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Financial Services Risk and Regulation

Hot topic

PRA publishes final rules and supervisory statements on Solvency II

Highlights

PRA has published final rules and supervisory statements ahead of Solvency II going live. This hot topic provides a summary of the areas that may be of most interest to insurers.

On 20 March the PRA published **Policy Statement 2/15 'Solvency II: A new regime for insurers'** (the 'policy statement') which sets out the PRA's final Solvency II rules and accompanying supervisory statements together with providing feedback on the responses to earlier consultation papers.

The PRA has followed an 'intelligent copy-out' approach to incorporating the Solvency II Directive into the PRA rulebook. As such there are comparatively few differences between the PRA's rules and the Solvency II Directive. It is therefore the areas of interpretation dealt with in the supervisory statements that may be of more interest to many insurers.

The PRA received strong feedback in some areas such as the need for insurers to be able to cancel dividends on ordinary shares at any time prior to payment and the definition of surplus funds. However, the final rules and supervisory statements in these areas remained broadly unchanged. There have been some changes to the PRA's proposals in respect of the transitional measures on technical provisions. In other areas the PRA has made final rules and supervisory statements broadly in line with the proposals consulted on.

The publication of the policy statement is a significant step in completing the Solvency II framework in the UK and will provide welcome certainty to insurers. These final rules and supervisory statements will act as a catalyst for many insurers to push through some final and necessary changes ahead of 1 January 2016.

Final rules

The policy statement includes the new chapters of the PRA's Rulebook capturing the requirements of the Solvency II Directive which are being transposed into UK regulation. In general the PRA have very limited scope for discretion as to how they implement Solvency II's requirements and, as a result, the PRA have followed an 'intelligent copy out' approach whereby the proposed text of the PRA Rulebook follows the Solvency II Directive's text as closely as possible. As such the areas of interpretation dealt with in the various supervisory statements discussed below may be of more interest to many insurers than the content of the PRA's rules themselves.

In some clearly defined areas the Directive provides Member State options where national supervisor have discretion over whether or how to implement certain requirements. The final rules confirm the approach previously proposed by the PRA in these areas including:

- The PRA has confirmed its previous proposal to allow non-disclosure of capital add-ons or the required use of USPs for a period of two years following Solvency II's implementation (as opposed to the maximum of five years permitted) – PRA Rulebook: Transitional Measures 13.1 & 13.2.
- The PRA confirmed they will permit the use of local rules in respect of insurers based in equivalent third countries when calculating group solvency on a deduction and aggregation basis – PRA Rulebook: Group Supervision 10.4(2).
- The PRA did not adopt the option of allowing the use of a duration-based equity risk sub-module by life insurers in respect of insurance business meeting specific criteria as it believes there is very little UK business that would meet these criteria.

The elements of the Solvency II Directive that are being transposed into UK law (as opposed to the PRA Rulebook) were implemented by The Solvency 2 Regulations 2015 (SI 2015/575). Taken together the policy statement and The Solvency 2 Regulations 2015 complete the required transposition of the Solvency II Directive into UK law and regulation. A transposition table¹ is available which provides a mapping of the Directive to where it has been transposed.

The legal form of the Level 2 Solvency II Regulations (i.e. the delegated acts and technical standards underpinning the Directive) is such that they have direct application across the EU without needing to be transposed into national regulation and, as a result, the PRA has not incorporated the requirements of the Level 2 Solvency II Regulations into its Rulebook. A practical consequence of this approach is that insurers do not have a single source of Solvency II regulation to which they are subject. Insurers

will have to follow both the PRA Rulebook and accompanying supervisory statements as well as the requirements of the Level 2 Solvency II Regulations.

Supervisory statements

The policy statement is accompanied by 17 supervisory statements (SS) covering the following areas:

- Insurance general application.
- Own funds.
- The quality of capital instruments.
- The solvency and minimum capital requirements.
- The treatment of pension scheme risk.
- The internal model treatment of participations.
- -Supervision of firms in difficulty or run-off.
- Composites.
- Group supervision.
- Third-country branches.
- Regulatory reporting and exemptions.
- Lloyd's.
- Surplus funds.
- With-profits.
- Approvals.
- Conditions governing business.
- Transitional measures on risk-free interest rates and technical provisions.

Below we discuss some of the key messages included in the policy statement and supervisory statements indicating whether they were subject to change since consultation.

Own funds² and the quality of capital instruments³

Cancellation of dividends on ordinary shares

The PRA has confirmed that firms cannot classify ordinary shares as Tier 1 (or Tier 2) capital unless the firm has the right to cancel (or defer in the case of Tier 2) dividends at any time prior to payment. This has been included as a requirement in the PRA Rulebook (PRA Rulebook: Own Funds 3.7).

The PRA believes that to meet this requirement firms will need to declare dividends on a conditional basis and some firms might need to amend their articles of association to include a specific power enabling them to declare dividends subject to conditions. The PRA also confirms that if a firm's articles of association do not prohibit the cancellation of a dividend at any time (including after declaration) then it could be argued that such cancellation may be possible, which means that in practice it is possible for the firm to cancel the dividend at any point prior to payment. Insurers must ensure that they review their

¹ http://www.legislation.gov.uk/ukxi/2015/575/pdfs/ukxi_tn_20150575_en.pdf

² SS2/15 Own Funds & PS2/15 Chapter 11

³ SS3/15 The quality of capital instruments

articles of association to establish that such a prohibition does not exist.

This is an area where the PRA received strong feedback against the proposals with arguments being made that the rule goes beyond Solvency II's requirements or is unnecessarily onerous and may place UK insurers at a competitive disadvantage. However, the PRA reiterates that its rules are a direct consequence of the Level 2 Solvency II Regulations where the mandatory dividend cancellation feature is not restricted to the period before the dividend is declared. The PRA indicates that other Member States are considering implementing, or have already implemented, provisions to ensure compliance with this requirement.

Transitional measures for own funds

Insurers are expected to carry out an analysis of capital instruments issued before the cut-off date for transitionals (18 January 2015) to determine which instruments are Solvency II compliant and which require the application of transitional measures. There are no changes since the consultation on this matter with instruments eligible under the transitional measures that were classified as Upper Tier 2 and above under Solvency I being treated as restricted Tier 1 under Solvency II's transitional measures.

Capital instruments which currently only qualify as Solvency I capital resources under transitional measures in GENPRU will not be eligible for 'grandfathering' into the Solvency II regime.

Given that instruments issued on or after 18 January 2015 will not be eligible for transitional measures, the PRA believes that insurers issuing capital instruments prior to 1 January 2016 should consider extending the scope of the required legal opinions addressing compliance with the current GENPRU regime to also cover compliance with Solvency II requirements to provide assurance that the instruments will be compliant on 1 January 2016.

Ancillary Own Funds (AOFs)

In SS 2/15 the PRA confirms that it will only approve AOFs where the credit taken within own funds reflects the loss absorbency of the instrument.

Pre-issuance notification

Whilst not a requirement of the Solvency II Directive, the PRA has retained its current requirements that, except in exceptional circumstances, the PRA should be notified at least one month prior to the issuance notification of own funds items (PRA Rulebook: Own Funds 5). The PRA considers that the exceptional circumstances in which insurers may give less than one month's notice are likely to relate only to risk of non-compliance with SCR or MCR.

Early calls treatment

Under both current and Solvency II rules, Tier 1 and 2 instruments cannot be redeemed prior to five years from date of issue. However, under the current regime the PRA had the ability to waive the requirement when such an early call was caused by a change in taxation or regulation. Under Solvency II rules the PRA will not have the ability to grant such a waiver.

However, under Solvency II's requirements insurers will be able to call an instrument early if it is replaced by an instrument of the same or higher quality. Terms covering this eventuality should be drafted in a clear and transparent manner including the need for regulatory pre-approval.

The PRA also points out that any instrument that contains an early call option that only provides for redemption, does not meet the Solvency II requirements whatever the trigger for the early call. These provisions remain unchanged since the consultation.

Buy-back exercises (such as repurchase, reduction or repayment of own shares or debt) are also considered a call and therefore subject to the above restrictions.

Liability management and capital reduction (pre-approval of buy-back transactions)

Insurers and groups sometimes engage in liability management exercises whereby they engage in transactions to buy back, repay or reduce their own capital instruments. The PRA expects that any of these transactions will be subject to prior supervisory approval and this fact should be included in the terms and conditions of the relevant capital instruments.

Restricted Tier 1 instruments

Under Solvency II any preference shares, subordinated liabilities or subordinated mutual members accounts included in Tier 1 own funds (also called restricted Tier 1 instruments) must possess a principal loss-absorbency mechanism (PLAM). The PLAM must operate so that when the 'trigger point' is reached the restricted Tier 1 instrument will either be written down or convert into an unrestricted Tier 1 instrument. The PRA expects the PLAM to be included in the terms and conditions of the instrument and firms should be clear about how the PLAM is expected to operate.

Trigger points: The minimum trigger points for the operation of the PLAM are outlined in the delegated acts as being either a breach of MCR or a significant breach in SCR. The PRA recognises that firms can use higher triggers if they wish provided they can be monitored at all times.

In the event of the trigger being reached the PRA expects the instrument to be either converted or written down in its entirety. In addition, firms that have issued several instruments with PLAMs with different trigger points should be clear about how they would interact with each other in the event of one or several triggers being reached.

Temporary write-downs: If the instrument is temporarily written down when triggered, then special consideration should be given to ensure that the potential for future write-ups does not act to hinder recapitalisation. If potential investors are aware that certain instruments will have to be written up with future profits then it might act as a disincentive to invest in the capital of the firm since dividends will likely be reduced by the need to restore the position of the written down instrument. The PRA also expects that any write-up mechanism will include a basis for apportioning future profits that does not undermine its loss absorbency.

This element of the supervisory statement remains broadly unchanged since the consultation.

Group own funds

The PRA expects that for an own fund item to count towards group own funds, it will have to include some additional specific features. This means that when the PRA assesses group own funds, it will not only look at availability and fungibility but also at whether these additional features are included in the instrument. 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 capital at a group level. Where method 1 (the accounting consolidation-based method is being applied) the features the PRA will consider include:

- ***Instrument issued by an insurer subject to Solvency II***
Where the instrument includes references to trigger points (breach of MCR/SCR at solo level) it should also include references to breach of group SCR and the minimum group SCR (as proxy for MCR).
- ***Instrument issued by a third country insurer***
The instrument should include references to group SCR, minimum group SCR and local capital requirement imposed by the third country supervisor.
- ***Instrument issued by ultimate holding company or a non-insurance subsidiary thereof***
The instrument should satisfy the requirements as if the issuer were an insurer subject to Solvency II but with references to SCR being read as references to group SCR and references to MCR being read as references to both the minimum group SCR and to insolvency of the issuer.
- ***Instrument issued by insurance holding company or mixed financial holding company***
Will not count towards group own funds unless claims relating to the instrument rank after the claims of all group policyholders. The instruments should include terms to provide that in the case of winding up of any insurer in the group, repayment of the instrument will be refused until all claims of policyholders of that insurer have been met.

The PRA also expects the own fund items of the solo entities that form part of the group solvency calculation under the deduction and aggregation method (method 2) to have the necessary references to both the solo SCR and the group SCR.

This element of the supervisory statement remains broadly unchanged since the consultation.

Solvency Capital Requirement and Minimum Capital Requirement⁴

Undertaking Specific Parameters (USPs): The PRA confirms that insurers can replace a subset of standard formula parameters with their own USPs subject to the PRA's approval. The USPs must be calibrated on the basis of the insurer's internal data. The PRA might require a firm to replace a subset of parameters with USPs because its risk profile deviates from that of the standard formula.

Significant deviations from standard formula assumptions, internal model or system of governance:

The PRA outlines how in the case of significant deviations from standard formula assumptions it might require the insurer to develop a full or partial internal model. This could also lead to the imposition of capital add-ons.

An insurer with an improved internal model may apply to the PRA for a waiver to revert to calculation the SCR on the basis of the standard formula if there are justified circumstances for such a change.

The PRA will only approve credit for diversification effects within an internal model where there is an adequate system for their measurement.

Where a firm wishes to use an internal model but is unable to derive the SCR directly from the probability distribution forecast it will need to apply to the PRA for a rule waiver.

Surplus funds⁵ and with-profits business⁶

The PRA received a significant volume of comments on the proposed definition of 'surplus funds' of a with-profits fund, the distribution of which should not form part of the Solvency II technical provisions. Notwithstanding the feedback received the PRA has concluded that no changes are required to the proposed rules governing the calculation of surplus funds. We thus have confirmation that, contrary to the current treatment within Realistic Balance Sheet reporting, future enhancements to benefits resulting from the distribution of surplus assets such as an inherited estate should only be included in technical provisions to the extent that they are permanent. Additional guidance has been included in supervisory statement SS13/15 to clarify certain elements of the calculation, including the definition of a permanent enhancement to benefits.

The policy statement also contains the PRA's response to CP22/14, which consulted on proposed changes to its regulation of with-profits business beyond those required to transpose the Solvency II Directive into UK law. This consultation also appears to have elicited quite a number of comments and requests for clarification. While there have

⁴ SS4/15: Solvency Capital Requirement and Minimum Capital Requirement

⁵ SS13/15: Surplus funds & PS1/15 Chapter10

⁶ SS14/15: With-profits business & PS1/15 Chapter 13

been no changes to the proposed contents of the with-profits chapter of the PRA Rulebook, some amendments have been made to supervisory statement SS14/15 to clarify the requirements. In addition, the definition of 'with-profits policy liabilities' has been amended to ensure that non-Directive firms are not drawn into requirements to calculate future policy-related liabilities.

Matching adjustment⁷

The policy statement does not provide any further details around the matching adjustment. Instead it confirms that the proposed approach, of an 'intelligent copy-out' of the Directive, would be applied in the UK. Much of the detail underlying the matching adjustment has instead been set out in PRA letters to the industry. Firms are due to receive specific feedback from the PRA on their matching adjustment pre-application submissions by 28 March 2015.

Transitional measures on technical provisions and risk free interest rates⁸

The policy statement (and accompanying supervisory statement) changes the application of the technical provisions transitional from that proposed in the original consultation. The rules set out in this policy statement are now quite limited, with the majority of rules made in the UK being set by statutory instrument in The Solvency 2 Regulations 2015.

The key points to note are:

- The technical provisions transitional will now start from a comparison to only Pillar 2 ('ICA') technical provisions; references to Pillar 1, and the EU Minimum Solvency regime (and the adjusted Pillar 2 basis) have now been removed.
- The PRA has made it clearer that the technical provisions transitional will not have to be recalculated annually, but instead only when instructed by the PRA e.g. when there is a significant change in the firm's risk profile.
- The technical provision transitional cannot be applied at any level more granular than that of the homogeneous risk groups defined for Solvency II purposes – it will not be permissible to apply this transitional to a sub-set of the homogeneous risk groups.
- The benefit initially arising from the transitional measure must be capped so that the financial resources required under the Solvency II regime are not less than the financial resources that would be required if the PRA's overall financial adequacy rule (GENPRU 1.2.26R) was still in force. This cap applies at an entity

level and (absent a recalculation of the transitional measure) should be run-off on a straight line basis.

The section of the supervisory statement dealing with transitional measure on risk-free interest rates now provides guidance on the interaction of this transitional measure with the volatility adjustment.

Pension scheme risk⁹

The PRA consulted on its supervisory statement on pension scheme risk in CP24/14. The final supervisory statement is broadly unchanged from the consultation.

The highlights are:

- The balance sheet should recognise pension scheme liabilities or assets under International Accounting Standard 19 (IAS 19).
- There may be circumstances where insurers in the group are not required to recognise any element of the pension scheme on their solo balance sheet. For example, this may arise when the pension scheme is recognised within a group service company.
- The PRA reminds insurers that they should consider the formality of any contractual arrangements with such a service company, including the terms of the written agreement covering the outsourcing of key functions to the group service company as this may define rights and obligations in a way that triggers recognition under IAS 19.
- The PRA reminds insurers that pension schemes sponsored by group service companies may generally pose a risk to the solo insurer (e.g. through the risk that a firm might find it necessary to provide support for the scheme in future).
- Thus, where a firm uses an internal model, that model will generally need to take account of the risk that the firm may need to fund any existing deficit not currently recognised and also the risk that the pensions scheme's financial position may deteriorate. If an insurer using an internal model decides not to model this risk, other than at the Group level, it would need to provide evidence that modelling is not necessary e.g. by demonstrating that unencumbered capital is held elsewhere that could, and would, meet any demands to support the pension scheme.
- Where a firm applies the standard formula it is required to assess the significance of the extent to which its risk profile deviates from the assumptions underlying the standard formula. The extent of any deviation may depend on whether the pension scheme obligations are on balance sheet or not. To the extent that the risk is not captured by the standard formula, it may be dealt with through Pillar 2 measures or through the use of a partial internal model – the PRA plans to take a proportionate approach in assessing how the risk should be reflected.

⁷ PS1/15 Chapter 2

⁸ SS17/15: Transitional measures on risk-free interest rates and technical provisions & PS1/15 Chapter 5

⁹ SS5/15: the treatment of pension scheme risk

- The supervisory statement considers the treatment of credit risk within the internal model. The discount rate used in IAS 19 is based on market yields on high quality corporate bonds. As spreads on such bonds widen then (provided their quality is unchanged) the discount rate increases and the pensions liability decreases. For the purposes of an internal model, the PRA queries whether the high quality bonds used as a reference for pension scheme discounting would remain high-quality following a credit shock and, if they do, what their yield would be in such circumstances. Firms are therefore required to justify any allowance made in an internal model for pension scheme liabilities to change following a credit spread shock.
- The standard formula SCR recognises the need to stress a pension scheme for market risks and counterparty default, but not insurance or operational risks. The PRA does not indicate what approach it will take in general terms in respect of any pension risks not captured by the standard formula, nor on credit spreads. It is possible that it may follow the proportionate approach it indicates it will follow in respect of group service companies (where deviations in risk profile may be dealt with either through Pillar 2 measures or by consideration of the use of partial internal models).

Third country branches¹⁰

A third-country branch must maintain adequate worldwide financial resources. The PRA will assess the adequacy of these resources by considering the entity's compliance with the prudential regime under its home country. There is not a requirement for a capital calculation for the whole undertaking based on Solvency II rules.

The third-country branch is expected to provide the PRA with sufficient information so that the PRA can form an opinion on the adequacy of the financial resources of the entity. If the PRA assesses the prudential regime of the third country to be broadly equivalent to the UK regime then compliance with that regime may be relied on as tending to establish compliance with the PRA's worldwide financial resources rule. If the prudential regime of the third country is not broadly equivalent then the PRA will assess the adequacy of financial resources using the methods and techniques applicable to insurers with head offices in the UK.

The PRA has confirmed that its general rules for branches are also applicable to branches carrying on only reinsurance business. However, the PRA will consider applications to waive requirements for such branches.

The PRA plans to consult in the summer on the adoption of EIOPA's Guidelines on branch supervision. Subject to the outcome of that consultation, the third-country branches supervisory statement may be updated.

National specific reporting templates (NSRTs)¹¹

The PRA has now made rules (Reporting 2.6 – 2.14) on a set of 11 reporting templates for UK insurers driven by UK specific reporting requirements or by particular characteristics of the UK market. The NSRTs require information that at present is not included in the Solvency II Quantitative Reporting Templates (QRTs).

NSRTs will apply to individual insurers rather than to insurance groups¹². NSRTs will be required to be submitted by insurers on an annual basis. Reporting deadlines are aligned with those required under the Solvency II Regulations. The templates are accompanied with LOG files explaining how they should be completed (in a similar fashion to QRTs).

Appendix 1 to this Hot Topic includes a list of the templates together with a brief explanation as to whether the information is already submitted under current insurance regulatory reporting or prepared by firms for other purposes and the changes made since the consultation.

Other areas included in the supervisory statements

Insurance general application¹³

This SS clarifies that in the PRA rulebook the Solvency II rules apply to a UK Solvency II firm, to Lloyd's and, where specified, to managing agents. In the case of a firm that might be excluded from the scope of UK Solvency II firm the Solvency II rules will still apply if the firm's permission includes a requirement that it must comply with Solvency II (this is in the case where the firm has opted in to the Solvency II regime or where the PRA has decided to apply the Solvency II rules to a firm that would otherwise be excluded from the regime).

Supervision of firms in difficulty or run-off¹⁴

Firms in breach of MCR will not be permitted to effect new contracts of insurance but may continue in run-off where necessary for the protection of policyholders. These firms should be run in such a way to ensure policyholders are appropriately protected. The PRA will take the same approach to insurers in breach of MCR regardless of whether they are run by management or by an administrator/liquidator.

The PRA expects firms in run-off that are considering applying for transitional provisions (and thus be excluded from the application of the Solvency II regime) to notify the PRA well ahead of 1 January 2016.

¹¹ PS2/15 Chapter 12 and Appendix 3

¹² There are also two templates specific to the Society of Lloyd's

¹³ SS1/15: Insurance general application

¹⁴ SS7/15: Supervision of firms in difficulty or run-off

¹⁰ SS10/15: Third-country branches and PS2/15 Chapter 9

The PRA will determine whether the conditions for transitional measures are met.

- **Composites¹⁵**

The PRA will not grant permission to establish new composite insurers (except where long-term business is restricted to reinsurance or where general insurance business is restricted to accident and sickness).

However, those composite insurers that already have life and non-life permission can have their permissions varied to add other classes.

Composite firms are expected to comply with the governance rules of the PRA rulebook separately in respect of the life and non-life business where practicable. They should also identify the assets attributable to each of its life and non-life business as well as maintain the assets in respect of each business separate from each other. Composites should prepare separate notional balance sheets for each of their life and non-life business. Own funds from one business can only be transferred to the other to remedy a breach in notional MCR if the PRA grants a waiver to do so.

- **Group supervision¹⁶**

Exclusion of entities from group supervision: Where the PRA is the group supervisor and the group wishes to exclude entities from group supervision, the PRA will require a formal application outlining how the conditions for exclusion laid out in the Directive are met. The PRA will assess these applications on a case-by-case basis and consult with the concerned supervisors before making a decision.

Group capital add-on: The PRA will, in particular, consider imposing a group capital add-on when:

- A specific risk at group level is not sufficiently covered by the standard formula or an internal model; or
- A capital add-on is imposed on a Solvency II undertaking in the insurance group because its risk profile deviates significantly from the assumptions underlying the group's internal model.

Groups headed in non-equivalent third countries: Where a group is headed in a third-country whose group supervisory regime has not been determined to be equivalent to Solvency II, the default position is that Solvency II group supervision will apply to the worldwide group. Insurers who wish the PRA to apply 'other methods' of group supervision need to apply to the PRA for a rule waiver stating the 'other methods' that they wish the PRA to consider.

Other group matters: The SS also touches on applications for groups to be subject to centralised risk management; applications to submit a single ORSA or a single SFCR; and the undertaking in the insurance group responsible for group-wide requirements.

- **Appointment of actuaries¹⁷**

The PRA has made rules to align the PRA Rulebook with the Solvency II Directive. Solvency II requires all firms to have an actuarial function. The proposed rules require firms to appoint an external actuary if they lack the internal capability, it would also be possible for an individual in another group company to carry out the function. The proposed rules define the relationship between insurers and their actuaries and between actuaries and the regulator.

- **Exemptions from quarterly reporting under Solvency II¹⁸**

Solvency II allows national supervisors to exempt firms from quarterly reporting where requiring such reporting would be overly burdensome. All insurers (solo or part of a group) designated by the PRA in categories 4 or 5 may apply for exemption from quarterly reporting (some other firms might also, exceptionally, be eligible). The exemption does not include quarterly reporting of MCR, semi-annual reporting of own funds and balance sheet, nor the basic information and content of submission templates. Insurers planning to apply for this exemptions should discuss with their supervisors first, then fill in the relevant questionnaire published on the PRA's website and should make the application by 1 September 2015.

- **Lloyd's¹⁹**

This SS is of interest to Lloyd's only and addresses amendments to trust deeds, solvency capital requirement, capital add-ons and composites.

- **Approvals²⁰**

The PRA confirms that insurers can submit applications for the PRA for Solvency II approvals from 1 April 2015. It reiterates the messages included in a previous consultation that firms should discuss dependencies between approvals and establish contingency plans in case approvals are not granted.

- **Conditions governing business²¹**

The PRA defines what type of business a pure reinsurer can carry on as related to its insurance business; this will include activities such as the provision of statistical or actuarial advice, risk analysis or research for its clients, and a holding company function. The carrying of unrelated banking and financial activities is not permitted.

- **Internal model treatment of participations²²**

For the purpose of solo internal models, UK insurers should consider the risks posed by any obstacles to

¹⁵ SS8/15: Composites

¹⁶ SS9/15: Group supervision

¹⁷ PS01/15: A new regime for insurers - Chapter 14

¹⁸ SS11/15: Regulatory reporting and exemptions

¹⁹ SS11/15: Regulatory reporting and exemptions

²⁰ SS15/15: Approvals

²¹ SS16/15: Conditions governing business

²² SS6/15: the internal model treatment of participations

covering losses with resources currently held in the form of a participation in related undertakings (e.g. barriers to moving resources taking into account the lack of diversification in extreme scenarios) as such obstacles are not taken into account when determining solo own funds. Firms also need to demonstrate that any allowance for inter-entity diversification in the calculation of the solo SCR appropriately takes account of restrictions on transferring resources between the participant and participations. Such considerations are not relevant to the group SCR as the calculation of group own funds takes account of obstacles to transferring resources between entities.

Areas not included in the supervisory statements

In its previous consultation the PRA had proposed issuing supervisory statements on *Reporting internal model outputs* and *ORSA and the ultimate time horizon – non-life firms*. However, final versions of these supervisory statements are not included in the policy statement which makes no mention of them. We understand the PRA plans to issue finalised supervisory statements in these areas at a later date.

What do I need to do?

Capital instruments

The policy statement and supervisory statements provide helpful certainty about the features capital instruments must possess in order to qualify as own funds under Solvency II's requirements. A case in point is the need for insurers to assess whether they have a right to cancel or defer their payment of dividends and other types of distribution at any point prior to payment. For example, an inability to cancel declared but unpaid dividends on ordinary shares will lead to them not qualifying as Tier 1 capital. Firms should be ensuring that their articles of association do not preclude dividends from being declared on a contingent basis (or making the necessary amendments if they do). Firms should also be considering Solvency II's requirements for all new issues of capital instruments. For example, these instruments will have to incorporate in their terms and conditions references not only to breaches of solo SCR and MCR but also to group SCR. Some of these requirements might ultimately have an impact on the attractiveness of insurance capital instruments.

The ability of existing capital instruments to qualify as own funds under the transitional provisions is limited. Therefore firms will also need to assess whether the terms of their existing instruments meet Solvency II requirements and, where they do not, determine if the limit on instruments that may qualify via transitional provisions will lead to instruments in issue not qualifying as own funds once Solvency II goes live.

Reporting templates

There are now also final rules on NSRTs. These new reporting requirements have an impact on the data, processes and solutions you are currently in the process of building. The latest rules and log files on reporting should provide enough certainty to incorporate NSRTs on the Pillar 3 preparation processes and IT solutions.

Transitional provisions on technical provisions

Firms now have a clearer idea of what the PRA are looking for in the application, and how the transitionals will work over time. The pressure is now on to ensure the applications have time to be agreed through internal governance processes, and take account of the common situation of parallel, and contingent, applications for other matters such as matching adjustment and internal models.

With-profits

Surplus Funds rules have not changed significantly and work is now needed to ensure technical provisions are adjusted to take account of the requirements here. This will often amend longstanding practice so the implications for IFRS reporting also need to be considered.

Pension scheme risks

While the PRA have fully accepted the IAS19 basis, they remain concerned over the recognition of the liability, and in particular the capital for such risks, across a group structure. There are complex issues here, not just in satisfying the regulator's concerns but in reaching a sensible position for holistic risk management of the firm and its pension scheme. Firms need to consider how their own view of risk sits with, or diverges from, the regulatory view and whether any divergence should be addressed solely within the SCR or also within the ORSA.

Groups headed in non-equivalent third countries

Insurers who wish the PRA to apply 'other methods' of group supervision need to apply to the PRA for a rule waiver stating the 'other methods' that they wish the PRA to consider.

Appendix 1

Table 1

Number	Template name	Content/materiality thresholds	Changes since consultation
NS.01	With-profits value of bonus	Information requested is largely consistent with Form 58 of Insurance Annual Returns (IARs) for each ring-fenced fund. The need for this template stems from the UK's legislative requirements specific to the regulation of with-profits business.	Minor amendment to make calculation basis clear and remove requirement to report funds subject to special apportionment rules.
NS.02	With-profits assets and liabilities	Some information already reported in Forms 19 and 48 of IARs. The need for this template stems from the UK's legislative requirements specific to the regulation of with-profits business.	No amendments made.
NS.03	Material pooling arrangements	Currently reported through pool accounts or via ad-hoc request. The need for this template is driven by the non-standard capital structure of protection and indemnity clubs, where some types of information are required for effective supervision but is not included in QRTs. The template should enable the analysis of the effect of material pooling arrangements (capacity greater than 1 bn USD) on the insurer's performance.	No material amendments except for some minor changes in wording of log files.
NS.04	Assessable mutuals	Currently reported in IARs and P&I club accounts. The template is applicable to assessable mutuals: • With permission to write new contacts that have made supplementary calls since January 2006; or • That have received approval to treat potential future supplementary calls as ancillary own funds. A separate template is completed for each class of mutual members. The template obtains the supplementary call history for each class of mutual members and collects data to show the financial performance of the mutual.	No material amendments.
NS.05	Revenue account (life)	Based on accounting basis of reporting (previously stated UK GAAP on consultation) – not currently reported but PRA expects insurers to already record and keep this information. A template is required for the total life business, each ring-fenced fund and the remaining part of the business.	Log file modified to clarify that deposit accounting' does not apply to this template for the reporting of premiums and claims and some other minor amendments.
NS.06	Business model analysis (life)	PRA believes this information will be produced as part of the ORSA and the forward looking horizon of three years is consistent with common industry practice. Applicable to life insurers with gross technical provisions greater than £500m at reference date.	Minor amendments.

Number	Template name	Content/materiality thresholds	Changes since consultation
NS.07	Business model analysis (non-life)	Currently obtained through ad-hoc requests. PRA believes this information will be produced as part of the ORSA and the forward looking horizon of three years is consistent with common industry practice. Unlike for life insurers, all non-life insurers with permission to write new business are required to submit this template.	Definitions of premiums written, premiums earned, claims incurred and expenses incurred to follow Solvency II basis (same as in QRT S.05). Breakdown by distribution channel is only required for years Y and Y+1.
NS.08	Business model analysis – financial guarantee insurers	The purpose of this template is to collect sufficient information about the portfolio of securities against which financial guarantees have been given to facilitate PRA's business model analysis. Some information is currently collected in the financial guarantee insurer 'benchmarker' template or through ad-hoc requests.	Adjustment to template to remove overlap with NS.07 and some minor changes to better align schedule of securities with current reporting.
NS.09	Best estimate assumptions for life insurance risk	The purpose of this template is to give an indication of changes in the valuation basis, how the basis compares with experience and the variability of the firm's recent experience. Best estimate assumptions will be produced by the firm as a requirement of Solvency II, this template requires the reporting of the information.	Firms are only required to show experience where they have carried out analysis on a consistent basis and should complete the template on a best efforts basis. As 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)	This template requires a split by line of business of information required to be reported in the QRTs at the level of the whole portfolio of non-life obligations. It also requires information to be provided by claim type (including actual historical cash out-flows of payments to policyholders for specified claim types). It captures cash flow projections for employers' liability (EL) business, large bodily injury claims (with potential to be settled by periodic payment order) and very long tail claims (such as latent diseases).	No material amendments.
NS.11	Non-life insurance claims information (general liability sub-classes)	This information is currently gathered on an ad-hoc basis and this template is based on an equivalent QRT but requires a more detailed analysis. This template applies to all insurers writing EL business, public and products liability and professional indemnity subject to materiality thresholds. One template is required for each of the above classes of business. Insurers are required to report the development triangles (15 years) for each of the relevant classes. The PRA believes claim run-off in these classes make the best estimate particularly uncertain so they require more information.	No material amendments.

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