

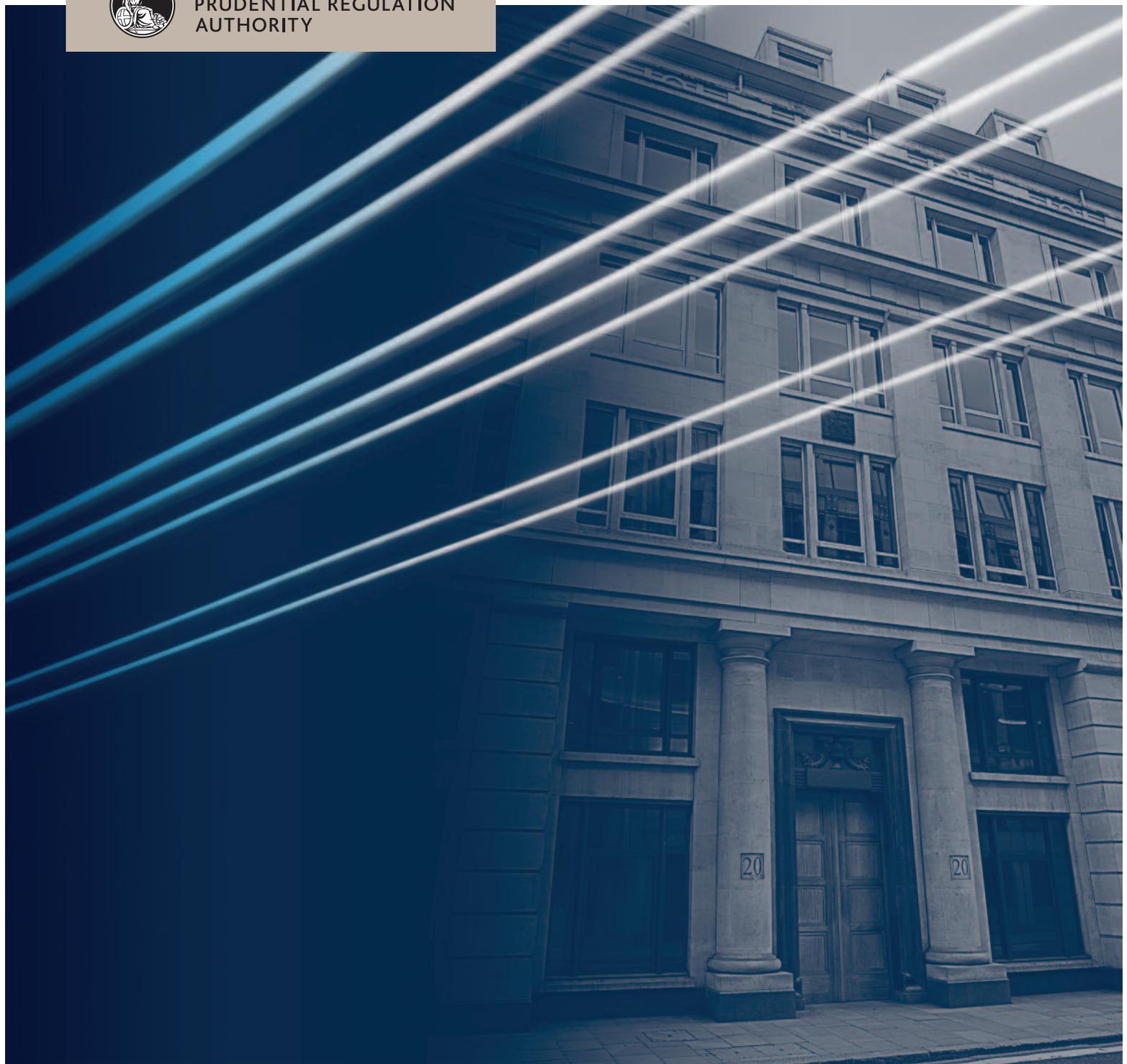
Supervisory Statement | SS22/15

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

April 2015



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## 1 Introduction

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

1.2 This supervisory statement expands on the Prudential Regulation Authority's (PRA's) general approach set out in the PRA's Approach to Insurance Supervision.<sup>(2)</sup> By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the Regulatory Principles<sup>(3)</sup> and relevant provisions of the Legislative and Regulatory Reform Act 2006.<sup>(4)</sup> This statement is not expected to have any direct or indirect discriminatory impact under existing UK law.

1.3 This statement has been subject to public consultation<sup>(5)</sup> and reflects the feedback that was received by the PRA. It sets out the PRA's expectation that all firms comply with the EIOPA Set 1 Guidelines. It also provides further commentary on certain Guidelines where additional considerations, largely set out in previous PRA supervisory statements, should be taken into account by firms.

## 2 Compliance with the Guidelines

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

2.2 Those Guidelines on which further commentary is provided are:

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

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

3.1 These Guidelines complement the Solvency II Regulations. In particular, they complement Commission Delegated Regulation (EU) 2015/35 ('the Delegated Regulation')<sup>(8)</sup> and Commission Implementing Regulation (EU) 2015/499<sup>(9)</sup> in respect of the criteria for the approval of and the application procedures for ancillary own-funds (AOF). Firms should refer to the checklist for AOF applications<sup>(10)</sup> and consider its relationship with the AOF Guidelines when preparing their applications.

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

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

4.1 These Guidelines are organised in several sections.

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

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

4.3 Firms should follow these Guidelines when designing and classifying their capital instruments and the PRA expects this to be reflected in firms' submissions of pre-issuance

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- (1) EIOPA Set 1 of Solvency II Guidelines: <https://eiopa.europa.eu/regulation-supervision/guidelines>.
  - (2) PRA's approach to insurance supervision: [www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf](http://www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf).
  - (3) Section 3B of the Financial Services and Markets Act 2000 (FSMA): [www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga\\_20000008\\_en.pdf](http://www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga_20000008_en.pdf).
  - (4) Legislative and Regulatory Act 2006: [www.legislation.gov.uk/ukpga/2006/51/contents](http://www.legislation.gov.uk/ukpga/2006/51/contents).
  - (5) *PRA Consultation Paper CP5/15*, 'Solvency II: applying EIOPA's Set 1 Guidelines to PRA-authorised firms', February 2015; [www.bankofengland.co.uk/pr/Pages/Documents/publications/cp/2015/cp515.pdf](http://www.bankofengland.co.uk/pr/Pages/Documents/publications/cp/2015/cp515.pdf).
  - (6) Article 16(3) of Regulation (EU) No. 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/79/EC: <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1429014380486&uri=CELEX:02010R1094-20140523>.
  - (7) Recital 19 of the Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast): <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1429014864472&uri=CELEX:02009L0138-20150331>.
  - (8) Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II); <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1429014558562&uri=CELEX:32015R0035>.
  - (9) Commission Implementing Regulation (EU) 2015/499 of 24 March 2015 laying down implementing technical standards with regard to the procedures to be used for granting supervisory approval for the use of ancillary own-fund items in accordance with Directive 2009/138/EC of the European Parliament and of the Council; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0499&from=EN>.
  - (10) PRA Solvency II approvals; [www.bankofengland.co.uk/pr/Pages/authorisations/siapprovals/applying.aspx](http://www.bankofengland.co.uk/pr/Pages/authorisations/siapprovals/applying.aspx).

notifications as set out in the Own Funds Part of the PRA Rulebook.

4.4 In Section 2 of SS3/15<sup>(1)</sup> the PRA sets out its expectations relating to terms permitting the call of an instrument earlier than five years from date of issue. These will be relevant in respect of Guideline 15 on call options predicated on unforeseen changes and the paragraphs referred to within that Guideline.

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

4.5 Section 4 contains Guidelines relevant to all tiers. Firms should follow the approach set out in these Guidelines in order to ensure compliance with the Delegated Regulation.

4.6 In Section 3 of SS3/15 the PRA sets out its expectation regarding a broad scope for the term 'redemption' in line with Guideline 13.

4.7 Guideline 14 sets out the considerations relevant to encumbrance. Firms should identify the substance and not simply the form of arrangements and connected transactions when considering the potential impact on the quality of capital. Firms should consider SS8/14<sup>(2)</sup> on subordinated guarantees in the light of Guideline 14.

4.8 In relation to Guideline 18, firms should comply with this Guideline regarding the nature of the information to be provided and when it should be submitted. The PRA will approach its review of potential redemptions in line with Guideline 18.

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

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

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

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

5.1 These Guidelines complement the Delegated Regulation regarding ring-fenced funds (RFF).

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

5.2 Guidelines 1 to 4 describe the characteristics of RFF together with details of arrangements, restrictions and types

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

5.3 In SS14/15<sup>(3)</sup> the PRA sets out its expectation that the restrictions on assets and own funds resulting from the nature of, and regulatory regime for, with-profits insurance business in the United Kingdom will generally mean that each with-profits fund displays the characteristics of a RFF under Solvency II.

### Materiality (Guideline 5)

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

5.5 Where a RFF is not material, firms should apply paragraph 1.16 of Guideline 5.

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

5.6 Firms should follow Guidelines 6 to 8 in determining the assets and liabilities within the scope of RFF. The PRA's approach to with-profits business, as set out in the With-profits Part of the PRA Rulebook, and supervisory statement SS14/15, will apply to those firms which have with-profits funds and their treatment as RFF. The PRA notes that Guideline 8 will be of particular relevance to with-profits funds and the treatment of profit-sharing arrangements whereby transfers to shareholders arise from the distribution of discretionary benefits to policyholders. The treatment of other types of profit-sharing arrangements will depend on the structure of the business and the scheme or other legal arrangement that specify the mechanism by which amounts are distributed to shareholders and policyholders. Firms with more complex arrangements should engage with their usual supervisory contact regarding their treatment.

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

5.7 Firms should follow Guidelines 9 to 13, and 17 in carrying out the calculations required by the Delegated Regulation in

(1) PRA Supervisory Statement SS3/15, 'Solvency II: the quality of capital instruments', March 2015;

[www.bankofengland.co.uk/pr/Documents/publications/ss/2015/ss315.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/ss/2015/ss315.pdf).

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

(3) PRA Supervisory Statement SS14/15, 'With-profits', March 2015; [www.bankofengland.co.uk/pr/Documents/publications/ss/2015/ss1415.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/ss/2015/ss1415.pdf).

respect of the:

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

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

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

6.1 These Guidelines complement the Delegated Regulation in respect of related undertakings, including participations. They cover the identification of related undertakings and their treatment both for capital resources and capital requirements purposes.

### Identification (Guidelines 1–2)

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

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

### Strategic participations (Guideline 3)

6.4 The Delegated Regulation sets out tests a firm must be able to meet before an equity investment in a related undertaking can be considered strategic. Firms should follow Guideline 3 when seeking to demonstrate that these tests are met and be able to provide credible supporting evidence set out in paragraph 1.26 of the Guideline. In particular, the PRA draws firms' attention to the need to demonstrate that the value of the equity investment is likely to be materially less volatile than other equities. Firms should justify the selection of equities used for comparison.

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

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

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

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

6.7 In relation to paragraph 1.40 of Guideline 9, firms should also refer to supervisory statement SS6/15<sup>(2)</sup> where the firm calculates its solo-level SCR using an internal model.

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

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

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

7.2 These Guidelines address how firms should calculate the loss-absorbing capacity of deferred tax at a solo level. They cover the appropriate level of granularity which firms should apply to the calculation, valuation principles to be used and

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

(2) PRA Supervisory Statement SS6/15, 'Solvency II: the internal model treatment of participations', March 2015; [www.bankofengland.co.uk/prd/Documents/publications/ss/2015/ss615.pdf](http://www.bankofengland.co.uk/prd/Documents/publications/ss/2015/ss615.pdf).

the extent to which undertakings can use group relief. The PRA expects firms to refer to SS2/14<sup>(1)</sup> which sets out further details regarding PRA expectations in relation to group relief and the need to avoid inappropriate set-off.

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

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

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

## 8 Group solvency (Guidelines 1–27)

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

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

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

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

8.4 Guideline 5 states that supervisory authorities do not need to apply group supervision at the ultimate level of the European Economic Area (EEA). Instead, they can apply group supervision solely at the level of the ultimate parent located in a third country, if that country operates a regime deemed equivalent to Solvency II, where this would result in a more efficient supervision of the group. The PRA has transposed the Directive to apply the requirements necessary for it to exercise group supervision at the ultimate EEA level, although the PRA may grant waivers. If, therefore, a firm considers that it would be appropriate for group supervision to be exercised solely at the level of the ultimate third-country parent, it should apply for a modification of the relevant PRA rules in accordance with Section 138A of FSMA.

(1) PRA Supervisory Statement SS2/14, 'Solvency II: recognition of deferred tax', updated February 2015; [www.bankofengland.co.uk/pr/Documents/publications/ss/2015/ss214update.pdf](http://www.bankofengland.co.uk/pr/Documents/publications/ss/2015/ss214update.pdf).