm's own funds will only be equal to its nominal value where that value appropriately reflects its loss absorbency (see Article 90(2) of the Solvency II Directive).

2.2 Article 96 of the Solvency II Directive contemplates that:

- (a) surplus funds will normally be classified as Tier 1 own funds;
- (b) letters of credit and guarantees which are held on trust for the benefit of policyholders by an independent trustee and are provided by credit institutions authorised in accordance with the Capital Requirements Directive will normally be classified as Tier 2 ancillary own funds;
- (c) any future claims which a mutual of shipowners with variable contributions solely insuring risks listed in general insurance business class 6 (ships), class 12 (liability of ships) and class 17 (legal expenses), may have against its members by way of a call for supplementary contributions within the next twelve months will normally be classified as Tier 2 ancillary own funds; and

(1) *The Prudential Regulation Authority's approach to insurance supervision*, June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf.

(2) *PRA Consultation Paper CP16/14*, 'Transposition of Solvency II: Part 3', August 2014; www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1614.pdf.

(d) any future claims which a mutual with variable contributions may have against its members by way of a call for supplementary contributions within the next twelve months which do not fall within (c) above will normally be classified as Tier 2 ancillary own funds where they substantially possess the characteristics set out in Own Funds 3.2(2)

2.3 The classification of the items referred to in (a) to (d) will depend on the extent to which they satisfy the requirements in Own Funds 3.1–3.6 and Articles 69 to 78 of the Solvency II Regulations, which set out requirements relating to the classification of own funds.

3 The transitional measures for own funds

3.1 Article 308b (9) and (10) of the Solvency II Directive (the Directive) set out how regulatory capital items which could be used to meet capital requirements before 1 January 2016, but do not meet the criteria for available basic own funds, will be treated under Solvency II. These are referred to as the transitional measures for own funds in this statement.

3.2 Firms should not assume that all instruments issued before the cut-off date for the transitional measures automatically receive transitional treatment. The PRA expects firms to carry out their own analysis of instruments against the required features in the Solvency II Regulations and the transitional measures. The purpose is to determine which instruments can be classified as Solvency II compliant and those for which the transitional measures will be required.

3.3 This analysis should be carried out before 1 January 2016 in order that any necessary discussions with supervisors can take place, and that the firm can be clear as to the treatment of its instruments, before Solvency II applies. It is important that firms consult the Solvency II Regulations as the PRA rules

transposing the Directive do not contain all of the necessary requirements in order to apply the transitional measures. Firms will also be expected to comply with the EIOPA Guidelines that complement and clarify the Solvency II Regulations. Firms should note that the inclusion of an item in Tier 1 own funds under the transitional measures is subject to the effect of the limits on such items specified in the Solvency II Regulations.

3.4 The operation of the transitional measures are summarised in **Table A**.

3.5 The PRA also expects firms to analyse the impact of the transitional measures on their current and projected capital position, instruments currently in issue, the ten-year transitional period and the incidence of call dates within that time.

3.6 The PRA expects firms not to rely on capital instruments that are already subject to transitional measures under GENPRU. Such instruments are unlikely to provide adequate loss-absorbency, thereby running contrary to the PRA's objectives to promote the safety and soundness of firms and the securing of an appropriate degree of protection for policyholders. For this reason, the PRA has excluded from the scope of Own Funds 4.1 and 4.2 items that are only eligible for the treatment specified by virtue of GENPRU Transitional Provision 4 of the current PRA Handbook. Similarly, the PRA does not expect to renew existing waivers, relating to capital instruments, which expire before 1 January 2016.

4 The right to cancel (or defer) dividends or other distributions

4.1 This section is relevant to all firms assessing the quality of their own-fund items by reference to the features determining classification as Tier 1.

Table A The operation of the transitional measures

GENPRU instrument subject to transitional arrangements	Treatment under Directive 2002/83/EC or Directive 2002/13/EC to cover the available solvency margin	Treatment under Solvency II transitional measures (for up to 10 years from 1 January 2016)
Core Tier 1	Not limited	Tier 1 restricted (Transitional Measures 4.1 (3) in the Transitional Measures Part of the PRA Rulebook applies)
Perpetual non-cumulative preference shares	Not limited	Tier 1 restricted (Transitional Measures 4.1 (3) applies)
Innovative Tier 1	Category limited to 50%	Tier 1 restricted (Transitional Measures 4.1 (3) applies)
Upper Tier 2	Category limited to 50%	Tier 1 restricted (Transitional Measures 4.1 (3) applies)
Lower Tier 2	Category limited to 25%	Tier 2

4.2 The same considerations can also apply where own-fund items are classified in Tier 2 and the Solvency II Regulations require deferral as opposed to cancellation of distributions.

4.3 All items of basic own funds must meet the criteria in Own Funds 3 and the features determining classification in the Solvency II Regulations. In relation to paid-in ordinary share capital, matters such as the absence of mandatory fixed charges or encumbrances will be a characteristic until such time as a dividend is declared but the shares would cease to meet this criterion unless there is the ability to cancel a dividend after this point but prior to payment.

4.4 The PRA considers that where a firm's articles of association do not prohibit the cancellation of a dividend at any time, including after declaration, then they may be said to allow such cancellation so that the firm may be able to declare a dividend on a conditional basis, allowing cancellation of the dividend at any time prior to payment, if the applicable conditions are not met. Firms should ensure that they review their own articles to establish the absence of any such prohibition. Firms should also consider whether it is appropriate to amend their articles to include a specific power for the firm to declare dividends subject to conditions or even for all declarations of dividend to be conditional upon fulfilment of the requirements in the Solvency II Regulations. Firms should give consideration to amending their articles so that all declarations of dividends are conditional, particularly if they have concerns that otherwise they may inadvertently declare an unconditional dividend.

4.5 Article 71 of the Solvency II Regulations sets out in more detail the nature of the conditionality that firms will need to apply to their declaration of dividends for these purposes. In order to link these provisions with the PRA Rulebook, Own Funds 3.7(1) requires firms to include in their classification of Tier 1 own funds only ordinary share capital in respect of which a dividend or other distribution is capable of being cancelled and withheld at any time prior to payment and where the firm exercises its rights to do so, where necessary. Where firms whose articles so permit adopt the practice of declaring all dividends conditionally (or amend their articles to provide that all dividends are conditional) and the conditions applied satisfy the requirements of Article 71 of the Solvency II Regulations, they would be in a position to satisfy Own Funds 3.7(1).

4.6 There may be additional considerations for any firms with publicly traded shares for which an 'ex dividend' date may apply. Such firms may also have disclosure or other obligations arising from their listing arrangements in relation to possible non-payment of a declared dividend. The PRA expects firms to continue to monitor their solvency positions carefully during this time and to engage with supervisors at an early stage to be assured that the need to cancel dividends is unlikely to arise.

4.7 The same considerations as to cancellation (or, in the case of Tier 2 own funds, deferral) of distributions apply to relevant Tier 1 own-fund items of mutuals. These comprise paid-in initial fund, members' contributions and any other equivalent items. While for many mutuals, distributions in relation to these items may not be relevant or common, reference to the firm's constitution or governing statute should be made to confirm that there are no provisions in relation to distributions which would disqualify the item as Tier 1 own funds.

4.8 The PRA is adopting this approach in order to provide clarity as to the manner in which relevant firms can demonstrate when classifying items as own funds that ordinary share capital can qualify as Tier 1 (or Tier 2) own funds. While firms may incur some administrative and legal costs in order to achieve compliance with this approach, the benefits of retaining compliant own funds will outweigh these.

4.9 Articles 71 and 73 of the Solvency II Regulations envisage exceptional circumstances in which respectively the cancellation (or deferral in the case of a Tier 2 item) may be waived. In the event of a firm applying for a waiver of cancellation (or deferral in the case of a Tier 2 item), the PRA would consider those circumstances carefully and, if it is satisfied the relevant conditions are met, signify its permission to the firm not to cancel or defer by waiving the relevant Part of Own Funds 3.7(1) or (2) respectively.

5 Pre-issuance notification

5.1 Own Funds 5.2 provides that, in exceptional circumstances, a firm may provide less than one month's notice of the intended issue of own fund items. The PRA is unlikely to consider circumstances to be exceptional unless they are such that there is a risk of a firm not complying with its SCR or, as the case may be, MCR if a one-month notification period is observed. In such circumstances, a firm should notify the PRA as soon as it has resolved to issue further items it intends to include as basic own funds, and provide details of its circumstances and why it is not possible to provide one month's notice of the intended issue.

5.2 Details of the notification to be provided by a firm in relation to items of basic own funds issued by another undertaking in its group for inclusion in its own funds are set out in Group Supervision 6.