

Supervisory Statement | SS2/15

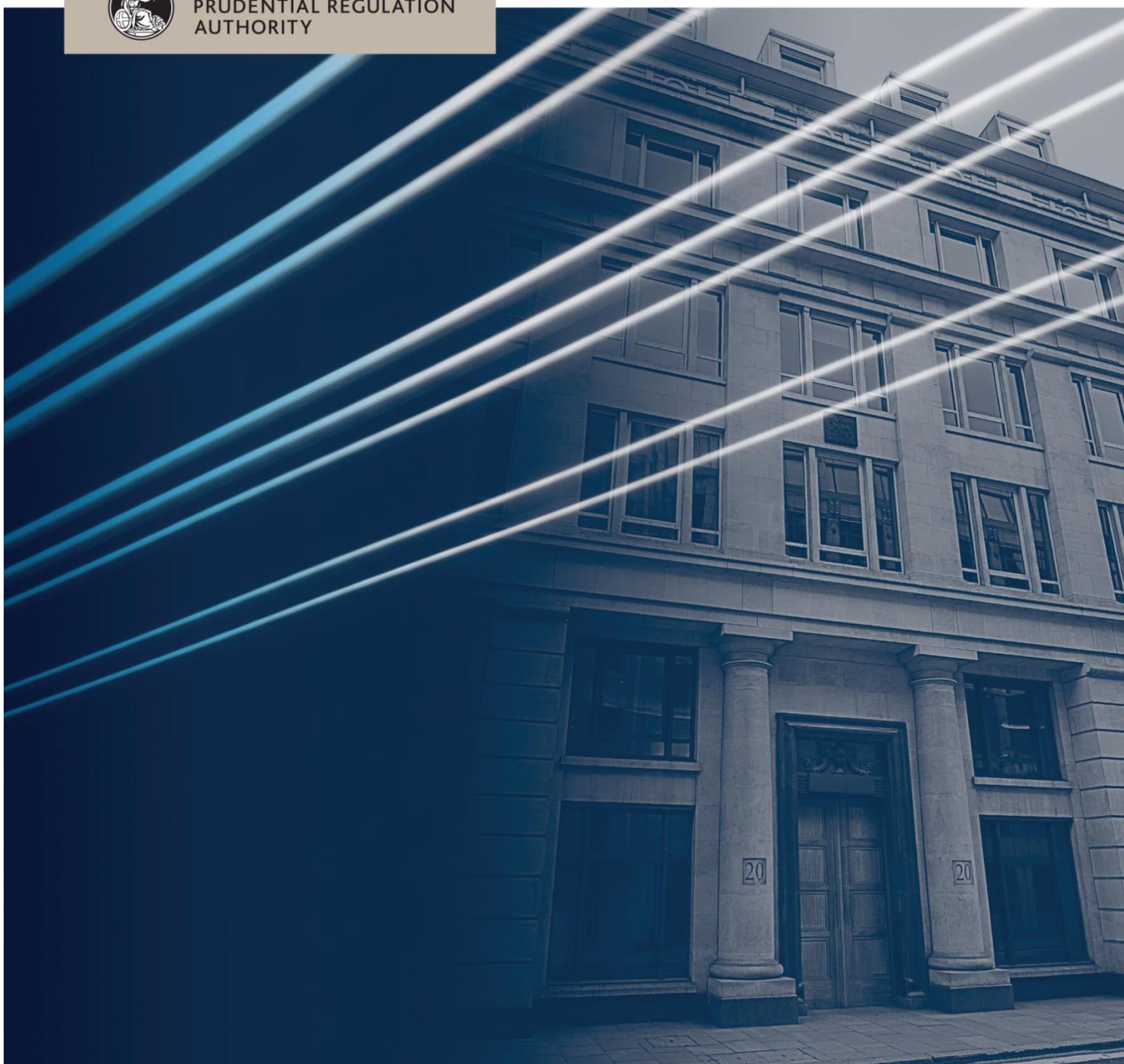
Solvency II: Own funds

September 2019

(Updating March 2015)



BANK OF ENGLAND
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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 [Deleted]

1.5 [Deleted]

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
- (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 [deleted]

[This chapter has been deleted in its entirety]

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.

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.

4.8 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.

Annex – updates to SS2/15

This annex details changes made to SS2/15 following its initial publication in March 2015 following PRA Policy Statement 2/15 ‘Solvency II: A new regime for insurers’.¹

2019

September 2019

Following publication of Policy Statement 21/19 ‘Responses to CP13/19 Occasional Consultation Paper’, this SS was updated to delete historical material from the SS contained in Chapters 1 (1.4 and 1.5) and 3 (deleted in its entirety).

The new policy will come into effect for all instruments issued on or after Monday 30 September 2019.

¹ <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-a-new-regime-for-insurers> .