Supervisory Statement | SS3/15

Appendix 2.3

Solvency II: the quality of capital instruments

March 2015

BANK OF ENGLAND
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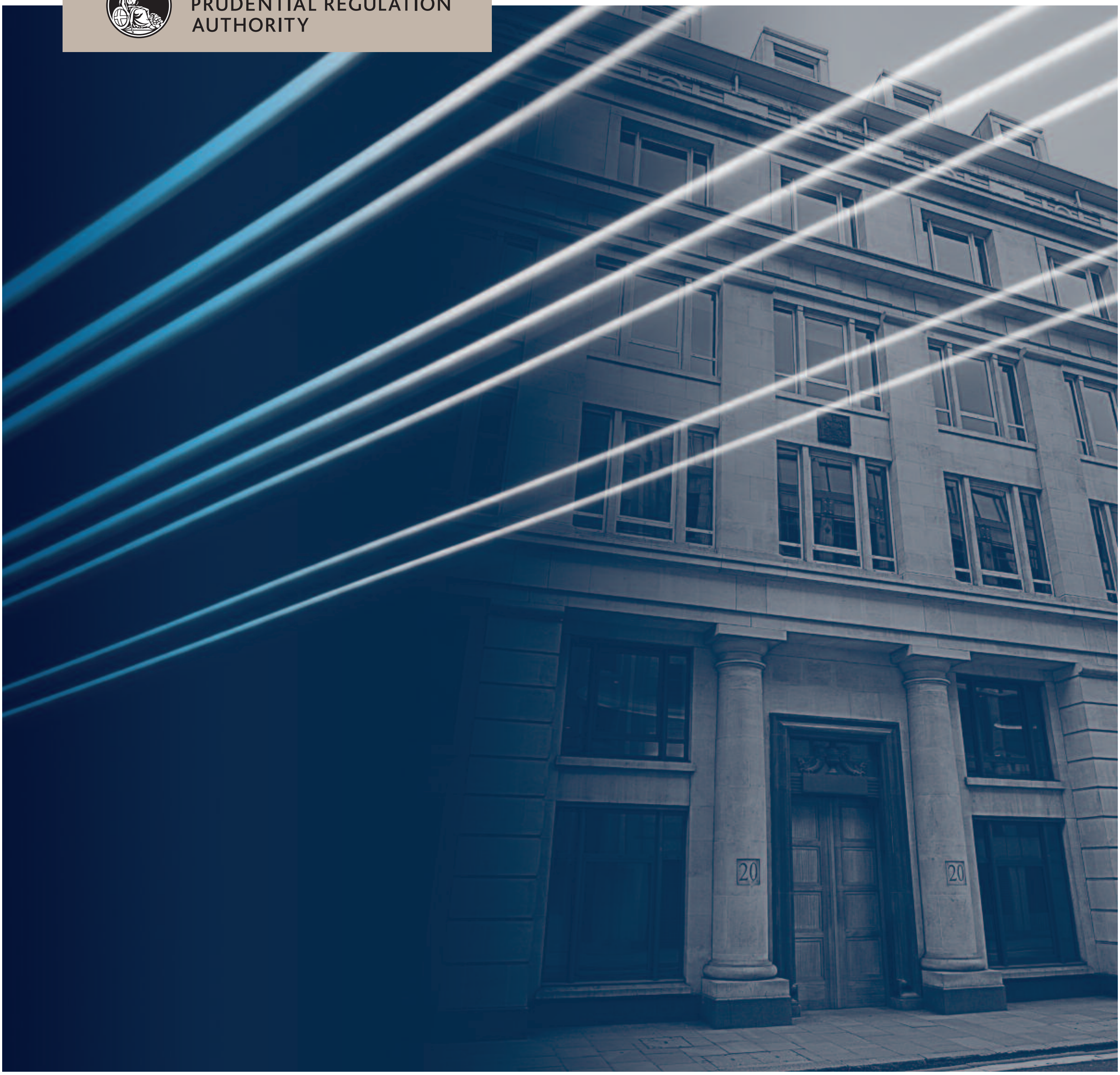

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Solvency II: the quality of capital instruments

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1 Introduction

1.1 This supervisory statement is of interest to all UK insurance firms within the scope of Solvency II, the Society of Lloyd's, and firms that are part of a Solvency II group that will determine and classify capital instruments under the Solvency II own funds regime, together with their advisors. This statement should be read alongside all relevant European legislation and relevant parts of the Prudential Regulation Authority (PRA) Rulebook.

1.2 This statement clarifies the PRA's expectations of the quality of capital instruments in the period prior to 1 January 2016, and after the commencement of Solvency II. By clarifying its expectations in relation to the quality of capital instruments, 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.

1.3 This statement has been subject to public consultation(1) and reflects the feedback that was received by the PRA.

1.4 The PRA made clear in its approach to insurance supervision(2) that it expected firms issuing or amending capital instruments to anticipate the enhanced quality of capital required under Solvency II. Many firms engaged actively with their supervisors to meet these expectations. However, some firms encountered difficulty in applying some of the Solvency II concepts; this statement comments on a number of these concepts.

1.5 As the Solvency II Regulations have now come into force, the cut-off date for the issue of instruments which will qualify for consideration under the own-fund transitionals has passed. Firms' capital instruments will therefore need to meet all the Solvency II criteria. Firms should consider extending the scope of the legal opinions addressing compliance with the current GENPRU regime to cover compliance with the Solvency II requirements. This would provide firms and their supervisors with assurance that capital instruments would be compliant on 1 January 2016.

1.6 This supervisory statement covers the following topics:

- prohibition on redemption of instruments within five years of the date of issue;
- liability management and capital reduction;
- principal loss-absorbency mechanism for Tier 1 instruments subject to limitation ('restricted Tier 1'); and
- additional considerations for instruments intended to contribute to group own funds.

2 Prohibition on redemption prior to five years from date of issue

2.1 Under the General Prudential sourcebook (GENPRU of the PRA Handbook) firms are prohibited from redeeming an instrument under Tier 1 or Tier 2 prior to five years from the date of issue.(3) However GENPRU also provides(4) that firms may seek a waiver to redeem an instrument in the event of changes to the tax or regulatory treatment of an instrument within five years, where it would have been reasonable for firms to conclude at issue that such changes would not occur.(5) These calls prior to five years from issue are often referred to as tax calls, regulatory calls or more generally early calls.

2.2 The corresponding provisions under Solvency II(6) prohibit calls prior to five years from issue, but do not include a waiver provision in respect of early calls. This difference in approach has attracted many questions from firms during the development of Solvency II.

2.3 The Solvency II Regulations(7) provide that a transaction does not constitute a repayment or redemption of an instrument if it is:

- exchanged or converted into another instrument of the same or higher quality; or
- repaid or redeemed out of the proceeds of a new instrument of the same or higher quality.

2.4 The PRA considers that this reflects an approach similar in nature to the current GENPRU rule on the 'meaning of redemption'.(8)

2.5 In order to satisfy the Solvency II provisions, the PRA expects firms to ensure that any terms or conditions relating to early calls make clear that this call could only occur when the instrument is exchanged or converted, or redeemed out of the proceeds of a new instrument of the same or better

(1) *PRA Consultation Paper CP24/14*, 'Solvency II: further measures for implementation', November 2014; www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp2414.pdf.
(2) *The Prudential Regulation Authority's approach to insurance supervision*, June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf.
(3) GENPRU 2.2.70 and GENPRU 2.2.172 respectively.
(4) GENPRU 2.2.71 and 2.2.173.
(5) GENPRU 2.2.71.
(6) Articles 71(1)(f), 73(1)(c) and 77(1)(c) of Regulation 2015/35.
(7) Articles 71(2), 73(2) and 77(2) of Regulation 2015/35.
(8) GENPRU 2.2 77.

quality. The PRA expects that terms covering this matter should be drafted with clarity and transparency, making clear the need for prior supervisory approval of the call.

2.6 The PRA considers that any instrument containing an early call option that only provides for redemption and therefore a reduction in capital resources, would not comply with the Solvency II provisions whatever the circumstances giving rise to that call.

3 Liability management and capital reduction

3.1 In recent years some firms have conducted 'liability management' exercises in which they have bought back some of their outstanding capital instruments. Firms have generally engaged with their supervisors prior to carrying out such exercises. In accordance with the relevant Solvency II provisions(1) the PRA expects that any means by which capital instruments are reduced, repaid or bought back (including share repurchases), will be subject to prior supervisory approval. The PRA also expects firms to ensure that any relevant terms and conditions in their capital instruments include the requirement for such prior supervisory approval. Buyback exercises would also fall within the scope of the minimum period of five years from issue date described in paragraph 2.6.

3.2 Since the economic substance of a substitution of issuer is equivalent to a redemption by the original issuer and issuance by the substituted firm, the PRA regards issuer substitution as falling within the scope of redemption and thus subject to prior supervisory approval.

4 Principal loss-absorbency mechanism

4.1 The PRA recognises that firms issuing restricted Tier 1 instruments will need to achieve clarity as to the manner in which a principal loss-absorbency mechanism (PLAM) would operate(2) and expects the instrument's terms and conditions to be sufficiently clear, for the PRA to be confident that the mechanism works as expected and meets the requirements of the Solvency II Regulations. The Solvency II Regulations contain a number of high-level requirements which instruments with a PLAM will have to meet and the European Insurance and Occupational Pensions Authority (EIOPA) guidelines also clarified some aspects of how these requirements might apply in practice.

4.2 The PRA considers that the minimum trigger point for an instrument with a PLAM will be that specified in the Solvency II Regulations(3) and recognises that firms may choose a higher point or points for the mechanism to operate should they so wish.

4.3 If a trigger higher than the minimum is specified, the PRA expects this to be sufficiently clearly defined so that the firm could identify at any point in time whether or not that trigger is met.

4.4 Once the trigger point is reached, the PRA expects the instrument with a PLAM to achieve the write-down or conversion required by the Solvency II Regulations so that the nominal or principal amount absorbs loss. The PRA considers that the conversion or write-down would need to apply to the total of the nominal or principal amount so that the instrument converts or is written down in its entirety.

4.5 Similarly if firms issue several instruments with a PLAM with differing trigger points, the PRA expects them to be mindful of the need for clarity and transparency regarding how they interact with each other, and the firm's overall capital arrangements.

4.6 The PRA considers that any temporary write-down mechanism needs to be considered carefully in order to ensure that the potential for any subsequent write-up does not act to hinder future recapitalisation through the raising of new ordinary share capital. The PRA considers that the potential for eligible future profits to be used to restore the position of holders of the written-down instrument could be viewed by future potential shareholders as limiting the extent to which they might receive dividends and thus could act as a disincentive to their providing investment to recapitalise.

4.7 In addition, the Solvency II provisions require firms to demonstrate that any write-up mechanism has a basis for apportioning eligible future profits that does not undermine the loss absorbency of the instrument,(4) eg if appropriate, by adopting a similar basis as between all Tier 1 instruments, including ordinary share capital and the reconciliation reserve.

5 Instruments intended to count towards group own funds

5.1 The PRA recognises that many of the Solvency II provisions at solo level apply with the necessary modifications for the purposes of group solvency calculations. In respect of own funds requirements, the Solvency II Regulations require specific additional features that will be necessary if a capital instrument is to count towards group own funds. The detail of the additional features required by the Solvency II Regulations differs depending on which type of company in the group has issued the instrument. The PRA will consider the inclusion, or not, of these specific features as well as assessing the availability of own group funds.

(1) Articles 71(1)(h), 73(1)(d) and 77(1)(d) of Regulation 2015/35.
(2) Article 71(1)(e) of Regulation 2015/35.
(3) Article 71(8) of Regulation 2015/35.
(4) EIOPA Guidelines on classification of own funds, Guideline 5 para 1.33 (d).

5.2 Where a UK Solvency II firm has issued the instrument, the PRA expects that instrument to meet the features determining classification for the relevant tier at a solo level. If that same item is to count towards group own funds, then the PRA expects that actions required in relation to the firm's solvency capital requirement (SCR) and minimum capital requirement (MCR) at solo level will also need to be triggered by reference to the group SCR, and the minimum group SCR as proxy (since there is no group MCR) where method 1[(1)] applies in whole or part to the group solvency calculation.[(2)] The PRA considers that compliance with relevant group features for such an instrument does not obviate the need for the item's availability to be assessed.[(3)] In the absence of evidence regarding availability, the PRA expects to apply the rebuttable assumption that the item is not effectively available to cover the group SCR.[(4)]

5.3 In the case of an instrument issued by a third country insurer, the PRA expects groups to classify the item by reference to the solo features determining classification as set out in the Solvency II Regulations. Where method 1 applies in whole or part to the group solvency calculation, the PRA also expects appropriate references to the group SCR, the local capital requirement laid down by the third country supervisor and the minimum group SCR.[(5)]

5.4 The PRA recognises that many groups choose to issue capital instruments from the ultimate holding company, or sometimes from a subsidiary set up for the purpose of issuing capital. In such circumstances, the PRA expects firms to consider the extent to which the instruments satisfies the solo requirements as if the issuer were an insurance undertaking subject to Solvency II,[(6)] with suitable adjustments to the references to SCR to group SCR, and for MCR to the minimum group SCR in relation to method 1, and to the insolvency of the issuer.

5.5 The PRA expects all instruments classified at the group level to be free from any encumbrances and any connected arrangements which would undermine the quality of the instrument at group level. The PRA draws firms' attention to the fact that an instrument issued by an insurance holding company or a mixed financial holding company should be deemed to be encumbered, unless the claims relating to the instrument rank after the claims of policyholders and beneficiaries of all group companies.[(7)] This is consistent with the detailed requirements for group capital. For example, pursuant to the PRA's rules at Own Funds 3.5(2)[(8)] the PRA expects groups to consider the development of terms providing that, in the case of winding up proceedings of any firm in the group, repayment of amounts due under that instrument are refused until all obligations by that member of the group to its policyholders and beneficiaries have been met.

5.6 Holding company issues must therefore satisfactorily address the position of all group policyholders and beneficiaries. Instruments will not qualify for classification as own funds at the group level if this consideration is omitted.

5.7 In assessing the availability of own funds at group level where group solvency has been calculated on the basis of method 2, the PRA will apply similar consideration as to whether own-fund items of related undertakings meet the solo requirements and have suitable references to the undertaking's SCR and the group's SCR.

6 Cost benefit analysis

6.1 The PRA does not expect this statement to give rise to significant incremental costs as it clarifies, but does not add to, Solvency II requirements. The statement delivers benefit since without it firms may in future incur higher-than-expected capital compliance costs if they misinterpret the Solvency II requirements.

(1) Article 331 of Regulation 2015/35.
(2) The PRA's rules at Group Supervision 11 and 12 lay down two methods by which group solvency can be calculated. It refers to these as 'Method 1' and 'Method 2'. Method 1 (the default method) is an accounting consolidation-based method. The alternative Method 2 is a deduction and aggregation method.
(3) Article 331(2)(b) of Regulation 2015/35.
(4) Article 330 of Regulation 2015/35.
(5) Article 332 of Regulation 2015/35.
(6) Article 333 of Regulation 2015/35.
(7) Recital 127 of Regulation 2015/35.
(8) See 3.5(2) of the Own Funds Part of the PRA Rulebook.