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A Guide to Solvency II

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Foreword

Today, insurers and their partners are asked to do business against an increasingly complex backdrop of economic, social, environmental, demographic, geopolitical and technological factors. In this ever-evolving landscape, change is the only constant. With such uncertainty comes tremendous challenges — but also unique opportunities for the creative, the bold and the *well-informed*. In our age of information overload, there is no shortage of articles, publications and webinars flooding our inboxes and demanding our attention. What makes *A Guide to Solvency II* different? I promise, it is well worth your time.

Over the past several years, our colleagues in London and throughout Europe (with an occasional helping hand from those of us across the pond) have, through their tireless efforts, produced a compendium of clear, practical and thoughtful guidance — distilling an overwhelming volume of complex directives, regulations, guidance materials and rules into small, digestible bites. We are so proud to deliver a work of such value to our clients across the globe. In this regard, we are greatly indebted to our partner, Robert Chaplin, for his knowledge, his leadership and his vision. This momentous publication is the capstone of the first two years of *The Standard Formula* podcast and its related publications, but I assure you, Rob and team are just getting started (and indeed, have already broken ground on next year's ambitious publication — *An Encyclopedia of Prudential Solvency*).

I hope that you enjoy this guide as much as I have for its commercially oriented approach to the law. I encourage you to keep it close, as a reference on your desk, and to consult it often. If a question ever arises beyond the scope of what these pages answer, please do not hesitate to reach out to any member of our global financial services team. Until we speak again, happy reading — your dedicated team at Skadden wishes you well in your future business endeavors, and is standing by to assist.

Elena Coyle
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Skadden, Arps, Slate, Meagher & Flom LLP, New York
December 2024

Preface

Welcome to our first edition of *A Guide to Solvency II*. The guide represents the culmination of a significant multiyear effort by our practice, with contributions from over two dozen team members. I am enormously grateful for their efforts. What may have initially seemed like a daunting task has proven to be a rewarding experience, broadening and deepening our team's regulatory knowledge and enhancing our everyday practice, which in turn has benefitted the *Solvency II* project.

Each chapter of the *Guide* may also be found on Skadden.com, along with a condensed version of each chapter as a podcast, offering an accessible introduction to this complex subject. We plan to issue updates on significant new developments periodically and update the *Guide* on approximately an annual basis.

Looking ahead to next year, we are launching a new project: *An Encyclopedia of Prudential Solvency*. We will again issue chapters monthly, each focusing either on a specific jurisdiction or region, to offer readers a "rough and ready" appreciation of the insurance prudential regulatory regime therein. We are greatly looking forward to this tremendously exciting project.

In the meantime, we hope you find the *Guide* useful. We welcome your feedback, whether general or specific. One challenge we faced was addressing the gradual divergence between EU Solvency II and what has come to be known as Solvency UK. Our team has endeavored to cover both regimes, with a bias in coverage towards the UK where appropriate and adopting the draft Solvency UK regulatory taxonomy. While this may require correction in the next edition, we believe it is beneficial to include, alongside the European taxonomy. At the end of the publication, you will find a helpful glossary.

Perhaps most importantly, please feel free to contact us via the details on the Contacts page. We would enjoy answering questions and tackling challenging issues regarding any prudential solvency matters with you informally.

The law in this publication is as stated as of 8 November 2024.

Robert A. Chaplin
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Skadden, Arps, Slate, Meagher & Flom (UK) LLP, London
December 2024

Chapter 1

Own Funds

Introduction

Own funds is the term employed in the Solvency II Directive for the items that constitute a (re)insurer's regulatory capital. These are principally balance sheet items, with limited allowance for off-balance sheet items.

Own funds are items that are most available to absorb losses, such as retained earnings, the proceeds of paid-in ordinary share capital and/or types of long-term debt instruments. Allowance is also made for certain assets that are less available to absorb losses and, subject to eligibility criteria, may extend to uncalled share capital and to other items such as deferred tax assets.

A (re)insurer must hold own funds at least equal to the sum of its capital requirements. Capital requirements are comprised, first, of the Solvency Capital Requirement (SCR) and, second, of the Minimum Capital Requirement (MCR) within the SCR. These are not to be confused with a (re)insurer's technical provisions, which are required to meet a (re)insurer's obligations to policyholders as they fall due on a business-as-usual (BAU) basis. Equally, own funds are not to be confused with the assets in which a (re)insurer may invest (including with the proceeds of such own-fund items). These different concepts and regimes will be covered in other chapters.

Following Brexit, the UK's divergence from EU-derived rules has been a tale of its own. This divergence includes liberalisation of the EU Solvency II regime. These changes do not, for now, include own funds, and we expect the UK Prudential Regulation Authority (PRA) to continue to follow current Solvency II requirements in this regard for the foreseeable future. In this chapter, we summarise the position from the Solvency II Directive, together with the UK approach (to the extent different or otherwise noteworthy). In the area of own funds, the UK has remained aligned with Solvency II, and hence these instances are limited.

The key regulations for own funds are detailed in Articles 87 to 99 of the Solvency II Directive, the Own Funds Section of the PRA Rulebook, the Commission Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC of the European Parliament and of the Council (Level 2 Delegated Regulation) and the European Insurance and Occupational Pensions Authority (EIOPA) Guidelines on Classification of Own Funds (EIOPA-BoS-14/168 EN) (Classification Guidelines). The regulations are supplemented by various PRA supervisory statements (PRA SSs),[1] which clarify the same or provide the PRA's views where the regulations or subsidiary legislation are unclear.

In addition to the existing regulations, the European Parliament, on 23 April 2024, voted in plenary session to adopt a legislative resolution amending certain provisions of the Solvency II Directive.[2] The European Parliament confirmed the final text under the corrigendum procedure in October 2024, the European Council adopted the amendments on 5 November 2024 and these amendments will take effect 20 days after their publication in the Official Journal (Amendments).[3] Member states will be required to implement the Amendments into national law within 24 months and one day after its entry into force. The Amendments have, however, left the existing own funds regime largely untouched, with the only material changes being in the treatment of (re)insurers' participations in financial and credit institutions (discussed in Section 12 below).

[1] (1) PRA SS2/15; (2) PRA SS3/15; (3) PRA SS4/18; and (4) PRA SS19/16.

[2] European Parliament Briefing, "Proposal Amending the Solvency II Directive", 10 April 2024.

[3] *See generally* "Solvency II and IRRD: Council Signs Off New Rules for the Insurance Sector", Council of the EU, 5 November 2024.

1. Categorisation

Insurers are required to classify own funds into three categories, with varying degrees of availability and subordination. Tier 1 is considered of the highest quality, Tier 2 sits in the middle and Tier 3 offers a broader spectrum and increased flexibility.

Own-fund items are further classified as either "basic own funds" (BOF) or "ancillary own funds" (AOF).[4] The former are on-balance sheet items and qualify automatically and have a higher eligibility ranking. The latter are off-balance sheet items that cannot qualify as Tier 1 own funds and require supervisory approval (discussed in Section 8 below). Specifically, whereas BOF are comprised of the excess of assets over liabilities less the amount of own shares held by a (re)insurer, and a (re)insurer's subordinated liabilities,[5] AOF consist of items other than BOF which can be called up to absorb losses.[6]

2. Composition of Own Funds

(Re)insurers must observe prescribed limits in the composition of their own funds, as follows:[7]

- Tier 1 items cover at least half of the SCR and 80% of the MCR.
- Tier 2 items shall not exceed 20% of the MCR.
- Tier 3 items are restricted to no more than 15% of the SCR.
- The sum of Tier 2 and Tier 3 items shall not exceed 50% of the SCR.

Preference shares, subordinated debt and certain other items are limited to less than 20% of the total amount of Tier 1 (see Section 5 below).[8]

3. General Characteristics of Own Funds

The Own Funds Part of the PRA Rulebook states that "a firm may only include an own-fund item in its Tier 1 own funds if (a) it is an item of BOF, and (b) it substantially possesses the characteristics set out in 3.5(1) [permanent availability] and 3.5(2) [subordination], taking into consideration the features set out in 3.6 [Own Funds Characteristics]".[9]

The two characteristics, which are fundamental to understanding own funds, are "permanent availability" and "subordination":

- "Permanent availability" relates to how readily such own funds can be mobilised to absorb losses on a going-concern basis or in the case of a winding up.[10]
- "Subordination" refers to whether and to what extent the item is accessible to absorb losses in a winding-up. This prioritises and protects policyholders and other similar beneficiaries.

[4] Article 87 of the Solvency II Directive (transposed in Paragraph 2.1, Own Funds Part of the PRA Rulebook).

[5] Article 88, *ibid* (transposed in Paragraph 2.2, Own Funds Part of the PRA Rulebook).

[6] Article 89(1), *ibid* (transposed in Paragraph 2.3, Own Funds Part of the PRA Rulebook).

[7] Article 82(1) and (2) of the Level 2 Delegated Regulation.

[8] Article 82(3), *ibid.*

[9] Paragraphs 3.1 and 3.2, Own Funds Part of the PRA Rulebook (transposing Article 94(1) of the Solvency II Directive).

[10] Article 93(1) of the Solvency II Directive (transposed in Paragraph 3.5, Own Funds Part of the PRA Rulebook).

The greater the availability and subordination, the better the capital from a regulatory perspective.

In assessing capital instruments, (re)insurers and, in certain contexts, regulators, will need to evaluate the following four characteristics of the relevant capital item:[11]

- The duration of the item, in particular whether the item is dated or not and, where an own-funds item is dated, the relative duration of the item as compared to the duration of the insurance and reinsurance obligations of the firm (sufficient duration).
- Whether the item is free from requirements or incentives to redeem the nominal sum (absence of incentives to redeem).
- Whether the item is free from mandatory fixed charges (absence of mandatory servicing costs).
- Whether the item is clear of encumbrances (absence of encumbrances).

Where a (re)insurer has insurance obligations that are long-term, it will correspondingly require capital that is reliably available over at least a matching time period. These own-fund items should not have restrictions or conditions that might unexpectedly deplete them, thus they will need to be stable, unencumbered and without mandatory costs attached.

We set out in Section 4 the specific criteria that all BOF items must meet. Sections 5, 6 and 7 set out the additional criteria for Tier 1, Tier 2 and Tier 3, respectively.

4. Criteria for All Basic Own Fund Items

Encumbrances and Connected Transactions

Own funds must be unencumbered, meaning they should not be linked to transactions that could compromise requirements encapsulated in the Solvency II Directive for Tier 1, Tier 2 or Tier 3 own funds set out below.[12] This requirement ensures that capital elements are genuinely available to absorb losses, reflecting their classification and importance in the company's financial stability.

The Classification Guidelines emphasise that firms must critically assess the economic consequences of any encumbrances.[13] Consequences range from liens, pledges or legal restrictions, each potentially eroding the utility and effectiveness of the capital. An evaluation should go beyond legal formalities and involve a "substance over form" approach. Hence (re)insurers should discern the practical implications of any encumbrances beyond their face value.

Encumbrances include the following, per the Classification Guidelines:[14]

- Rights of set-off.
- Restrictions.
- Charges or guarantees.
- Holdings of own-fund items of the undertaking.

[11] Article 93(2), *ibid* (transposed in Paragraph 3.6, Own Funds Part of the PRA Rulebook).

[12] Articles 71(1)(o), 73(1)(i) and 77(1)(h) of the Level 2 Delegated Regulation.

[13] Paragraph 1.59(a), Guideline 13 of the Classification Guidelines.

[14] Guideline 13, *ibid*.

- The effect of a transaction or a group of connected transactions that have the same effect as any of the above, or which otherwise undermine an item's ability to meet the features determining classification as an own-fund item.

Suspension of Repayment or Redemption on Breach of SCR

All BOF instruments must provide for suspension of repayment or redemption in the case of noncompliance with the SCR (or where repayment or redemption would lead to such noncompliance).[15]

However, the own-fund item may allow for early redemption or repayment in such circumstances when:

- The supervisory authority has exceptionally waived the suspension of repayment or redemption of that own-fund item.
- The item is exchanged for or converted into another own-fund item of at least the same tier.
- There is no MCR breach as a result.[16]

Restrictions on Incentives To Redeem

Guideline 19 of the Classification Guidelines elaborates on factors considered as "incentives to redeem". The factors are not confined to specific instances and, consequently, are prohibited across all tiers. In particular, the following factors will be considered prohibited "incentives to redeem":

- Principal stock settlement combined with a call option, where the holder of the own-fund item is obliged to receive ordinary shares if the call is not exercised.
- Mandatory conversion combined with a call option.
- An increase in the principal amount that is applicable subsequent to the call date, combined with a call option.
- Any other provision or arrangement that might reasonably be regarded as providing an economic basis for the likely redemption of the item.[17]

Exchange Into (or Repayment From Proceeds of) an Equivalent Item

A BOF item may be exchanged or converted into another BOF item of at least the same tier out of the proceeds of a new BOF item of at least the same tier. However, such conversion or exchange is subject to regulatory approval.[18]

5. Criteria for Tier 1 Own Funds

Tier 1 capital is of the highest quality and there is no limit to its use. Capital in this tier must meet the highest standards, in particular:

- The item must be readily accessible or callable on demand comprehensively to offset losses, both in ongoing operations and during liquidation (ensuring permanent availability).[19]

[15] Articles 71(1)(j), 73(1)(f) and 77(1)(f) of the Level 2 Delegated Regulation.
[16] Articles 71(1)(k), 73(1)(h) and 77(1)(h, *ibid.*
[17] Paragraph 1.74(a)-(d), Guideline 19 of the Classification Guidelines.
[18] Articles 71(2), 73(2) and 77(2) of the Level 2 Delegated Regulation.
[19] Article 93(1)(a) of the Solvency II Directive (transposed in Paragraph 3.5(1), Own Funds Part of the PRA Rulebook).

- In the case of winding up, the total amount of the item is available to absorb losses and the repayment of the item is refused to its holder until all other obligations, including insurance and reinsurance obligations to policyholders, have been met (ensuring subordination).[20]

Tier 1 capital includes:

- Paid-in ordinary share capital (or equivalent).
- Surplus funds (effectively profit).
- A so-called reconciliation reserve (being a flexible category allowing a (re)insurer to take into account foreseeable dividends as well as expected profits in future premiums).[21]
- Paid-in preference share capital and subordinated debt (restricted Tier 1 or RT1).

The Solvency II Directive also imposes specific requirements on: (a) duration; (b) incentives to redeem; (c) cancellation or deferral of dividends; (d) "full flexibility"; and, in the case of RT1; (e) a principal loss absorbency mechanism, analysed further below.[22]

Duration

- All Tier 1 instruments must be (a) undated[23] and (b) repayable or redeemable only at the option of the firm, subject to prior supervisory approval.[24]
- An RT1 instrument (a) must not be redeemable before five years after the date of issuance and (b) may only be redeemable between five and 10 years after the date of issuance[25] where the SCR is exceeded by an appropriate margin, taking into account the (re)insurer's solvency position and medium-term capital management plan.[26]

Incentives To Redeem

Tier 1 capital instruments may not include any incentives to redeem.[27]

Dividends, Distributions or Coupons – Solvency Capital Requirement Breach

Tier 1 capital instruments may not allow for payment of a dividend, distribution or coupon to be made in the event of a breach of the SCR or where the payment would lead to such a breach, save where all of the following conditions are met:

- The supervisory authority has exceptionally waived the cancellation of distributions.
- The distribution does not further weaken the solvency position of the firm.
- The MCR is complied with after the distribution.[28]

[20] Article 93(1)(b), *ibid* (transposed in Paragraph 3.5(2), Own Funds Part of the PRA Rulebook).
[21] Article 260(2) of the Level 2 Delegated Regulation.
[22] Article 94(1) of the Solvency II Directive (transposed in Paragraph 3.1, Own Funds Part of the PRA Rulebook).
[23] Article 71(1)(f)(i) of the Level 2 Delegated Regulation.
[24] Article 71(1)(h), *ibid.*
[25] Article 71(1)(f)(ii), *ibid.*
[26] Article 71(1)(f)(ii) and 71(1)(g), *ibid.*
[27] Article 71(1)(i), *ibid.*
[28] Article 71(1)(m), *ibid.*

It has proved challenging for UK (re)insurers to cancel final dividends in light of a breach of the SCR, as shareholder approval of a final dividend is, under English company law (absent any provision to the contrary in the company's constitution or approving resolution) a binding obligation giving rise to a debt. In response, the PRA has published guidance stating that if a company's articles of association do not explicitly forbid the cancellation of dividends — even post-declaration — such cancellations are implicitly permissible.[29] This allows firms to declare dividends conditionally, retaining the right to withdraw the dividend before payout if specific conditions are not satisfied.

UK-based listed (re)insurers will typically announce conditional dividends, appending an explanatory note in the annual general meeting notice. The note usually clarifies that the board does not plan to use its right to cancel dividends unless mandated by the PRA or to comply with regulatory capital requirements. Firms with publicly traded shares must be mindful of additional factors, such as the "ex-dividend" date, and may also face disclosure or other requirements resulting from their listing obligations concerning potential non-payment of declared dividends. The PRA has urged firms to track their solvency status during such period and to initiate early discussions with regulatory supervisors to minimise the likelihood of needing to retract dividends.[30]

"Full Flexibility"

A Tier 1 capital instrument must also provide for "full flexibility" by the (re)insurer over any dividend or coupon, *i.e.*, be fully discretionary.[31] "Full flexibility" is defined as follows:

- Distributions are solely paid from distributable items.
- Non-disbursement does not constitute an event of default.
- Cancellation of distributions does not restrict the firm's operations.[32]

For ordinary shares and equivalent instruments, full flexibility includes:

- No preferential rights or hierarchy in payment order.
- Distribution amounts are not linked to the initial purchase price of the own-fund item.
- No upper limit is placed on distribution levels.
- Firms are under no compulsion to make distributions.[33]

For RT1 instruments, additional conditions include:

- Unrestricted authority for firms to indefinitely cancel distributions on a noncumulative basis, utilising these funds to meet due obligations.
- No obligation to substitute the distribution by a payment in any other form.
- No obligation to make distributions linked to a distribution on another own-fund item.[34]

[29] Paragraph 4.4 of the PRA SS2/15.
[30] Paragraph 4.6, *ibid.*
[31] Article 71(1)(n) of the Level 2 Delegated Regulation.
[32] Article 71(3), *ibid.*
[33] Article 71(3), *ibid.*
[34] Article 71(4), *ibid.*

The provisions are developed in the Classification Guidelines. Notably "dividend stoppers" — *i.e.*, provisions in lower tier items that restrict Tier 1 distributions — may not be used, since this could discourage new investors in Tier 1 own funds, which may be desirable in a recapitalisation context.[35]

Restricted Tier 1 – Principal Loss Absorbance Mechanism

RT1 instruments must also feature a mechanism that, upon a significant breach of the SCR or the MCR (see below), enables one of the following:

- A write-down of the principal amount of the item.
- An automatic conversion of the item into ordinary share capital (or equivalent).
- A mechanism with an equivalent outcome.[36]

This poses a challenge for (re)insurers in the UK given that the value of share capital cannot be reduced under UK corporate law without a shareholder resolution (and, in certain circumstances, court approval). In practice, firms may achieve this through a temporary write-down, meaning values can decrease now and potentially increase later. The PRA emphasises the need for thorough deliberation around temporary write-down strategies, ensuring that the prospect of future write-ups does not impede potential recapitalisation via the issuance of new ordinary share capital.[37] The prospect of future profits being applied toward preexisting investors after a write-down might deter prospective investors and future recapitalisation efforts.[38]

Restricted Tier 1 – Trigger Events for Principal Loss Absorbance Mechanism

The following constitute trigger events for the RT1 principal loss absorbance mechanism described above:[39]

- The amount of own-fund items eligible to cover the SCR is equal to or less than the 75% of the SCR.
- The amount of own-fund items eligible to cover the MCR is equal to or less than the MCR.
- Compliance with the SCR is not reestablished within a period of three months of the date when noncompliance with the SCR was first observed.[40]

(Re)insurers retain the discretion to incorporate extra trigger events within the terms and conditions of their instruments. This flexibility is particularly pertinent when multiple instruments are issued, each exhibiting unique trigger events for principal loss absorbency mechanisms. In such scenarios, the PRA anticipates that firms provide transparency concerning the interplay among these instruments, ensuring they cohesively function within the broader framework of the firm's capital strategies.[41]

[35] Paragraph 1.13 of the Classification Guidelines.
[36] Article 71(1)(e) of the Level 2 Delegated Regulation.
[37] Paragraph 4.6 of the PRA SS3/15.
[38] Paragraph 4.7, *ibid.*
[39] Article 71(8) of the Level 2 Delegated Regulation.
[40] Article 71(8), *ibid.*
[41] Paragraph 4.5 of the PRA SS3/15.

6. Criteria for Tier 2 Basic Own Funds

Tier 2 BOF are effectively those balance sheet items that are not eligible to constitute Tier 1 BOF, other than Tier 3 BOF (see Section 7 below). Tier 2 funds are subject to more relaxed standards relative to Tier 1 funds and must rank only after the claims of all policyholders and/or beneficiaries and nonsubordinated creditors.[42]

Duration

Tier 2 BOF items must either be undated or have an original maturity of no less than 10 years.[43] Further, the first contractual possibility for redemption must be no earlier than five years from the issue date.[44]

As with Tier 1, repayment or redemption must be at the sole discretion of the (re)insurer (and subject to PRA approval).[45]

Limited Incentives To Redeem

Tier 2 BOF may, however, feature limited incentives to redeem (such as interest step ups), which can only apply after 10 years of the date of issuance.[46] These may include an interest rate step-up associated with a call option, where the step-up takes the form of a single increase in the coupon rate no greater than the higher of the following:

- 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis.
- 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.[47]

Dividends, Distribution or Coupons – Solvency Capital Requirement Breach

As with Tier 1, the instrument must also permit the (re)insurer to delay distributions, dividends and coupon payments for the duration of any breach of the SCR (or where such distribution, dividend or coupon payment would cause any breach of the SCR).[48]

There is no requirement for full flexibility (as is the case with Tier 1), and hence fixed and/or cumulative distributions, dividends and coupon payments by the (re)insurer are permissible.

7. Criteria for Tier 3 Basic Own Funds

Tier 3 BOF effectively represent the remainder of the balance sheet items subordinated after policyholder and beneficiaries' claims, and which are not eligible to constitute Tier 1 or 2.[49] They may also include a (re)insurer's deferred tax assets.[50]

[42] Article 73(1)(a) of the Level 2 Delegated Regulation.
[43] Article 73(1)(c), *ibid.*
[44] Article 73(1)(c), *ibid.*
[45] Article 73(1)(d), *ibid.*
[46] Article 73(1)(e), *ibid.*
[47] Article 73(4), *ibid.*
[48] Article 73(1)(g), *ibid.*
[49] Article 77(1)(a), *ibid.*
[50] Article 76(a)(iii), *ibid.*

Duration

Tier 3 BOF instruments must be undated, or have a minimum maturity of five years.[51]

Dividends, Distribution or Coupons – Minimum Capital Requirement Breach

Tier 3 BOF instruments must also provide for the deferral of distributions in the case of noncompliance with the MCR (or where the payment would lead to such noncompliance).[52]

Limited Incentives To Redeem

Tier 3 BOF instruments may include limited incentives to redeem at any time, in the same manner as Tier 2 BOF (see Section 6 above).[53]

8. Ancillary Own Funds

Tier 2 and 3 capital may also take the form of AOF. These are off-balance sheet items that (re)insurers can call up to absorb losses if necessary. They must involve legally binding obligations and can be callable on demand. Importantly, AOF may not constitute Tier 1.

Tier 2 Ancillary Own Funds

To qualify as Tier 2, AOF must display the features of a Tier 1 instrument (in accordance with Section 5 above) once the item has been called up and paid in.[54] Tier 2 AOF include the following:

- Unpaid/uncalled ordinary or preference share capital.
- Unpaid subordinated debt.
- Letters of credit and guarantees.
- Other legally binding commitments provided that the item can be called up on demand and is clear of encumbrances.[55]

Tier 2 AOF must be callable on demand.[56] This means that the call must not be:

- Contingent on the occurrence of an event or criteria being met.
- Subject to the agreement of the counterparty or any third party.
- Subject to any arrangement or incentive, which would mean that the firm is not permitted or is not likely to call up the item.
- Subject to any arrangement or combination of arrangements that has the same effect.[57]

[51] Article 77(1)(c), *ibid.*

[52] Article 77(1)(g), *ibid.*

[53] Article 77(1)(e) and Article 77(4), *ibid.*

[54] Article 75, *ibid.*

[55] (1) Article 89(1) of the Solvency II Directive (transposed in Paragraph 2.3, Own Funds, Part of the PRA Rulebook); and (2) Article 74 of the Level 2 Delegated Regulation.

[56] Article 74 of the Level 2 Delegated Regulation.

[57] EIOPA Guidelines on ancillary own funds (EIOPA-BoS-14/167 EN).

Tier 3 Ancillary Own Funds

Tier 3 AOF are effectively AOF that do not meet all of the requirements for Tier 2 AOF.[58]

Supervisory Approvals for Ancillary Own Funds

Inclusion of AOF requires regulatory approval. In our experience, such inclusions have typically been heavily scrutinised by the PRA. A (re)insurer seeking approval must scrupulously demonstrate to a high standard that the proposed AOF meet the regulatory criteria, including its legally binding nature, availability and reliability for absorbing losses.

The PRA and EU supervisory authorities will provide approval for a specified monetary amount or a method to determine the amount of AOF for a predefined period.[59] The PRA and EU supervisory authorities also require that the quantitative amount attributed to AOF must be prudent, realistic and reflective of the item's ability to absorb losses.[60]

Where the PRA is the group supervisor, and the relevant item is to be counted toward the group's SCR, a firm may also request that the PRA make an availability determination, which confirms that the instrument meets the regulatory criteria for permanent availability and subordination.

Specific supervisory approval procedures for AOF emphasise the need for firms to furnish comprehensive supporting evidence,[61] in particular a legal opinion affirming the enforceability of contracts and associated arrangements across pertinent jurisdictions, together with a detailed medium-term capital management plan. The latter should elucidate the intended contribution of AOF to the existing capital framework and their role in satisfying current or prospective capital mandates.[62]

The approval timeline for supervisory authorities mandates a decision within a maximum of three months following the receipt of a complete application. The period may extend to six months in the presence of "exceptional circumstances", a term which remains unspecified, thereby ensuring procedural adaptability.

9. Pre-Issuance Notification

A (re)insurer must make a pre-issuance notification (PIN) to the PRA before issuing or amending certain capital instruments that it intends to classify as own-fund items. With the exception of ordinary shares (or any issuance of a class or type previously approved within the prior 12 months), the PRA expects a minimum of one month of notice for a PIN, prior to the inclusion of any instrument in BOF.[63] In respect of any issuance of own funds, a Solvency II firm must submit the following to the PRA, one month in advance of the intended issue date and via email:

- A completed PIN form.
- A copy of the draft terms and conditions for the intended instrument.

[58] Article 78 of the Level 2 Delegated Regulation.

[59] Article 90(1) of the Solvency II Directive (transposed in Paragraph 2.5, Own Funds Part of the PRA Rulebook).

[60] Article 90(2), *ibid* (transposed in Paragraph 2.7, Own Funds Part of the PRA Rulebook).

[61] (1) Article 90, *ibid* (transposed in (i) Regulation 44 of the Solvency II Regulations; and (ii) Paragraphs 2.5 to 2.7, Own Funds Part of the PRA Rulebook); and (2) Article 62 of the Level 2 Delegated Regulation.

[62] Commission Implementing Regulation (EU) 2015/499.

[63] (1) Paragraph 5.2, Own Funds Part of the PRA Rulebook; and (2) Paragraph 6.2, Group Supervision Part PRA Rulebook.

- A draft of an independent legal opinion from a qualified individual, confirming that the capital instrument meets the conditions for qualification in the intended tier of capital.
- In the case of RT1, a draft of an independent accounting opinion from a qualified individual, identifying the instrument's treatment in the firm or group member's finance statements.[64]

Note that the PIN is not a preapproval process, and the PRA does not provide approval, or confirm eligibility, of instruments for inclusion as part of a particular tier of regulatory capital.

10. Surplus Funds — With-Profits Funds

Generally, all of a firm's insurance and reinsurance obligations to policyholders must be captured when calculating its technical provisions.

However, there is an exception to that requirement, which is where those obligations constitute "surplus funds" under relevant national law and, also, satisfy the criteria for Tier 1 own funds (see Section 5 above).[65] The PRA's definition of surplus funds for these purposes is "in relation to a with-profits fund, accumulated profits which have not been made available for distribution to policyholders or other beneficiaries".[66]

To meet the exemption from inclusion in the technical provisions, the value of such funds must be calculated in accordance with a formula specified by the PRA for inclusion in a (re)insurer's own funds.[67]

11. Ring-Fenced Funds

Ring-fenced funds (RFFs) arise where own-fund items within an insurance undertaking have been restricted to meet only the losses of a specific class of liabilities or policyholders.

Such funds cannot be accessed to cover losses more generally, which requires an adjustment in the calculation of own funds and the SCR. The Solvency II Directive requires "adjustments … to reflect the lack of transferability of those own-fund items that can be used only to cover losses arising from a particular segment of liabilities or from particular risks (ring-fenced funds)".[68]

The following products generally would not qualify as RFFs:

- Conventional unit-linked products.
- Conventional index-linked products.
- Conventional reinsurance business provided that individual contracts do not give rise to restrictions on the assets of the undertakings.
- Coverage assets and similar arrangements that are established for the protection of policyholders in the case of winding-up proceedings.[69]

[64] Paragraph 5.2, Own Funds Part of the PRA Rulebook.

[65] Article 91 of the Solvency II Directive (transposed in (i) Paragraph 2.1, Surplus Funds Part of the PRA Rulebook; and (ii) the PRA Glossary "surplus funds").

[66] Paragraph 1.2, Surplus Funds Part of the PRA Rulebook.

[67] Paragraph 3.1, *ibid.*

[68] Article 99(b) of the Solvency II Directive. *See also* (i) Article 80 of the Level 2 Delegated Regulation; and (ii) EIOPA Guidelines on ring-fenced funds (EIOPA-BoS-14/169 EN).

[69] EIOPA Guidelines on ring-fenced funds (EIOPA-BoS-14/169 EN).

The "adjustment" in question involves a modification of capital requirements or risk management measures that (re)insurers must undertake to ensure they maintain adequate financial resources and solvency capital, protecting policyholders against insolvency. This may involve adjustments to SCR calculations, technical provisions or other risk management systems to accurately reflect the firm's risk profile and to comply with regulatory financial resilience standards.[70]

12. Own Funds Treatment of Participations

The Solvency II Directive requires participation by a (re)insurer in financial and credit institutions (essentially banks and investment firms) to be deducted from the (re)insurer's own funds, save where an exception applies.[71] A participation is the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking.[72]

The rationale for this treatment is to reduce double counting in the capital benefit that is derived from banks' and investment firms' regulated capital.

These own funds are to be reduced by the full value of participation in a financial and credit institution that exceeds 10% of the (re)insurer's Tier 1 own funds other than RT1.[73] In solo calculations, risk is addressed through the sub-module for equity risk, meaning that, in place of a deduction in own funds, a capital charge is applied.[74]

An exception applies such that (re)insurers shall not deduct "strategic participations" that are included in the calculation of group solvency on the basis of the "accounting consolidation" method.[75] Strategic participations include equity investments for which the participating (re)insurer demonstrates:

- The value of the equity investment is likely to be materially less volatile for the following 12 months than the value of other equities over the same period as a result of both the nature of the investment and the influence exercised by the participating undertaking in the related undertaking.
- The nature of the investment is strategic, taking into account certain relevant factors listed thereafter, including the existence of a consistent, long-term, clear and decisive strategy to continue holding the participation.[76]

The EIOPA indicates in its guidelines that a participation cannot be divided into strategic and non-strategic parts.

[70] Article 81 of the Level 2 Delegated Regulation.

[71] Article 68(1), *ibid.*

[72] Article 13(20) of the Solvency II Directive (transposed in Section 421A(2) of the Financial Services and Markets Act and the PRA Glossary). Note different definition in the group context, being "the holding, directly or indirectly, of voting rights or capital in an undertaking over which, in the opinion of the supervisory authorities, a significant influence is effectively exercised". Article 212(2) of the Solvency II Directive (transposed in the PRA Glossary).

[73] Article 68(1) of the Level 2 Delegated Regulation.

[74] Articles 168 to 173, *ibid.*

[75] Article 68(3), *ibid.*

[76] Article 171, *ibid.*

The Amendments will introduce new exceptions whereby supervisory authorities will be able to permit (re)insurers to not deduct the value of their participations in financial or credit institutions from the value of their own funds.[77] In particular, the value of such participations would not need to be deducted where the following conditions are met:

- The (re)insurer is in one of the following circumstances:
  - The (re)insurer belongs to the same group as the financial or credit institution in which a participation is held; group supervision applies to that group and the relevant financial or credit institution is not subject to the deduction in Article 228(5) as changed by the Amendments.
  - A supervisory authority requires the (re)insurer to apply certain technical calculation methods and the financial or credit institution falls under the same supervision as the (re)insurer under Directive 2002/87/EC.
- Supervisory authorities are satisfied as to the level of integrated management, risk management and internal control applied by the (re)insurers and financial or credit institutions constituting part of the same group.
- The participation in the financial or credit institution is a strategic equity investment.[78]

13. Application to Lloyd's

The requirements outlined above apply equally to Lloyd's overall in its capacity as a quasi-insurance entity that is subject to prudential supervision by the PRA.[79] Accordingly, the Society of Lloyd's overall is required to hold own funds in the proportions set out above.

Although an individual Lloyd's member or syndicate is not directly subject to the PRA's own funds requirements, Lloyd's has elected to treat them in certain respects as though they were, which in turn allows Lloyd's to meet the requirements overall. As a result, the traditional reliance by Lloyd's members on letters of credit (in some cases as to 100%) has been scaled back so that, from December 2020, letters of credit may not exceed 50% of a member's individual Lloyd's capital requirement (referred to as the Economic Capital Assessment, being the Lloyd's equivalent of the SCR).[80]

[77] Paragraph 45 of the Amendments.

[78] Paragraph 45, *ibid*.

[79] Paragraph 3.1, Insurance General Application Part of the PRA Rulebook.

[80] Lloyd's of London, Market Bulletin Y5117, April 2018.

Chapter 2

Reinsurance and Risk Transfer

Introduction

The primary function of an insurer is the assumption and management of insurance risk. Very commonly, this will involve an insurer passing (or "ceding") risk to other (re)insurers or protection providers in the relevant market. When ceding risk, a (re)insurer has a range of motives or objectives in undertaking such a transaction, including:

- A means of managing the risk that it holds, *i.e.*, laying off risk with third parties.
- The acquisition of capacity to unlock the writing of new business.
- A potential solution for non-core, difficult or stubborn legacy risks.
- A facility in order to take advantage of future market conditions opportunistically.
- An M&A tool with the reinsurance constituting either the transaction itself or a preliminary step towards an insurance business transfer scheme or even the acquisition of the ceding entity itself.

In each case, the (re)insurer will also aim to achieve regulatory capital credit against the insurance obligations that it has covered with the reinsurance asset. Pursuant to the Solvency II Directive, (re)insurers are able to lower their capital requirements through the use of risk transfer techniques. This chapter focuses on the regulatory conditions that a (re)insurer must satisfy, through an analysis of three key criteria:

- The terms of the risk transfer arrangement.
- The identity, quality and integrity of the reinsurer (protection provider).
- Any collateral that the (re)insurer is able to obtain by way of security for the reinsurer's (protection provider's) obligations.

Following Brexit, the UK continues to pursue a managed divergence from EU-derived legislation, including a targeted liberalisation of the Solvency II regime. Presently, such changes do not focus on risk transfer and the PRA is expected to continue to follow current Solvency II requirements for the foreseeable future.

In this chapter, "(re)insurer" takes on a special meaning: where an undertaking is acting in its capacity as cedant (or acquiror of reinsurance, retrocession, risk mitigation or risk transfer). The party on the opposing side of the transaction is distinguished, where applicable, as reinsurer (protection provider) regardless of whether the contract is one of reinsurance or retrocession.

1. What Is Risk Mitigation (or Risk Transfer)?

Risk mitigation techniques are "all techniques which enable insurance and reinsurance undertakings to transfer part or all of their risks to another party".[81] These encompass a wide array of techniques, including reinsurance arrangements, transactions with special purpose vehicles (SPVs) and financial instruments such as derivatives and guarantees, all of which fall under the category of risk mitigation techniques.

Pursuant to Solvency II, (re)insurers are subject to specific rules and regulations governing risk mitigation. Such rules aim to ensure that any transfer of risk is effective and reliable whilst creating a structured framework for assessing the eligibility of various risk mitigation techniques. The impact of such a technique on a (re)insurer's balance sheet (see Section 6 below) will depend on whether or not it calculates its solvency capital position using the standard formula or an internal model (IM):

[81] Article 13(36) of the Solvency II Directive (transposed in Paragraph 1,2, Conditions Governing Business Part of the PRA Rulebook).

- **Standard Formula:** The calculation of the SCR can account for the effect of risk mitigation techniques, provided that credit risk and other risks arising from the use of such techniques are properly reflected.[82] The standard formula for calculating the SCR involves a set of predefined parameters and calculations.
- **Internal Model:** An approved IM may account for the effect of risk mitigation techniques, subject to the same requirement that credit and other risks are properly reflected in the SCR.[83] IMs offer greater flexibility in applying capital charges associated with risk mitigation techniques which allows for a more nuanced alignment with specific risks faced. For instance, if a specific instrument triggers a counterparty default risk charge that appears higher than the internal assessment, the IM will allow for a more accurate evaluation.

In July 2021, the EIOPA emphasised the need for a holistic approach to risk mitigation.[84] This approach underscores the importance of thorough analysis and assessment of the risks being transferred, integrating this analysis into broader solvency considerations to ensure a well-informed decision-making process in line with Solvency II requirements.

What Is Reinsurance?

As a general proposition, there is no statutory definition of reinsurance under English law. However, England and Wales have a long-established body of common law, statute and regulatory guidance as to what does (and does not) constitute a contract of (re)insurance; at times, however, such authorities do not provide a consistent definitional approach. It is generally accepted that under a contract of reinsurance, the reinsured, being the insurer of the original risk pursuant to the underlying insurance contract, cedes part or all of its risk to a reinsurer. In return for the payment of a premium, the reinsurer undertakes to indemnify the reinsured for losses that fall within the scope of the reinsurance contract. However, for Solvency II purposes, reinsurance is: "the activity consisting in accepting risks ceded by an insurance undertaking or third country insurance undertaking, or by another reinsurance undertaking or third country reinsurance undertaking".[85]

Notwithstanding this definition, any reinsurance contact will also need to meet all other relevant tests at law in order to qualify as such. It is important to satisfy these requirements, as well as Solvency II requirements, which in turn leads to complex and nuanced questions as to categorisation. For example, at what point does a contract of guarantee, or a derivative, become a contract of (re)insurance? Different categorisations will drive different recognition and effects on the (re)insurer's balance sheet. Typically such definitions of reinsurance do not focus on the premium due or payable by the (re)insurer to the reinsurer (risk provider), or the adequacy thereof, although some element of consideration is expected.

Reinsurance comes in numerous forms, including quota share, excess of loss, facultative and treaty. The Solvency II Directive makes exceptional provision for just one variety of reinsurance: finite insurance. Finite insurance is: "reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, arising from both a significant underwriting risk and timing risk transfer, exceeds the premium over the lifetime of the contract by a limited but significant amount, together with at least one of the following features:

[82] Article 121(6), *ibid* (transposed in Paragraph 11.8(2), Solvency Capital Requirements — Internal Models Part of the PRA Rulebook).

[83] *Ibid.*

[84] The EIOPA, Financial Stability Report, 1 July 2021.

[85] Article 13(7)(a) of the Solvency II Directive (transposed in the PRA Glossary).

(a) explicit and material consideration of the time value of money;

(b) contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer".[86]

In the case of finite reinsurance contracts, the regulatory capital benefits accruing to the (re)insurer are key, noting that — in order to distinguish from mere financial engineering — it remains vital to evidence a justifiable degree of risk transfer to the reinsurer (protection provider).

Other Risk Mitigation Tools

The Level 2 Delegated Regulation refers to a range of less common risk mitigation tools including:

- **Financial Instruments** such as derivatives and options. Derivatives originate their value from an underlying asset or index and can be utilised to hedge against various risks, such as market fluctuations, interest rate changes, duration mismatches or currency fluctuations. Options provide the right (but not the obligation) to buy or sell an asset at a predetermined price, offering a strategic tool for managing volatility. Options are subject to further specific requirements detailed in Section 5 below.
- **Contingent Capital/Contingent Convertible Bonds** allow a (re)insurer to draw down capital from a counterparty at a predetermined price on the occurrence of a future event. The status of these instruments under the Solvency II Directive is unclear; it is important to assess whether such instruments rise to the level of "risk transfer" as distinct from a source of additional capacity. Indeed, they appear to have many of the qualities of an item of AOF. The EIOPA has subsequently recommended amending the Level 2 Delegated Regulation to clarify that such instruments should not be included as risk mitigation techniques to reduce the SCR, either in the standard formula or when using an IM.
- **Letters of Credit, Guarantees and Similar Instruments** differ from conventional risk mitigation strategies covered in this chapter in that they provide credit protection rather than transferring risk. (Re)insurers are permitted to consider the instrument provider as the counterparty for the purposes of determining the quantity of the related counterparty exposure charge,[87] subject to further specific requirements set out in Section 5 below. A letter of credit may also constitute an item of a (re)insurer's AOF although Solvency II principles do not permit the (re)insurer to enjoy a double benefit from the instrument.

2. Identity of Reinsurer (Protection Provider)

The identity of the reinsurer (or protection provider) is key to establishing the capital benefits that a (re)insurer may derive from the risk transfer technique in question. When a (re)insurer employs the standard formula, it must meet not only the general eligibility requirements under Articles 209 and 210 of the Level 2 Delegated Regulation, but also specific requirements defined in Articles 211, 212 and 214. These criteria primarily revolve around which entity stands on the other side of the risk mitigation technique. Absent Solvency II-grade supervision, a reinsurer (protection provider) must have a minimum rating. Alternatively, a (re)insurer may obtain collateral from the reinsurer (protection provider). Provided this in turn meets eligibility requirements, the (re)insurer may obtain maximum credit for the risk transfer technique.

[86] Article 210(3), *ibid* (transposed in the PRA Glossary: "finite insurance").

[87] Article 189(5) of the Level 2 Delegated Regulation.

The counterparty to an uncollateralised reinsurance contract must be one of the following:

- A (re)insurer authorised under the Solvency II Directive that complies with its SCR.[88]
- A third country (re)insurer, situated in a country whose solvency regime is deemed "equivalent" or "temporarily equivalent" to the Solvency II regime or the UK regime, as applicable, and which complies with the solvency requirements of that third country.[89]
- A third country (re)insurer, situated in a non-equivalent jurisdiction with a credit quality that has been assigned to credit quality step three or better.[90]

Jurisdiction – Equivalence

An insurer can obtain maximum credit in respect of reinsurance to any reinsurer (protection provider) that is also subject to reinsurance supervision in the European Economic Area (EEA) (and hence subject to Solvency II). The same applies in the case of a reinsurer (protection provider) from a jurisdiction that is deemed by the EU Commission to be "equivalent" for the purposes of reinsurance supervision.

"Equivalence" for the purposes of reinsurance supervision entails recognition of the regulatory framework of another jurisdiction as equivalent to the Solvency II regime, facilitating cross-border cooperation in respect of risk mitigation.[91] Predictably, the aim of the "equivalence" regime is to ensure that any such third country upholds standards at least as stringent as those prescribed under Solvency II. Examples of such criteria considered include:

- Whether supervisory authorities in that third country have the power, by law or regulation, to effectively supervise domestic insurance undertakings carrying out reinsurance activities and to impose sanctions or take enforcement action where necessary.[92]
- Whether supervisory authorities in that third country have the necessary means, the relevant expertise, capacities including financial and human resources, and mandate to effectively protect policyholders and beneficiaries regardless of nationality or place of residence.[93]
- Whether supervisory authorities in that third country duly consider the impact of their decisions on the stability of global financial systems.[94]
- Whether supervisory authorities in that third country take into account the potential pro-cyclical effects of their actions where exceptional movements in the financial markets occur.[95]
- Whether the taking-up of business in that third country is subject to prior authorisation conditional on a clear, objective and publicly available set of written standards.[96]

[88] Article 211(2)(a), *ibid.*

[89] Article 211(2)(b), *ibid.*

[90] Equivalent to a BBB rating given by Fitch or S&P and a Baa rating given by Moody's.

[91] Article 172 of the Solvency II Directive.

[92] Article 378(a) of the Level 2 Delegated Regulation.

[93] Article 378(b), *ibid.*

[94] Article 378(c), *ibid.*

[95] Article 378(d), *ibid.*

[96] Article 378(e), *ibid.*

- Whether the solvency regime of that third country requires domestic insurance or reinsurance undertakings carrying out reinsurance to have an effective system of governance in place which provides for sound and prudent management of the business.[97]

For reinsurance purposes, only Switzerland and Bermuda have been named as fully equivalent. Although, there are certain exceptions in place regarding captives and special purpose insurers in Bermuda.

The US is not formally equivalent for reinsurance purposes. However, in practice, credit can be taken by EEA (re)insurers for reinsurance agreements with US reinsurers (and vice versa) if certain conditions are met. A bilateral agreement between the EU and the US signed in 2017 (EU-US Bilateral Agreement)[98] prohibits any requirement for an EEA reinsurer (protection provider) to post collateral before a US (re)insurer may take credit for a reinsurance arrangement, and vice versa. Following Brexit, the UK entered into similar arrangements with the US in 2018.

Additionally since Brexit, the UK has been considered a "third country" for Solvency II purposes, given it is outside the EEA, even though it is subject to a substantially identical regulatory framework.

Arrangements made between EU (re)insurers and UK reinsurers will only qualify as risk mitigation techniques under the Solvency II Directive if the UK reinsurer (protection provider) meets the minimum credit rating referred to above, or if there are qualifying collateral arrangements in place. In addition, UK reinsurers (protection providers) no longer have an automatic right to conduct reinsurance activities in the EEA, whether on a freedom of establishment or cross-border services basis.

The UK regards all EEA States,[99] Switzerland[100] and Bermuda[101] as being fully equivalent for reinsurance purposes.

Special Purpose Vehicles

(Re)insurers may obtain regulatory capital credit by ceding risk to an SPV, which in turn transforms such risks into investment risk — whether debt or otherwise — in which non-insurance investors may participate. For Solvency II purposes, SPVs are: "any undertaking, whether incorporated or not, other than an existing insurance or reinsurance undertaking, which assumes risks from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issuance or any other financing mechanism where the repayment rights of the providers of such debt or financing mechanism are subordinated to the reinsurance obligations of such an undertaking".[102]

The sole function of such an SPV is to assume specific risks from (re)insurers. Unlike a traditional reinsurer, an SPV "fully funds" its exposure to the assumed risks through the proceeds of a debt issuance (typically referred to as insurance-linked securities or ILS) or another financing mechanism. This can be viewed as a variety of collateral, where the debt proceeds are held subject to suitable custody arrangements for the benefit of the (re)insurer. The repayment rights of the providers of such debt or financing mechanism are

[97] Article 378(f), *ibid.*

[98] Bilateral Agreement Between the US and the EU on Prudential Measures Regarding Insurance and Reinsurance.

[99] Solvency 2 Regulations Equivalence Directions 2020.

[100] Paragraph 6, Schedule 2 of the Equivalence Determinations for Financial Services and Miscellaneous Provisions (Amendment etc.) (EU Exit) Regulations 2019.

[101] Paragraph 7, Schedule 2, *ibid.*

[102] Article 13(26) of the Solvency II Directive.

explicitly subordinated to the reinsurance obligations of the SPV. Subordination ensures that the financial arrangements are designed to prioritise the fulfilment of reinsurance obligations, reinforcing the commitment to risk assumption.

The Solvency II Directive demands that eligibility criteria that are adopted in respect of SPVs be followed in a scenario where risk mitigation is transferred to an SPV.[103] Such criteria provide a detailed framework for the authorisation and functioning of SPVs in the context of risk mitigation within the Solvency II regime:

- The SPV must be "fully funded",[104] meaning that:
  - Its assets are to be valued in accordance with the general rules on valuation of assets.[105] Namely, assets and liabilities shall be valued at the amount for which they could be exchanged between parties in an arm's length transaction.[106]
  - Its assets are to be equal to or exceed the aggregate maximum risk exposure (AMRE)[107] and the SPV must be able to pay its debts as they fall due.[108]
  - The proceeds of any debt issuance or financing proceeds must be paid-in in full.[109]
- The contractual arrangements for risk transfer to and from the SPV must be effective in all circumstances, clearly defining and incontrovertibly establishing the extent of the risk transferred. The transfer of risk may be ineffective if undermined by connected transactions.[110]
- There must be a limitation of rights for debt or financing providers, specifically, the contractual arrangements must:
  - Subordinate the rights of debt or finance providers to the reinsurance obligations.
  - Prevent payments that would leave the SPV in a position where it is not fully funded.
  - Deny any right of recourse to the SPV's assets, and such providers of debt or finance must have no right to apply for the winding-up of the SPV.[111]
- Persons managing the SPV must meet the "fit and proper" requirements specified in the Solvency II Directive. The supervisory authority must be informed of their identity and any changes.[112] Likewise, shareholders with a 10% or more holding must meet fit and proper requirements, assessed based on reputation, financial soundness, level of influence and potential connections with money laundering or terrorist financing.[113] In addition to the individuals who control the SPV, either on a day-to-day basis or by way of a shareholding, the SPV itself must have an effective system of governance, including written policies, internal controls and risk management systems appropriate to the risks assumed.[114]

[103] Article 211 of the Level 2 Delegated Regulation.
[104] Article 319, *ibid.*
[105] Article 326(1)(a), *ibid.*
[106] Article 75 of the Solvency II Directive (transposed in Paragraph 2.1, Valuation Provisions Part of the PRA Rulebook).
[107] Article 1(44) of the Level 2 Delegated Regulation.
[108] Article 326(1)(b), *ibid.*
[109] Article 326(1)(c), *ibid.*
[110] Article 320, *ibid.*
[111] Article 321, *ibid.*
[112] Article 322, *ibid.*
[113] Article 323, *ibid.*
[114] Article 324, *ibid.*

- SPVs are also subject to specific reporting requirements in addition to those outlined as a general rule for undertakings in Chapter 3: Cross-Border Services and Overseas Branches. SPVs must submit an annual report with specified information to the supervisory authority, including the valuation of its assets and AMRE.[115]
- With respect to the calculation of assets, future payments from existing reinsurance contracts are allowed in the calculation of the SPV's assets provided certain conditions are met.[116] Further, the SPV must invest its assets according to detailed requirements, ensuring proper identification, measurement, control of risks, appropriate diversification and avoidance of excessive risk concentration. An SPV may use derivative instruments only insofar as they contribute to a reduction of risks or facilitate efficient portfolio management. It must also keep investments and assets that are not admitted to trading on a regulated financial market to prudent levels.[117]

UK ILS Regime

In 2017, the United Kingdom implemented a new legislative framework that significantly liberalised the PRA's regime for the authorisation and governance of insurance SPVs (ISPVs) and was initially heralded as a sea-change in the UK's approach to alternative risk transfer activities, encompassing corporate, insolvency, regulatory and tax dimensions. To date, however, the UK's ILS industry remains nascent and very few ISPVs have been formed. The ease of setting up such a vehicle (and taxation) remain important factors in a sponsor's decision as to where to domicile an ILS structure and offshore jurisdictions such as Bermuda continue to serve as a first-in-class destination in this field.

The UK regime is contained principally in three different authorities:

1. The Risk Transformation Regulations 2017

- Created a new regulated activity of "insurance risk transformation".[118]
- Introduced a new UK corporate vehicle in the form of a protected cell company (PCC) comprised of a "core" and "cells", such that each ILS deal can be ascribed to a different cell (ring-fenced from the other cells and the core).[119]
- Permitted the establishment of ISPVs, as well as multi-arrangement insurance SPVs (MISPVs): an ISPV that assumes risks under more than one separate contractual arrangement from one or more cedants and taking the form of a PCC. For the purposes of this chapter, references to an ISPV should be construed as a reference also to an MISPV, unless the context otherwise requires.
- Made special provision for the position of an MISPV on insolvency (effectively allowing one cell to "fail" without impacting the solvency of the others).

[115] Article 325, *ibid.*

[116] Article 326(4), *ibid.*

[117] Article 327, *ibid.*

[118] Article 13A of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

[119] Regulation 12(1) of the Risk Transformation (Tax) Regulations 2017.

2. The Risk Transformation (Tax) Regulations 2017

- Removed corporation tax in relation to profits arising from the activity of insurance risk transformation, other than in the case of a basic life assurance and general annuity business.[120]
- Exempted interest payments from ISPVs to investors from withholding tax.[121]
- Denied special tax treatment when UK ISPVs are used as part of a tax avoidance scheme or where there has not been a genuine transfer of risk to an ISPV.[122]

3. PRA SS8/17 of December 2022

A UK ISPV must be approved by the PRA under Part 4A of the Financial Services and Markets Act 2000 (FSMA). The PRA leads the application process but requires the Financial Conduct Authority's (FCA's) consent before granting approval. All UK ISPVs are dual regulated by the PRA and FCA. An ISPV may operate only in accordance with an approved Scope of Permission (SOP) and is otherwise subject to certain limited obligations on an ongoing basis, with the PRA's ongoing assessment being proportionate and risk based.

The PRA will determine authorisation of an ISPV within six months from receipt of a complete application, but will aim for a shorter period in the case of a straightforward and high-quality application (the length of time taken, and process complexity, is thought to have been a significant deterrent against the use of the UK ISPV structure, as compared to Bermuda). In the case of the addition of cells to an existing MISPV, there is no pre-notification requirement for the establishment of new cells, but a post-notification is required within five working days of the assumption of a new risk (provided always that the MISPV is operating within its SOP).

All individuals who are "effectively running" the ISPV must satisfy the fit and proper criteria set out in the Insurance — Fitness and Propriety Part of the PRA Rulebook. Such criteria will apply to the ISPV's senior management together with any shareholders or members who have a qualifying holding on the basis that they hold 10% or more of the voting rights in the ISPV, or have significant influence over the management of the ISPV. The PRA requires applicants to nominate "fit and proper" individuals for approval by the PRA including: chief executive, chief financial officer and a chair of the board. While it is expected that a different individual fulfils each of these functions, the PRA may consider an individual with the proper skills to perform a combination of these roles, as assessed on a case-by-case basis.

As mentioned, ISPVs must be fully funded; the PRA interprets this requirement as follows:

- The assets of the ISPV must be valued in accordance with international financial reporting standards (IFRS) and otherwise in accordance with the Solvency II Directive.
- The proceeds of the ISPV's debt issuance or other funding mechanism must be fully paid-in. In other words, the ISPV should have received the proceeds of the debt issuance or other mechanism by which it is financed. Therefore, the PRA expects ISPVs not to include contingent assets for the purposes of satisfying the fully funded requirement. Accordingly, ISPVs should not count legally binding commitments that could be treated as AOF (or off balance sheet/callable items) as assets for the purposes of satisfying the fully funded requirement.

[120] Regulation 4(1), *ibid.*

[121] Regulation 5, *ibid.*

[122] Regulation 6, *ibid.*

- Payments expected to be received from the cedant (*e.g.*, funds withheld) may be recognised as an asset only if all the requirements in Article 326(4) of the Level 2 Delegated Regulation are met (as outlined in Section 2 above).
- The ISPV must at all times have assets equal in value or exceeding its AMRE such that it is able to pay the amounts it is liable for as they fall due. The PRA considers that the AMRE must be an amount that is determinable at any given point in time, so that ISPVs and the PRA are able to assess whether the fully funded requirement is being met.
- For an SPV, there will be one AMRE that applies in respect of the entire risk exposure of the ISPV. For MISPVs, the AMRE should generally be determined and fully funded at the level of each individual cell (save in the case of a group of cells).
- While the AMRE should be fully funded at all times, the PRA recognises that the AMRE can change over the life of the arrangement. The PRA expects an ISPV to ensure that the contractual provisions should provide for any increase in the AMRE during the life of the arrangement and is only effective if and when the corresponding funds are paid-in. The PRA expects ISPVs to ensure that this is made clear in its contractual provisions.

3. General Eligibility Criteria — Standard Formula

There is a comprehensive framework of criteria that risk mitigation techniques must fulfil to be incorporated into the SCR calculation for (re)insurers. The initial set of eligibility criteria focuses on qualitative benchmarks for any risk mitigation technique and are as follows:

- The contractual arrangements and the transfer of risk must be legally effective and enforceable in all relevant jurisdictions.[123] Such determination must consider whether:
  - The arrangement is subject to any condition that could undermine the effective transfer of risk, the fulfilment of which is outside the direct control of the cedant.
  - There are any connected transactions that could undermine the effective transfer of risk.[124]
- The (re)insurer must have taken all appropriate steps to ensure the arrangement's effectiveness and address related risks.[125]
- The (re)insurer must be able to monitor the effectiveness of the arrangement and the related risks on an ongoing basis.[126]
- In the event of a default, insolvency or bankruptcy of a counterparty or some other credit event set out in the transaction documentation, the (re)insurer must be able to make a direct claim on the counterparty.[127]
- There must be no double counting of risk mitigation effects in own funds and in or within the calculation of the SCR.[128]

[123] Article 209(1)(a) of the Level 2 Delegated Regulation.
[124] Article 210(4), *ibid.*
[125] Article 209(1)(b), *ibid.*
[126] Article 209(1)(c), *ibid.*
[127] Article 209(1)(d), *ibid.*
[128] Article 209(1)(e), *ibid.*

These criteria require an assessment of the legal effectiveness and enforceability of contractual arrangements across all relevant jurisdictions. Effective risk transfer in particular must be closely guarded in the course of negotiating a reinsurance arrangement, if the cedant is to achieve full regulatory capital benefit. Accordingly, attempts by the reinsurer to introduce optionality around termination of the agreement (or even around initiation of a consultation between the parties on the future shape or duration of the agreement) must generally be resisted or appropriately moderated, whether on a stand-alone basis or in response to a change in law, regulation, tax treatment or otherwise.

Equally as important is considering what termination events (or other contractual triggers) may be viewed as outside the direct control of the undertaking. Externalities, such as a change in law, a change in control of the (re)insurer or even the insolvency of the (re)insurer will all need to be carefully considered from this perspective.

The coverage achieved by the risk mitigation technique (and the corresponding risk transfer) must be "clearly defined and incontrovertible".[129] The remote nature of the amount or timing of payments by the reinsurer (protection provider) should not, by itself, undermine the recognition that the reinsurer (protection provider) has assumed risk.[130] Such arrangements must not result in a material basis risk or the creation of additional risks, unless these risks are duly considered in the calculation of the undertaking's SCR.[131] In this context, "basis risk" refers to a significant mismatch between the level of protection provided and the characteristics of the underlying liabilities. Whether or not a risk is "material" is assessed as to whether it leads to a misstatement of the risk-mitigating effect on an undertaking's SCR.[132] This nuanced definition emphasises the importance of avoiding misrepresentations that could influence decision-making or judgement regarding the effectiveness of the risk mitigation technique.

With respect to duration, the standard position is that only those risk mitigation techniques which are in force for a minimum of 12 months and meet the criteria above may be fully taken into account in the calculation of the SCR.[133] Should the duration be shorter, its impact on the SCR will be proportionate to either the total term of the risk exposure or the operational period of the technique.

4. Specific Eligibility Criteria — Standard Formula

There are two specific areas that bring their own eligibility criteria to be compliant with SCR calculations. First, financial risk mitigation techniques must comply with additional qualitative criteria:

- Financial risk mitigation techniques must have a clearly defined methodology for calculating their risk mitigation effect. This involves a quantitative assessment of how the technique contributes to reducing the overall risk exposure of the (re)insurer.[134]
- The technique's calculations and methodologies should be consistent with the standard formula and other relevant calculation methods used for determining the SCR.[135]

[129] Article 210(1), *ibid.*
[130] Recital 71, *ibid.*
[131] Article 210(2), *ibid.*
[132] Article 210(3), *ibid.*
[133] Article 209(2), *ibid.*
[134] Article 212(2), *ibid.*
[135] Article 212(3), *ibid.*

- Where the risk mitigation technique involves the use of financial instruments, the financial instruments must have a credit quality of step three or higher.[136] Conversely, where it does not involve a financial instrument, the counterparty itself must have a credit quality of step three or higher.[137]

Second, in order for guarantees to be recognised as eligible in calculating the SCR, they must meet the criteria summarised below:

- The credit protection pursuant to the guarantee must be direct.[138]
- The scope of coverage provided by guarantees must be clearly defined and incontrovertible.[139]
- The guarantee must not contain any clause, the fulfilment of which is outside the direct control of the undertaking, that could:
  - Allow the guarantor to cancel the protection unilaterally.
  - Increase the effective cost of the protection as a result of a deterioration in the credit quality of the underlying liabilities.
  - Prevent the guarantor from being obliged to pay out in a timely manner if the original obligor fails to make any payments due.
  - Allow the maturity of the guarantee to be reduced by the guarantor.[140]
- On default, insolvency, bankruptcy or other credit event of the counterparty, the (re)insurer must have the right to pursue the guarantor for any monies due without first having to pursue the counterparty.[141]
- The guarantee must be an explicitly documented obligation assumed by the guarantor.[142]
- The guarantee must fully cover all regular payments the counterparty is expected to make.[143]

5. Collateral Arrangements

Notwithstanding the additional qualitative criteria imposed as discussed throughout this chapter in relation to SPVs, there is an exception where a risk mitigation technique is coupled with another risk mitigation technique, and the combination of the two satisfies the outstanding specific eligibility requirements under Article 211 or 212, respectively, as set out above in the relevant parts of Sections 2 and 4 above.[144] This exemption is available where a risk mitigation technique is supported by collateral arrangements that meet the relevant criteria as set out below. There are numerous ways in which collateral can be structured, for example: on a funds-withheld or deposit-back basis, or by posting of secured assets by means of security agent or custodian. If the value of any compliant collateral arrangement is less than the total risk exposure, the arrangement will only be considered to the extent that the collateral covers the risk exposure.[145]

[136] Article 212(4), *ibid.*
[137] Article 212(5), *ibid.*
[138] Article 215(a), *ibid.*
[139] Article 215(b), *ibid.*
[140] Article 215(c), *ibid.*
[141] Article 215(d), *ibid.*
[142] Article 215(e), *ibid.*
[143] Article 215(f), *ibid.*
[144] Article 213, *ibid.*
[145] Article 213(2), *ibid.*

Collateral arrangements must align with the general eligibility criteria set out in Articles 209 and 210 (as analysed in Section 3 above).[146] As with other qualitative specific requirements, collateral arrangements are subject to further specific eligibility requirements to ensure their compliance:

- The (re)insurer must have the right promptly to liquidate or retain collateral in the event of counterparty default, insolvency, bankruptcy or other credit events.[147]
- The collateral must be of sufficient credit quality, liquidity and stability in value or is guaranteed by a counterparty (excluding certain counterparties that have been given a concentration risk factor of 0%;[148] such examples include, amongst others, counterparties whose exposure is covered by a state government).
- There is no material positive correlation between the credit quality of the counterparty and the value of the collateral itself, thus maintaining the independence of the collateral's value from the counterparty's creditworthiness.
- The collateral should not include securities issued by the counterparty or its related entities to prevent potential conflicts of interest and undue influence.
- Where the collateral is held by a third party (such as a custodian or subject to a security arrangement), the relevant third party must keep the assets separate from its own.
- The collateral must be held by a party with a credit quality rating of step three[149] or higher.
- The assets must be individually identifiable and can only be altered or substituted with the explicit consent of the (re)insurer (or trustee).
- The assets must not be used to pay or to provide collateral for any other person other than the cedant (or as directed by the cedant).

6. Impact of Risk Mitigation on Capital Requirements

A risk mitigation technique will, to the extent effective and eligible, operate to reduce the (re)insurer's capital requirements, in particular its SCR and technical provisions.

Solvency Capital Requirement

The calculation of the SCR may account for a risk mitigation technique, provided that credit risk and other risks arising from the use of such techniques are properly reflected.[150] Under the standard formula, the SCR aggregates capital charges arising from the various constituent risk modules. The capital charge for a given module reflects the impact a prescribed (adverse) scenario on the (re)insurer's own funds. An eligible risk mitigation instrument may be taken into account (*i.e.*, the capital charge will be reduced) if it has the effect of lessening the impact on own funds.[151] The (re)insurer will also need to reflect the credit and counterparty impacts of entering into the arrangement, in particular with regard to the reinsurer (protection provider). Such exposure is, however, reduced to the extent that eligible collateral is provided (see Section 3 above).

[146] Article 214, *ibid.*

[147] Article 214(1)(a), *ibid.*

[148] Pursuant to Article 184(2) or Article 187(5), *ibid.*

[149] Equivalent to a BBB rating given by Fitch or S&P and a Baa rating given by Moody's.

[150] Article 101(5) of the Solvency II Directive (transposed in Paragraph 3.5, Solvency Capital Requirement — General Provisions Part of the PRA Rulebook).

[151] Article 83(4) of the Level 2 Delegated Regulation.

Where the (re)insurer uses an IM, a similar assessment is required based on the more calibrated and bespoke procedure that the (re)insurer has agreed with its regulator as part of the model, and remains subject to the same requirement that credit and other risks are properly reflected in the SCR.[152]

Technical Provisions

Technical provisions correspond to the current amount a (re)insurer would have to transfer to another (re)insurer to accept its insurance and reinsurance obligations. In calculating technical provisions, amounts recoverable from reinsurance contracts may be taken into account. Given that assets held against technical provisions usually represent the majority of a (re)insurer's assets, it follows that an eligible risk transfer instrument delivers the majority of its capital benefit in this area. Such recoverables must be calculated separately in accordance with Article 81 of the Solvency II Directive to take account of any lag between recoveries and direct payments and reduction in recoveries due to default of the counterparty. Articles 41 and 42 of the Level 2 Delegated Regulation provide further rules around how amounts recoverable from reinsurance contracts and SPVs should be calculated, and how such amounts should be adjusted to account for expected losses due to counterparty default.

Risk Margin

The "risk margin" is a layer of prudence on top of a (re)insurer's best estimate of liabilities (BEL) and forms part of its technical provisions. The notional transfer of liabilities assumed as part of the assessment of technical provisions would also involve the notional transfer of reinsurance assets relating to the "transferring" book.[153] Accordingly, the risk margin is also reduced to the extent of an eligible risk mitigation technique.

[152] Article 121(6) of the Solvency II Directive (transposed in Paragraph 11.8, Solvency Capital Requirement — Internal Models Provisions Part of the PRA Rulebook).

[153] Article 38(1)(c) of the Level 2 Delegated Regulation.

Chapter 3

Cross-Border Services and Overseas Branches

Introduction

(Re)insurance is a global business. It is common for (re)insurance groups to operate in a range of jurisdictions via:

i. Locally incorporated and authorised subsidiaries.

ii. Local branches of third country subsidiaries.

iii. The cross-border provision of insurance, reinsurance or other insurance-related services.

In this chapter, we deal with items (ii) and (iii) in relation to both direct insurance as well as reinsurance, focussing on the regimes in place in the EEA and the UK for a range of participants/combinations as follows:

- **EEA (re)insurers doing business within the EEA.**
  - The cross-border provision of services[154] within the EEA by EEA (re)insurers (freedom of services passporting).
  - The establishment of branches within the EEA by EEA (re)insurers (freedom of establishment passporting).
  - The conduct and supervision of EEA (re)insurers exercising rights to freedom of services or of establishment passporting.
- **Third country (re)insurers doing business with (or in) the EEA.**
  - The cross-border provision of services into the EEA by non-EEA (re)insurers (third country (re)insurers).[155]
  - The establishment of branches in the EEA by third country (re)insurers (third country branches).
- **Non-UK (re)insurers doing business with (or in) the UK.**
  - The cross-border provision of services into the UK by non-UK (re)insurers.
  - The establishment or operation of branches in the UK by non-UK (re)insurers.

These permutations inevitably require an examination of:

- The Solvency II Directive, both in relation to the EU and its interactions with all third country (re)insurers (including, post-Brexit, the UK).
- The EU's attitude towards the UK following Brexit.
- The UK's attitude towards the EU, and indeed the rest of the world, following Brexit.
- Relatedly, the UK's efforts to establish bilateral arrangements with other key third countries — in particular, the United States and Switzerland — following Brexit.

Inevitably, there is a political component to consider, with, on one hand, the UK broadly attempting to make a success of Brexit by keeping access to its insurance markets open to international participants and, on the other hand, the EU seeking to maintain its integrity. We therefore also consider the respective publications of the EIOPA and the UK, including the PRA's proposals to further liberalise the UK position and implement certain reforms as set out in their recent consultation papers (PRA CPs).

[154] In this chapter, "services" may be taken to include all insurance-related services (including (re)insurance), unless the context requires otherwise.

[155] Following Brexit, the UK is a "third country" with respect to the EEA, and vice versa.

1. EEA (Re)insurers Doing Business Within the EEA

Solvency II requires that EEA member states subject the taking-up of insurance or reinsurance activities to prior authorisation.[156] Authorisation requirements are implemented as a matter of the local laws of an EEA member state, albeit subject to harmonisation.

A (re)insurer authorised under the laws of one EEA member state can provide (re)insurance services in another member state by providing services on a cross-border basis or setting up a branch (the set-up of which is not subject to full local authorisation requirements).[157]

Freedom of Services Passporting

Direct Insurers

Where an EEA-authorised direct insurer wishes to exercise passporting rights without setting up a branch, the direct insurer must notify the supervising authority of its home member state, indicating the insurer's proposed coverage of certain liabilities or risks.[158]

The supervisory authority of the direct insurer's home member state should, within one month of receiving the notification, inform the direct insurer of the contents of — and communicate to the supervising authority of the member state into which it intends to provide services — the following:

- A certificate attesting that the direct insurer covers its SCR and MCR.
- The classes of insurance that the direct insurer has been authorised to offer.
- The nature of the risks or commitments that the direct insurer proposes to cover in the host member state.

Direct insurers can begin offering cross-border services on the date that they are informed that the communication to the relevant authority of the non-home member state has been made. If the supervising authority in the home member state does not agree to communicate the required information, it must let the direct insurer know of its reasons for the refusal by the end of the one-month period referred to above. The direct insurer has the right to then apply to overturn the decision in a court in its home member state.[159]

Under Article 149 of the Solvency II Directive, if the direct insurer's situation changes and the contents of the initial communication become inaccurate, the direct insurer will need to adhere to the communication procedure referred to above once again.[160]

One of the Amendments (discussed previously in the chapters) amends Article 149 to clarify that an insurer must inform the supervisory authority of its home member state of any changes in business materially affecting its risk profile or materially influencing insurance activities in one or more member states.[161]

[156] Recital 8 of the Solvency II Directive.

[157] The EIOPA, formerly the Committee of European Insurance and Occupational Pensions Supervisors, in 2008 published the "General Protocol Relating to the Collaboration of the Insurance Supervisory Authorities of the Member States of the European Union" in relation to these arrangements. In 2000, the European Commission published an interpretative communication, "Freedom To Provide Services and the General Good in the Insurance Sector" (2000/C43/03) (the Interpretative Communication), containing guidance on the difference between a branch and the provision of services.

[158] Article 147, *ibid.*

[159] Article 148, *ibid.*

[160] Article 149, *ibid.*

[161] Article 1(63) 2021/0295 (COD).

Reinsurers

Though there are no notification requirements for the passporting of reinsurers, a reinsurer must adhere to the legal and regulatory requirements to which it would be subject to as a reinsurer in the host member state.[162] If a reinsurer does not comply with such provisions, the supervising authority in the host member state will require the reinsurer to rectify the problem and report these findings to the supervisory authority in the reinsurer's home member state.

If the reinsurer continues not to comply with local rules, then the supervisory authority in the host member state can take measures against the reinsurer, for example by barring it from entering into and honouring any new reinsurance contracts within the host member state.[163]

Freedom of Establishment Passporting

Freedom of establishment passporting under Solvency II allows insurance undertakings authorised in an EEA state to provide insurance in another EEA state by setting up a permanent establishment in that other EEA state, which does not separately require local authorisation.[164] Passports are available to both insurers and reinsurers, albeit with different rules applying to each entity type.

A "branch" is defined as "an agency or a branch of an insurance or reinsurance undertaking which is located in the territory of a member state other than the home member state".[165] This process entails notifying the supervising authority in its home member state, including informing it of the details of the scheme of operations.[166] The home state regulator will then notify the host state regulator.

Only activities carried on "within" the territory of an EEA state are subject to prior authorisation. This can capture services provided both on a cross-border basis and by a branch. The notion of "within" requires looking at the location of risks for a given insurance contract. Solvency II differentiates between the following types of risks:[167]

- For property insurance, the risk is where the property is situated.
- For vehicle insurance, the risk is where the vehicle is situated.
- For travel, the risk is where wherever the policyholder was situated when the policy was entered into.
- In all other cases, the risk is wherever the policyholder is situated, or for non-natural legal persons, the establishment of the policyholder, to which the contract of insurance relates.

Conditions for EEA (Re)insurers Establishing an EEA Branch

A (re)insurer must notify the supervising authority in its host member state of the following information:

- The member state within the territory of which it proposes to establish the branch.
- A scheme of operations setting out, at least, the types of business envisaged and the structural organisation of the branch.

[162] Article 158 of the Solvency II Directive.
[163] *Ibid.*
[164] Article 15(1), *ibid.*
[165] Article 13(11), *ibid.*
[166] Article 145(2), *ibid.*
[167] Article 13(13), *ibid.*

- The name of a person who possesses sufficient powers to bind, in relation to third parties, the insurance undertaking.
- The address in the host member state from which documents may be obtained and to which they may be delivered, including all communications to the authorised agent.[168]

The home state supervisory authority must, within three months of receiving the information referred to above, communicate that information to the supervisory authority in the host member state and confirm that the (re)insurer covers its SCR and MCR.[169] This is so that the supervisory authority of the host member state is confident in the adequacy of the system of governance, in the financial situation of the (re)insurer and that the proposed authorised agent has the requisite qualifications, experience and integrity.

If the home supervisory authority declines to relay this information to the host member state, it must explain its reasoning to the (re)insurer within the three-month period. If it fails to do so within this statutory period, its failure or delay can be questioned by the (re)insurer in the home member state's courts.

The supervisory authority of the host member state has two months from receiving the information referred to above to inform the supervisory authority of the (re)insurer's home member state of any conditions under which the branch's business should be pursued before the (re)insurer's branch can start business.

If any such conditions are imposed, the (re)insurer must be informed of these requirements, after which the branch may start pursuing its business. If there is no communication of any condition at the end of the two-month period, the branch can commence its business with the understanding that there are no applicable conditions.[170]

General Good

(Re)insurers carrying on business in another member state (whether through a branch or provision of services) must comply with conditions imposed by the host member state "in the interest of the general good", a somewhat vague principle that can be interpreted differently per member state.[171] There is no definition under Solvency II of "general good".

However, the European Commission has provided some general guiding principles, stating it must:

- Come from within a field that has not been harmonised at the EEA level.
- Pursue an objective of the general good.
- Be non-discriminatory.
- Be objectively necessary.
- Be proportionate to the objective pursued.
- Not duplicate rules to which the provider of services is already subject in its home state.[172]

[168] Article 145(2), *ibid.*

[169] Article 146(1), *ibid.*

[170] Article 146, *ibid.*

[171] Article 180, *ibid.*

[172] Official Journal of the European Communities, Commission Interpretative Communication — "Freedom To Provide Services and the General Good in the Insurance Sector" (2000/C 43/03).

Solvency II prohibits host member states from requiring the following of passporting (re)insurers:

- Systematic notification of general and special policy conditions, scales of premiums or, in the case of life insurance, the technical bases used in particular for calculating scales of premiums and technical provisions, or the forms and other documents that an insurance undertaking intends to use in its dealings with policyholders.
- Prior notification or to obtain the approval of proposed increases in premium rates, except as part of general price-control systems.[173]

These conditions are analysed in more detail in the Interpretative Communication and have also been the subject of cases heard in the European Court of Justice.

Conduct and Supervisory Responsibility

The home member state supervisory authority retains the responsibility for prudential supervision of the passporting (re)insurer, whereas the passporting (re)insurer must comply with the conduct rules of the host member state.

Where the host supervisory authority establishes that a (re)insurer is not complying with the applicable legal provisions, the host supervisory authority will notify and require remediation from the (re)insurer. Where such action is not taken, the supervising authority of the host member state must inform the supervising authority of the home member state, which must ensure the passporting entity's compliance.[174]

The host member state can take steps to penalise the behaviour of the passporting entity if necessary, including preventing that undertaking from engaging in new insurance contracts in the host member state.[175]

2. Third Country (Re)insurers Doing Business With (or in) the EEA

Cross-Border Services – Direct Insurance

A third country direct insurer (which, post-Brexit, includes the UK) may not write risks in the EEA without the requisite local authorisation. As the UK is no longer part of the EU, UK (re)insurers can no longer provide business to EU policyholder customers either on the basis of freedom of services passporting or freedom of establishment passporting. UK-incorporated (re)insurers have in response had to undertake significant Brexit transition steps in order to continue to service EEA policyholders.

Such transition steps have included:

- The identification of affected customers (see Section 1 above on what activities are considered to be "within" an EEA member state).
- The setting up and authorisation of new EEA-based (re)insurers.
- Transferring or otherwise migrating customers to locally authorised EEA entities.

Note that a third country branch authorised in an EEA member state is authorised to provide services in the home state of authorisation but cannot itself benefit from passporting. Only EEA-incorporated subsidiaries of (re)insurers are entitled to such passporting rights.

[173] Article 154 of the Solvency II Directive.

[174] Article 30(3), *ibid.*

[175] Articles 155 and 158, *ibid.*

Cross-Border Services – Reinsurance

There is more scope for a third country reinsurer to write reinsurance risk in the EEA. Solvency II is not prescriptive in this regard; it provides only that an EEA member state may not impose requirements on a third country reinsurer such that the requirements are more favourable than for EEA reinsurers.[176]

Member states must apply their own requirements for third country reinsurers, and there are a range of approaches — from a requirement for minimum rating, to a requirement for collateral or even outright prohibition — depending on the member state in question.

Note, however, the particular treatment of reinsurers subject to regulatory regimes deemed "equivalent" for these purposes — see Chapter 2: Reinsurance and Risk Transfer.

Third Country Branches – Direct Insurance

Conditions of Authorisation

An undertaking with its head office outside the EU must obtain authorisation to carry out direct insurance business in the EU. (This requirement is specific to undertakings carrying out direct insurance business.) The following requirements apply to the insurer in question:[177]

- It is entitled to pursue insurance business under its national law.
- It establishes a branch in the territory of the member state in which authorisation is sought.
- It undertakes to set up, at the branch's place of management, accounts specific to the business that it pursues there, and to keep there all the records relating to the business transacted.
- It designates a general representative, to be approved by the supervisory authorities.
- It possesses, in the member state in which authorisation is sought, assets of an amount equal to at least half of the absolute floor prescribed in Article 129(1)(d)[178] in respect of the MCR, that absolute floor being:

  i. €2.7 million for non-life insurance undertakings, unless certain risks set out in classes 10 to 15 of Part A of Annex 1 of Solvency II (together, these classes encompass all liability-related risk, such as motor vehicle, aircraft and ship liability; certain types of credit risk; and suretyship risk)[179] are covered, in which case the absolute floor would be €3.4 million;
  ii. €3.4 million for life insurance undertakings (including captive insurance undertakings);
  iii. €3.9 million for reinsurance undertakings, except in the case of captive reinsurance undertakings, in which case the MCR must be no less than €1.3 million; or
  iv. The sum of the relevant amounts set out at (i) and (ii) above for insurance undertakings that simultaneously pursue both life and non-life insurance activities as described in Article 73(5).[180]

[176] Article 174, *ibid.*
[177] Article 162(2), *ibid.*
[178] Article 129(1)(d), *ibid.*
[179] Annex I (Classes of Non-Life Insurance), *ibid.*
[180] Article 73(5), *ibid.*

- It deposits, in respect of the MCR, one-fourth of the relevant absolute floor described in the bullet above as security (with an EEA-authorised credit institution that has acknowledged that it does not have, or will not exercise, any rights of set-off of claims it may have against the undertaking if it chooses to, or is forced to, wind down).[181]
- It undertakes to cover the SCR and MCR in accordance with the requirements referred to in Articles 100[182] and 128.[183] Note that streamlined rules apply in the case of branching (re)insurers that are authorised in more than one member state, provided there is mutual agreement among all the relevant member states.[184]
- It communicates the name and address of the claims representative appointed in each member state other than the member state in which the authorisation is sought (where the risks to be covered are classified as "motor vehicle liability", other than carrier's liability).
- It submits a scheme of operations in accordance with the provisions in Article 163.[185]
- It fulfils the governance requirements of Solvency II.[186]

Third Country Branches – Reinsurance

Solvency II does not provide separately for third country branches that conduct only reinsurance business (as opposed to insurance or mixed insurance/reinsurance branches). Generally, the treatment of third country reinsurers is at the discretion of member states, provided that member states may not treat such reinsurers more favourably than EEA entities.[187] Member states may impose additional restrictions as a matter of national law and regulation. The requirements to treat third country branches "no more favourably" than EEA reinsurers applies also here.

3. Non-UK (Re)insurers Doing Business With (or in) the UK

Cross-Border Services – Direct Insurance

Any non-UK insurer newly doing direct business in the UK must now obtain UK authorisation. EEA (re)insurers may now only provide services to UK policyholders if authorised in the UK or by utilising the temporary permission and the Financial Services Contracts Regime (FSCR) until full UK authorisation is obtained (see further below). Accordingly, the Solvency II provisions on passporting are no longer of relevance, with the PRA's rules covering third country branches assuming greater significance.

[181] Guideline 19, Paragraph 1.45 of the EIOPA Guidelines on the supervision of branches of third country insurance undertakings (EIOPA-BoS-15/110).

[182] Article 100 of the Solvency II Directive.

[183] Article 128, *ibid.*

[184] Article 167(1), *ibid.*

[185] Article 163, *ibid.*

[186] Articles 41 to 50, *ibid.*

[187] Article 174, *ibid.*

Cross-Border Services – Reinsurance

There is more scope for a third country reinsurer to write UK reinsurance risk. The PRA does not apply specific requirements for a minimum rating or a requirement for collateral, although such features are likely to improve the credit that a UK cedant is able to take in respect of the reinsurance asset. We discussed this topic in Chapter 2: Reinsurance and Risk Transfer.

Third Country Branches

A (re)insurer with its head office outside the UK seeking to carry out direct or reinsurance business in the UK must obtain authorisation by the PRA under Section 19 of the FSMA. By March 2021, 30 international insurers had established branches in the UK.

The UK has largely retained Solvency II's specific principles and conditions for third country branches.[188] These requirements can be found in the Third Country Branches Part of the PRA Rulebook, which was amended post-Brexit to reflect certain necessary adjustments. Further, parts of Article 162 have already been adopted under UK law by virtue of the FSMA and the Variation of Threshold Conditions Order thereunder.[189]

The principal requirements that a third country (re)insurer carrying on (re)insurance business in the UK must meet are:

- The threshold conditions set out in Schedule 6 (Threshold Conditions) of the FSMA,[190] in relation to non-UK (re)insurers, which are:
  - It must have a representative who is resident in the UK and who has authority to bind it in its relations with third parties and to represent it in its relations with the PRA and the courts in the UK.
  - It must be a body corporate entitled under the law of the place where its head office is situated to effect and carry out contracts of insurance.
  - It must have in the UK assets of such value as may be specified (discussed further below).
  - Unless the regulated activity relates solely to reinsurance, it must have made a deposit of such amount and with such a person as may be specified (discussed further below).[191]
- It must maintain, at a place of business in the UK, all records relating to the activities carried on from the third country branch.[192]
- Unless a pure reinsurance branch, it must hold in the UK assets to cover the branch SCR and must deposit as security in the UK with a UK bank assets of an amount equal to at least one-quarter of the absolute floor of the MCR.[193]
- It must calculate a branch MCR and a branch SCR and cover each of the branch MCR and branch SCR with eligible own funds.[194]

[188] Article 162, *ibid.*
[189] Financial Services and Markets Act 2000 (Variation of Threshold Conditions) Order 2001 (SI 2001/2507).
[190] Schedule 6 (Threshold Conditions) of the FSMA.
[191] *Ibid.*
[192] Paragraph 2.1, Third Country Branches Part of the PRA Rulebook.
[193] Paragraphs 3.1 and 3.3, *ibid.*
[194] Paragraphs 4.1 and 4.2, *ibid.*

- It must establish adequate branch technical provisions.[195]
- It must comply with rules as to how branch assets and liabilities are valued and how branch own funds should be classified.[196]
- It must have a branch scheme of operations that adheres to the informational requirements set out in Article 163(1) and (2).[197]

The PRA's recent efforts to reform the UK Solvency II regime (discussed below) have resulted in reduced regulatory requirements for third country (re)insurers. The PRA's final policy takes effect on 31 December 2024 and is contained in PRA PS2/24, which amends the Third Country Branches Part of the PRA Rulebook in the following key respects:[198]

- Removes the requirement for third country (re)insurers to calculate a branch SCR and branch MCR and to cover these with eligible own funds.
- Removes the associated requirement to calculate branch own funds for the purposes of complying with the branch SCR and branch MCR.
- Removes the SCR localisation requirement *i.e.*, the requirement for third country (re)insurers to hold assets in the UK to cover the branch SCR.
- Replaces the requirement for third country (re)insurers (expect (re)insurers that have a third country pure (re)insurance branch) to deposit as security in the UK assets of an amount equal to at least one-quarter of the absolute floor of the MCR, with an amount equal to:
  - £600,000 for a third country insurance branch whose insurance business is limited to general insurance business.
  - £875,000 for a third country insurance branch whose insurance business is limited to long-term insurance business.
  - The sum of the amounts set out in (i) and (ii) for a third country insurance branch that is a composite third country branch.

Branch Own Funds and Financial Resources

The PRA provides further guidance on branch own funds in PRA SS44/15, stating the following:

- It expects third country (re)insurers to comply with the EIOPA Guidelines on the supervision of branches of third country insurance undertakings (EIOPA BoS-15/110) (Branch Guidelines) and to comply with the Third Country Branches Part of the PRA Rulebook in light of such guidelines.[199]
- It expects third country (re)insurers to maintain financial soundness at branch level, to ensure that branch policyholders enjoy the same level of protection as the policyholders of an insurer established in the UK.[200]
- Only those assets that are available to pay the claims of branch policyholders in the event of a winding-up should be included in the calculation of branch assets (either in priority to other creditors or exclusively).[201]

[195] Paragraph 6.1, *ibid.*
[196] Paragraphs 6.3 and 6.4, *ibid.*
[197] Paragraph 5.1, *ibid.*
[198] Annex K of Appendix 2 of the PRA PS2/24.
[199] Paragraph 2.1 of the PRA SS44/15.
[200] Paragraph 3.2, *ibid.*
[201] Paragraph 3.3, *ibid.*

- It expects to receive an analysis from the (re)insurers of the applicable winding-up regime analysing the priority given to branch policyholders and how the assets of the third country (re)insurer would be distributed to those policyholders.[202]

Third country (re)insurers with a UK branch are also required to maintain adequate worldwide financial resources.[203] The branch must also provide the PRA with enough information to make an informed assessment as to the adequacy of such financial resources.[204]

If the home regime of the (re)insurer is similar to the PRA regime, the branch may be able to rely on financial resources per its home state regime, subject to regulatory reporting of the same to the PRA.[205] However, if the home regime is significantly different to the PRA regime, the PRA will be required to assess the adequacy of its financial resources with the principles that apply to UK (re)insurers.[206]

Governance

Third country branches must comply with the governance requirements of Provisions 1, 2.2 to 2.6 and 3 to 7 of Conditions Governing Business, modified as set out in Provisions 7.2 and 7.3 of the Third Country Branches Part of the PRA Rulebook. These deal with:

- General governance requirements, including the need to have written policies in relation to risk management, internal control, internal audit and, where relevant, outsourcing, which should be subject to the prior approval of the governing body.
- Fitness and propriety requirements in respect of persons performing a key function.
- Risk management.
- The own risk and solvency assessment (ORSA).
- Actuarial function.[207]

The PRA provides further guidance on its expectations as to notifications, ORSA reporting, systems of governance, senior management functions and outsourcing/operational risk in Chapters 9 to 14 of the PRA SS44/15.[208]

PRA Approach to Third Country Branches

On 28 March 2018, the PRA published the PRA SS2/18 setting out its approach to branch authorisation and supervision.[209] This was published in the run-up to the UK's withdrawal from the EU, with the PRA contemplating the implications of the exit for EU (re)insurers who had previously operated on a freedom of establishment basis. PRA SS2/18 was subsequently replaced by a new PRA policy statement (PS) published in May 2024, which consolidates and clarifies the PRA's approach to authorising and supervising third country branches.[210]

[202] Paragraph 3.4, *ibid.*
[203] Paragraph 4.1, *ibid.*
[204] Paragraph 4.2, *ibid.*
[205] Paragraph 4.3, *ibid.*
[206] Paragraph 4.4, *ibid.*
[207] *See* Paragraphs 2 to 7 Conditions Governing Business Third Country Branches Part of the PRA Rulebook.
[208] PRA SS44/15.
[209] PRA SS2/18.
[210] PRA PS8/24.

The PRA states that, when considering applications from a (re)insurer for authorisation as a third country branch, it will consider regulatory equivalence and its ability to supervise the insuring entity.[211] The PRA must be satisfied that the below factors are cumulatively met:[212]

- The (re)insurer's ability to meet the applicable "threshold conditions" under the FSMA.
- The home jurisdiction's supervisory equivalence.
- The capability of the (re)insurer to be effectively supervised by the home supervisor.
- Sufficient supervisory cooperation between the PRA and the home supervisor.
- UK insurance policyholders of the (re)insurer will be given the appropriate priority in an insolvency and there is no discrimination against policyholders whose business is written in the UK in the event of a winding up.
- The scale of the UK branch activity covered by the Financial Services Compensation Scheme (FSCS).
- The nature, scale and complexity of the (re)insurer's proposed activity.
- The impact of the failure of a (re)insurer on the wider UK insurance market and financial system.
- The PRA's assessment of the outwards reinsurance arrangements of the third country branch and the (re)insurer.
- The third country branch's and (re)insurer's abilities to meet relevant PRA rules and expectations, including the Senior Managers and Certification Regime (SMCR).

The Statement of Policy goes on to explain in detail each of the factors listed above. The PRA emphasises that the overall "supervisability" of a (re)insurer operating through a branch, and the extent and quality of cooperation with the home supervisor, are key tenets in its assessment.[213] "Supervisability" is a holistic assessment, which will consider the governance arrangements of a branch and third country (re)insurer as a whole.

The PRA expects third country branches to have under £500 million in insurance liabilities covered by the FSCS.[214] Although this is not a hard threshold, the PRA is likely to require a third country (re)insurer to authorise a subsidiary when such a limit has been surpassed.[215] As a consequence, many larger branches are expected to end up subsidiarising, if they have not done so already.

However, the PRA will consider the branch's medium-term strategy, business plan and forecast in assessing the FSCS-protected liabilities threshold and then make an informed judgement of whether such liabilities are likely to fall above or below the limit.[216] Whether the third country (re)insurer operates as a branch or subsidiary does not have a consequent impact on the potential cost to the FSCS of a default, as eligible policyholders of authorised insurance entities in the UK fall within the ambit of the FSCS.[217]

The PRA therefore considers that the level of FSCS-protected liabilities is a strong indicator of the impact of a branch's failure on both policyholders and FSCS levy payers.[218]

[211] Paragraph 1.8, *ibid.*
[212] Paragraph 2.1, *ibid.*
[213] Paragraph 1.2, *ibid.*
[214] Paragraph 2.29, *ibid.*
[215] *Ibid.*
[216] Paragraph 2.31, *ibid.*
[217] Paragraph 2.27, *ibid.*
[218] Paragraph 2.28, *ibid.*

The PRA applies most of its third country branches rules to pure reinsurance branches, noting that (as stated above) pure reinsurance branches are exempt from some requirements in the UK.

Recent PRA Reforms

In 2023, the PRA published a number of PRA CPs on significant reforms for third country branches in the UK. These PRA CPs form part of the UK's "Edinburgh Reforms" announced in December 2022.

June 2023 Consultation Paper

Most significantly, the PRA proposed to remove the need to calculate and report third country branch capital requirements.[219]

This included proposals that non-UK (re)insurers no longer be required to account for a branch SCR and a branch MCR. Further, the PRA proposed to abolish the SCR localisation requirement for third country branches — that is, the requirement to hold assets in the UK to cover the branch SCR, and the requirement to establish and report branch risk margins on balance sheets.

Here, the PRA sought to capture the reality that a third country branch should not be viewed as an independent entity severable from its wider legal enterprise. This perhaps indicates that the PRA will exercise greater scrutiny over entities holistically (including over their home regimes). This also means that third country branches will not have to comply with both home state and UK rules, which will alleviate the burden for them of the doubling up of requirements, thereby making the UK more attractive as a jurisdiction to do business in.

The PRA continues its focus on protecting policyholders with these reforms. The PRA will still depend on home state authorities to check that these third country insurance undertakings are properly regulated and overseen. Moreover, the PRA will still require third country firms to show that they maintain "adequate worldwide financial resources". The date for the implementation of these reforms is 31 December 2024.

October 2023 Consultation Paper

In a further PRA CP,[220] the PRA set out its proposals to consolidate and formalise existing PRA policies. The three main proposals were as follows:

- Introduction of a new Statement of Policy that would replace PRA SS2/18 on branch authorisation and international (re)insurer supervision.
- Amendment of the PRA SS44/15 on third country insurance and pure reinsurance branches. The PRA proposed to make amendments to existing texts, updating the information it publishes on its expectations relating to notifications, ORSA reporting, systems of governance, Senior Management Functions and outsourcing/operational risk.
- Amendment of the PRA SS20/16 on reinsurance and counterparty credit risk to clarify that it is applicable to third country branch undertakings and amend the provision so that it is consistent with the language used in the PRA Rulebook.

These proposals took effect in May 2024 (see below).

[219] PRA CP12/23.

[220] PRA CP21/23.

PRA Final Policy and Implementation

Following expiration of the consultation period, the PRA published its final policy in PRA PS2/24.[221] The PRA indicated that the proposals set out in the June 2023 PRA CP received general support, particularly the proposal to remove the requirement to calculate branch capital requirements. These proposals will be implemented subject to minor amendments.[222] Once the reforms take effect on 31 December 2024, third country (re)insurers will no longer be required to account for a branch SCR and branch MCR. Consequently, the requirement to hold assets in the UK to cover the branch SCR and the requirement to establish and report branch risk margins on balance sheets will also be removed.

The PRA subsequently published PRA PS8/24 providing feedback to responses received from PRA CP21/23.[223] Respondents generally welcomed the PRA's proposals to consolidate and clarify its existing approach to insurance branches.[224] PRA PS8/24 introduced several key updates:

- A new PRA PS replaced PRA SS2/18 on branch authorisation and international (re)insurer supervision on 23 May 2024.[225] The substance of this PRA PS is discussed above. The PRA's approach under the new policy is largely in line with the approach set out in PRA SS2/18. The new PRA PS, however, covers the factors to be considered in assessing third country branch risks in much greater detail.
- Two new versions of the PRA SS44/15 on third country insurance and pure reinsurance branches:
  - The current version (which took effect on 23 May 2024) that incorporates amendments proposed by PRA CP21/23.[226]
  - A future version of the PRA SS44/15,[227] to take effect on 31 December 2024, that incorporates amendments confirmed in the PRA PS3/24 on reporting and disclosure.[228] Key amendments include updated disclosure requirements, removing references to the EIOPA and highlighting Branch Guidelines that will remain relevant following PRA PS3/24.
- An updated PRA SS20/16 (taking effect on 23 May 2024) implementing proposals from PRA CP21/23.[229]

4. Impact of Brexit on EEA (Re)insurers Operating in the UK

Contingency Arrangements Implemented by the UK Government

The UK's withdrawal from the EU meant that EEA (re)insurers with UK operations could no longer rely on passporting rights for continued market access. Accordingly, the UK government set in place two contingency arrangements:

- The Temporary Permissions Regime (TPR).
- The FSCR.

Please also see the discussion of reinsurance equivalence in Chapter 2: Reinsurance and Risk Transfer.

[221] PRA PS2/24.
[222] Paragraph 1.20, *ibid.*
[223] PRA PS8/24.
[224] Paragraph 1.9, *ibid.*
[225] PRA PS8/24.
[226] Paragraphs 9 to 14 of the PRA SS44/15.
[227] Future Version of the PRA SS44/15.
[228] PRA PS3/24.
[229] PRA SS20/16.

Temporary Permissions Regime

The TPR acted as a transition mechanism for EEA firms that operated in the UK on the basis of passporting rights to continue to do so whilst awaiting and applying for full UK authorisation — *i.e.*, to subsidiarise in the UK.

This scheme ended on 30 December 2023, and the FCA expected any firms remaining in the TPR that had not have, by this time, filed active applications for full permission under Part IV of the FSMA either to apply to cancel their temporary permission or indicate that they expected to enter the FSCR.

Financial Services Contracts Regime

The FSCR is an additional transition mechanism for EEA (re)insurers that did not wish to enter the TPR or seek UK authorisation.[230] It allows such EEA (re)insurers to run off their existing regulated business in the UK. But unlike the TPR, it does not allow for (re)insurers to write new businesses in the UK. Instead, it enables EEA (re)insurers that previously passported into the UK to wind down their UK business in an orderly fashion.

The FSCR itself also consists of two regimes: the Supervised Run-Off regime (SRO) and Contractual Run-Off regime (CRO), as follows:

- **The SRO** applies to firms with a UK branch (*i.e.*, which formerly operated under a freedom of establishment passport) that did not enter the TPR (meaning such (re)insurers did not intend to seek authorisation for the specific passporting entity), as well as (re)insurers that have exited the TPR.
- **The CRO** applies to firms without a UK branch (*i.e.*, which formerly operated under a freedom of services passport) that did not enter the TPR. These firms entered the CRO automatically by operation of law after the end of the Brexit transition period.

The FSCR allows firms to use the SRO or CRO for five years after entering into such arrangements, with an exception for insurance contracts that have a time limit of 15 years (*i.e.*, until end of 2035). These regimes will cease to apply to any firm whose home authorisation is cancelled, and such firms are required to notify such cancellations to the FCA or PRA.

5. Bilateral Arrangements Post-Brexit

EU-US

The EU-US Bilateral Agreement signed in 2017 addresses three principal areas:

- **Group supervision.** The agreement allows reinsurance groups operating in each other's market to be subject to worldwide prudential insurance group oversight only by the home supervisor. Essentially, this precludes EU insurance supervisors from applying Solvency II group-level solvency and capital standards to US insurance groups.
- **Reinsurance supervision.** The agreement prohibits a US state regulator from imposing on an EU assuming reinsurer either collateral or local presence requirements that it does not also impose on a local US assuming reinsurer as a condition to a reinsurance agreement, and vice versa, subject to certain financial and contractual conditions.

[230] The FSCR.

- **Exchange of information.** The agreement encourages both parties' supervisory authorities to cooperate in exchanging information in accordance with the practices set out in the memorandum of understanding that is annexed to the agreement.

UK-US

In 2018, the UK and the US entered into an arrangement very similar in effect to the EU-US Bilateral Agreement (UK-US Bilateral Agreement).[231]

UK-Switzerland

In 2023, the UK and Switzerland entered into what is known as the Berne Financial Services Agreement, which provides market access to financial services firms in both jurisdictions without the need for local authorisation.[232] This is particularly important as, from the start of 2024, Switzerland requires all non-Swiss firms to establish a base before providing services to Swiss customers. The UK is the only country that will be exempt from this requirement.

The agreement applies, *inter alia*, to select lines of non-life insurance business. It does not apply to life, accident, health and most liability insurance streams (including monopoly insurance and business interruption insurance). The agreement only applies to larger corporate clients and professional policyholders.[233]

UK-incorporated (re)insurers may, from the start of 2024 and subject to limited conditions, establish a base in Switzerland and provide services to Swiss consumers without having to set up a locally authorised branch or subsidiary, and vice versa. These arrangements are based on deference: Switzerland will defer to the domestic authorisation and prudential measures of the UK, and vice versa.

[231] Agreement Between the UK and the US on Prudential Measures Regarding Insurance and Reinsurance.

[232] Agreement Between the UK and the Swiss Confederation on Mutual Recognition in Financial Services.

[233] Defined as "enterprises" that meet two of these three criteria: (i) net turnover in excess of 40 million Swiss francs, (ii) balance sheet total in excess of 20 million Swiss francs, or (ii) employment of over 250 employees.

Chapter 4

Groups

Introduction

Group supervision regulates the impact that members of a Solvency II group have on a Solvency II insurer. The UK rules governing Solvency II groups are contained in the Group Supervision Part of the PRA Rulebook, the Solvency 2 Regulations 2015 and Articles 328 to 350 of the Level 2 Delegated Regulation, and are supplemented by, among other things, PRA SS9/15: Group Supervision (as updated in February 2024) (PRA SS9/15), and the PRA Statement of Policy (February 2024): The PRA's approach to insurance group supervision (effective from 31 December 2024).

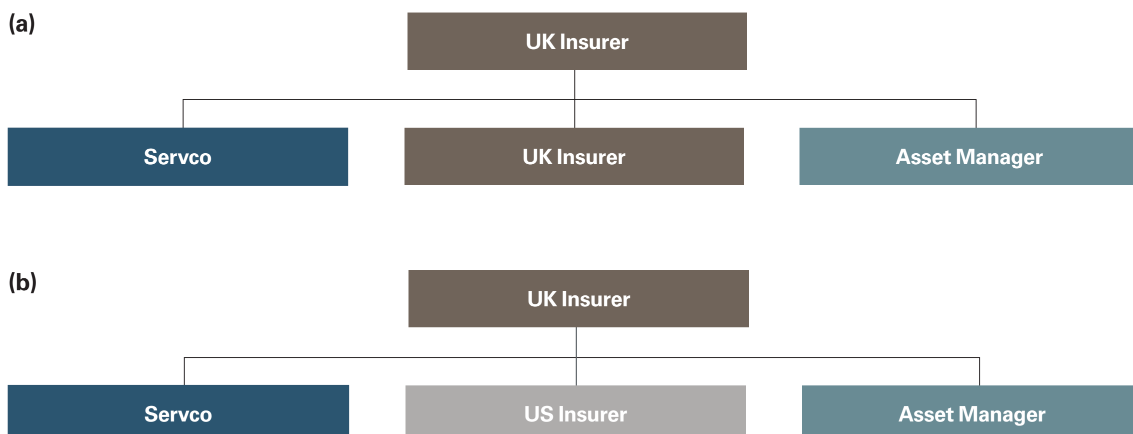
The rules governing Solvency II groups set standards that must be maintained by the Solvency II group as a whole. In this chapter we dwell principally on the rules on group supervision that apply in the UK.

1. Types of Solvency II Groups

There are four scenarios where group supervision applies on a group-wide basis.

Scenario 1

Scenario 1 occurs either (i) when a UK Solvency II insurer owns directly or indirectly 20% or more of the voting rights or capital of, or otherwise exercises significant influence over, at least one other UK Solvency II insurer or third country (re)insurer, or (ii) when a Gibraltarian (re)insurer owns directly or indirectly 20% or more of the voting rights or capital of, or otherwise exercises significant influence over, at least one UK Solvency II insurer.

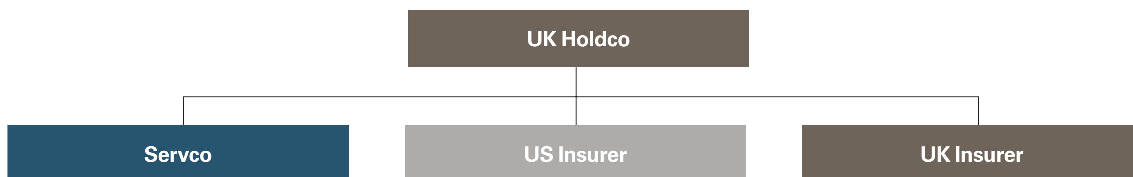


Example (b) above is deemed to be a group despite the fact that the subsidiary third country (re)insurer is not a UK Solvency II insurer.[234]

[234] Article 213(2) of the Solvency II Directive (transposed in (i) Regulation 9A of the Solvency 2 Regulations 2015; and (ii) Paragraph 2.1, Group Supervision Part of the PRA Rulebook).

Scenario 2

Scenario 2 involves a UK Solvency II insurer that has a parent entity which is an insurance holding company or a mixed financial holding company with its head office in the UK or Gibraltar.[235]



An insurance holding company is a parent entity that is not a UK Solvency II insurer or a mixed financial holding company, whose main business is to acquire and hold directly or indirectly 20% or more of the voting rights or capital of, or otherwise exercises significant influence over, subsidiary undertakings that are either exclusively or mainly UK Solvency II insurers or third country (re)insurers, or ancillary insurance service undertakings, and where such entities comprise more than 50% of two or more of:

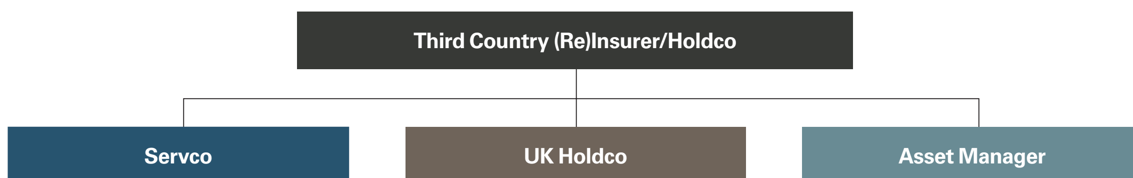
- The parent entity's consolidated assets.
- The parent entity's consolidated revenues.
- The group SCR (as if calculated at the level of the parent entity).[236]

At least one of the parent entity's subsidiary undertakings must be a UK Solvency II insurer.[237]

A mixed financial holding company is a parent entity that is not a regulated entity itself but, along with its subsidiaries (at least one of which is a regulated entity with its head office in the UK) and other entities, forms a financial conglomerate as defined by the applicable rules.[238]

Scenario 3

Scenario 3 occurs where the top company is an insurance holding company or a mixed financial holding company with its head office outside the UK or Gibraltar or a third country (re)insurer.



[235] *Ibid.*

[236] PRA Glossary "insurance holding company".

[237] Article 213(2) of the Solvency II Directive (transposed in (i) Regulation 9A of the Solvency 2 Regulations 2015; and (ii) Paragraph 2.1, Group Supervision Part of the PRA Rulebook).

[238] PRA Glossary "mixed financial holding company".

Unless otherwise agreed with the PRA, the PRA must rely on the equivalent group supervision exercised by the third country supervisory authorities where the jurisdiction of the third country supervisory authority has been deemed equivalent and there is group supervision.[239] In a UK context, equivalence, for this purpose, means Bermuda (save for captives and SPVs) and Switzerland (and see further below re the US); and in respect of EEA member states (but, note, not the other way around — *i.e.*, the EU does not recognise the UK for group supervision equivalence).

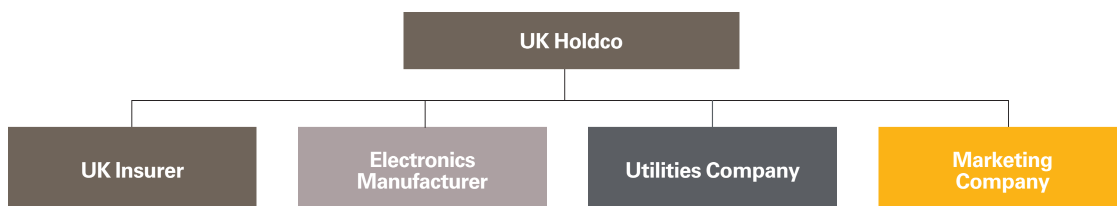
Regarding EU Solvency II (as distinct from Solvency UK), only Bermuda, Switzerland and the EEA member countries have been deemed to be equivalent as it relates to EU supervision of groups under the Solvency II Directive (note also the position explained below regarding US-parented groups — the position in the UK and EU is similar).[240]

If there is a sub-group headed by a UK insurance holding company, additional group supervision can be imposed at the level of the UK Solvency II sub-group. Conversely, where it would be more efficient and, importantly, supervisory efforts are not negatively impacted, the PRA may exempt any UK sub-group from additional supervision.[241]

Where the jurisdiction of the third country parent entity is not equivalent, the PRA has the flexibility to determine whether to regulate the entire group (*i.e.*, from the third country parent entity down) or, if satisfactory other methods can be agreed, from the level of the top UK holding company down.[242] The PRA exercises this jurisdiction through the UK Solvency II insurer's authorisation. The purpose of other methods pursuant to Group Supervision 20.1(2) is to ensure sufficiency of governance and prudential solvency at that lower level, and therefore other methods structures will involve ensuring that the group (and, in particular, the constituent UK Solvency II insurers) have appropriate governance, staffing, boards, independence and access to capital when it is required.

Scenario 4

Scenario 4 occurs where a UK Solvency II insurer has a parent entity that is a mixed-activity insurance holding company.[243]



[239] Article 262(2) of the Solvency II Directive (transposed in (i) Regulation 35 of the Solvency 2 Regulations 2015; and (ii) Paragraph 20.1(1), Group Supervision Part of the PRA Rulebook).

[240] The EIOPA, "International Regulations and Equivalence".

[241] PRA CP12/23.

[242] Paragraph 20.1(2), Group Supervision Part of the PRA Rulebook.

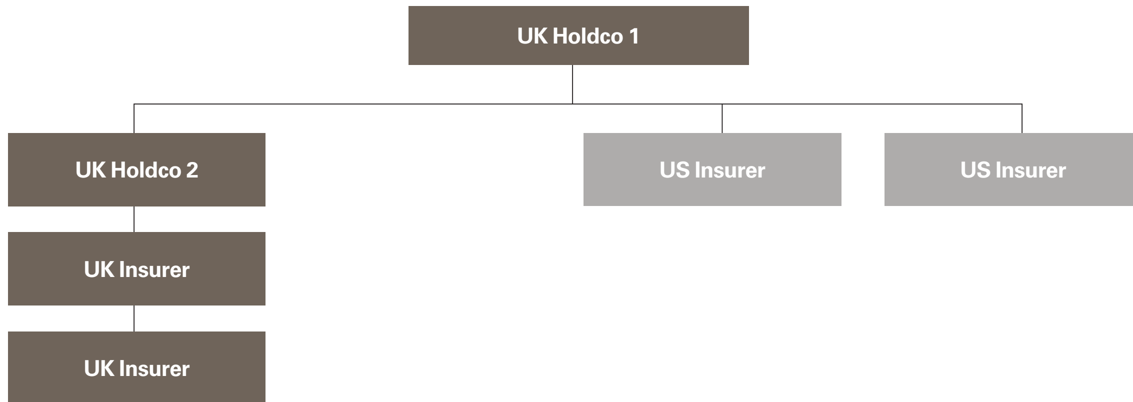
[243] Article 213(2) of the Solvency II Directive (transposed in (i) Regulation 9A of the Solvency 2 Regulations 2015; and (ii) Paragraph 2.1(4), Group Supervision Part of the PRA Rulebook).

The extent of group supervision for Scenario 4 groups is limited. Parent companies of Scenario 4 groups are not insurance holding companies due to the fact that holding interests in (re)insurers is not its primary business and the group's main activities are non-financial. The revised definition of insurance holding company has made the delineation between what is a mixed-activity insurance holding company and an insurance holding company clearer, though the presence of insurance intermediaries in a group that place most of their insurance business with group insurers (and/or group insurers who receive most of their business from group intermediaries) continues to complicate matters, especially in the case of Gibraltarian carriers.

In determining if a group with a UK Solvency II insurer or a third country (re)insurer falls within Scenario 4, one must first consider if the parent entity of the group is a UK Solvency II insurer. Second, one must consider whether the parent entity is an insurance holding company. Third, one must consider whether the parent entity is a mixed financial holding company. If the answer is no, in respect of the above three stages, the parent entity is a mixed-activity insurance holding company.

Existence of a UK Solvency II Group at Different Levels of the Group Structure

As noted in the diagram below, a UK Solvency II group can exist at different levels in a group structure.



In this scenario, group supervision rules will apply only at the level of the ultimate UK Solvency II insurer, UK insurance holding company or UK mixed financial holding company in the group. If the ultimate holding company's head office is outside the UK, the applicable rules will depend on whether the jurisdiction in which the entity is incorporated is deemed to be equivalent to the UK and, if not, whether other methods apply.[244] However, the PRA has the option to supervise the group at a UK level where a group's head office is in Gibraltar.[245]

[244] Article 213(2) of the Solvency II Directive (transposed in (i) Regulation 9A of the Solvency 2 Regulations 2015; and (ii) Paragraph 2.1, Group Supervision Part of the PRA Rulebook).

[245] Regulation 13 of the Solvency 2 Regulations 2015.

2. Group Supervision: Applicable Rules and Specific Considerations

Scenario 1 and Scenario 2 Groups

Both Scenario 1 and Scenario 2 groups are supervised pursuant to the rules set out in the Group Supervision Part of the PRA Rulebook, which includes rules governing group solvency (discussed in the next section), group reporting requirements, certain requirements regarding intra-group transactions, and certain risk management and internal control requirements.

The governance requirements that apply at the level of a Scenario 1 and Scenario 2 group are largely similar to the equivalent solo level governance requirements. Requirements include carrying out an ORSA and implementing risk management and internal control systems.[246]

Scenario 1 and 2 groups must report on a regular basis (at least annually) to the PRA all "significant" intra-group transactions by (re)insurers. A very significant intra-group transaction must be reported as soon as practicable.[247] The Level 2 Delegated Regulation makes it clear that an intra-group transaction can be considered "significant" if it would materially influence the solvency or liquidity position of the group or one of the companies involved in the transaction. The PRA expects to be notified of any very significant intra-group transaction before the relevant company has entered into the transaction. Article 377 of the Level 2 Delegated Regulation includes a non-exhaustive list of such transactions.[248]

Scenario 3 Groups

In respect of Scenario 3 groups, the PRA must rely on the equivalent group supervision exercised by the third country supervisory authorities where the jurisdiction of the third country supervisory authority has been deemed equivalent.[249]

At the date of this publication, only Bermuda,[250] Switzerland[251] and the EEA member countries[252] have been deemed to be equivalent for this purpose.

Bermuda and Switzerland were granted equivalent status by the EU Commission. These decisions were given effect in the UK's solvency regime by operation of Regulation 35(2) of the Solvency 2 Regulations 2015. These Delegated Decisions will no longer have any effect in the UK after 31 December 2024, at which point His Majesty's Treasury (HM Treasury) will restate them such that Bermuda and Switzerland retain their equivalent status.[253]

[246] Article 45 of the Solvency II Directive (transposed in Paragraph 3.8, Conditions Governing Business Part of the PRA Rulebook).

[247] Article 245, *ibid* (transposed in (i) Regulation 24 of the Solvency 2 Regulations 2015; and (ii) Paragraph 16.2, Group Supervision Part of the PRA Rulebook).

[248] Article 377 of the Level 2 Delegated Regulation.

[249] Article 261 of the Solvency II Directive (transposed in (i) Regulation 35 of the Solvency 2 Regulations 2015; and (ii) Paragraph 20.1(1), Group Supervision Part of the PRA Rulebook).

[250] Commission Delegated Decision (EU) 2016/309.

[251] Commission Delegated Decision (EU) 2015/1602.

[252] Solvency 2 Regulations 2015 Equivalence Directions 2020.

[253] Financial Services and Markets Act 2023 (Commencement No 8) Regulations 2024 (SI 2024/1071).

Due to the UK-US Bilateral Agreement, supervision for US-parented groups occurs at the level of the US parent entity and by the supervisor in that parent entity's home state, with the PRA having the ability to supervise at the level of any UK sub-group.

To exercise the process outlined in the UK-US Bilateral Agreement, UK Solvency II insurers in a US-parented group must apply for a rule modification. The application process is standardised. The PRA will issue bespoke individual other methods directions to UK Solvency II insurers that meet the requirements in the Bilateral Agreement, which effectively amend the requirements set out in Paragraphs 20.1 and 20.2 in the Group Supervision Part of the PRA Rulebook.[254]

The UK-US Bilateral Agreement streamlines the administrative impact for insurance groups with a US parent entity by requiring that each relevant member of the group and the UK insurance holding company provide to the PRA its group risk report (ORSA or equivalent) and provide the same to its US supervisor.[255] The submission including the group risk report must include:

- A description of the (re)insurance group's risk management framework.
- An assessment of the (re)insurance group's risk exposure.
- A group assessment of risk capital and a prospective solvency assessment.

As regards to insurance groups with an EU parent entity, a single group supervisor is designated the group supervisor as per Article 247 of the Solvency II Directive.

If there are (re)insurers in more than one EU member state, and the relevant group is:

- Headed by a parent entity that is a (re)insurer, the group supervisor will be the national regulator that supervises that (re)insurer.
- Not headed by a parent entity that is a (re)insurer, Article 247 sets out a number of different factors that must be taken into account in establishing who the group supervisor should be, for example:
  - Where more than one (re)insurer shares its headquarters with the same insurance holding company or mixed financial holding company, the supervisory authority of those (re)insurers shall be the group supervisor.
  - Where the group is headed by more than one insurance holding company or mixed financial holding company, and these companies have their head offices in different EU member states and there is a (re)insurer in each of those EU member states, the supervisory authority of the (re)insurer with the largest balance sheet total shall be the group supervisor.
  - Where multiple (re)insurers that have their head offices in the EU also have as their parent the same insurance holding company or mixed financial holding company, and none of the entities have been authorised in the member state in which the insurance holding company or mixed financial holding company has its head office, the supervisory authority that authorised the (re)insurer with the largest balance sheet total shall be the group supervisor.
  - Where the group does not have a parent entity, the supervisory authority that authorised the (re)insurer with the largest balance sheet total shall be the group supervisor.

[254] Article 262(2) of the Solvency II Directive (transposed in (i) Regulation 35 of the Solvency 2 Regulations 2015; and (ii) Paragraph 20.1, Group Supervision Part of the PRA Rulebook).

[255] Articles 4(c)-(d) of the UK-US Bilateral Agreement.

Under Article 247, each relevant national supervisor can dispute whether the selection criteria have been applied appropriately. In the event of a disagreement, the EIOPA has ultimate authority to resolve any dispute. Article 248 of the Solvency II Directive sets out the rights and duties of the group supervisor. Article 249 of the Solvency II Directive sets out obligations regarding the cooperation and exchange of information between regulators of (re)insurers in the group.

3. Group Solvency Calculation for Scenario 1 and 2 Groups

Groups falling within Scenarios 1 and 2 are required to calculate their group solvency in accordance with relevant provisions of the PRA Rulebook.[256] In respect of Scenario 1, it is the UK Solvency II insurer that is required to ensure that group solvency requirements are met. In respect of Scenario 2, where the group is headed by an insurance holding company or a mixed financial holding company, it is the UK Solvency II insurer in the Solvency II group that is responsible for ensuring compliance with group solvency requirements.

There are two possible means of calculating group solvency:

- The accounting consolidation method (Method 1).
- The deduction and aggregation method (Method 2).

One key difference between the two methods is that under Method 2, diversification benefits between group members are not recognised (although there is a degree of nuance to this position in the recent Solvency UK reforms within subgroups). Additionally, the use of local rules is possible under Method 2 for the calculation of group solvency where the relevant non-UK entity is in an equivalent jurisdiction (at this time, Switzerland, Bermuda or an EEA member country).[257]

While Method 1 is the default, the PRA may allow Method 2 or a combination of both to be used (a partial Method 2 approach).[258] When assessing whether or not to allow the use of Method 2, the PRA must consider if:

- There is a sufficient amount and quality of information available in a particular instance to allow for the use of Method 1.
- The use of Method 1 be disproportionately burdensome.
- Intra-group transactions are not significant both in terms of volume and value.
- The group includes non-UK entities that are equivalent (either provisionally or absolutely).

The use of Method 2 (in whole or part) most often occurs where the overseas operations of a group are located in a jurisdiction deemed equivalent for group solvency purposes.

4. Group Solvency Calculation: Method 1

Under Method 1 group solvency is assessed by calculating the difference between:

- The own funds eligible to cover the SCR, calculated on the basis of consolidated data.
- The SCR at group level, calculated on the basis of consolidated data.[259]

[256] Paragraphs 4 to 14, Group Supervision Part of the PRA Rulebook.

[257] Article 227 of the Solvency II Directive (transposed in Paragraph 10.4, Group Supervision Part of the PRA Rulebook).

[258] Article 220(2), *ibid* (transposed in Paragraph 7.1, Group Supervision Part of the PRA Rulebook).

[259] Article 230(1), *ibid* (transposed in Paragraph 10.4, Group Supervision Part of the PRA Rulebook).

Consolidation includes all related undertakings whether they are regulated undertakings or not; but not all types of undertaking are included on a fully consolidated basis.

The own funds and SCR sections of the PRA Rulebook apply in respect of the calculation of:

- The group SCR based on consolidated data.
- The calculation of own funds eligible at group level.

Entities Included in the Method 1 Calculation

Group entities not included in the scope of group supervision are excluded from the calculation. It is explicitly stated in Article 335 of the Level 2 Delegated Regulation that consolidated data in respect of each group entity is included, save where:

- Necessary information in respect of an undertaking necessary to calculate group solvency is not available, in which case the book value of that entity must be deducted from the own funds eligible for the group SCR and the unrealised gains connected with the participation must not be recognised as own funds eligible for the group SCR.[260]
- A company has been granted a waiver by the PRA, excluding it from group supervision by the PRA where there are legal impediments to the transfer of information.[261]
- The relevant entity is an SPV and compliance has been made with certain relevant requirements.[262]

Data Included in the Method 1 Calculation

The basic principle is that Method 1 uses consolidated data from all entities within the Solvency II group and own funds is calculated as if the Solvency II group was one single insurer. There is proportional consolidation of data where members of the group share control of an entity with an entity outside the group. The proportional share of a group entity's holdings in credit institutions, investment firms and UCITS management companies, among others, are calculated on the basis of sector specific rules.

Article 335 of the Level 2 Delegated Regulation specifies that the consolidated data should include:

- Full consolidation of data of the following types of undertaking where they are subsidiaries of the parent entity:
  - (Re)insurers.
  - Third country (re)insurers.
  - Insurance holding companies.
  - Mixed financial holding companies.
  - Ancillary insurance services undertakings.
- Full consolidation of data of SPVs to which the participating undertaking or one of its subsidiaries has transferred risk and that are not excluded from the scope of the group solvency calculation under Article 329(3).

[260] Paragraph 10.6, Group Supervision Part of the PRA Rulebook.
[261] Article 214 of the Solvency II Directive (transposed in Paragraph 2.3, Group Supervision Part of the PRA Rulebook).
[262] Article 229(3) of the Level 2 Delegated Regulation.

- Proportional consolidation of data of the same types of undertaking as are referred to in the first bullet above, but where they are managed jointly by one of the aforementioned undertakings and one or more other undertakings.
- Data of all holdings in the types of undertaking referred to in the first bullet above that are not subsidiaries of the parent entity and to which the proportional consolidation does not apply, on the basis of the adjusted equity method.
- The proportional share of the undertakings' own funds calculated in accordance with the relevant sectoral rules in relation to holdings in related undertakings that are:
  - Credit institutions.
  - Investment firms.
  - Financial institutions.
  - Alternative investment fund managers.
  - UCITS management companies.
  - Institutions for occupational retirement provision.
  - Non-regulated undertakings carrying out financial activities.
- Data of all other related undertakings (including ancillary service undertakings, collective investment undertakings and investments packaged as funds) other than those referred to above.[263]

As a default, related undertakings must be valued using quoted market prices in active markets as provided for in Article 10(2) of the Level 2 Delegated Regulation. Where this is not possible, undertakings should be valued using quoted market prices for similar assets, after having made any adjustments to reflect differences between the quoted asset and the undertaking being valued.

It may be necessary for adjustments to be made in order to account for:

- The condition or location of the asset.
- The extent to which the asset is comparable to the undertaking.
- The level of activity in the markets in which the asset is being assessed.

Third Country Subsidiaries

It is irrelevant under Method 1 whether or not third country (re)insurers in the group are in equivalent jurisdictions because the calculation will be carried out by applying Solvency II rules to consolidated data of the group as a whole. A partial use of Method 2 in respect of specific undertakings can be requested by a group. The PRA has wide discretion over whether or not the request is granted.

Treatment of Own-Fund Items

Under Method 1, own-fund items of third country (re)insurers are classified using the tests set out in Article 332 of the Level 2 Delegated Regulation and Paragraph 11.3 of the Group Supervision Part of the PRA Rulebook, with adjustments appropriate to the group calculation.

[263] Article 13, *ibid.*

Proportional Shares

The calculation of group solvency under Method 1 should take into account the proportional share held in related undertakings that are not 100% owned.[264] Where the subsidiary undertaking does not have sufficient eligible own funds to cover its SCR, unless the PRA decides otherwise, the total solvency deficit must be taken into account in the group solvency calculation.[265]

In addition, the PRA is allowed to determine the applicable proportional share in unusual circumstances. These are typically situations where the participation is held in an unusual way, such as significant influence.[266]

Treatment in Method 1 Calculation of Ring-Fenced Funds and Matching Adjustment Portfolios

RFFs and matching adjustment (MA) portfolios should not be fully consolidated in the Method 1 group solvency calculation. Method 1 groups will need to consider the availability and transferability of own funds attributable to an RFF or MA portfolio. Restricted own-fund items within RFFs would not be considered as effectively available to cover the group SCR.[267]

Minimum Capital Requirement Under Method 1

Where Method 1 is used to calculate group solvency, the consolidated group SCR must be, at a minimum, the sum of the MCR of each insurance carrier in the group and the proportional share of the MCR of the related Solvency II undertakings.[268]

For groups using Method 1, the sum of solo MCRs (the group MCR floor) can potentially prove to be higher than the group SCR, which has the effect of, in practice, limiting the diversification benefits available under Method 1.

5. Group Solvency Calculation: Method 2

Method 2 calculates the group solvency requirement based on the accounts of the solo entities. It is calculated by comparing:

- The aggregated group eligible own funds on the one hand.
- The aggregated group SCR plus the value in the participating undertaking of the related undertakings.[269]

The value of the related undertakings is added to avoid double counting between the value of those participations in the parent and the own funds of those undertakings in their contribution to group own funds.

Method 2 does not, unlike Method 1, facilitate the recognition of diversification benefits on an intragroup basis.

[264] Article 222(1) of the Solvency II Directive (transposed in Paragraph 8.1, Group Supervision Part of the PRA Rulebook).

[265] Article 221(1), *ibid* (transposed in Paragraph 8.3, Group Supervision Part of the PRA Rulebook).

[266] Article 221(2), *ibid* (transposed in Paragraph 8.3, Group Supervision Part of the PRA Rulebook).

[267] Article 330(4) of the Level 2 Delegated Regulation.

[268] Article 230(2) of the Solvency II Directive (transposed in Paragraph 11.3, Group Supervision Part of the PRA Rulebook).

[269] Article 233(1), *ibid* (transposed in Paragraph 12.1, Group Supervision Part of the PRA Rulebook).

The application of Method 2 to third country (re)insurers means, however, that there may be a less onerous treatment than the application of Solvency II rules to the assets and liabilities of those (re)insurers on a consolidated Method 1 basis. Method 2 may also allow for a more practical calculation where calculation on a Solvency II basis may be problematic in respect of the assets and liabilities of a third country (re)insurer.

With regard to the own funds calculation and SCR and in the absence of equivalence, the SCR and own funds calculation should be carried out by applying Solvency II rules,[270] which may be difficult to apply in practice and may negatively and materially impact group solvency calculations if such entities are significant relative to the size of the Solvency II regulated insurance group.

Equivalence for Group Solvency Purposes

Regulation 19 of the Solvency 2 Regulations 2015 provides for equivalence in respect of third country (re)insurers within a Solvency II group. This is not relevant for the application of the Method 1 calculation, under which Solvency II rules are applied to all consolidated data.

Where the third country regime is equivalent, the PRA must permit the group to take into account the own funds eligible to satisfy the SCR in the calculation of group solvency, and with respect to national laws adopted by the third country in respect of the group's SCR, unless it is not in the interests of policyholders to do so or there has been a significant change in the relevant third country regime.[271] If the third country (re)insurer is not subject to equivalent supervision, its contribution to the group SCR and group own funds must be calculated on the basis of Solvency II rules.

At the time of this publication, only Switzerland, Bermuda and the EEA member countries have been found to be equivalent for these purposes in the UK.[272]

Under the UK-US Bilateral Agreement, where a US (re)insurer is subject to a local group capital requirement, the PRA must not impose a group capital requirement or assessment at the level of the worldwide parent undertaking of the insurance or reinsurance group.

Treatment of Non-Insurance Undertakings

It is unclear how other related regulated entities should be treated under Method 2. Group Supervision 12.1 to 12.3 only requires the SCR and own funds of the participating (re)insurer and its related (re)insurers and, by virtue of Group Supervision 10.4, related third country (re)insurers to be taken into account in calculating group solvency.

However, Article 329 of the Level 2 Delegated Regulation requires the group solvency calculation to include capital requirements and own funds (calculated in accordance with applicable sectoral rules) — *e.g.*, for investment firms, credit institutions, UCITS management companies, alternative investment fund managers, etc. — and, in addition, a notional capital requirement and own funds for related undertakings that are non-regulated undertakings carrying out financial activities.

[270] Article 227, *ibid* (transposed in Paragraph 10.4, Group Supervision Part of the PRA Rulebook).

[271] Regulation 19(2) of the Solvency 2 Regulations 2015.

[272] As at the time of publication, no reciprocal determination has been made by the EU in respect of the UK. UK insurers will need to apply the Solvency II Directive rules to calculate the contribution of the UK undertakings to group SCR.

Under Method 2, non-regulated related undertakings (other than those carrying out financial activities) are included as assets of the relevant regulated parent entity within the group calculation and valued in accordance with Article 13 of the Level 2 Delegated Regulation.

Availability and Transferability

As is the case for Method 1 groups, Method 2 groups will need to consider the availability and transferability of own funds attributable to an RFF or MA portfolio. Article 330(4) of the Level 2 Delegated Regulation specifies that restricted own-fund items within RFFs would not be considered as effectively available to cover the group SCR.

Proportional Shares

The same provisions apply with respect to Method 2 save that, instead of the proportional share being calculated as the percentage used for the establishment of the consolidated accounts. The proportional share is calculated as the proportion of the subscribed capital held, directly or indirectly, by the participating undertaking.[273]

MCR Under Method 2

Whereas under Method 1 the consolidated group SCR must be, at a minimum, the sum of the MCR of each insurance carrier in the group and the proportional share of the MCR of the related Solvency II undertakings, there is no comparable requirement for Method 2. This is because Method 2 results in an SCR that exceeds the sum of the MCR of each insurance carrier in the group plus the proportional share of the MCRs of the related undertakings that are not wholly owned or controlled.

6. Group Solvency Calculation: Specific Points

Holding Companies

The group solvency calculation should be carried out at the level of that holding company where (re)insurers are subsidiaries of an insurance holding company or mixed financial holding company.[274] Where a group includes a (re)insurer indirectly holding a participation in a related (re)insurer through an insurance holding company or mixed financial holding company, the relevant intermediate holding company through which that (re)insurer holds those shares should be treated as if it were a (re)insurer subject to the rules on SCR and own funds for the purposes of the group solvency calculation.[275]

Elimination of Double Use of Own Funds and Intragroup Creation of Capital

Own funds that represent the same assets in two separate entities must not be double counted. For example, the value of one insurer's holding of ordinary shares in another insurer should not be valued as both an asset of the first insurer and an own-fund item of the second insurer. Paragraphs 9.1, 9.7 and 9.8 of the Group Supervision Part of the PRA Rulebook set out provisions to avoid such double counting. These provisions state that the following shall be excluded from the group SCR calculation:

[273] Article 221(1) of the Solvency II Directive (transposed in Paragraph 8.2, Group Supervision Part of the PRA Rulebook).

[274] Article 225, *ibid* (transposed in Paragraph 14.1, Group Supervision Part of the PRA Rulebook).

[275] Article 221(2), *ibid* (transposed in Paragraph 10.3, Group Supervision Part of the PRA Rulebook).

- The value of any asset of the participating UK Solvency II insurer that represents the financing of own funds eligible for the SCR of one of its related (re)insurers.
- The value of any asset of a related (re)insurer of the participating UK Solvency II insurer that represents the financing of own funds eligible for the SCR of that participating UK Solvency II insurer or any other related (re)insurer of the UK Solvency II insurer.
- Own funds arising out of reciprocal financing between the participating UK Solvency II insurer and a related undertaking, participating undertaking or another related undertaking of any of its participating undertakings.
- Own funds of a related (re)insurer of a participating UK Solvency II insurer arising out of reciprocal financing with any other related undertaking of that UK Solvency II insurer.

Reciprocal financing includes situations where one undertaking holds shares in or makes loans to another undertaking that holds own funds eligible for the SCR of the first undertaking.[276] Article 335(3) (for Method 1) and Article 342(1) (for Method 2) of the Level 2 Delegated Regulation mandate the elimination of intra-group transactions in the group own funds calculation.

Treatment of Undertakings Regulated Under Another Sector

There are conflicting rules in situations where a non-insurance undertaking is included in an insurance group with respect to the group solvency calculation. Article 223 of the Solvency II Directive only requires (re)insurance undertakings to participate in the group solvency calculation.[277] However, Article 329 of the Level 2 Delegated Regulation provides that the calculation of group solvency shall include:

- The capital requirements for related undertakings that are credit institutions, investment firms or financial institutions and the own-fund items of those undertakings calculated according to the relevant sectoral rules referred to in Article 2(7) of the Financial Conglomerates Directive.
- The capital requirements for related undertakings that are institutions for occupational retirement provision and the own-fund items of those undertakings calculated according to Articles 17 to 17c of the IORP Directive (2003/41/EC).
- The capital requirements for related undertakings that are UCITS management companies and the own fund items of those undertakings calculated in accordance with the relevant provisions of Article 7(1)(a) of Directive 2009/65/EC and the own funds of those undertakings calculated in accordance with point 1 of Article 2(1) of that directive.
- The capital requirements for related undertakings that are alternative investment fund managers calculated in accordance with Article 9 of the Alternative Investment Fund Managers Directive (2011/61/EU) and the own funds of those undertakings calculated in accordance with Article 4(1) of that directive.

Special Purpose Vehicles

If an SPV complies with Solvency II requirements or is governed by rules that are deemed to be equivalent, it can be excluded from the group solvency calculation under Article 329(3) of the Level 2 Delegated Regulation.

[276] Article 223, *ibid* (transposed in Paragraph 9.8, Group Supervision Part of the PRA Rulebook).

[277] Article 223, *ibid* (transposed in Paragraphs 12.1 to 12.3, Group Supervision Part of the PRA Rulebook).

Availability and Transferability

Pursuant to Group Supervision 9.4, if a supervisory authority considers that own funds eligible for the SCR of a related (re)insurer are not capable of being made available to cover the SCR of the participating undertaking for which group solvency is calculated, those own funds may only be included in the group solvency calculation to the extent that they are eligible for covering the SCR of the related undertaking to which the own funds belong.[278]

Pursuant to paragraph 5A.2 of the PRA SS9/15, a group must set out its own assessment of any items that, due to any significant restriction affecting the availability, fungibility or transferability, might be deducted from own funds. Unless a formal determination is made by the PRA in respect of a particular own-fund item, a group should report own-fund items as available (notwithstanding its own assessment), except where the treatment of that own-fund item is specifically referenced under Paragraphs 9.1 to 9.6 (inclusive) of the Group Supervision Part of the PRA Rulebook and Article 330 of the Level 2 Delegated Regulation.

Paragraph 5A.4 of the PRA SS9/15 provides that the assessment of the availability of own-fund items of a third country related undertaking must, instead of being assessed under local rules, be assessed by reference to the UK group provisions, where a group uses Method 2 for the calculation of its solvency requirements.

The PRA Rulebook states that subscribed but not paid-up capital of related (re)insurers of the participating (re)insurer and surplus own funds for which the group solvency is being calculated can only be included in the group solvency calculation insofar as they are eligible for covering the SCR of the related undertaking concerned.[279] Furthermore, where subscribed but not paid-up capital of a relevant related undertaking represents a potential obligation of the participating undertaking or another relevant related undertaking, or vice versa, the amount must be excluded from the calculation entirely.[280]

Paragraph 5A.2B of the PRA SS9/15 clarifies that a group should not consider the solo SCR as restricting the availability of own-fund items or assets at group level where the relevant related (re)insurer is subject to the UK Solvency II regime. The PRA expects Solvency II groups to engage from an early stage with the PRA should there be any doubt as to the availability and transferability of group own-fund items.

Additionally, different valuation bases and quality of capital permitted for the purpose of local regulatory requirements may affect the availability of any capital that represents the difference between the contribution to the group SCR and the solo SCR, but also the availability of any surplus capital in excess of the local solo regulatory requirement.[281] The PRA expects UK Solvency II insurers to take this into account when providing it with information on which the PRA will base its judgements as to the point at which other regulators would intervene to restrict flows of capital out of their jurisdiction.

Group Supervision 9.4, itself, refers only to non-availability of own funds eligible for the SCR of related (re)insurers. Therefore, the requirements with regard to other related undertakings are unclear.

Article 330 of the Level 2 Delegated Regulation expands on Group Supervision 9.4:

- Article 330(1) provides that, in assessing whether own funds can effectively be made available to cover the group SCR, supervisory authorities must consider whether:

[278] Article 222(5), *ibid* (transposed in Paragraph 9.4, Group Supervision Part of the PRA Rulebook).

[279] Paragraph 9.2, Group Supervision Part of the PRA Rulebook.

[280] Paragraph 9.3, *ibid.*

[281] Paragraph 5A.2E of the PRA SS9/15.

  - The own-fund item is subject to a legal or regulatory requirement that restricts the ability of the item to absorb all types of losses wherever they arise in the group.
  - There are legal or regulatory requirements that restrict the transferability of assets to another (re)insurer in the group.
  - Making those own funds available for covering the group SCR would not be possible within a maximum of nine months.
  - Where Method 2 is used, the own-fund item does not satisfy the requirements set out in Articles 71, 73 and 77 of the Level 2 Delegated Regulation (features determining classification for Tier 1, Tier 2 and Tier 3 own funds), where the term SCR in those articles is to mean both the SCR of the issuer of the own funds and the group SCR.
- Article 330(2) provides that supervisory authorities should consider the Article 330(1) restrictions on an ongoing concern basis and should also take into account any likely costs to the relevant undertaking of making the own funds available for the group.
- Article 330(3) lists items that should be assumed not to be effectively available to cover the group SCR, unless the participating undertaking can demonstrate to the satisfaction of the supervisory authority that this assumption is inappropriate in the circumstances (but see Article 330(5) referred to below). These are:
  - AOF.
  - Preference shares, subordinated mutual members accounts and subordinated liabilities.
  - Net deferred tax assets (after deducting the associated deferred tax liability).
- Article 330(4) builds on the list in Article 330(3), however the following items shall not, in any case, form part of the group SCR:
  - Any minority interest in a subsidiary that is a (re)insurer, third country (re)insurer, insurance holding company or mixed financial holding company exceeding the contribution of that subsidiary to the group SCR.
  - Any minority interest in a subsidiary ancillary services undertaking.
  - Any restricted own-fund item in an RFF.

Where subordinated debt is intended to be used as group own funds, the UK Solvency II insurer will need to be able to demonstrate to the PRA that such debt should be eligible.[282] The UK Solvency II insurer will need to satisfy the PRA that these own-fund items are available to absorb losses anywhere in the group. A firm may demonstrate this through intragroup guarantees, but this is not likely to be appropriate for most groups.[283] The PRA is receptive to proposals for alternative approaches that address the legal restrictions associated with such instruments.[284]

Where an own-fund item of a related (re)insurer, third country (re)insurer, insurance holding company or mixed financial holding company cannot effectively be made available to cover the group SCR, it can be included in the calculation of group solvency but only up to the contribution of that undertaking to the group SCR.[285]

[282] Paragraph 5B.1B, *ibid.*
[283] Paragraph 5B.1C, *ibid.*
[284] Paragraph 5B.1E, *ibid.*
[285] Article 218 of the Solvency II Directive (transposed in Paragraph 4, Group Supervision Part of the PRA Rulebook).

Groups must provide to the PRA details of how own funds may be made available, for example, by paying dividends or selling the assets of an undertaking or insurance holding company to recapitalise other group companies in difficulty, which the PRA will consider when reviewing a group's assessment of transferability.[286] The PRA will expect a group to demonstrate that own funds can be made available within a maximum of nine months, otherwise it will not be able to apply group own funds treatment to those particular own-fund items.[287] It is questionable how the nine month rule can be applied in practice. Particular supervisory scrutiny/judgement is required in respect of assumptions made by insurance groups, which may be unrealistic.

PRA SS9/15 provides clarity on how firms may demonstrate that subordinated liabilities and preference shares are available to absorb losses anywhere in the UK Solvency II group. For example by demonstrating that:

- Each (re)insurer (including any (re)insurer acquired after the relevant instruments were issued) in the Solvency II group has the right to claim against the issuing entity if that (re)insurer is wound up and there is a shortfall for its policyholders and beneficiaries. Furthermore, the right of the group (re)insurers to claim on the issuing entity does not significantly increase group risks, including the level of complexity when winding up and contagion risk for issuing entities that are (re)insurers.
- The legal obligations of the issuing entity to the holders of the instruments, including coupon payments, are subordinated to any claims made by group (re)insurers that are being wound up.[288]

Pursuant to paragraph 5B.1D, the PRA considers, however, that intragroup guarantees used for this purpose increase certain risks in the group, particularly where:

- The issuing entity is a (re)insurer.
- There are multiple (re)insurers in the group.
- The issuing entity is a subsidiary of an entity that either has related (re)insurers or is a (re)insurer.
- There are significant intragroup transactions (both in terms of volume and value).[289]

The PRA expects that it will not be appropriate to use intragroup guarantees to ensure that subordinated liabilities and preference shares are available for these purposes for most groups. Correspondingly, the PRA is receptive to other approaches that UK Solvency II insurers may wish to propose when seeking to demonstrate availability of subordinated liabilities and preference shares, but these must address the legal restrictions derived from such instruments. The PRA will assess such proposals on a case-by-case basis. These complexities are a material driver for large groups to consolidate their carriers, insofar as reasonably possible.[290]

Classification of Group Own Funds

The Level 2 Delegated Regulation sets out rules for how the own funds of group companies should be classified in respect of the group solvency calculations, and these rules apply to both the Method 1 and Method 2 calculations.

[286] Paragraph 5A.3 of the PRA SS9/15.

[287] *Ibid.*

[288] Paragraph 5B.1B, *ibid.*

[289] Paragraph 5B.1D, *ibid.*

[290] Paragraph 5B.1E, *ibid.*

Own Funds of Related (Re)insurers at Group Level

Own funds of (re)insurers in the group will be classified at group level in the same tier as they are classified at solo level provided that:

- The items must be free from encumbrances and not connected with other transactions that would undermine their satisfaction of the relevant criteria at group level.
- In order to qualify as group own funds, the item must meet the requirements of Article 71, 73 or 77 of the Level 2 Delegated Regulation (as applicable) both on a solo and a group basis. This means that references to SCR and MCR should be read also to mean the group SCR and the minimum group MCR, and references to the (re)insurer shall be read to mean the participating (re)insurer. Therefore, for example, to qualify as Tier 2 own funds at group level a Tier 2 subordinated debt instrument issued by a related (re)insurer will need to provide for deferral of distributions both on breach of the issuing undertaking's SCR and on a breach of the group SCR.
- Own-fund items included in Tier 2 at solo level by of Article 73(1)(j) of the Level 2 Delegated Regulation — *i.e.*, those that which meet the Tier 1 requirements but exceed the limits on subordinated mutual member accounts, preference shares, subordinated liabilities and grandfathered items set out in Article 82(3) of the Level 2 Delegated Regulation — can be included in Tier 1 at group level if the limits set out in Article 82(3) would be met at group level.[291]

Group Level Own Funds of Related Third Countries

Own funds of related third country (re)insurers should be classified using the criteria set out in Articles 69 to 79 of the Level 2 Delegated Regulation with the following additional requirements:

- The items must be free from encumbrances and not connected with other transactions that would undermine their satisfaction of the relevant criteria at group level.
- For the purposes of assessing compliance with Article 71, 73 or 77 of the Level 2 Delegated Regulation: (i) SCR shall mean the group SCR; and (ii) MCR shall mean both the capital requirement of the issuing undertaking as laid down by the relevant third country supervisory authority and the minimum group MCR.[292]

Own Funds of Insurance Holding Companies, Mixed Financial Holding Companies and Ancillary Insurance Services Undertakings at Group Level

Own funds of insurance holding companies, intermediate insurance holding companies, mixed financial holding companies, intermediate mixed financial holding companies and subsidiary ancillary insurance services undertakings are classified using the criteria set out in Articles 69 to 79) of the Level 2 Delegated Regulation with the following additional requirements:

- The items must be free from encumbrances and not connected with other transactions that would undermine their satisfaction of the relevant criteria at group level.
- For the purposes of assessing compliance with Article 71, 73 or 77 of the Level 2 Delegated Regulation: (i) SCR shall mean the group SCR; and (ii) MCR shall mean both the minimum group MCR, and the insolvency of the insurance holding company, intermediate insurance holding company, mixed financial holding company, intermediate mixed financial holding company or subsidiary ancillary insurance services undertaking.

[291] Article 331(1) of the Level 2 Delegated Regulation.

[292] Article 332, *ibid.*

- References to the (re)insurer shall be read to mean the insurance holding company, intermediate insurance holding company, mixed financial holding company, intermediate mixed financial holding company or subsidiary ancillary insurance services undertaking which has issued the own-fund item.

Own Funds of 'Residual Related Undertakings' at Group Level

Own funds of other related undertakings will be considered as part of the reconciliation reserve at group level.[293] The own-fund items should be classified into tiers based on the criteria set out in Section 2 of the Level 2 Delegated Regulation where practicable and where the own-fund items are material.[294]

Subordination to Group Policyholders

Recital 127 of the Level 2 Delegated Regulation states that:

"In order to ensure that the policyholders and beneficiaries of insurance and reinsurance undertakings belonging to a group are adequately protected in the case of the winding-up of any undertakings included in the scope of group supervision, own-fund items which are issued by insurance holding companies and mixed financial holding companies in the group should not be considered to be free from encumbrances unless the claims relating to those own-fund items rank after the claims of all policyholders and beneficiaries of the insurance and reinsurance undertakings belonging to the group."

Paragraph 6.5 of the PRA SS3/15 states that the PRA expects that the terms of instruments issued by insurance holding companies or mixed financial holding companies should include terms providing that, in the case of winding up proceedings of any firm in the group until all obligations by that member of the group to its policyholders and beneficiaries have been met, repayment of amounts due under the instrument are refused. In the absence of such provision, the instrument will not qualify as group own funds. The PRA subsequently confirmed in discussions with firms that:

- The deferral applies only to redemption and not payment of interest.
- The requirement does not extend to the winding up of the issuing insurance holding company or mixed financial holding company itself.

7. Group Internal Models

An application can be made to use an IM to calculate either only the group SCR or both the group SCR and the individual SCR of (re)insurers within the group.[295]

Articles 343 to 350 of the Level 2 Delegated Regulation set out details of the application requirements and approval procedures.

[293] Article 334(1), *ibid.*

[294] Article 334(2), *ibid.*

[295] Article 231 of the Solvency II Directive (transposed in Paragraph 11.4, Group Supervision Part of the PRA Rulebook).

Chapter 5

The Matching Adjustment

Introduction

"Where insurance and reinsurance undertakings hold bonds or other assets with similar cash flow characteristics to maturity, they are not exposed to the risk of changing spreads on those assets. In order to avoid changes of asset spreads from impacting on the amount of own funds of those undertakings, they should be allowed to adjust the relevant risk-free interest rate term structure for the calculation of the best estimate in line with the spread movements of their assets."[296]

The MA is a significant item of life insurance capital management in the UK, which can trace its origins back to historic concessions made by HM Treasury to the UK life and savings market. Although not included in the original Solvency II Directive when agreed upon in 2009, it was subsequently added to its scope in 2014 as a result of the efforts of UK negotiators, in turn representing sustained pressure from the very large UK life and savings market — the chief beneficiary of the MA regime.

Although a technical area, the capital benefits of the MA are very significant. In April 2018, the PRA reported that the MA was worth £66 billion to the UK insurance industry, a figure that is expected to be materially bigger today given the subsequent significant expansion of the life market, particularly through bulk purchase annuity transactions.

Following Brexit, the UK's reform efforts in this area have continued apace, resulting in an additional round of reforms designed to further streamline and update the MA. The PRA has explored avenues for creative application of the MA, both in terms of eligibility of underlying insurance liabilities and assets that may be included in an MA portfolio, while balancing these ambitions against the need for an appropriate degree of overall prudence in the sector. This innovative spirit, which has facilitated the use of MA assets ranging from gilts to equity release mortgage (ERM) portfolios, and beyond, has recently come to encompass more asset and liability classes through the PRA's latest set of MA reforms, which became effective in June 2024 (see Section 10 below).

For its part, the EU has also looked again at the MA as part of its 2020 review of the Solvency II Directive (2020 Review), but limited to narrow issues, such as the removal of the limitations to the diversification benefits between MA portfolios and other portfolios in the calculation of the SCR.[297] The Amendments (discussed in previous chapters) do not seek to overhaul the MA, with most proposed changes being tangential, arising from changes in related areas.

This chapter touches on the Solvency II foundations of the MA, but primarily focuses on the UK's implementation of the same, including in the current round of reforms.

1. What Is the Matching Adjustment?

Long-term insurance products that may not generally be lapsed, such as annuities, are typically backed by (re)insurers with long-term assets that match the cash flows closely (such as long-dated bonds) and are expected to be held to maturity.

[296] "Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014", amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No 1060/2009, (EU) No 1094/2010 and (EU) No 1095/2010.

[297] The EIOPA, Consultation Paper on the Opinion on the 2020 Review of Solvency II (EIOPA-BoS-19/465).

In this context, where a (re)insurer holds, *e.g.*, a bond to maturity, it is exposed only to the default of the issuer in paying the coupon and/or redeeming the principal amount. In other words, the (re)insurer can effectively disregard changes to market value (other than those that reflect default risk) between acquisition and maturity of the asset. This is sometimes referred to as an "illiquidity premium". The MA is the mechanism that delivers the capital benefit of this illiquidity premium to (re)insurers.

The detail of this mechanism is highly technical in nature and revolves around how life (re)insurers calculate their insurance liabilities, otherwise known as technical provisions (which is the subject of Chapter 7: Technical Provisions). In short, a (re)insurer is required to hold assets equal to the present value of future net cash flows under the relevant policies. This involves applying a discount rate to those cash flows to account for the time value of money. The MA is an adjustment to that discount rate, allowing the (re)insurer to use a discount rate closer to the credit-adjusted market rate of return for the relevant liabilities instead of the risk-free interest rate (RFR) prescribed by Solvency II (see Section 5 below). This higher discount rate lowers the present value of liabilities and, consequently, lowers the technical provisions of the (re)insurer. In other words, the illiquidity premium is delivered by means of a synthetic reduction in a (re)insurer's capital requirements.[298]

2. The Matching Adjustment Regulatory Framework in the UK

Despite Brexit, the Solvency II regime, relating to the MA still remains relevant in the UK. The Solvency II regime was transposed into UK law in the Solvency 2 Regulations 2015. In addition, parts of the PRA Rulebook (including, the Technical Provisions, Conditions Governing Business and Reporting Parts of the PRA Rulebook) as well as each PRA SS below (as amended), are key to the application of the MA in the UK as follows:

- **Solvency II: Matching Adjustment (PRA SS7/18):**[299] The scope of this PRA SS includes the assessment of eligibility for assets and liabilities, demonstrating compliance with the matching conditions, calculation of the MA benefit, ongoing management and compliance of MA portfolios, applications for MA approval and subsequent changes to an MA portfolio, and the implication of changes to an MA portfolio that are outside the scope of an existing MA approval.
- **Solvency II: Internal Models — Modelling of the Matching Adjustment (PRA SS8/18)**:[300] This PRA SS sets out the PRA's expectations of (re)insurers regarding the application of the MA within the calculation of the SCR.
- **Solvency II: Illiquid Unrated Assets (PRA SS3/17)**:[301] This PRA SS sets out the PRA's expectations in respect of (re)insurers investing in illiquid, unrated assets within their MA portfolios and is relevant to life insurance and reinsurance undertakings holding or intending to hold unrated assets.

Additionally, many of the PRA's proposed reforms became effective on 30 June 2024, following PRA PS10/24, which published the PRA's final policy on the MA (for the time being). These reforms are discussed in Section 10 below.

[298] PRA CP19/23 (as amended by the PRA PS10/24).

[299] PRA SS7/18 (as amended by the PRA PS10/24).

[300] PRA SS8/18 (as amended by the PRA PS10/24).

[301] PRA SS3/17 (as amended by the PRA PS10/24).

3. Matching Adjustment-Eligible Liabilities

Solvency II

Only certain liabilities are eligible for MA treatment:[302]

- They must be life (re)insurance obligations, including annuities.
- The portfolio of (re)insurance obligations to which the MA is applied must be identified, organised and managed separately from the other obligations of the undertaking.
- The contracts underlying the (re)insurance obligations must not give rise to future premium payments.
- The only underwriting risks connected to the portfolio of (re)insurance obligations are longevity risk, expense risk, revision risk and mortality risk.
- The contracts underlying the portfolio of (re)insurance obligations include no surrender options for the policyholder or only a surrender option where the surrender value does not exceed the value of the assets, valued in accordance with Article 75 of the Solvency II Directive (transposed in the Valuation Part of the PRA Rulebook), covering the (re)insurance obligations at the time the surrender option is exercised.
- The (re)insurance obligations of a (re)insurance contract must not be split into different parts when composing the portfolio of (re)insurance obligations.

PRA Approach

In PRA SS7/18, the PRA set out its expectations in relation to the liability eligibility conditions in Article 77b of the Solvency II Directive and takes a view in respect of the following (amongst other things):[303]

Must not give rise to future premium payments

- **Deferred Premiums.** The PRA takes the view that insurance contracts that include an option for the premium to be paid as an initial sum followed by a series of further instalments are unlikely to satisfy the condition in Article 77b(1)(d).
- **Premium Adjustment Clauses.** The PRA takes the view that insurance contracts that include a premium adjustment clause that permits the initial premium to be adjusted post-contract inception are likely to satisfy the condition in Article 77b(1)(d) provided that the adjustment is made only to correct for an overpayment or underpayment of a defined premium and does not have the effect of varying the contract.

No policyholder options or only a surrender option

- **Surrender Options.** The PRA takes the view that, in the case of deferred annuity contracts that are subject to a right of surrender before the start of the annuity payments, the absence of a contract-level surrender basis does not necessarily disqualify the obligations for the purposes of Article 77b(1)(g).

See also the PRA reforms for extension of eligible liabilities summarised in Section 10 below.

[302] Article 77b of the Solvency II Directive (transposed in Paragraphs 6.1 to 6.4, Technical Provisions Part of the PRA Rulebook).

[303] PRA SS7/18 (as amended by the PRA PS10/24).

4. Matching Adjustment-Eligible Assets

Solvency II

The MA asset eligibility criteria are as follows:[304]

- The portfolio of assets assigned by the (re)insurer to cover the best estimate of the portfolio of (re)insurance obligations must consist of bonds and other assets with similar cash-flow characteristics over the lifetime of the obligations (except where the cash flows have materially changed).
- The assigned portfolio of assets must be identified, organised and managed separately from other assets of the undertaking.
- The expected cash flows of the assigned portfolio of assets must replicate each of the expected cash flows of the portfolio of (re)insurance obligations in the same currency and any mismatch must not give rise to risks that are material in relation to the risks inherent in the (re)insurance business to which the MA is applied.
- The cash flows of the assigned portfolio of assets must be fixed and cannot be changed by the issuers of the assets or any third parties, save that:
  - Inflation-linked assets are permitted provided that the assets replicate the cash flows of (re)insurance obligations which depend on inflation.
  - A right of the issuer or a third party to change the cash flows of an asset is permitted provided that the (re)insurer will receive sufficient compensation to allow it to obtain the same cash flows by reinvesting in assets of an equivalent or better credit quality.

PRA Approach

In PRA SS7/18, the PRA sets its expectations in relation to the asset eligibility conditions in Article 77b and takes a view in respect of the following (amongst other things):[305]

- **Bonds or Other Assets With Similar Cash Flow Characteristics:** The PRA takes the view that assets can be grouped into an MA asset portfolio, which in aggregate satisfies the requirement for "bonds or other assets with similar cash flow characteristics". In this case, the PRA expects the relevant (re)insurer to indicate clearly where groups of assets need to be considered in aggregate to demonstrate these qualities.
- **Same Currency:** The PRA takes the view that, even if an individual asset in an MA asset portfolio is denominated in a currency different to the currency of the expected liability cash flows, this does not necessarily mean that such asset would fall short of satisfying the relevant condition in Article 77b(1)(c), provided that the MA asset portfolio in aggregate replicates the expected liability cash flows in the relevant currency. This includes, for instance, where a foreign currency bond with an appropriate currency swap is used in combination to generate a cash flow in the relevant currency.
- **Mixed Cash Flows:** The PRA takes the view that (re)insurers may potentially take into account an asset with both fixed and non-fixed cash flows (provided that the bond also meets the rest of the MA asset eligibility criteria). For instance, (reinsurers) may be able to demonstrate that the cash flows from callable bonds up to the first call date are fixed.

[304] Article 77b of the Solvency II Directive (transposed in Paragraphs 6.1 to 6.4, Technical Provisions Part of the PRA Rulebook).

[305] PRA SS7/18 (as amended by the PRA PS10/24).

- **Redemption or Termination Rights:** The PRA takes the view that certain categories of redemption or termination rights are less likely to undermine "the need for predictability of cash flows", further noting that, this would apply in particular where (i) issuer or third-party rights of early redemption or termination are solely triggered by events that are outside the control of the issuer, (ii) they cannot be avoided by such issuer or third party and (iii) where such events would arguably change the nature or substance of the underlying contract. This includes instances where:
  - The issuer of a corporate bond has a right of early redemption in the event of a tax change that results in the issuer having to pay additional amounts under the bond contract.
  - The issuer of an index-linked bond has a right of early redemption in the event the relevant index is no longer available.
- **Sufficient Compensation:** With regard to the fixed cash-flow requirement, the PRA takes the view that (re)insurers may be able to satisfy the "sufficient compensation" requirement spelled out above on the basis of an adequate contractual compensation clause, provided that the relevant (re)insurance cash flows would continue to be matched out of the assets acquired with the compensation payable.
- **Reinsurance Assets:** The PRA takes the view that reinsurance assets (and any other assets whose cash flows vary with the underlying underwriting risks) may be MA-eligible provided (re)insurers can demonstrate that:
  - Any variation in timing, duration or quantum of cash flows from the reinsurance asset is solely attributable to and reflects the variation in the timing, duration or quantum of cash flows of the underlying (re)insurance obligations that are covered by the reinsurance asset.
  - The cash flows of the reinsurance asset replicate the cash flows of the underlying (re)insurance obligations covered without giving rise to material mismatch risk.
  - The (re)insurance obligations that are covered under the reinsurance asset satisfy the MA liability eligibility conditions.
  - The reinsurance asset satisfies all MA asset eligibility conditions (other than the condition in Article 77b(1)(h)), including that it is structured in such a way that it produces bond-like cash flows.
  - The inclusion of the reinsurance asset in an MA portfolio is consistent with the assumptions underlying the MA, including the assumption that insurance and reinsurance undertakings will hold the matching assets to maturity.
- **Asset Restructuring:** The PRA recognises that (re)insurers may undertake certain risk transformation transactions in order to produce a portfolio of MA-eligible assets, noting that (re)insurers that engage in such restructuring should discuss their plans with their supervisor at the earliest opportunity and should also be considering contingency options in case it is not possible to transform the asset cash flows in a way that meets the MA asset eligibility criteria. Accordingly, UK market participants have restructured a diverse range of income streams into the MA-grade assets often by means of quasi-securitisation-like structures. In this way, revenues from ERM portfolios (for example) with maturities similar to/matching the obligations to the insureds have been restructured by means of securitisation to meet the "fixed cash flow" requirement.

See also the PRA's reforms in relation to highly predictable and sub-investment grade (SIG) assets summarised in Section 10 below.

5. Calculation of the Matching Adjustment

General

Solvency II

The MA is calculated for each currency in accordance with the following principles:[306]

- The MA must be equal to the difference of:
  - The discount rate that, where applied to the cash flows of the portfolio of (re)insurance obligations, results in a value that is equal to the market value[307] of the portfolio of assigned assets.
  - The discount rate that, where applied to the cash flows of the portfolio of insurance and reinsurance obligations, results in a value that is equal to the value of the best estimate of the portfolio of (re)insurance obligations where the time value of money is taken into account using the basic RFR term structure (*i.e.*, the relevant RFR term structure without (i) an MA, (ii) a volatility adjustment (VA) or (iii) an RFR transitional measure).[308]
- The MA must not include the fundamental spread (FS) — discussed below — reflecting the risks retained by the (re)insurer.
- The FS must be increased to ensure that the MA for assets with SIG quality does not exceed the MA for assets of investment grade (IG) quality and the same duration and asset class.
- The use of external credit assessments in the calculation of the MA must be in accordance with Article 111(1)(n) of the Solvency II Directive.

In addition, the Level 2 Delegated Regulation provides that for the purpose of the calculation of the MA:[309]

- Insurance and reinsurance undertakings must only consider assets whose expected cash flows are required to replicate the cash flows of the (re)insurance obligations.
- The expected cash flows of the relevant assigned assets should be adjusted to allow for the probability of default element of the FS.
- The deduction of the FS in accordance with Article 77c(1)(b) of the Solvency II Directive must only include the portion of the FS not already reflected in the adjustment to the cash flows of the assigned portfolio of assets referred above.

Risk-Free Interest Rate

Solvency II

A (re)insurer must, in setting technical provisions under Article 77(1) of the Solvency II Directive, calculate its best estimate of the probability-weighted average of future cash flows, taking account of the time value of money (expected present value of future cash flows), using the relevant RFR.[310] This is calculated as follows:

[306] Article 77c(1) of the Solvency II Directive.

[307] Article 75, *ibid* (transposed in Paragraphs 2.1 and 2.2, Valuation Part of the PRA Rulebook).

[308] Article 1(36) of the Level 2 Delegated Regulation.

[309] Article 53, *ibid*.

[310] Article 77(2) of the Solvency II Directive (transposed in Paragraph 3.1, Technical Provisions Part of the PRA Rulebook).

- The EIOPA is required to publish for each relevant currency on a quarterly basis a relevant RFR term structure for these purposes.[311]
- The EIOPA is to derive the basic RFR for each currency and maturity on the basis of interest swap rates for interest rates of that currency, adjusted to take account of credit risk.[312]
- For maturities where interest swap rates are not available from "deep, liquid and transparent"[313] financial markets, the EIOPA must derive the basic RFR, for each currency, on the basis of the rates of government bonds issued in that currency, adjusted to take account of the credit risk of the government bonds, provided that such government bond rates are available from "deep, liquid and transparent" financial markets.

PRA Approach

In the UK, the PRA is similarly responsible for calculating and publishing the relevant RFR term structure.[314]

Fundamental Spread

The FS captures the credit spread corresponding to (i) the probability of default and (ii) the expected loss resulting from the downgrading of MA assets, and operates to restrict the scope of the MA.

Solvency II

The EIOPA is responsible for publishing each relevant duration, credit quality and asset class of an FS for the calculation of the MA. In addition, the Level 2 Delegated Regulation provides that for the purpose of the calculation of the FS:[315]

- The FS must be calculated in a "transparent, prudent, reliable and objective" manner that is consistent over time, based on relevant indices where available.
- The calculation of the credit spread referred to in Article 77c(2)(a)(i) of the Solvency II Directive shall be based on the assumption that in case of default 30% of the market value can be recovered.
- The long-term average referred to in Article 77c(2)(b) and (c) of the Solvency II Directive must be based on data relating to the last 30 years, and where such data is not available, constructed data based on prudent assumptions.
- The expected loss referred to in Article 77c(2)(a)(ii) of the Solvency II Directive must correspond to the probability-weighted loss the (re)insurer incurs where the asset is downgraded to a lower credit quality step and is replaced immediately afterward (assuming that the replacing asset (i) has the same cash flow patterns as the replaced asset before downgrade, (ii) belongs to the same asset class as the replaced asset and (iii) has the same credit quality step as the replaced asset before downgrade or a higher one).

[311] Article 77e(1)(a), *ibid.*
[312] Article 44(1) of the Level 2 Delegated Regulation.
[313] Article 44(1), *ibid.*
[314] Regulation 3 of the Insurance and Reinsurance Undertakings (Prudential Requirement) Regulations 2023.
[315] Article 54(1) of the Level 2 Delegated Regulation.

PRA Approach

The PRA is responsible for calculating and publishing the FS in the UK.[316] The FS must be:[317]

- Equal to the sum of:
  - The credit spread corresponding to the probability of default of the assets.
  - The credit spread corresponding to the expected loss resulting from downgrading of the assets.
- For exposures to the UK's central government and central bank, no lower than 30% of the long-term average of the spread over the RFR of assets of the same duration, credit quality and asset class, as observed in financial markets.
- For assets other than exposures to the UK's central government and central bank, no lower than 35% of the long-term average of the spread over the RFR of assets of the same duration, credit quality and asset class, as observed in financial markets.

The probability of default referred to above shall be based on long-term default statistics that are relevant for the asset in relation to its duration, credit quality and asset class.

Where no reliable credit spread can be derived from the default statistics, the FS shall be equal to the portion of the long-term average of the spread over the RFR.

The PRA has recently reformed the FS in the UK as part of its Solvency UK project, to make the FS more sensitive and tailored so that it better measures credit risk (see Section 10 below).

6. Management of a Matching Adjustment Portfolio

Solvency II

The portfolio of (re)insurance obligations to which the MA is applied and the assigned portfolio of assets must be "identified, organised and managed" separately from other activities of the undertakings, and the assigned portfolio of assets cannot be used to cover losses arising from other activities of the undertakings.[318]

A portfolio of assets must be assigned to cover the relevant liabilities with such assignment being maintained over the lifetime of the obligations, except for the purpose of maintaining the replication of expected cash flows where the cash flows have materially changed.[319]

PRA Approach

In PRA SS7/18, the PRA sets its expectations in relation to the management of an MA portfolio as follows (amongst other things):

[316] Regulation 3 of the Insurance and Reinsurance Undertakings (Prudential Requirement) Regulations 2023.

[317] Article 77c(2) of the Solvency II Directive.

[318] Article 77b(1)(b), *ibid.*

[319] Article 77b(1)(a), *ibid.*

Identified, organised and managed separately

- All (re)insurers must demonstrate that separate processes have been put in place relating to accounting systems, investment policy and mandates, processes and controls (including controls to ensure that assets within the portfolio will not be used to cover losses arising elsewhere), governance and management information.
- The notional splitting of assets (*e.g.*, individual derivative contracts) between MA and non-MA portfolios, as well as the management of derivatives forming part of an MA portfolio at a level higher than the level of that MA portfolio is unlikely to be consistent with Article 77b(1)(b) of the Solvency II Directive.

Maintained over the lifetime of the obligations except for replication purposes

- The investment policy for the assets in an MA portfolio must principally be based on a buy-to-hold strategy, and any asset rebalancing in an MA portfolio is for the purposes of good risk management (*e.g.*, changes in expectations of future asset cash flows).
- (Re)insurers must (i) in their applications for MA treatment explain the process by which they will maintain an MA portfolio on an ongoing basis, and (ii) have a robust governance process around any extraction of surplus.

Ongoing MA compliance and changes to the MA portfolio

- (Re)insurers must have robust processes in place to ensure that their existing approved MA portfolios satisfy the MA criteria on an ongoing basis. The PRA provides the following examples where (re)insurers must consider whether a new MA application is required, noting that in the first instance this should be a judgement made by the (re)insurer itself:
  - Restructuring, mergers or disposals.
  - The entry into new, or changes to existing, reinsurance and other risk transfer arrangements.
  - Changes to the way a (re)reinsurer maintains and manages its MA portfolio.
  - Changes to the scope of an MA portfolio, including the addition or removal of MA assets or liabilities and changes to the features of any MA asset or liability covered by the original application.

7. Noncompliance With the Matching Adjustment Criteria

Solvency II

Where a (re)insurer:[320]

- That applies the MA is no longer able to comply with the MA criteria, it must "immediately" (i) inform the regulator and (ii) take any necessary measures to restore compliance with the MA criteria as soon as possible.
- Is not able to restore compliance with the MA criteria within two months of the date of noncompliance:
  - It must cease to apply the MA and must not apply the MA for a period of a further 24 months.
  - The regulator must revoke the MA approval granted to that (re)insurer.

[320] Article 77b(2), *ibid.*

PRA Approach

In PRA SS7/18,[321] the PRA sets its expectations in relation to a possible breach of the MA criteria and takes a view in respect of the following:

- (Re)insurers must have appropriate processes in place to identify and investigate any potential breaches of the MA criteria "on a timely basis" and engage with the PRA as soon as possible where there is a risk that the MA criteria will be breached.
- In cases where a breach is reasonably only determined after the date it has occurred (whether identified by the (re)insurer or notified to the (re)insurer by the PRA), the two-month period to restore compliance starts from the point at which the breach is detected or confirmed to have happened.

Please also see Section 10 below.

8. Internal Models — Modelling of the Matching Adjustment

PRA Approach

In PRA SS8/18, the PRA set out its expectations of (re)insurers using full or partial IMs regarding the application of the MA within the calculation of the SCR. The PRA's starting point in this analysis is that a (re)insurer's SCR must capture all material and quantifiable risks to which that (re)insurer is exposed and, therefore, the calculation of the SCR must allow for any changes to the FS (and therefore the MA) following a stress event. The PRA further notes that (re)insurers must:

- Determine the risks to which their MA portfolio is exposed and how these risks could affect the FS (and therefore the MA).
- Assess how this impact is captured within their SCR calculation.
- Ensure that their modelling approach results in an SCR that covers risks that have been retained within their MA portfolio at the 99.5% confidence level.

To assist (re)insurers in exhibiting and validating that their modelling approach covers all material and quantifiable risks to which their MA portfolio is exposed, the PRA has developed a framework that sets out how the MA could be considered in the context of the SCR calculation, noting that it would be "good practice" for (re)insurers to reconcile their approach with the steps in the framework in their IM documentation. The following five steps comprise the PRA's relevant framework:

- **Step 1:** Revalue the MA portfolio assets under a one-year stress.
- **Step 2:** Calculate updated FS values, reflecting the stress-modelled economic environment.
- **Step 3:** Verify whether the MA criteria are still met (allowing also for any changes in liability cash flows/values).
- **Step 4:** If Step 3 has failed then the cost of reestablishing an MA-compliant positing must be estimated.
- **Step 5:** Recalculate the MA (this may need to be based on a rebalanced MA asset portfolio).

In addition to the above, PRA SS8/18 also contains the PRA's more detailed expectations as to how the MA should be reflected within the SCR calculation grouped under the following three sub-headings:

[321] PRA SS8/18 (as amended by the PRA PS10/24).

- Impact of a one-year stress on the MA.
- Maintaining compliance with the MA requirements in stress conditions.
- Validation of the amount of MA assumed in the SCR calculation.

9. Illiquid Unrated Assets

PRA Approach

In PRA SS3/17 the PRA set out its expectations in respect of illiquid, unrated assets (including restructured ERMs) within (re)insurers' MA portfolios. The PRA's starting point in this analysis is that (re)insurers applying for MA treatment are required as part of their MA applications to explain how they will categorise the assets in their MA portfolios in terms of credit quality step, asset class and duration for the purpose of determining the FS (and therefore the size of the MA claimed), appreciating that (re)insurers' judgements in respect of such grouping of assets will be more important, given the degree of discretion involved, for internally rated assets (*i.e.*, assets without credit ratings assigned to them by external credit assessment institutions) as opposed to externally rated assets (*i.e*., assets with credit ratings assigned to them by external credit assessment institutions).

Internal credit assessments used as part of determining the FS

The PRA provides an indicative list of areas to be implemented and documented by (re)insurers to evidence the robustness of their internal credit assessment processes[322]:

- **Risk Identification:** Identifying the risks affecting an asset and assessing how the (re)insurer has satisfied itself that it has considered all potential sources of risk (both systemic and idiosyncratic) in its internal credit assessment must at a minimum include consideration of the following factors:
  - External market factors.
  - Cash-flow predictability.
  - Collateral.
  - Loan characteristics (*e.g.*, refinancing risk).
  - Legal, political and regulatory risks.
  - Potential future risks (*e.g.*, impacts arising from climate change risks).
- **Internal Credit Assessment Methodology Criteria:** The (re)insurer's internal credit assessment methodology and criteria must:
  - Set out the overall credit assessment philosophy and the ratings process.
  - Set out the scope of types of loans or entities the methodology applies to.
  - Set out the scope of risks covered and define the credit and other relevant risks being measured.
  - Where an external credit assessment institution has a published credit rating methodology for an asset class, have in scope at least the same range of risks, qualitative and quantitative factors and risk mitigating considerations or justify any difference in the scope.
  - Describe how different loan features, risks and other relevant factors are assessed.

[322] PRA SS3/17.

- Set out the key assumptions and judgements underlying the assessment, including the treatment of assumed risk mitigating actions which rely on the (re)insurer's own or outsourced processes involved in managing assets through their life cycles.
- Define whether the credit assessment is calibrated to a point in time or through the cycle.
- Use both qualitative and quantitative factors.
- Explain the limitations of the internal credit assessment (*e.g.*, risks that are not covered) and when it would not be appropriate to allow for these limitations by overriding judgements.

- **Data:** (Re)insurers must consider the availability, appropriateness and quality of data over the credit cycle on which their internal risk assessments and calibrations are based, as well as document how they allowed for any incomplete or missing data in their internal credit assessments.
- **Expert Judgements:** Expert judgements made in the determination of the internal credit assessment and credit quality step mappings must be transparent, justified and well documented.
- **Expertise and Potential Conflicts of Interest:** The credit rating methodology and criteria development and approval, credit assessment and credit quality step mappings must be performed by individuals (whether internal or external to the (re)insurer) with relevant asset-specific credit risk expertise and competency who are independent and with minimised conflicts of interest.
- **Validation:** (Re)insurers must undertake validation of the internal credit assessment methodology and criteria (including how they have identified and allowed for all sources of credit risk).
- **Ongoing Appropriateness:** (Re)insurers must have a robust process for the ongoing review of the credit assessments and credit quality step mappings (including how they have satisfied themselves that these will remain appropriate over the lifetime of the assets and operate robustly under a range of different market conditions and operating experience).
- **Process Improvements:** (Re)insurers must identify potential refinements needed to their methodology by monitoring their own credit experience against the internal credit assessments and changes made by external credit assessment institutions.

Internal credit assessment processes for restructured assets (including ERMs)

In addition to the above, the PRA sets its expectations in respect of internal credit assessment processes for restructured assets (including ERMs), noting the following (amongst other things):

- Internal credit assessments for restructured assets must be anchored on a risk analysis of the legal documentation among all parties concerned (*e.g.*, in the case of restructured ERMs, this must include a risk analysis of the original loan agreement between the borrower and the lender, the contract between the originator and the insurance (re)insurers and the legal structure of the notes issued by the SPV as applicable).
- In respect of ERMs, (re)insurers must explicitly consider the following quantitative features:
  - Underwriting terms of the underlying ERMs (*e.g.*, prepayment terms, interest rate at which the loan will accrue, conditions attaching to the borrowers and conditions attaching to the property).
  - Exposures (*e.g.*, loan-to-value ratios, ages of borrowers and health of borrowers).
  - Strength of security (*e.g.*, location, state and concentration of the properties used as collateral and rights of the SPV to substitute underlying ERMs).

- Leverage, including a full analysis of the cash flow waterfall between the loan receivables and the cash flows paid to the senior noteholder.
- Stress and scenario testing of the amount and timing of receivables, for instance as a result of (i) changes in the value of the properties that collateralise the ERMs, both in the immediate and longer term, including allowance for additional costs (*e.g.*, dilapidation costs and transaction costs relating to sales), (ii) demographic risks relating to the borrowers under the ERMs (*e.g.*, longevity trend and volatility, and morbidity) and (iii) prepayment risk.

- Where a (re)insurer has restructured an asset into a range of tranches, the spread on a given tranche must be commensurate with the level of risk to which that tranche is exposed.
- (Re)insurers must carefully justify any reliance on credit-enhancing or liquidity-enhancing features, taking into account the availability of these facilities over the expected lifetime of the SPV.

10. PRA Reforms to the Matching Adjustment

On 27 September 2023, the PRA issued its first substantive consultation, PRA CP19/23, on the detail of its proposed changes to the MA. The wide-ranging proposals contain therein marked a substantial relaxation of the Solvency II Directive's requirements around which (fixed) assets are eligible for inclusion in an MA portfolio, and the (narrow) scope of liabilities that they can be held against. Such proposals were tempered, however, by increased governance on the part of (re)insurers, including principles-based judgements, as well as a hard attestation from the (re)insurer's chief financial officer (or other senior officer) that they have a "high degree of confidence" that the MA assets will deliver the intended result.

The consultation closed on 5 January 2024. Subsequently, on 6 June 2024, the PRA published PRA PS10/24, in which it affirmed or amended many of the most consequential proposals laid out in PRA CP19/23 and in the aforementioned PRA SSs. As of 30 June 2024, these final policies are effective and can be leveraged by (re)insurers using the MA, whilst all other changes related to the Solvency II review will take effect on 31 December 2024. The key new elements of the regime are summarised below.

Matching Adjustment Asset Eligibility for Assets That Are Highly Predictable

The new framework moves away from a requirement for the MA to be applied only to fixed income assets to allow for the limited inclusion within an MA portfolio of assets with HP cash flows (*i.e.*, with cash flows that are capable of being changed by the issuers of the assets or third parties) provided such assets do not represent more than 10% of the total MA benefit claimed by the relevant (re)insurer. Such HP assets must:

- Be contractually bound as to timing and amount of cash flows (with failure to pay constituting a default event).
- Be "bonds or other assets with similar cash flow characteristics".
- Have a credit quality capable of assessment through a credit rating or internal credit assessment of comparable standard.

Where the relevant contracts do not specify an upper limit on the cash-flow amounts (*e.g.*, leases with "upward only rent increases"), the PRA considers that the upper bounding of cash-flow amounts may be determined through appropriate assumptions for the rate of any future escalation.

The PRA recognises that it will not always be clear whether an asset should be classified as having fixed or HP cash flows. In these cases, (re)insurers are prohibited from "decomposing" any asset within the MA portfolio into distinct fixed and HP cash flow components. Instead, as a whole the PRA provides that it may be reasonable for (re)insurers to change the classification of their assets, as a whole, from having fixed cash flows to having HP cash flows and vice versa where:

- The (re)insurer has permission from the PRA to apply the new treatment for the given assets and manages the assets in accordance with that permission (including applying an FS addition where moving an asset from fixed cash flows to HP cash flows and considering attestation implications of the move).
- Movements from one classification to the other are subject to the (re)insurer's policies on managing the MA portfolio such that they are subject to an appropriate level of governance and oversight by the (re)insurer.
- The (re)insurer justifies any frequent movements in classification.
- The (re)insurer carefully considers the operational implications of effecting different movements in classifications to distinct holdings of the same asset, before effecting such movements.

The PRA will continue to permit certain non-fixed cash-flows to be treated as "fixed" (rather than HP), and hence will continue to allow changes related to inflation indices and changes to cash flows for which suitable compensation is paid (*i.e.*, leaving available the 10% allowance for HP assets). The PRA does, however, foresee that assets that were restructured to meet current MA requirements may be "unrestructured" to fall within the looser HP regime (albeit still requiring approval), and indeed reiterates its expectation (from PRA SS7/18) that such assets should be included "directly" where possible. Even if the assets remain in "securitised" form, the value of any residual interest should not be greater than what would have applied to the underlying assets in "unsecuritised" form.

In any case, the PRA expects (re)insurers to include MA eligible assets, regardless of whether they are classified as having fixed or HP cash flows, in MA portfolios without restructuring. Where (re)insurers do restructure their assets to ensure MA compliance, the aggregate value of the restructuring arrangements — including any MA benefit arising therefrom — should not generally exceed the value that would otherwise have been created if (re)insurers included the assets directly in their MA portfolios without restructuring. Furthermore, (re)insurers who adopt restructuring arrangements must explain the rationale for restructuring their assets, how any resulting MA benefit has arisen and how they are satisfied that the resulting MA benefit is appropriate, and demonstrate that any such benefit has been created on an arm's-length basis.[323]

For HP assets, the PRA builds on the matching tests set out in PRA SS7/18, to deal with the new risks introduced by inclusion of HP assets, for example, as follows:

- Cash flows being received earlier (or later) than expected, for example where a callable bond is redeemed earlier (or later) than expected.
- Cash flows of a different amount being received than what was expected, for example where coupons are linked to the achievement of environmental impact targets.
- Future contractual payments to the borrower being of different amounts and/or timing than expected, for example from a lease related to the completion of a construction project.

[323] Paragraph 2.55B of the PRA SS7/18 (as inserted by the PRA PS10/24).

The decision on whether to take a deterministic or statistical approach when projecting HP cash flows may not always be clear cut, and the PRA has given examples of scenarios where it could be appropriate to take a deterministic approach:

- An infrastructure project where the project sponsor can prepay in the event of construction failure.
- Limited holdings of callable bonds where the option is significantly in (or out of) the money and a "yield to worst" approach has been taken.

(Re)insurers should make proposals for management of the aforementioned risks in their MA applications to the PRA, including ideally modelled distribution of losses arising from HP assets. It will also provide substantial guidance to assist (re)insurers in this. The PRA will launch a verification process for MA applications ensuring (re)insurers are held responsible for their MA, backed by an FS that aligns with their MA portfolio's inherent risks.

For HP assets, the PRA proposes a "yield to worst" projection, and where the asset can be repaid early, with a typical worst-case outcome being a minimum MA benefit of zero, but subject to a consideration of the prevailing operating conditions.

The FS should reflect all risks retained by (re)insurers under the MA, principally credit risk but also the repayment, reinvestment and liquidity risk that results from an HP approach, for which the PRA proposes a minimum level of 10 basis points.[324] It also makes clear that the additional risks due to a lack of "fixity" should not give rise to an MA benefit; rather, that part of the spread that arises from lack of fixity should be part of the FS.[325]

The PRA has also incorporated a criterion for MA eligibility that mandates (re)insurers to showcase their adherence to the Solvency II prudent person principle (PPP). Compliance with the PPP means that (re)insurers will need to determine internal quantitative investment limits for types of assets in which they are proposing to assets to invest.

Sub-Investment Grade Assets

The PRA has increased the allowance of SIG assets in an MA portfolio by removing the current cap and modifying expectations around the management and modelling of SIG assets. These adjustments aim to promote investments that hover around the threshold between IG and SIG assets. That said, the PRA expects that any investment in SIG assets will remain limited given that annuity policyholders do not necessarily benefit from the higher yield on these products, and states that these should remain at prudent levels. (Re)insurers will be required to account for the risk of market conditions downgrading investment asset holdings from IG to SIG. In line with the PPP, the PRA also considers that (re)insurers should only invest in SIG assets to the extent that they have an effective risk management system for the risks particular to these assets.

Extension of the Categories of Insurance Liabilities Eligible for Matching Adjustment

The PRA's reforms also expand the scope of liability portfolios that may benefit from the MA. These now include in-payment income protection claims, including recovery time risk (*i.e.*, the risk that income protection policyholders take longer to recover from sickness than the (re)insurer's best estimate

[324] Paragraph 5.20 of the PRA SS7/18 (as amended by the PRA PS10/24).

[325] Paragraph 2.44 of the PRA CP19/23 (as affirmed by the PRA PS10/24).

projection). This is a significant extension of the MA to a new business line, which may produce significant capital benefits in the relevant market. The extension also now permits the guaranteed components of with-profits annuities to be included in an MA portfolio, (but with the non-guaranteed elements remaining outside). Although unlikely to have a significant impact on the market overall, this will likely assist the limited number of providers of these specialised products.

Implementing a More Efficient Matching Adjustment Application Procedure Tailored to Specific Assets

The PRA has also optimised its MA application processes to help (re)insurers respond to investment opportunities more swiftly. Specifically, the PRA has set itself a target of six months for decisions on MA applications, and intends to develop another timeline for the completion of streamlined reviews,[326] which the PRA expects to be shorter than the aforementioned six-month timeline.[327]

A More Balanced Approach to Matching Adjustment Condition Breaches

The PRA has retained the two-month compliance restoration period (noting that minor breaches should not necessarily impose a restriction on the MA's application).[328] However, to promote flexibility, where compliance is not restored within this window, (re)insurers may reduce the MA in a staggered fashion, rather than face immediate termination of their MA permission (as the previous framework required). The PRA has set out that this reduction should be at least 10% of the unadjusted MA, increasing by 10% for each month of noncompliance following the two-month window. Where the MA has been reduced to zero, the PRA expects to revoke the permission to apply the MA. Were the (re)insurer to restore compliance during the reduction period the restriction would be rescinded, subject to PRA confirmation. Additionally, a (re)insurer that applies such reductions as a result of a breach of the MA eligibility conditions is not expected by the PRA to recalculate the SCR to reflect the reductions.[329]

Matching Adjustment Attestation

The PRA requires the following formal statement be made on an annual basis by the chief financial officer (or other relevant senior manager) of a (re)insurer: "*The fundamental spread used by the firm [(re)insurer] in calculating the matching adjustment reflects compensation for all retained risks, and the matching adjustment can be earned with a high degree of confidence from the assets held in the relevant portfolio of assets*."[330]

The attestation must be given, for each MA portfolio within the (re)insurer, annually, with the effective date aligned to the (re)insurer's solvency and financial condition report (SFCR), and upon any material change in the (re)insurer's risk profile. The PRA notes that the reference to "compensation" refers not just to the illiquidity premium, but also higher spread related to barriers to entry, or specialist skills in sourcing and developing a relevant asset.[331] The PRA considers that the reference to "high degree of confidence" requires the MA to be materially more certain than a 50% percentile or best estimate basis.[332]

[326] Paragraph 5.9 of the PRA PS10/24.

[327] Paragraph 4.2 of the PRA SS7/18.

[328] Paragraph 8.1B, *ibid* (as inserted by the PRA PS10/24).

[329] Paragraph 8.1G, *ibid*.

[330] Paragraph 6.15 of the PRA CP19/23 (as affirmed by the PRA PS10/24).

[331] Paragraph 6.17, *ibid*.

[332] Paragraph 6.20, *ibid*.

A new senior management function holder will have prescribed responsibility for the (re)insurer's financial information and regulatory reporting and must be responsible for the attestation.[333] A policy on providing the attestation must be established and maintained by (re)insurers, as well as appropriate internal processes. This statement will arguably generate much attention within a (re)insurer, with the relevant individual looking to bolster their position, likely with the support of actuarial advisers. This may lead to interesting discussions as to whether the related liability provisions operate to mitigate impact of potential regulatory sanctions. The PRA does, however, acknowledge that responsibility for different elements of the statement may be delegated, and that ultimate responsibility for the attestation may be shared by two or more senior individuals.

Matching Adjustment Asset and Liability Information Return

The PRA also set out a new annual reporting requirement requiring (re)insurers to provide portfolio metrics and detailed information on the assets and liabilities held in their MA portfolios, standardising the data that (re)insurers provide to the PRA concerning their MA portfolio's assets and liabilities.

[333] Paragraph 6.25 of the PRA SS7/18 (as affirmed by the PRA PS10/24).

Chapter 6

Investment Rules

Introduction

This chapter discusses and analyses the investment rules that apply to Solvency II insurers and reinsurers in the UK.

In particular, this chapter outlines the PPP and discusses the relevant guidance from the EIOPA, and the PRA, on how the PPP is to be applied in practice. Further, specific asset classes will be explored, including how the Solvency II investment rules apply in relation to each. Finally, this chapter analyses the relationship between environmental, social and governance (ESG) requirements and the investment rules.

It should be noted that the Solvency II investment rules are not the only factor that insurance undertakings consider when developing their investment strategies. Most insurers and reinsurers aim, and indeed the PRA expects firms, to hold sufficient capital above and beyond the strictly prescribed coverage ratios to increase their investment flexibility, obtain enhanced credit ratings or pursue other agendas, such as being a leader in sustainable investment.

The rules governing investments are contained in the Investments Part of the PRA Rulebook, the Solvency II Directive and the Solvency 2 Regulations 2015, and are supplemented by (among other things) PRA SS1/20 (as updated) and the PRA PS14/20 (as updated).

1. What Is the Prudent Person Principle?

Pre-Solvency II

The pre-Solvency II framework for investments centered around the "admissible assets" regime, whereby insurance firms (but not reinsurance firms) were required, among other things, to invest technical provisions in admissible assets. The Consolidated Life Directive (CLD) (now repealed) set out an exclusive list of assets that insurers were able to use to cover their technical provisions on a prescribed basis. Examples of admissible assets under the pre-Solvency II regime were debt securities (such as bonds), loans, land and real property. Commodities, for example, were not included under the FCA's General Prudential sourcebook, and therefore insurers could not count these assets toward their regulatory solvency calculation.[334] Under the previous regime insurers also had to comply with limits on exposures to particular counterparties, groups and asset types (*e.g.*, there was a 10% limit on investments in unlisted securities). Additionally, the pre-Solvency II regime controlled only assets held to cover technical provisions (as opposed to all assets).

A different set of rules applied to reinsurers and in relation to linked business.

Post-Solvency II

Since the introduction of Solvency II, a less prescriptive, principles-based approach, with a market-focused regime, applies to firms within the Solvency II perimeter. The same rules apply to insurance as well as reinsurance undertakings,[335] other than in relation to linked business[336] and with one other exception for securitisations.[337] The Solvency II Directive replaced the CLD provisions governing investments,

[334] Paragraph 2 and Annex 7 of the FCA General Prudential Sourcebook.

[335] Article 132(1) of the Solvency II Directive.

[336] Article 132(3), *ibid* (transposed in Paragraph 4.3, Investments Part of the PRA Rulebook).

[337] Paragraph 6, Investments Part of the PRA Rulebook.

and removed the requirement for insurers to invest in specified assets. Under the Solvency II regime, insurance firms have greater investment freedom and flexibility to determine how to invest their assets. They must invest in accordance with the PPP (discussed below), which ensures that this flexibility is exercised responsibly.

Solvency II – Prudent Person Principle

The PPP, which sets objective standards for prudent investment, is set out in Article 132 of the Solvency II Directive, as adopted in the PRA Rulebook.[338] An insurance firm (hereafter meaning insurers and reinsurers) must invest its assets in accordance with the following requirements:

- The firm must only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report and appropriately take into account in the assessment of its overall solvency needs in accordance with Conditions Governing Business 3.8(2)(a).
- All of the assets of the firm must be:
  - invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio of assets of the firm as a whole; and
  - localised such as to ensure their availability.
- In the case of a conflict of interest the firm must, or must procure that any third party which manages its assets will, ensure that the investment of assets is made in the best interest of policyholders.[339]

In addition to meeting the requirements set out above, insurance firms must make sure that assets held to cover technical provisions are invested in a manner appropriate to the nature and duration of the firm's insurance and reinsurance liabilities and in the best interests of all policyholders, taking into account any disclosed policy objectives.[340]

Furthermore, all assets other than those held in respect of life insurance contracts where policyholders bear the investment risk (*i.e.*, linked business) and which are not held to cover the technical provisions for a guarantee of investment performance (or some other guaranteed benefit) must comply with the following requirements:[341]

- Investments in derivative or quasi-derivative instruments shall only be permitted to the extent that they contribute to a reduction of risks or facilitate efficient portfolio management.
- Investments in unlisted securities must be kept to prudent levels (as opposed to the pre-Solvency II regime where such investments were capped at 10%, as discussed above).
- Assets must be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer, group of undertakings or geographical area and excessive accumulation of risk in the portfolio as a whole.
- Investments in assets issued by the same issuer, or issuers belonging to the same group, must not expose the insurer to excessive risk concentration.

[338] Paragraph 2, Investments Part of the PRA Rulebook.

[339] Article 132(1)-(2) of the Solvency II Directive (transposed in Paragraph 2.1, Investments Part of the PRA Rulebook).

[340] Article 132(2), *ibid* (transposed in Paragraph 3.1, Investments Part of the PRA Rulebook).

[341] Article 132(4), *ibid* (transposed in Paragraph 5, Investments Part of the PRA Rulebook).

The PPP also includes additional requirements for linked business, which are discussed in Section 5 below.

It is important to emphasise that Solvency II refers to the "whole portfolio of assets", meaning that the PPP applies to an insurer's entire portfolio of investments, therefore including assets covering technical provisions, the MCR and SCR, as well as any other assets.[342]

The PRA notes that the PPP sets objective standards for prudent investment. This means that compliance with these standards must be assessed on an objective basis, from the standpoint of the hypothetical prudent person in similar circumstances (taking into account all relevant factors case-by-case), rather than a firm's subjective view about the prudence of its investment standards.[343]

The PPP is intention- and competency-based, instead of being outcome-based. The prudency requirements are continuous, meaning the entire portfolio of assets must be governed and monitored on a routine basis to ensure compliance.

Limitations to Freedom Under the Prudent Person Principle

Notwithstanding the increased freedoms to the investment regime since the introduction of Solvency II, it should be noted that:

- Different investment categories will attract different capital charges when calculating the SCR.
- An insurance firm's freedom of investment under Solvency II is not absolute but is constrained by all the requirements of the Solvency II regime, including the PPP.[344]

2. Application of the Prudent Person Principle

The EIOPA and the PRA have each published guidance that must be considered in the application of the PPP in practice.

EIOPA Guidance

The EIOPA has published Guidelines on system of governance (EIOPA BoS-14/253 EN) (Governance Guidelines) that are relevant for this purpose and continue to apply in the UK (as confirmed by the Bank of England and PRA).[345] Guideline 29 states that insurance firms should regularly review and monitor the security, quality, liquidity and profitability of the portfolio as a whole by considering at least:

- Any liability constraint, including policyholder guarantees, and any disclosed policy on future discretionary benefits and, where relevant, policyholders' reasonable expectations.
- The level and nature of risks that an insurance firm is willing to accept.
- The level of diversification of the portfolio as a whole.
- The characteristics of the assets, including the credit quality of counterparties, liquidity, tangibility, sustainability, existence and quality of collateral, leverage, encumbrances and tranching.

[342] Article 132(2) of the Solvency II Directive.

[343] Paragraph 1.3 of the PRA SS1/20.

[344] Paragraph 2.10 of the PRA PS14/20.

[345] Appendix 1 of the Bank of England and PRA Statement of Policy: Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU.

- Events that could potentially change the characteristics of the investments, including any guarantees, or affect the value of the assets.
- Issues relating to the localisation and availability of the assets, including non-transferability, legal issues in other countries, currency measures, custodian risk, over-collateralisation and lending.

Where an investment is of a non-routine nature, the insurance firm should conduct additional due diligence, which should include an assessment of at least:[346]

- Its ability to perform the investment activity and manage the investment.
- The risks specifically related to the investment or the investment activity and the impact of the investment or the investment activity on the insurance firm's risk profile.
- The consistency of the investment or investment activity with policyholders' interests, liability constraints set by the insurer and efficient portfolio management.
- The impact of this investment or investment activity on the quality, security, liquidity, profitability and availability of the whole portfolio.

The insurance firm should require that an investment or investment activity entailing a significant risk or change in the risk profile must be communicated in the risk profile to the firm's administrative, management or supervisory body.[347]

Further guidance from the EIOPA on the application of the PPP includes that insurance firms should not solely depend on information provided by third parties (*e.g.*, financial institutions, asset managers or rating agencies). Insurers are required to develop their own set of key risk indicators in line with their investment risk management policy and business strategy. Additionally, when making its investment decisions, the insurer is required to take into account the risks associated with the investment without relying only on the risk being adequately captured by the relevant capital requirements.[348]

When assessing the profitability of an insurance firm's investment portfolio, the firm is required to establish targets for the returns it seeks from its investments taking into account the need to obtain a sustainable yield on the asset portfolios to reasonably meet policyholders' expectations.[349]

The EIOPA advises that where investment assets are not admitted to trading on a regulated financial market or are complex products which are difficult to value, insurance firms should implement, manage, monitor and control procedures in relation to such investments. Equally, an insurance firm should treat assets which are admitted to trading, but not traded or not frequently traded, in a similar manner to assets not admitted to trading on a regulated financial market.[350]

The rules relating to assets covering technical provisions specifically include an obligation to invest assets in the "best interests" of policyholders. This is also the case where there are conflicts of interest. However, it should be noted that the concept of policyholders' "best interests" is not a known concept in UK regulation and thus there is no specific guidance on what it might mean to invest in the best interests of policyholders or beneficiaries.

[346] Guideline 28 of the Governance Guidelines.
[347] *Ibid.*
[348] *Ibid.*
[349] Guideline 30, *ibid.*
[350] Guideline 33, *ibid.*

PRA Guidance

In May 2020, the PRA published a PRA PS[351] and in June 2024 a PRA SS[352] setting out final guidance on the PPP.

The PRA SS contains guidance on specific areas:[353]

- **Investment Strategy:** The PRA sets out expectations on insurance firms to develop and document an investment strategy which describes at least:
  - The investment objectives and strategic asset allocation.
  - Consideration of investment constraints when setting investment objectives and strategic asset allocation.
  - Alignment of the investment strategy with the business model and, where appropriate, how the strategy takes into account the nature and duration of a firm's liabilities and obligations, and the best interests of policyholders.
  - Alignment of investment strategy with board risk appetite, risk tolerance limits and investment risk and return objectives.
  - A complete list of assets and how those assets have been invested in accordance with the PPP.
- **Investment Risk Management:** There are a wide range of requirements regarding the content of firms' risk management policies and monitoring frameworks. These include, among others:[354]
  - Investments should be aligned with the insurance firm's risk appetite, risk management policies, risk tolerance limits and investment strategy alongside the firm's overall business model (including its product and policyholder profile).
  - Where investments are made in asset structures where the risk exposure is dependent on the performance of underlying assets (*e.g.*, derivatives or securitisations), those risks should be within the scope of the firm's investment risk management framework.[355]
  - The investment risk management policy must include internal quantitative investment limits for assets and exposures.[356]
  - Firms' investment risk monitoring should cover (among other things): changes in the value and volatility of investment portfolios and individual assets, changes in characteristics of the assets held, changes in the external environment that may affect the security of assets and changes in the value or characteristics of underlying exposures on which the performance of the asset(s) invested in depend.[357]

[351] PRA PS14/20.
[352] PRA SS1/20.
[353] Paragraph 2.1, *ibid.*
[354] Paragraph 3.1, *ibid.*
[355] Paragraph 3.4, *ibid.*
[356] Paragraph 3.5, *ibid.*
[357] Paragraph 3.6, *ibid.*

- **Risk Concentration, Risk Accumulation and Lack of Diversification:** Firms that appear to have excessive levels of concentration risk will be subject to greater supervisory scrutiny.[358] The PRA expects that:
  - Insurance firms will stress test their portfolios to demonstrate that they are not exposed to excessive risk concentration.[359]
  - The solvency of an insurance firm, at a minimum, would not be impacted by any plausible crystallisation of a risk related to assets issued by the same issuer or by issuers belonging in the same group.[360]
  - Firms pay more attention to risks that are more complex and less understood (such as climate risk) and avoid overexposure to such risks.
  - Firms pay particular attention to their exposure to political risks, particularly when investing in assets that are ultimately government-backed.[361]
  - The investment risk management policy will articulate how the firm has identified and is managing any potential correlation or contagion risks between assets that would lead to excessive concentration of risk and any risks that are common to a material proportion of the firm's investment portfolio.[362]
  - Firms, in determining their quantitative investment limits, should have due regard to concentration risk and set out the level of concentration exposure that they will not exceed.[363]
- **Outsourcing of Investment Activities:** Importantly, insurance firms that wholly or partially outsource their investment function remain subject to the requirements of the PPP. Therefore, firms must ensure that any external investment manager only invests their assets in accordance with the PPP. The PRA expects that firms will undertake appropriate due diligence regarding outsourced investment activities. Insurance firms must be confident that any external party to whom they outsource any investment function has sufficient risk management expertise to comply with the PRA SS.[364] Where insurance firms outsource critical or important functions or activities, they become subject to an additional requirement of a written notification to the PRA prior to outsourcing such functions or activities.[365] The PRA has, through a PRA SS, set out the requirements of what a written agreement for material outsourcing must cover (as a minimum). As an example, written agreements must include, amongst other things, the following details:[366]
  - A description of the outsourced services.
  - The locations (including where appropriate, details of the regions or countries) where material services will be provided.
  - The agreed service level.
  - The reporting obligations of the service provider to the firm.

[358] Paragraph 3.20, *ibid.*

[359] Paragraph 3.18, *ibid.*

[360] *Ibid.*

[361] (1) Paragraph 3.19, *ibid*; and (2) Paragraph 5.2, Investments Part of the PRA Rulebook.

[362] Paragraph 3.21 of the PRA SS1/20.

[363] Paragraph 3.22, *ibid.*

[364] Paragraph 4.3, *ibid.*

[365] Article 49 of the Solvency II Directive (transposed in Paragraph 7, Conditions Governing Business Part of the PRA Rulebook).

[366] Paragraph 6.4 of the PRA SS2/21.

- **Exposure to Non-Traded Assets:**
  - The PRA's guidance regarding exposure to non-traded assets does not apply to insurance firms' investments in assets covering technical provisions for linked long-term contracts of insurance, except where the assets are held to cover additional technical provisions in respect of policyholder liabilities.[367]
  - The PRA notes that although investments in non-traded assets can be an appropriate match for insurance liabilities, they can also give rise to additional risks. For example, they can be difficult to value in the absence of regular market pricing and to sell in a timely manner, particularly under stressed market conditions.[368]
  - The PRA expects that before investing in non-traded assets, when determining any internal investment limit, and as part of ongoing practice, insurance firms will consider and assess (among others): the appropriateness and robustness of the valuation methodology; the robustness, capability and maturity of the internal rating framework and the materiality of any embedded optionality; and how time, stress or any other factor may affect the asset's risk profile.[369]
  - The PRA expects that the level of expertise of key persons (including investment managers) and the robustness of risk management systems and controls would increase commensurate with any increases in the scale, complexity or concentration of investments in non-traded assets.[370]
  - The PRA further sets out expectations that firms investing in non-traded assets should, at a minimum, be able to meet and demonstrate that key persons have sufficient experience to understand and manage risks involved, and that the suitability of an investment matching firms' liabilities has been assessed in light of suitably severe stress scenarios projected over suitably long horizons.[371]
- **Valuation Uncertainty:** Valuation uncertainty with respect to assets is a key risk for non-traded assets as well as listed assets that are thinly traded. Therefore, the PRA expects that insurance firms take into account valuation uncertainty risk for the purposes of complying with the PPP. The PRA further expects that insurance firms are able to demonstrate that they comply with the PPP and the relevant risk management requirements.[372]
- **Intragroup Loans and Participations:**
  - In respect of assets backing technical provisions, the PPP requires that these must be invested in a manner appropriate to the nature and duration of the firm's insurance and reinsurance liabilities and in the best interests of all policyholders, taking into account any disclosed policy objectives.[373] This requirement is particularly relevant for certain intragroup transactions (*e.g.*, intragroup loans), which may be in shareholders' interests but not necessarily in the interests of policyholders.
  - The PPP requires that in the case of a conflict of interest, assets are invested in the best interests of the policyholders.[374] While this provision applies to all asset classes, it is of particular importance in the context of intragroup transactions. In such transactions, the relevant firms' boards should be satisfied that any conflicts of interest have been resolved in the best interest of policyholders before investing

[367] Paragraph 5.1 of the PRA SS1/20.

[368] Paragraph 5.2, *ibid.*

[369] Paragraph 5.3, *ibid.*

[370] Paragraph 5.6, *ibid.*

[371] Paragraph 5.8, *ibid.*

[372] Paragraph 6.2, *ibid.*

[373] Paragraph 7.1, *ibid.*

[374] Article 132(2) of the Solvency II Directive (transposed in Paragraph 2.1, Investments Part of the PRA Rulebook).

in an intragroup asset. The PRA further expects that any conflicts of interests that arise following investment in an intragroup transaction should also be resolved in the best interest of policyholders, which may mean ceasing to invest in that asset.[375]

- In relation to intragroup reinsurance, the PRA notes that such arrangements are less likely to present conflicts of interest and are usually different in substance economically, but nonetheless the PRA will look into the economic substance of those arrangements to determine whether any arrangements are effectively structured as loans, in which case the PRA will treat them as such.
- The PRA expects that intragroup assets are subject to at least the same level of arm's length scrutiny and risk management as other assets, as well as proper governance and documentation with regard to conflicts of interest, concentration risk, credit risk, liquidity risk, legal and operational risk and further risks as set out in the PRA SS.[376]

- **Outwards Reinsurance:** As stated above, the PPP applies to all assets, including reinsurance arrangements. In considering whether such arrangements meet the PPP standards, the PRA will adopt a case-by-case approach and will take into account a particular insurance firm's circumstances, including the impact of various risk mitigation factors, such as the use of collateral.[377] The PRA has set out its expectations in relation to insurance firms' management of risk in relation to reinsurance arrangements in the PRA SS20/16.[378] Further, in relation to funded reinsurance arrangements, the PRA has proposed that insurers set limits on their exposure to funded reinsurance counterparties that should apply equally to multiple highly correlated counterparties. These limits are designed to ensure that an insurer's exposure is limited to a level that does not threaten the insurer's ongoing business model viability even if the reinsurance is terminated.[379]

3. Derivatives

As mentioned above, under the PPP, investments in derivative or quasi-derivative instruments shall only be permitted to the extent that they contribute to a reduction of risks or facilitate efficient portfolio management.[380]As such, a hedging derivative is more likely to be compliant in contrast to a purely speculative derivative.

The Governance Guidelines stipulate further guidance on the use of, and investment in, derivatives products by insurers or reinsurers. Guideline 34 provides as follows:[381]

- The insurance firm should implement procedures in line with its investment risk management policy to monitor the performance of any relevant derivatives.
- The insurance firm should demonstrate how the quality, security, liquidity or profitability of the portfolio is improved without significant impairment of any of these features where derivatives are used to facilitate efficient portfolio management.

[375] Paragraph 7.3 of the PRA SS1/20.

[376] Paragraph 7.6, *ibid.*

[377] Paragraph 8.1, *ibid.*

[378] *Ibid.*

[379] Skadden, Arps, Slate, Meagher & Flom client alert, "The PRA Tightens Expectations for Funded Reinsurance for the UK Bulk Purchase Annuity Market", 18 November 2023.

[380] Article 132(4) of the Solvency II Directive (transposed in Paragraph 5.2, Investments Part of the PRA Rulebook).

[381] Guideline 34 of the Governance Guidelines.

- The insurance firm should document the rationale and demonstrate the effective risk transfer obtained by the use of the derivatives where derivatives are used to contribute to a reduction of risks or as a risk mitigation technique.

Derivative instruments may be particularly useful when an insurance firm is required to hold assets to cover the technical provisions. Technical provisions comprise the BEL plus a risk margin. Where future cash flows associated with the relevant insurance liabilities can be reliably replicated using a derivative instrument for which there is a reliable market value which is observable, there is no requirement to calculate a separate risk margin.[382] In such cases, the value of technical provisions associated with those future cash flows shall be determined on the basis of the market value of the relevant derivative instrument.

4. Repackaged Loans/Securitisation Positions

In addition to the PPP, insurers and reinsurers must also comply with specific rules regarding risk retention and due diligence in relation to investments in tradable securities or other financial instruments based on repackaged loans, known as "securitisation positions" or "securitisations". The specific rules applicable depend on whether the securitisation position was issued before, on or after 1 January 2019, or following more recent reforms on 1 November 2024. This chapter focusses on the currently applicable, November 2024 regime. That said, the 2024 November regime is closely aligned with the January 2019 framework.

The 2024 Framework

Following a consultation in July 2023, the post-Brexit replacement of the EU Securitisation Regulation (Regulation (EU) 2017/2402) (EU Securitisation Regulation), the Securitisation Regulations 2024 (SI 2024/102) (UK Securitisation Regulations) were made final on 29 January 2024. The FCA, PRA and HM Treasury have implemented the UK Securitisation Regulations on 1 November 2024, with HM Treasury revoking the old securitisation framework.[383] HM Treasury exercised its powers under Section 86(3) and (4) of the Financial Services and Markets Act 2023 (Commencement No. 7) Regulations 2024/891 to repeal Regulation (EU) 2017/2402 on 2 September 2024. The new 2024 regulations are now in force.

Definition of "Securitisation Position"

The investment rules in the UK Securitisation Regulations only apply in relation to investments in a securitisation position, which means an exposure to a securitisation.[384] A securitisation is defined as follows:

> "Securitisation means a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:
>
> - Payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures.
> - The subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

[382] Article 77(4) of the Solvency II Directive (transposed in Paragraph 2.5, Technical Provisions Part of the PRA Rulebook).

[383] FCA, Repeal and Replacement of Assimilated Law.

[384] Paragraph 1, Securitisation Part of the PRA Rulebook.

- The transaction or scheme does not create exposures which possess all of the following characteristics:
  - The exposure is to an entity which was created specifically to finance or operate physical assets or is an economically comparable exposure.
  - The contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate.
  - The primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise".[385]

Risk Retention Requirements

The relevant risk retention requirements include, among others, the following:

- The originator, sponsor or original lender of a securitisation shall retain on an ongoing basis a material net economic interest in the securitisation of not less than 5%. That interest shall be measured at the origination and shall be determined by the notional value for off-balance-sheet items. Where the originator, sponsor or original lender have not agreed among them who will retain the material net economic interest, it is then the originator that must retain the material net economic interest. The rules contain further details on what qualifies as a retention of a material net economic interest of not less than 5%.[386]
- An entity shall not be considered to be an "originator" where the entity has been established or operates for the sole purpose of securitising exposures.[387] The PRA has confirmed that UK (re)insurers can be treated as both an 'originator' and 'institutional investor' in securitisation, and in some cases the sole investor in the transaction.[388] Consequentially, (re)insurers and reinsurers should consider whether any transactions, such as those that aim to refinance loans, exposures or receivables by transforming them into tranched securities and any internal restructurings may be considered securitisations for the purposes of the EU Securitisation Regulation.
- Originators shall not select assets to be transferred to the securitisation special purpose entity (SSPE) with the aim of rendering losses on the assets transferred to the SSPE, measured over the life of the transaction, or over a maximum of four years where the life of the transaction is longer than four years, higher than the losses over the same period on comparable assets held on the balance sheet of the originator.[389]
- The risk retention requirements will not apply where the securitised exposures are to (or fully, unconditionally and irrevocably guaranteed by), among others,[390] central governments or central banks; or to institutions to which a 50% risk weight or less is assigned under the standardised approach set out in the Capital Requirements Regulation.
- Risk retention requirements shall also not apply to transactions based on a clear, transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities that is widely traded, or are other tradable securities other than securitisation positions.[391]

[385] PRA Glossary "Securitisation".
[386] Paragraphs 1 to 3, Securitisation (Article 6 Risk Retention) Part of the PRA Rulebook.
[387] Paragraph 1, *ibid.*
[388] Paragraph 2.6 of the PRA SS10/18.
[389] Paragraph 2, Securitisation (Article 6 Risk Retention) Part of the PRA Rulebook.
[390] Paragraph 5, *ibid.*
[391] Paragraph 6, *ibid.*

Due Diligence Requirements

The PRA Rulebook also sets out the due diligence requirements that insurers and reinsurers must comply with, both prior to holding a securitisation position and on an ongoing basis for the duration of their exposure.

Before becoming exposed to a particular securitisation, insurers and reinsurers must:

- Ensure the structure is risk retention compliant. The relevant requirements differ where the originator or original lender is established in the UK or in a third country. The requirements include:[392]
  - Verification that the credits giving rise to the underlying exposures are granted on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits.
  - Verifying that the originator, sponsor and/or SSPE comply with the applicable disclosure obligations.
- Conduct a due diligence assessment that enables the insurer or reinsurer to assess the risks involved. That assessment shall consider at least:[393]
  - The risk characteristics of the individual securitisation position and of the underlying exposures.
  - All the structural features of the securitisation that can materially impact the performance of the securitisation position, including the contractual priorities of payment and priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers, and transaction-specific definitions of default.[394]

Noncompliant Investments in Securitisation Positions

If an insurer or reinsurer becomes aware that any of the above-mentioned requirements for investments in securitisation positions are not complied with, it must inform the PRA immediately. Where the requirements are not complied with as a result of negligence or omission of the insurer or reinsurer, the PRA shall impose a proportionate increase to the SCR in accordance with Article 257(3).[395] Risk factors will be progressively increased with each subsequent breach.

Simple, Transparent and Standardised Securitisation

The UK Securitisation Regulations create two classes of high-quality securitisations, namely:

- Simple, transparent and standardised (STS) securitisations.[396]
- Asset-backed commercial paper programmes (ABCP programmes) or transactions.[397]

The framework includes due diligence requirements that apply to insurance firms investing in STS securitisations.

Investments in STS securitisations attract preferable capital treatment when calculating an insurance firm's SCR coverage (as compared with non-STS securitisations).

[392] Paragraph 2(1), Securitisation Part of the PRA Rulebook.
[393] Paragraph 2(3), *ibid.*
[394] Section 4.2. 1R, Part 1 of the Securitisation Sourcebook (FCA).
[395] The Level 2 Delegated Regulation.
[396] Regulation 9 of the UK Securitisation Regulations.
[397] Regulation 3(1), *ibid.*

Before investing in STS securitisations, insurance firms must carry out additional due diligence as to whether the securitisation meets the STS criteria as set out in the SECN — FCA Sourcebook.[398] Institutional investors may rely to an appropriate extent on the STS notification and on the information disclosed by the originator, sponsor and SSPE on the compliance with the STS requirements, without solely or mechanistically relying on that notification or information.[399] For fully supported ABCP programmes, insurers and reinsurers shall also consider the features of the programme and the full liquidity support as part of the insurance firm's due diligence process.[400]

EIOPA Guidance

Where the insurance firm invests in securitised instruments, it should ensure that its interests and the interests of the originator or sponsor concerning the securitised assets are well understood and aligned.[401]

5. Unit Linked Funds

Unit linked funds or linked contracts are life and long-term insurance contracts where the investment risk is borne by the policyholder and where the benefits are wholly or partly determined by reference to the value of, or income from, property of any description or by reference to fluctuations in, or in an index of, the value of property of any description.[402] The PPP applies to linked funds with some exceptions. The requirements set out in Article 132(4) of Solvency II (transposed in Paragraph 2 of the Investments Part of the PRA Rulebook) with respect to derivatives, unlisted investments, diversification and counterparty concentration risk do not apply to assets held to cover benefits that are not subject to a guarantee of investment performance or other guaranteed benefit.

There are nonetheless additional close matching requirements set out in the PRA Rulebook, which provide as follows:[403]

- Where the benefits provided by a linked contract are directly linked to the value of units in an UCITS, or to the value of assets contained in an internal fund held by the insurance undertakings, usually divided into units, the technical provisions in respect of those benefits must be represented as closely as possible by those units or, in the case where units are not established, by those assets.
- Where the benefits provided by a contract are directly linked to a share index or equivalent, the technical provisions in respect of those benefits must be represented as closely as possible, either by the units deemed to represent the reference value or, in the case where units are not established, by assets of appropriate security and marketability which correspond as closely as possible with those on which the particular reference value is based.

These close matching rules aim to ensure that the insurer or reinsurer is not exposed to investment risk, as the insurance firm is required to hold the same assets, as closely as possible, as those by reference to which the policyholder benefits are calculated.

[398] SECN 2.3.26R, Securities Sourcebook 2 — FCA Handbook.

[399] SECN 2.2.29R, *ibid.*

[400] SECN 2.3.24R, *ibid.*

[401] Guideline 35 of the Governance Guidelines.

[402] PRA Glossary "linked-long term".

[403] Paragraph 4, Investments Part of the PRA Rulebook.

It must be noted that where the benefits provided under the linked policy include a certain guarantee of investment performance or another guaranteed benefit, the linked assets must continue to comply with the requirements set out in paragraph 5 of the Investments Part of the PRA Rulebook with respect to derivatives, unlisted investments, diversification and counter-party concentration risk.

Restrictions on Investment

Generally, the UK will not require (re)insurance firms to invest in particular categories of assets and will not subject their investment decisions or those of its investment manager to any kind of prior approval or systematic notification requirements. However, there is a carve-out from this prohibition to allow the UK to impose restrictions on the types of assets or reference values to which policy benefits may be linked in situations where the investment risk of a long-term insurance contract is borne by a policyholder who is a natural person.[404]

In the UK, the FCA in its *FCA Conduct of Business Sourcebook* (COBS) has set out limitations on the linked business that an undertaking can invest in on behalf of policyholders that are natural persons in order to protect them. In particular, COBS 21.3.1 sets out a specific list of "permitted" linked assets that an insurer or reinsurer may invest in where the policyholder is a natural person. This list includes approved securities, listed securities, land and property, loans and derivatives.[405]

Although the above restriction is formally only applied to policyholders who are natural persons, the former Financial Services Authority (FSA) (succeeded by the PRA in this regard) stated that it intended to adopt a relatively flexible approach towards who a policyholder is for these purposes, which would include trustees of defined contribution pension schemes. This is because the underlying scheme members are natural persons bearing the investment risk. In particular, the FSA commented that:

> "Individual policyholders who hold, for example personal pensions, whole-of-life plans, insurance bonds, and also members of DC occupational pension schemes invested in unit-linked life assurance policies bear all of the investment risk inherent in the assets backing their policy benefits. We consider restrictions on the assets that can be used to determine their benefits to be appropriate to meet our statutory objective of consumer protection".[406]

The Governance Guidelines do not provide further guidance on investments in linked assets to cover linked business. However, they do provide some guidance on investment in unit-linked and index-linked investments by an insurer or reinsurer itself:

- The insurer or reinsurer should ensure that its investments in unit-linked and index-linked contracts are selected in the best interests of policyholders and beneficiaries taking into account any disclosed policy objectives.
- In the case of unit-linked business, the insurer or reinsurer should take into account and manage the constraints related to unit-linked contracts, in particular liquidity or any contractual or legal transferability constraints.[407]

[404] Section 21.2.-1R of the COBS.

[405] *Ibid.*

[406] CP11/23, FSA "Solvency II and Linked Long-Term Insurance Business", published in November 2011.

[407] Guideline 32 of the Governance Guidelines.

6. ESG Movement and Its Impact on Investment Rules

It is widely understood that risks arising from sustainability impact the balance sheets of insurance and reinsurance undertakings. The increase in severe weather events predicted by most climate scientists is likely set to significantly impact the insurance industry by affecting the ability of underwriters to measure, predict and apportion risks.

General insurers and reinsurers, for example, are exposed to the direct risks of climate change, covering loss related to tsunamis, wildfires or typhoons. Life insurers and reinsurers are also under mounting pressure from consumers, shareholders and climate activists to diversify their asset portfolios and reduce their investments in non-sustainable businesses as well as lower their commitments in carbon-intensive industries.

Sustainability Risks

There are different types of sustainability risk that the PRA has identified as to which the insurance sector is exposed: physical risks, transition risks and liability risks. The PRA reported its findings in PRA SS3/19, "Enhancing Banks' and Insurers' Approaches to Managing the Financial Risks From Climate Change". Each type of sustainability risk is explained further below:

- **Physical Risks:**[408] These are risks that arise from a number of factors and relate to specific weather events (*e.g.*, floods, wildfires and storms) and longer-term shifts in the climate (*e.g.*, changes in precipitation, sea level rise and rising mean temperatures). Some examples of physical risks affecting insurers and reinsurers include:
  - Increasing frequency, severity or volatility of extreme weather events impacting property and casualty insurance.
  - Increasing frequency and severity of flooding leading to physical damage to the value of financial assets or collateral held by banks, such as household and commercial property. This can lead to increased credit risks, particularly for banks, or to underwriting risks for liability insurers if it results in legal claims to recover financial losses from this physical damage.
- **Transition Risks:**[409] These are risks that can arise from the process of adjustment towards the low-carbon economy. A range of factors influence this adjustment, including climate-related developments in policy and regulation, the emergence of disruptive technology or business models, shifting sentiment and societal preferences, or evolving evidence, frameworks and legal interpretations. Some examples include:
  - Tightening energy efficiency standards for real estate impacting the risks in banks' lending portfolios.
  - Rapid technological change, such as the development of self-driving cars and the widespread use of AI, affecting the value of financial assets in the automotive and other sectors.
  - Firms generally failing to mitigate, adapt or disclose financial risks from climate change that leads to them being exposed to climate-related litigation, which could impact their market value and/or lead to higher claims for insurers and reinsurers that provide liability cover to those firms.

[408] Paragraph 2.3 of the PRA SS3/19.

[409] Paragraph 2.4, *ibid.*

- **Liability Risks:**[410] These risks arise from parties who have suffered loss or damage from physical or transition risk factors seeking to recover losses from those they hold responsible. The legal risks from climate-related liabilities can be particularly important to insurance firms given that these risks can be transferred through liability protection, such as directors' and officers' and professional indemnity insurance.

Application of the Prudent Person Principle

The PPP requires insurance firms to diversify their asset portfolios in order to avoid excessive accumulation of risk. Therefore, insurers and reinsurers must as part of their alignment with the PPP consider whether there is an excessive accumulation of financial risks from climate change (in particular risks likely to come into effect via the transition risk factor discussed above) in their investment portfolio. Further, insurers and reinsurers must consider possible mitigants when this is the case.[411]

The PRA expects an insurance firm's response to the financial risks from climate change to be proportionate to the nature, scale and complexity of its business. As a firm's expertise develops, the PRA expects the relevant firm's approach to managing the financial risks from climate change to mature over time.[412]

The PRA intends to run a dynamic general insurance stress test in 2025[413] that will aim to:

- Assess the insurance industry's solvency and liquidity resilience to a specific adverse scenario.
- Assess the effectiveness of insurers' risk management and management actions following an adverse scenario.
- Inform the PRA's supervisory response following a market-wide adverse scenario.

Results of this exercise will be disclosed at an aggregate industry level.

Green Investing

In 2015, the PRA produced a report on the impact of climate change to the UK insurance sector as part of the second round of climate change adaption reports requested by the Department for Environment, Food and Rural Affairs. The report identified a number of climate change-related opportunities for insurance firms that include new sources of premium growth, such as renewable energy project insurance, supporting resilience to climate change through risk awareness and risk transfer, investments in green bonds and providing financial sector leadership on climate change.[414] These themes are now routinely championed by government regulators and others.

A number of European insurers have already publicly committed to lowering carbon-intensive investments and replacing such investments with low-carbon alternatives. Such commitments include investing in green bonds aiming at funding projects that have positive environmental benefits and phasing out coal from investment portfolios. For example, a large UK-based composite insurance group has announced its plan to become a net zero carbon emissions company by 2040 and to cut 25% in the carbon intensity of its investments by 2025 and 60% by 2030.[415]

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[410] Paragraph 2.2, *ibid.*

[411] Paragraph 3.11, *ibid.*

[412] Paragraph 3.1, *ibid.*

[413] PRA statement on the dynamic general insurance stress test in 2025 (3 October 2023).

[414] PRA Climate Change Adaption Report 2021.

[415] Aviva, "Aviva Becomes the First Major Insurer Worldwide To Target Net Zero Carbon by 2040", 1 March 2021.

Integration of Sustainability Risk Into the Prudent Person Principle at EU Level

On 24 May 2018, as part of its Action Plan on Financing Sustainable Growth, the EU Commission adopted a package of measures on sustainable finance.[416] The package contained several proposals aimed at:

- Establishing a harmonised EU classification system on sustainable economic activities.
- Improving and clarifying disclosure requirements on how institutional investors, such as asset managers and insurance firms, integrate ESG factors in their investment and advisory processes.
- Creating a new category of low-carbon benchmarks that will help investors compare the carbon footprint of their investments and facilitate better alignment with the Paris Agreement.

As a result of the action plan, changes were made to legislative instruments in August 2021, including the Solvency II Level 2 Delegated Regulation. However, these changes will not apply in the UK as they do not affect the post-Brexit onshored Solvency II regime.

[416] European Commission, "Sustainable Finance: Making the Financial Sector a Powerful Actor in Fighting Climate Change", 24 May 2018.

Chapter 7

Technical Provisions

Introduction

"The value of technical provisions shall correspond to the current amount insurance and reinsurance undertakings would have to pay if they were to transfer their insurance and reinsurance obligations immediately to another insurance or reinsurance undertaking."[417]

A (re)insurer must hold assets to meet its ongoing obligations to policyholders, which requires a forward-looking assessment of all relevant cash flows over the expected duration of the liabilities in question, subject to a risk margin.[418] This assessment results in a net amount that must be held in assets that are appropriate to the nature and duration of the liabilities. These are referred to as "technical provisions".

Technical provisions are not to be confused with a (re)insurer's capital requirements comprised of the SCR and MCR. The SCR (and MCR) sits as a buffer on top of technical provisions to guard against adverse deviation in market, operating, or other conditions on at least a 1 in 200 basis. Equally, technical provisions are not to be confused with "own funds", being the capital items with which a (re)insurer must cover its capital requirements (or the assets in which a (re)insurer may invest the proceeds of such own-funds items). These different concepts and regimes are covered in other chapters.

As such, technical provisions are typically the largest item on a (re)insurer's balance sheet. The methodology for calculating technical provisions is based on various factors, including expected future cash flows, potential risks and regulatory requirements taking into account the specific risk profile of each insurer.

Following Brexit, the UK's divergence from EU-derived rules includes liberalisation of the EU Solvency II regime towards a new Solvency UK, moving the UK back toward a less prescriptive and more principles-based regulatory rule set. The UK divergence from the EU Solvency II regime has also affected technical provisions, specifically the risk margin and MA. We expect the PRA to continue to develop these areas of divergence in the coming years. In this chapter, we summarise the Solvency II position, together with the UK approach (to the extent different or otherwise noteworthy).

For its part, the EU has also revisited technical provisions as part of the 2020 Review, with the EIOPA proposing "improvements" to:

- The VA to better align the design to its objectives and increase its effectiveness in curbing short-term volatility and rewarding insurers for holding illiquid liabilities.
- The calculation of the risk margin of insurance liabilities, recognising diversification over time, thus reducing its volatility and size, in particular for long-term liabilities.

The key requirements for technical provisions are detailed in Articles 76 to 86 of the Solvency II Directive, Articles 48 to 69 of the Level 2 Delegated Regulation and the Technical Provisions part of the PRA Rulebook. These are supplemented by (in the EU) the EIOPA Level 3 Guidelines and (in the UK) various PRA SSs,[419] which clarify the same or provide the PRA's views where the regulations or subsidiary legislation are unclear.

[417] Article 76(2) of the Solvency II Directive.

[418] Article 76(1), *ibid* (transposed in Paragraph 3.1, Technical Provisions Part of the PRA Rulebook).

[419] (1) PRA PS25/19; (2) PRA SS23/15, (3) PRA SS5/14; (4) PRA SS6/16; and (5) PRA SS7/18.

1. The Best Estimate of Liabilities

The main component of the technical provisions is the BEL. This represents the amount needed at the valuation date to discharge all insurance liabilities, together with all future expenses that will be incurred in managing the business until its expiry (or contract boundaries if sooner, described below).

The BEL corresponds to the probability-weighted average of future cash flows, taking into account the time value of money (expected present value of future cash flows) using the relevant RFR term structure (see below).[420] It must be calculated:

- Based on up-to-date and credible information and realistic assumptions.
- Using adequate, applicable and relevant actuarial and statistical methods.
- As a gross value, without deduction of the amounts recoverable from reinsurance contracts and UK ISPVs, which firms must calculate separately.[421]

Cash Flows

The cash flow projection used in the calculation of the best estimate (whether valued separately or determined on the basis of financial instruments, as described below) must take into account all the cash in- and out-flows required to settle the (re)insurance obligations over their lifetime.[422]

The general rule is that cash flows related to an insurance contract should be included from the earlier of the date the (re)insurer becomes a party to the agreement or the date the insurance or reinsurance cover starts (the recognition date). Such cash flows should include the following related to existing insurance and reinsurance contracts:

- Benefit payments to policyholders and beneficiaries.
- Payments incurred by the (re)insurer to provide contractual benefits in kind.
- Payments of certain expenses.
- Premium payments and any additional cash flows resulting from those premiums.
- Payments between the (re)insurer and intermediaries related to (re)insurance obligations.
- Payments between the (re)insurer and investment firms concerning contracts with index-linked and unit-linked benefits.
- Payments for salvage and subrogation to the extent they do not qualify as separate assets or liabilities under applicable international accounting standards (IASs).
- Taxation payments charged to policyholders or required to settle (re)insurance obligations.[423]

[420] Article 77(2) of the Solvency II Directive (transposed in Paragraph 3.1, Technical Provisions Part of the PRA Rulebook).
[421] *Ibid.*
[422] Article 77(2), *ibid* (transposed in Paragraph 3.2, Technical Provisions Part of the PRA Rulebook).
[423] Article 28 of the Level 2 Delegated Regulation.

The cash flows must also account for, either explicitly or implicitly:

- All uncertainties, including timing, claim amounts, expenses and policyholder behaviour.[424]
- Administrative, investment management, claims management and acquisition expenses.[425]
- Expected future developments outside the undertaking's control if these would materially impact cash flows over the policy's lifetime.
- Any financial guarantees and contractual options included in their (re)insurance policies, including the factors that may affect the likelihood that policyholders will exercise those contractual options or realise the value of financial guarantees.[426]
- The cost of hedging any embedded options and guarantees.[427]

Assumptions

While actuarial and statistical methods used to calculate the cash flows are not prescribed, the methodology and its results must be reviewable by a qualified expert.[428] However, these are based on a number of assumptions that may not be realised in the future. For example, material variances in premiums may be caused by factors such as changes in lapse/surrender rates, or changes in ceding company retentions which may be permitted under some treaties. The use of assumptions means that the BEL is at best an estimate, and the future outcome is likely to vary from the estimate. A great deal of time and effort goes into selecting assumptions that are viewed as being the best available.

Future Management Actions

(Re)insurers are also permitted to make certain assumptions relating to future management actions and, as such, effectively reduce the potential future liabilities or cash flows. These assumptions may only be taken into account if they are realistic, *i.e.*:

- Determined in an objective manner.
- Consistent with the current business practise and strategy.
- Consistent with each other.
- Not contrary to any obligations toward policyholders or legal requirements.
- Consistent with any public indications of what the future management actions may be.[429]

Discounting Using Risk-Free Interest Rate Term Structure

The BEL accounts for the fact that some liabilities only need to be met in the future, and returns can be earned on invested premiums in the meantime. Hence, in calculating the BEL, investment income on the assets associated with the BEL is taken into account, but based on "risk-free" assets, which are assets for which the risk of default is negligible, typically government bonds.[430]

[424] Article 30, *ibid.*
[425] Article 31, *ibid.*
[426] Article 32, *ibid.*
[427] Chapter III, Subsections 2 and 3, *ibid.*
[428] Article 34(1), *ibid.*
[429] Article 23(1), *ibid.*
[430] Chapter III, Section 4, *ibid.*

The BEL is therefore calculated by projecting future cash flows and discounting them back to the valuation date at the RFR. The RFR is not a simple rate of interest but a set of rates for each year in the future (an interest rate "curve"). The derivation of this curve is complex and beyond the scope of this chapter. However, (re)insurers must ensure that the RFR:

- Is determined using, and consistent with, information derived from relevant financial instruments.
- Takes into account relevant financial instruments of those maturities where the markets for those financial instruments, as well as for bonds, are deep, liquid and transparent.
- Is only extrapolated for maturities where the markets for the relevant financial instruments or for bonds are not deep, liquid and transparent. This shall be based on forward rates converging smoothly from one set of forward rates in relation to the longest maturities for which the relevant financial instrument and the bonds can be observed in a deep, liquid and transparent market to an ultimate forward rate (UFR).[431]

The Amendments (discussed in previous chapters) will introduce a new method for extrapolation of the RFR. Under this new method, extrapolation will start from a First Smoothing Point (FSP) *i.e.*, the point at which bond markets are no longer considered deep, liquid or transparent, which is set at a maturity of 20 years for the Euro.[432] The extrapolation will be based on forward rates converging smoothly from the applicable forward rate at the FSP to a UFR.[433] The Amendments provide for a phasing-in mechanism for this new extrapolation method, use of which will be subject to prior supervisory approval.[434] This will allow for the new extrapolation method to be phased in linearly between the implementation date of the Amendments and 1 January 2032, during which period (re)insurers must publicly disclose (as part of their SFCR) the impact of not applying the phase-in mechanism on their financial position.[435]

The RFR is calculated for each currency and maturity.[436] The EIOPA publishes the relevant RFR information for EU (re)insurers (including the EU subsidiaries of UK (re)insurance groups). The PRA publishes the equivalent information for UK (re)insurers.

The PRA determines its relevant currencies based on the materiality of technical provisions denominated in each currency and the currencies for which UK insurers are authorised to use the VA or the MA. The PRA will periodically review the list of relevant currencies.

If a UK insurer has technical provisions in a currency for which the PRA does not publish technical information, the (re)insurer must propose TI that complies with Solvency II requirements and justify this approach to its supervisor.

2. The Risk Margin

The risk margin covers the (re)insurer's need to hold capital against non-hedgeable risks. This requires a projection of the solvency capital, so as to ensure that the value of the technical provisions is equivalent to the amount that another (re)insurer would be expected to require in order to take over and meet the relevant

[431] Article 77a of the Solvency II Directive (transposed in Paragraph 5.1, Technical Provisions Part of the PRA Rulebook).

[432] Article 1(39) 2021/0295 (COD).

[433] *Ibid.*

[434] *Ibid.*

[435] *Ibid.*

[436] Article 43(1) of the Level 2 Delegated Regulation.

(re)insurance liabilities over their lifetime.[437] This is determined using a cost of capital rate[438] (to be added to the RFR to give the total return for the putative acquiror) using a prescribed formula/method.[439]

Solvency II sets the cost of capital rate at 6%.[440] Widely viewed as too high, the UK has reduced this to 4% for both life and non-life companies as part of the transition from Solvency II to Solvency UK,[441] with the result that the overall risk margin has reduced in the UK by around 65% for long-term life businesses and 30% for non-life businesses. As part of its review of Solvency II, the EIOPA had proposed to reduce the cost of capital rate to 4.75%, again for both life and non-life companies. One of the Amendments to the Solvency II Directive (that has not yet taken effect) acts upon the advice of the EIOPA and reduces the cost of capital rate from 6% to 4.75%.[442]

The risk margin calculation is based on various assumptions:

- The entire portfolio of insurance and reinsurance obligations of the original undertaking is taken over by a reference undertaking.
- If the original undertaking engages in both life and non-life insurance activities, these portfolios are taken over separately by different reference undertakings.
- The transfer includes any reinsurance contracts and arrangements with SPVs related to these obligations.
- The reference undertaking has no preexisting insurance or reinsurance obligations or own funds before the transfer.
- Post-transfer, the reference undertaking:
  - Assumes no new insurance or reinsurance obligations.
  - Raises eligible own funds equal to the SCR necessary to support the obligations over their lifetime.
  - Has assets equal to the sum of its SCR and technical provisions net of amounts recoverable from reinsurance contracts and SPVs.
- Assets are selected to minimise the SCR for market risk.
- The SCR of the reference undertaking includes:
  - Underwriting risk of the transferred business.
  - Material market risk, excluding interest rate risk.
  - Credit risk related to reinsurance contracts, SPVs, intermediaries, policyholders, and other related exposures.
  - Operational risk.
- The loss-absorbing capacity of technical provisions in the reference undertaking matches that in the original undertaking for each risk.
- There is no loss-absorbing capacity of deferred taxes.

[437] Article 77(3) of the Solvency II Directive (transposed in Paragraph 4.2, Technical Provisions Part of the PRA Rulebook).
[438] Article 39 of the Level 2 Delegated Regulation.
[439] Article 37, *ibid.*
[440] Article 39, *ibid.*
[441] Insurance and Reinsurance Undertakings (Prudential Requirements) (Risk Margin) Regulations 2023.
[442] Article 1(38) 2021/0295 (COD).

- The reference undertaking adopts future management actions consistent with those assumed by the original undertaking.[443]

Generally, the BEL and the risk margin are calculated separately. In the case of, for example, index-linked life insurance, a (re)insurer may calculate them together if the cash flows of the (re)insurance obligations can be reliably replicated by a financial instrument[444] provided that it is traded on an active, deep, liquid and transparent market to ensure a valid market value.[445] In such cases, the market value of the relevant financial instrument determines technical provisions for those future cash flows.

3. Contract Boundaries

Under Solvency II, a (re)insurer should stop recognising cash flows under an insurance contract when its obligations end.[446] In other words, only obligations within the contract boundary should be recognised. Contract boundary refers to the term of the insurance contract over which premiums and benefits are guaranteed.

In many cases, the boundary will be the same as the term of the contract, but if the (re)insurer has the right to increase premiums or vary benefits before the contract ends, the contract boundary is the point at which that right can be exercised. It is not enough simply to be able to increase premiums to establish a contract boundary. It is defined in the Solvency II regulations as "… the future date where the insurance or reinsurance undertaking has a unilateral right to amend the premiums or the benefits payable under the contract in such a way that the premiums fully reflect the risks".[447] This means that the insurer must be able to increase premiums sufficiently to cover the risks insured. Further, the insurer must have the right to compel the policyholder to pay the premiums for the risks undertaken, including any future date when the (re)insurer has a unilateral right to terminate the contract or has a unilateral right to reject premiums under the contract.[448]

The test can be applied at the portfolio level rather than the individual contract level, with limited exceptions. When assessed at the portfolio level, insurers should consider whether the premiums or benefits of the portfolio can be adjusted so that the premiums fully reflect the risks covered. This is valid only if no circumstances would cause the benefits and expenses to exceed the premiums. If the (re)insurer has a unilateral right that applies to only part of the contract, the same principles apply to that part.

4. The Matching Adjustment

Long-term insurance products, such as annuities, are typically backed by insurers with long-term assets that match the cash flows closely (such as long-dated bonds) and are expected to be held to maturity.

Where an insurer holds, for example, a bond to maturity, it is exposed only to the default of the issuer in paying the coupon and/or redeeming the principal amount. In other words, it can effectively disregard changes to market value (other than those that reflect default risk) between acquisition and maturity of the asset. This is sometimes referred to as an "illiquidity premium". The MA is the mechanism that delivers this illiquidity premium to (re)insurers.

[443] Article 38 of the Level 2 Delegated Regulation.

[444] Article 77(4) of the Solvency II Directive (transposed in Paragraph 2.5, Technical Provisions Part of the PRA Rulebook).

[445] Article 40 of the Level 2 Delegated Regulation.

[446] Article 17, *ibid.*

[447] Article 18, *ibid.*

[448] The EIOPA Level 3 Guidelines clarify the meaning of "unilateral right" in this context. *See* Guideline 2 of the EIOPA Guidelines on Contract Boundaries (EIOPA-BoS-14/165).

The detail of this mechanism resides in the calculation of technical provisions and, specifically, the discount rate that is applied to take account of the time value of money. The MA is an adjustment to that discount rate, allowing the insurer to use a discount rate closer to the credit-adjusted market rate of return for the relevant liabilities instead of the RFR prescribed by Solvency II (see above). This higher discount rate lowers the present value of liabilities and, consequently, lowers the technical provisions of the (re)insurer. In other words, the illiquidity premium is delivered by means of a synthetic reduction in an insurer's capital requirements.

More detailed information about the MA, together with the PRA's reforms under Solvency UK, can be found in Chapter 5: The Matching Adjustment.

5. The Volatility Adjustment

Similar to the MA, the VA modifies the RFR for each relevant currency but with the purpose of allowing a (re)insurer to smooth the balance sheet impact of volatility in financial markets.[449] This in turn prevents pro-cyclical investment behaviour.

The PRA considers that the VA achieves this by preventing the requirement for market-consistent valuation of assets and liabilities under Solvency II from disincentivising insurers from investing in assets that would otherwise be appropriate for the insurer to hold, taking into account the nature and duration of their insurance liabilities. The VA therefore aims to mitigate artificial balance sheet volatility caused by short-term market volatility in the value of assets arising from the exaggerations of bond spreads by allowing insurers to reflect movements to those asset prices within the market-consistent valuation of the corresponding liabilities.

The VA is calculated based on the spread between the interest rate from the reference portfolio assets and the relevant RFR for that currency.[450] The calculation follows a formula in Article 50 of the Level 2 Delegated Regulation, referring to the "risk-corrected currency spread", being the difference between the calculated spread and the portion attributable to expected losses or unexpected credit risks. This adjustment is based on a risk-corrected spread of assets in a reference portfolio, calculated by the EIOPA for EU member states[451] (and by the PRA for UK insurers)[452] on a currency and country basis at least quarterly.

The VA may not be used alongside the MA — only one may be used for a given portfolio of liabilities (noting that in the UK, a firm may apply for the VA as a contingency if its MA application is rejected).[453]

In the UK, a (re)insurer must apply to the PRA for approval to use the VA and satisfy three conditions ahead of approval:

- **Condition 1:** The VA is correctly applied to the relevant RFR term structure in order to calculate the best estimate.
- **Condition 2:** The firm does not breach a relevant requirement as a result or consequence of applying the VA.

[449] Articles 77d to 77e of the Solvency II Directive (transposed in (i) Regulation 43 of the Solvency 2 Regulations; (ii) Paragraphs 8.1 to 8.5, Technical Provisions Part of the PRA Rulebook); Articles 49 to 51 of the Level 2 Delegated Regulation.

[450] Article 77d of the Solvency II Directive.

[451] Article 77e, *ibid.*

[452] PRA Statement of Policy "The PRA's Approach to the Publication of Solvency II Technical Information" published in September 2022.

[453] Article 77d(5) of the Solvency II Directive (transposed in 8.5 Technical Provisions Part of the PRA Rulebook).

- **Condition 3:** The application of the VA does not create an incentive for the undertaking to engage in pro-cyclical investment behaviour.[454]

The Amendments update the EU's position on the VA in several respects. The key amendments to the VA are as follows:[455]

- Making the use of the VA subject to prior supervisory approval. Such approval will be granted where (i) the RFR does not include an MA for the given portfolio of liabilities, and (ii) the undertaking has adequate processes in place to calculate the VA. Undertakings that have previously applied the VA to the RFR to calculate the BEL will be able to continue to do so (without seeking approval), provided they are compliant with the two aforementioned conditions.
- Increasing the general application ratio from 65% to 85% such that a higher percentage of the "risk-corrected currency spread" derived from the representative portfolios will be taken into account for the VA.
- Introduction of an undertaking specific "credit spread sensitivity ratio" in the calculation of the VA.
- Introduction of an undertaking specific adjustment to the "risk-corrected currency spread" in an amount equal to the lower of 105% and the ratio of risk-corrected spread calculated based on an undertaking's investments in debt and risk-corrected spread calculated on a reference portfolio. The use of this undertaking specific adjustment will be subject to the following conditions:[456]
  - Prior approval from the supervisory authority.
  - The risk-corrected spread calculated on a reference portfolio must exceed the risk-corrected spread calculated based on an undertaking's investments in debt for four quarterly reporting periods prior to the reporting period.
  - The macro VA (discussed below) will not apply when using the undertaking specific adjustment.
  - The undertaking specific adjustment can only be applied to increase the "risk-corrected currency spread" for no more than two consecutive quarterly reporting periods.
- Replacement of the country component of the VA with a macro VA for member states with the Euro as their currency.

6. Transitional Measure on Technical Provisions

Given the scale and importance of technical provisions, Solvency II provides for a gradual transition on a straight-line basis over a 16-year period for liabilities that were in force prior to the introduction of Solvency II on 1 January 2016.[457] The application of this measure requires prior approval from the supervisory authority.[458] This is referred to as the transitional measure on technical provisions.

[454] (1) PRA SS23/15; and (2) Regulation 43(4) of the Solvency 2 Regulations 2015.

[455] Article 1(41) 2021/0295 (COD).

[456] *Ibid.*

[457] Article 308d of the Solvency II Directive.

[458] Article 308d(1), *ibid* (transposed in Paragraph 11.1, Transitional Measure Part of the PRA Rulebook).

In the UK, the PRA has simplified the TMTP as part of Solvency UK, which will benefit any firm that is granted TMTP permission in the future (including where it is accepting business that already benefits from TMTP, *e.g.*, by portfolio transfer or a 100% reinsurance transaction).[459] These reforms will be implemented by (re)insurers by 31 December 2024.[460] In summary, the simplifications:

- Introduce a simplified new default method for calculating TMTP.
- Permit firms for which the new TMTP method would be inappropriate to continue to use the existing calculation approach with some modifications.
- Remove the financial resources requirement test.
- Require all firms to amortise TMTP so that it decreases to zero by the end of the transitional period.
- Introduce an expectation that firms consider risks to meeting their solvency risk appetite in the medium term due to TMTP run off.
- Allow firms to calculate TMTP at the final day of each reporting period and remove the requirement for firms to seek the PRA's permission for a recalculation.
- Remove the expectation for TMTP calculations to have audit committee sign-off.
- Introduce a more consistent approach to TMTP methodology changes where business is transferred or 100% reinsured.
- Only grant any new permissions to apply TMTP in circumstances where a firm without an existing TMTP permission acquires or accepts business that already benefits from TMTP.
- Remove the ability for third country branches to use TMTP.

[459] (1) PRA PS2/24; and (2) PRA SS 17/15.

[460] *Ibid.*

Chapter 8

Capital Requirements

Introduction

"The supervisory regime should provide for a risk-sensitive requirement, which is based on a prospective calculation to ensure accurate and timely intervention by supervisory authorities (the Solvency Capital Requirement), and a minimum level of security below which the amount of financial resources should not fall (the Minimum Capital Requirement). Both capital requirements should be harmonised throughout the Community in order to achieve a uniform level of protection for policyholders. For the good functioning of this Directive, there should be an adequate ladder of intervention between the Solvency Capital Requirement and the Minimum Capital Requirement."[461]

The Solvency Capital Requirement

The SCR is designed to protect policyholders by helping ensure that insurers can survive difficult periods and pay claims as they fall due. It prescribes a specific level of capital that an insurer is expected to hold, calculated after taking into account a diverse range of risks. Solvency II requires that the SCR is calculated at a "value-at-risk" that is subject to a 99.5% confidence level. In other words, the SCR should allow the insurer to be able to withstand, without its entire depletion, all but the most extreme risks that occur less than once every 200 years.

The SCR operates alongside the MCR, which is a significantly lower threshold than the SCR. If an insurer's capital falls below the SCR, the PRA is able to intervene in the running of the insurer. If the level of capital falls below the MCR, the PRA has the right to withdraw authorisation and close the insurer to new business.

The SCR must be calculated at least annually and the result reported to the PRA. Insurers must continue to monitor their amount of capital and their SCR on an ongoing basis. If there is a significant change in an insurer's risk profile, it must recalculate its SCR as soon as possible and report the new result to the PRA.[462] The SCR may be calculated either by using the standard formula, prescribed by the PRA Rulebook and Solvency II, or by using a PRA-approved IM bespoke to the company concerned.

The SCR and MCR are not to be confused with a (re)insurer's technical provisions, being the assets required to meet its expected, ongoing obligations to policyholders. The SCR (and MCR) sits as a buffer on top of technical provisions to guard against adverse deviation in market, operating or other conditions on at least a 1 in 200 basis. Equally, the SCR and MCR are not to be confused with "own funds", being the capital items with which a (re)insurer must cover its SCR/MCR (or the assets in which a (re)insurer may invest the proceeds of such own-fund items). These different concepts and regimes are covered in other chapters.

There are two main methods of calculating the SCR under Solvency II: the standard formula and internal model methods. This chapter will focus on the former, which must be used by all (re)insurers not using an approved internal model.

Following Brexit, the UK's divergence from EU-derived rules includes liberalisation of the EU Solvency II regime towards a new Solvency UK, moving the UK back toward a less prescriptive and more principles-based regulatory rule set. To date, these changes have not touched directly on SCR and MCR, but we

[461] Recital 60 of the Solvency II Directive as onshored by the EU (Withdrawal) Act 2018, implemented through the PRA Rulebook.

[462] Article 102, *ibid* (transposed in Paragraphs 4.1 to 4.5, Solvency Capital Requirement — General Provisions Part of the PRA Rulebook).

expect the PRA to continue to develop these areas of divergence in the coming years. The Amendments (discussed in previous chapters) do, however, affect the treatment of both long-term equities and the symmetric adjustment, detailed further below.

In this chapter, we summarise the Solvency II position, together with the UK approach (to the extent different or otherwise noteworthy).

1. Key Features of the Solvency Capital Requirement

Structure

The SCR calculated using the standard formula is made up of:

- The basic SCR.
- The capital requirement for operational risk.
- An adjustment for the loss-absorbing capacity of technical provisions and deferred taxes.
- A capital requirement for intangible asset risk.[463]

Principles

The key principles of the SCR are as follows:[464]

- It must be calculated on the presumption that the undertaking will pursue its business as a going concern.
- It must be calibrated so as to ensure that all quantifiable risks to which an undertaking is exposed are taken into account.
- It must cover existing business as well as new business expected to be written over the following 12 months.

Diversification

Where appropriate, diversification effects must be taken into account in the design of each risk module.[465] This assumes that the assets of a (re)insurer are fungible, *i.e.*, they can be used generally to meet the liabilities of the (re)insurer wherever those liabilities arise.

Correlation matrices also apply within the underwriting and market risk modules. These allow for the recognition of "diversification effects" in the calculation — *i.e.*, where a (re)insurer has diversified its risks and/or holds a diversified asset portfolio, not all risks/assets will respond in the same way to a given event. The overall SCR calculation should therefore not simply aggregate all individually calculated capital charges.

As an exception to this, adjustments should be made to reflect the absence of diversification in the case of assets and liabilities where restrictions exist.[466] In these cases, a notional SCR should be calculated for (i) the RFF; and (ii) the remaining part of the undertaking, as though they were separate undertakings.

[463] Article 87 of the Level 2 Delegated Regulation.

[464] Article 101(2) and 101(3) of the Solvency II Directive (transposed in Paragraphs 3.2 to 3.4, Solvency Capital Requirement — General Provisions Part of the PRA Rulebook).

[465] Article 104(4), *ibid* (transposed in Paragraph 3.4, Solvency Capital Requirement — General Provisions Part of the PRA Rulebook).

[466] Recitals 37 and 39 and Articles 216 and 217 of the Level 2 Delegated Regulation.

Risk Mitigation

The SCR must take account of the effect of risk mitigation techniques, provided that credit risk and other risks arising from the use of such techniques are properly reflected in the SCR. Risk mitigation techniques include collateral, guarantees and reinsurance.

We discuss these techniques, and their impact on SCR, in detail in Chapter 2: Reinsurance and Risk Transfer.

Look-Through Approach

The SCR must be calculated, where applicable, on the basis of the "look-through approach". Where an undertaking has an indirect exposure to an asset, the SCR should be calculated with reference to that asset.

The EIOPA has published Level 3 Guidelines on how the look-through approach should be applied, including the application of the approach to money market funds, the number of iterations of the approach an undertaking should perform, the look-through treatment of real estate and the look-through treatment of catastrophe risk.

External Credit Ratings

The SCR standard formula provides for different risk charges depending on whether an external rating is available and what rating is assigned. (Re)insurers must evaluate the appropriateness of those external credit assessments as part of their risk management by using alternative credit assessments.[467]

There are references throughout the Level 2 Delegated Regulation to different credit ratings (or credit quality steps) measured in accordance with the Commission Implementing Regulation, which determine the relevant capital treatment.

2. Basic Solvency Capital Requirement[468]

The basic SCR figure is reached by aggregating the capital charges arising from each of the specified risk modules, in accordance with a formula and correlation matrix set out in the Solvency II Directive.

The specified risk modules are:

- Underwriting risk, split into:
  - Non-life underwriting risk.
  - Life underwriting risk.
  - Health underwriting risk.
- Market risk.
- Counterparty default risk.

[467] Article 44(4a) of the Solvency II Directive (transposed in Paragraph 3.6, Conditions on Governing Business Part of the PRA Rulebook).

[468] Article 104(1) and Annex IV, point 1, *ibid* (transposed in Paragraph 3.1, Solvency Capital Requirement — Standard Formula Part of the PRA Rulebook).

3. Underwriting Risk

Non-life Underwriting Risk Module

This must include at least:[469]

- A non-life premium and reserve risk sub-module covering the risk of loss, or of adverse change in the value of insurance liabilities, resulting from fluctuations in the timing, frequency and severity of insured events, and in the timing and amount of claim settlements.
- A non-life catastrophe risk sub-module covering the risk of loss, or of adverse change in the value of insurance liabilities, resulting from significant uncertainty of pricing and provisioning assumptions related to extreme or exceptional events.

The Level 2 Delegated Regulation also (i) adds a "non-life lapse risk sub-module" to the non-life underwriting risk module; and (ii) breaks up the non-life catastrophe risk sub-module into the following sub- and sub-sub-modules:[470]

- A natural catastrophe risk sub-module, which is sub-divided into risk of windstorms, earthquakes, floods, hail and subsidence.
- A man-made catastrophe risk sub-module, which is sub-divided into risk relating to motor vehicle liability, marine, aviation, fire, liability and credit and surety.

Life Underwriting Risk Module

This comprises sub-modules to cover the risk of loss, or of adverse change, in the value of insurance liabilities, resulting from:[471]

- **Mortality risk** *i.e.*, changes to the level, trend or volatility of mortality rates, where an increase in the mortality rate leads to an increase in the value of insurance liabilities.
- **Longevity risk** *i.e.*, changes to the level, trend or volatility of mortality rates, where a decrease in the mortality rate leads to an increase in the value of insurance liabilities.
- **Disability-morbidity risk** *i.e.*, changes to the level, trend or volatility of disability, sickness and morbidity rates.
- **Life expense risk** *i.e.*, changes to the level, trend or volatility of the expenses incurred in servicing contracts of (re)insurance contracts.
- **Revision risk** *i.e.*, changes to the level, trend or volatility of the revision rates applied to annuities, due to changes to the legal environment or to the state of health of the person insured.
- **Lapse risk** *i.e.*, changes to the level or volatility of the rates of policy lapses, terminations, renewals and surrenders.
- **Life-catastrophe risk** *i.e.*, significant uncertainty of pricing and provisioning assumptions related to extreme or irregular events.

[469] Article 105(2), *ibid* (transposed in Paragraphs 3.5 and 3.6, Solvency Capital Requirement — Standard Formula Part of the PRA Rulebook.

[470] Articles 114 to 135 of the Level 2 Delegated Regulation.

[471] (1) Article 105(3) and Annex IV, point 3 of the Solvency II Directive (transposed in Paragraphs 3.7 to 3.9, Solvency Capital Requirement — Standard Formula Part of the PRA Rulebook); and (2) Articles 136 to 143 of the Level 2 Delegated Regulation.

Detailed calculations for each of these, together with the formula and correlation matrix for calculating the overall life underwriting risk capital requirement, are set out in the Level 2 Delegated Regulation.[472]

Health Underwriting Risk Module

This must cover at least the risk of loss, or of adverse change, in the value of insurance liabilities resulting from:

- Changes to the level, trend or volatility of the expenses incurred in servicing contracts of (re)insurance contracts.
- Fluctuations in the timing, frequency and severity of insured events, and in the timing and amount of claim settlements at the time of provisioning.
- The significant uncertainty of pricing and provisioning assumptions related to outbreaks of major epidemics, as well as the unusual accumulation of risks under such extreme circumstances.

The Level 2 Delegated Regulation sets out further categories of risk sub-modules that must be covered in the health underwriting risk module and which treat the risk module with more granularity.

Undertaking Specific Parameters

Subject to approval by the relevant supervisory authority, an undertaking may replace a subset of parameters of the standard formula with parameters specific to the undertaking concerned when calculating the life, non-life or health underwriting risk modules.[473]

In addition, the supervisory authority may require this, where it is inappropriate for the (re)insurer to use the standard parameters where the risk profile of the undertaking deviates significantly from the assumptions underlying the standard formula calculation.[474]

In the UK (re)insurers wishing to use undertaking specific parameters (USPs) will need to apply to the PRA for approval in the form of a waiver. The PRA has been able to also use its powers under Section 55M of the FSMA where it wished to require a (re)insurer to use USPs; however, the PRA will no longer have this power effective from 31 December 2024.

4. Market Risk

Overview

The market risk module seeks to capture the risk of falls in the value of assets held by a (re)insurer and increases in the value of its non-insurance liabilities. It does this through a series of sub-modules addressing different market factors that may affect the value of assets and liabilities. In each case, a risk charge is calculated, which contributes towards the overall capital charge for market risk. The overall capital requirement for market risk is then calculated using the formula and correlation matrix set out in the Level 2 Delegated Regulation.[475]

[472] Articles 136 to 143 of the Level 2 Delegated Regulation.

[473] Article 104(7) of the Solvency II Directive (transposed in Regulation 47 of the Solvency 2 Regulations 2015).

[474] Article 110, *ibid* (transposed in Paragraphs 2.2 and 2.3 of the PRA SS4/15 — please note paragraph 2.3 will no longer be in force effective from 31 December 2024).

[475] Article 164(2) of the Level 2 Delegated Regulation.

The market risk module includes at least the following sub-modules.

Interest-Rate Risk Sub-Module[476]

The interest-rate risk sub-module covers the sensitivity of the values of assets, liabilities and financial instruments to changes in the term structure of interest rates, or in the volatility of interest rates.

Equity Risk Sub-Module

Overview

The equity risk sub-module covers the sensitivity of the values of assets, liabilities and financial instruments to changes to the level or to the volatility of market prices of equities.[477]

Equities are divided into type 1 equities, type 2 equities and qualifying infrastructure equities, with different risk charges applying to each category.

Type 1 and 2 Equities

Type 1 equities are:

- Equities listed in regulated markets in countries that are members of the EEA or the Organisation for Economic Co-operation and Development (OECD).[478]
- Equities held within or units or shares in:[479]
  - collective investment undertakings that are "qualifying social entrepreneurship funds";
  - collective investment undertakings that are "qualifying venture capital funds"; or
  - closed-ended and unleveraged alternative investment funds established or marketed in the EU.

Type 2 equities are:

- Equities listed on stock exchanges in countries that are not members of the EEA or OECD.
- Non-listed equities.
- Commodities and other alternative investments.
- All assets (other than those covered in the interest rate risk sub-module, the property risk sub-module or the spread risk sub-module), including the assets and indirect exposures where a look-through approach is not possible.

[476] Articles 165 to 167, *ibid.*
[477] Articles 168 to 173, *ibid.*
[478] Article 168(2), *ibid.*
[479] Article 168(6), *ibid.*

The Standard Charges

The risk charge for equities depends not just on the type of equity but also on whether or not it constitutes a "strategic investment" (see below). The charges under the "standard" equity risk sub-module are:

Equity type[480]	**Investment of a strategic nature in a related undertaking?**	**Risk charge equal to the loss in BOF resulting from a decrease in the value of equities of:**
1	Yes	22%
1	No	39% + symmetric adjustment mechanism
2	Yes	22%
2	No	49% + symmetric adjustment mechanism
Holdings in qualifying infrastructure entities[481 482 483]	**Investment of a strategic nature in a related undertaking?**	**Risk charge equal to the loss in BOF resulting from a decrease in the value of equities of:**
Qualifying infrastructure project entities	Yes	22%
Qualifying infrastructure project entities	No	30% + 77% of the symmetric adjustment mechanism
Qualifying infrastructure corporate entities	Yes	22%
Qualifying infrastructure corporate entities	No	36% + 92% of the symmetric adjustment mechanism

[480] Article 169(1)-(2), *ibid*.

[481] Article 169(3), *ibid* (as added by Commission Delegated Regulation (EU) 2016/467).

[482] These are entities or groups that derive the substantial majority of their revenues from owning, financing, developing or operating infrastructure assets split between: (i) infrastructure corporate entities (having a business object beyond a specific infrastructure project); and (ii) infrastructure project entities (being limited to one or more specific infrastructure projects).

[483] Article 164a of the Level 2 Delegated Regulation (as added by Commission Delegated Regulation (EU) 2016/467) sets out criteria such as the creditworthiness of the entity and applicable contractual arrangements. An infrastructure corporate entity must also meet the criteria set out in Article 164b of the Level 2 Delegated Regulation (as added by Commission Delegated Regulation (EU) 2016/467), including that the majority of the entity's revenues are derived from infrastructure assets located in the EEA or the OECD and other requirements regarding security on source and type of revenues.

Strategic Investments

Equity investments are of a strategic nature where:

- The value of the equity investment is likely to be materially less volatile for the following 12 months than the value of other equities over the same period.
- The nature of the investment is strategic taking into account all relevant factors, including:
  - The existence of a clear decisive strategy to continue holding the participation for a long period.
  - The consistency of the strategy with the main policies guiding the actions of the undertaking and, where the undertaking is part of a group, the actions of the group.
  - The participating undertaking's ability to continue holding the participation.
  - The existence of a "durable link".[484]

The Symmetric Adjustment Mechanism

The symmetric adjustment mechanism is intended to mitigate undue potential pro-cyclical effects of the financial system, and to avoid a situation where (re)insurers are forced to raise additional capital or sell investments as a result of adverse movements in financial markets.[485]

The symmetric adjustment mechanism adjusts the standard charge, where applicable, by reference to the current level and a weighted average level of an "appropriate equity index", to be determined by the EIOPA under an implementing technical standard (or by the PRA for UK purposes). The result of the adjustment must not result in a capital charge more than 10% higher or lower than the standard equity capital charge.[486]

In the 2020 Review, the European Commission proposed amending the parameters of the symmetric adjustment mechanism so that the adjustment must not result in a capital charge more than 17% higher or lower than the standard equity capital charge.

Long-Term Equity Investments

Long-term investments in equity benefit from the same capital charge as strategic investments, provided certain criteria relating to the asset-liability and investment management of the insurer are met. For example, such an investment must have an average holding period of five years or more and be able to be held under stressed conditions for a further 10 years.

In the 2020 Review, the European Commission proposed a series of updates to the qualifying criteria, including relaxing requirements around the ring-fencing and holding period of the assets, and introducing a differentiation between life firms (illiquidity of BEL and a duration of more than 10 years) and non-life firms (hold an amount of liquid assets larger than net BEL).

[484] Article 171 of the Level 2 Delegated Regulation.

[485] Recital 61 of the Solvency II Directive.

[486] Article 106, *ibid* (transposed in (i) Paragraph 4.1, Solvency Capital Requirement — Standard Formula Part of the PRA Rulebook; and (ii) Article 172 of the Level 2 Delegated Regulation).

The Committee on Economic and Monetary Affairs has further proposed to elevate the allowance for long-term equities to the level of the Solvency II Directive, from the Level 2 Delegated Regulation, signalling the political significance of this change. The European Parliament also proposes to simplify the eligibility criteria by leaving to the insurers the onus of managing such investments via risk management, asset-liability management and investment policy tools.

Retirement Business

A "duration-based equity risk sub-module" may apply instead of the equity risk sub-module to (re)insurers writing specified types of retirement business, where the assets and liabilities corresponding to the relevant business are ring-fenced, and where the average duration of the relevant liabilities exceeds 12 years.[487]

Property (Real Estate) Risk Sub-Module

The property risk sub-module covers the sensitivity of the values of assets, liabilities and financial instruments to changes to the level or to the volatility of market prices of real estate. The EIOPA Level 3 Guidelines distinguish:

- Direct investments in land, buildings and immovable property rights and property investment held for the own use of the undertaking, which should be dealt with under the property risk sub-module.
- Equity investments in companies exclusively engaged in facility management, real estate administration, real estate project development or similar activities, which should be dealt with under the equity risk sub-module.
- Investments in real estate through collective investment undertakings or other investments packaged as funds, which should have the look-through approach applied.

It provides that the capital requirement for real property risk is to be equal to the loss in the BOF that would result from a decrease of 25% in the value of immovable property.[488]

Spread Risk Sub-Module

The spread risk sub-module covers the sensitivity of the values of assets, liabilities and financial instruments to changes to the level or volatility of credit spreads over the RFR term structure.[489]

The capital charge for spread risk is made up of three components, as set out immediately below:

- **A Charge for Bonds and Loans.** This is an amount equal to the loss in the BOF that would result from a decrease in the value of such bonds or loans calculated in accordance with a table set out in the Level 2 Delegated Regulation.[490] The assumed decrease varies depending on the duration of the bond and the "credit quality" (*i.e.*, rating) of the bond or loan. Longer-dated instruments and instruments with a lower credit quality will attract a higher capital charge. Separate figures apply where no rating is available, which vary depending on whether collateral has been posted by the debtor.[491]

[487] (1) Article 304, *ibid*; and (2) Article 170 of the Level 2 Delegated Regulation.

[488] Article 74 of the Level 2 Delegated Regulation.

[489] Articles 175 to 181, *ibid.*

[490] Article 176, *ibid.*

[491] Reduced capital charges for unlisted debt are available in the case of an internal credit quality assessment by the (re)insurer itself, with either a step 2 or step 3 credit quality. These include requirements that the debt is issued by a corporate entity based in the EEA, that the corporate entity has operated for at least 10 years without a credit event and that the debt constitutes a senior exposure.

- **A Charge for Securitisation Position.** STS securitisations (both senior and non-senior)[492] are allocated a relatively low capital charge. In contrast, non-STS securitisations are allocated a different charge.
- **A Charge for Credit Derivatives.** This must be calculated under the methodology set out in the Level 2 Delegated Regulation[493] except where: (i) the credit derivative is part of the undertaking's risk mitigation policy; and (ii) the undertaking holds either the instruments underlying the credit derivative or another exposure, where the basis risk between the exposure held and the instruments underlying the credit derivative is not material.

Mortgage loans that meet the requirements set out in the Level 2 Delegated Regulation[494] are not covered by the spread risk sub-module. Instead, such loans are dealt with under the counterparty default risk module.

Specific Exposures

Certain types of instrument that would otherwise attract a capital charge under the provisions above qualify for special treatment in the spread risk sub-module (as specified in each case). These include:

- Highly rated covered bonds.
- Bonds or loans issued by (i) the European Central Bank, member states' central government and central banks (*i.e.*, EU sovereign debt) or, in the case of the UK, the UK government or the Bank of England; or (ii) multilateral development banks and certain international organisations.
- Bonds or loans issued by other governments and central banks.
- Bonds or loans issued by a (re)insurance undertaking or a third country (re)insurance undertaking in an equivalent jurisdiction.
- Bonds or loans issued by certain credit institutions and financial institutions.
- Credit derivatives where the underlying financial instrument is a bond or loan issued by (i) the European Central Bank, member states' central government and central banks (*i.e.*, EU sovereign debt) or, in the case of the UK, the UK government or the Bank of England; or (ii) multilateral development banks and certain international organisations.
- Exposures that relate to qualifying infrastructure investments (subject to certain conditions).

Market Risk Concentrations Sub-Module[495]

The market risk concentrations sub-module covers additional risks to a (re)insurer stemming either from lack of diversification in the asset portfolio or from large exposure to default risk by a single issuer of securities or a group of related issuers. It covers assets considered in the equity, interest, spread and property risk sub-modules of the market risk module. It does not apply to assets covered by the counterparty default risk module.

[492] As defined in the Commission Delegated Regulation (EU) 2018/1221.
[493] Articles 175 and 179 of the Level 2 Delegated Regulation.
[494] Article 191, *ibid.*
[495] Articles 182 to 187, *ibid.*

Currency Risk Sub-Module[496]

The currency risk sub-module covers the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of currency exchange rates.

The market risk module design is intended to strip out currency effects in the calibration of the other sub-modules so that currency effects appear only in the currency risk sub-module.

5. Solvency Capital Requirement Standard Formula: Counterparty Default Risk Module[497]

Counterparty default risk covers the risk of possible losses due to the unexpected default or deterioration in the credit standing of certain counterparties and debtors. The capital charge for counterparty default risk is made up of a capital requirement for type 1 exposures and a capital requirement for type 2 exposures.

Where an instrument is subject to market risk, SCR charges for spread risk and concentration apply. Otherwise, SCR charges for counterparty default risk apply.

Type 1 and 2 Exposures

Type 1 exposures are:

- Risk mitigation contracts including reinsurance arrangements, arrangements with SPVs, insurance securitisations and derivatives.[498]
- Cash at bank.
- Deposits with ceding undertakings where the number of single-name exposures (being exposures to undertakings belonging to the same corporate group) does not exceed 15.
- Guarantees, letters of credit and similar arrangements provided by the undertaking where payment obligations depend on the credit standing/default of a counterparty.

In this case, the capital requirement for counterparty default risk is calculated based on the "loss-given default" and the "probability of default" for a given asset.

Type 2 exposures are all credit exposures that are not covered in the spread risk sub-module and that are not type 1 exposures, including:

- Receivables from intermediaries.
- Policyholder debtors.
- Mortgage loans meeting requirements set out in Level 2 Delegated Regulation.[499]
- Deposits with ceding undertakings where the number of single name exposures exceeds 15.
- Commitments that are called up but unpaid where the number of single name exposures exceeds 15.

[496] Article 188, *ibid.*

[497] Articles 189 to 202, *ibid.*

[498] Irrespective of whether they are held for hedging or speculation.

[499] Article 191 of the Level 2 Delegated Regulation. These must be retail loans secured on residential property, the exposure must be to a natural person(s) or a small or medium enterprise, the value of the property must not materially depend on the credit quality of the borrower and the risk of the borrower must not materially depend on the performance of the underlying property asset. Other types of mortgage loans will be covered by the spread risk sub-module.

In this case, the capital requirement for counterparty default risk is calculated as the loss in BOF that would result from an instantaneous decrease in the value of type 2 exposures.[500]

6. Solvency Capital Requirement Standard Formula: Intangible Asset Module

Generally, intangible assets are valued at zero in the Solvency II balance sheet.

However, an intangible asset, other than goodwill (which is always valued at zero), can be ascribed a value (based on quoted market prices in active markets) if it can be sold separately and the undertaking can demonstrate that there is a value for the same or similar assets that has been derived in accordance with the Level 2 Delegated Regulation.[501] Accordingly, the Level 2 Delegated Regulation sets out a capital charge in respect of the amount of intangible assets.[502]

7. Solvency Capital Requirement Standard Formula: Operational Risk Module

The Solvency II Directive[503] requires the SCR (calculated under either the standard formula or using an IM) to cover operational risk to the extent not already reflected in the other risk modules. The capital requirement for operational risk is capped at 30% of the basic SCR (other than in respect of unit-linked business).[504]

The Level 2 Delegated Regulation sets out the calculation of the capital requirement for operational risk under the Standard Formula based on the level of earned premiums over a specified period and the amount of technical provisions (not including the risk margin and without deduction of recoverables from reinsurance contracts and SPVs).

8. Solvency Capital Requirement Standard Formula: Loss Absorbency

The calculation of the SCR under the Standard Formula includes an adjustment (where applicable) for the loss-absorbing capacity of technical provisions and deferred taxes.[505]

The purpose of the adjustment is to reflect the fact that in some circumstances where unexpected losses arise, the undertaking can partially compensate for these through: (i) reducing benefits payable on policies involving future discretionary benefits; and/or (ii) reducing future deferred tax liabilities.[506]

[500] Article 202 of the Level 2 Delegated Regulation.

[501] Article 10(2), *ibid.*

[502] Articles 12 and 201, *ibid.*

[503] Article 107(1) of the Solvency II Directive (transposed in Paragraph 5.1, Solvency Capital Requirement — Standard Formula Part of the PRA Rulebook).

[504] Article 204 of the Level 2 Delegated Regulation.

[505] Article 108 of the Solvency II Directive (transposed in Paragraph 6.1 and 6.2, Solvency Capital Requirement — Standard Formula Part of the PRA Rulebook).

[506] Articles 206 and 207 of the Level 2 Delegated Regulation.

9. Look-Through Approach[507]

The "look-through approach" applies to:

- Indirect exposures to market risk (including through collective investment undertakings and investments packaged as funds).
- Indirect exposures to underwriting risk.
- Indirect exposures to counterparty risk.

The Level 2 Delegated Regulation[508] sets out the steps required where it is not possible to apply the look-through approach, in the case of collective investment undertakings and investments packaged as funds. Grouping of exposures are permitted when the target asset allocation is not available at the requisite level of granularity for all sub-modules, provided this is applied in a prudent manner.

Related Undertakings

Related undertakings, except for those whose main purpose is to hold or manage assets on behalf of the participating (re)insurance undertaking, are explicitly excluded from the look-through approach[509] and are therefore treated under the equity risk sub-module.

10. The Minimum Capital Requirement[510]

In addition to the SCR, (re)insurers must also calculate the MCR and hold eligible own funds to cover it.

The MCR must be calibrated to a confidence level of 85% over a one-year period (in contrast to the 99.5% value-at-risk calibration for the SCR).

The MCR is subject to a cap and two separate floors:

- The MCR must not exceed 40% of the (re)insurer's SCR, including any capital add-on.
- The MCR must not be less than 25% of the (re)insurer's SCR, including any capital add-on.
- The MCR has an absolute floor, set at a different amount for each of general insurers, long-term insurers, pure reinsurers and composite insurers.

(Re)insurers must calculate the MCR and report the results to the PRA at least quarterly.

[507] Article 84, *ibid.*

[508] Article 84(3), *ibid.*

[509] Article 84(4), *ibid.*

[510] (1) Article 129 of the Solvency II Directive (transposed in Paragraphs 3.1 to 3.13, Minimum Capital Requirement Part of the PRA Rulebook); and (2) Articles 248 to 254 of the Level 2 Delegated Regulation.

Chapter 9

Internal Models

Introduction

There are two main methods of calculating the SCR under Solvency II, the "standard formula" and "IM" methods:

- The standard formula method, as its name suggests, is the default approach and is a standard set of rules which apply unless a (re)insurer has an IM. Nonetheless, calculation of the SCR under the standard formula method is complex, involving many assumptions and consideration of seven categories of risk and within that, 22 sub-categories — and a degree of standardisation that may not always be optimal or appropriate.
- Under the alternative, IM method, a (re)insurer must analyse data relating to its own risks and develop its own assumptions, calibrations and correlations. Stochastic models and other sophisticated statistical techniques will typically be used. The IM will be bespoke to the (re)insurer and may be voluntarily adopted with regulatory approval or, in theory at least, imposed upon the (re)insurer by its regulator.

Although the IM is bespoke to the (re)insurer in question, the PRA requires benchmarking to ensure there is a degree of consistency between IM firms. In practice this may, to a degree, limit the individuality of firms' IMs. The PRA may require a (re)insurer to run its IM on relevant benchmark portfolios, using assumptions based on external data, to verify the calibration of the IM and to check that its specification is in line with generally accepted market practice. Other requirements for the IM include: (i) an annual review of causes and sources of profits and losses and attribution of risk categories to those; and (ii) a regular cycle of IM validation and documentation. For larger, more complex businesses, an IM is more likely to reflect the risk profile of the (re)insurer more accurately than use of the standard formula.

A (re)insurer may also choose a partial IM where a particular aspect of its business does not fit well within the standard formula. In that case, it must explain and justify the reason for the limited scope of the model in its approval application. The partial IM must result in an SCR which reflects the risk profile of the (re)insurer more appropriately and must integrate into the SCR standard formula.[511]

Following Brexit, the UK's divergence from EU-derived rules includes liberalisation of the EU Solvency II regime towards a new Solvency UK, moving the UK back toward a less prescriptive and more principles-based regulatory rule set. To date, these changes have touched lightly on the area of IMs (see further below), and we expect the PRA to continue to tweak its approach to IMs in the coming years.

1. Advantages of an Internal Model

Advantages of an IM typically include:

- **Sophistication.** An IM generally allows a (re)insurer to reflect better the complexities of a multinational or specialist insurance business when compared to the standard formula.
- **Risk Sensitivity.** An IM tracks risks more accurately and, therefore, overall capital will be more accurately determined when compared to the standard formula. Less capital leads to a lower cost of capital, leading to cost advantages and the potential to utilise capital more efficiently within the business.
- **Risk Awareness.** Developing an IM requires a (re)insurer to invest time and resources in understanding the risks of the business at a fundamental level.

[511](1) Article 113 of the Solvency II Directive (transposed in Paragraph 4.2, Solvency Capital Requirements Part of the PRA Rulebook); and (2) Article 239 of the Level 2 Delegated Regulation.

- **Flexibility.** An IM provides more flexibility in how the (re)insurer takes credit for certain risk mitigation techniques it has implemented. IMs develop over time and can respond more quickly than the standard formula to changes in a (re)insurer's risk landscape.
- **Duration.** An IM permits a (re)insurer to calibrate its SCR using a longer timescale than the standard formula.[512] This may allow insurers to accommodate longer-term considerations into their IMs, such as sustainability risks.
- **Data.** An IM provides the (re)insurer with more data which can be used to make positive business decisions. For example, the model can provide information on different return periods, which can be extremely useful.

Originally it was assumed that smaller companies would use the standard formula at first, and graduate to IMs at a later stage. In practice, however, the hoped-for benefits of industry-wide use of IMs have not been borne out. The cost of developing an IM typically runs to tens of millions even for mid-sized companies, and hundreds of millions for larger companies.

Further, the capital benefit of using an IM has sometimes proved illusory, as supervisors tend to use the approval process to enforce the inclusion of conservatism into assumptions that concern them.

Moreover, practice has evolved and moved away from the original concept of the SCR. The original concept for Solvency II was that all insurers would have to hold capital of at least 100% of SCR. Many regulators now expect companies to document their "risk appetite" in a policy, with firms now generally expected to set their risk appetite targets at perhaps 130% of SCR for a company with a strong parent and parental guarantees, to 150% and perhaps even more for a self-standing company. Publicly quoted companies typically run at levels in excess of 180% of SCR. Frequently, you can see coverage levels even higher. Effectively, SCR has become a kind of MCR and risk appetite has become the new SCR. Relatedly, supervisors have typically required the larger companies in their market, and those with particularly complex businesses, to adopt an IM — which can be viewed as a means of supporting this conservatism.

2. Requirements for Use of an Internal Model

Model Approval

A (re)insurer may only calculate its SCR using a full or partial IM if it has been granted IM approval, and only to the extent of that approval.[513] Once approval has been granted, the (re)insurer is required to use the model to calculate its SCR.

Use Test

At the core of the use test is the requirement that firms can demonstrate that the IM is "widely used in and plays an important role in their system of governance".[514] (Re)insurers are expected to develop systems and controls to identify, measure and manage each risk. The use test specifies that a (re)insurer should use

[512] Article 122 of the Solvency II Directive (transposed in Paragraph 12.1, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook).

[513] Paragraph 2.1, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook.

[514] Article 120 of the Solvency II Directive (transposed in Paragraph 10.1, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook).

the same models for this purpose as are used to calculate its economic and solvency capital assessment and allocation processes, including its ORSA. The idea is that proper risk management should not be a compliance issue, but sit at the heart of running the business, including as follows:[515]

- The model supports relevant decision-making processes, including the setting of the business strategy.
- The model and its results are regularly discussed and reviewed by the (re)insurer's administrative, management or supervisory body (AMSB).
- All material quantifiable risks identified by the risk management system and which are within scope of the IM are covered by the model.
- The (re)insurer uses the IM to assess the impact on its risk profile of material decisions.
- The outputs from the IM are taken into account in formulating risk strategies, including risk tolerance limits.
- The IM outputs are included in internal risk management reporting procedures.
- Quantification and ranking of risks produced by the IM trigger risk management actions where relevant.
- Relevant change procedures are followed.

The Role of the Board

The PRA also stresses the responsibilities of a (re)insurer's board.[516] Although it is not necessary for all board members to be technical experts as such, the PRA does expect board members to be able to understand and explain areas such as the key strengths, limitations and judgements within the model; assumptions and judgements that have the most material impact on the model output; and key sources of information and advice which the board has relied on. This includes knowledge as follows:

- The structure of the IM.
- The way the model fits to the business and is integrated into the risk management system.
- The scope and purpose of the IM.
- The risks that are or are not covered by the model.
- The general methodology applied in the IM calculations.
- The limitations of the IM.
- The diversification effects taken into account in the IM.

The PRA also expects that the executive should be able to explain the (re)insurer's IM in simple and transparent terms to the non-executive directors (NEDs) — and that NEDs will challenge how the viability and sustainability of the business model, risk appetite and management framework are reflected in the IM.

[515] Articles 223 to 226 of the Level 2 Delegated Regulation.

[516] Article 116 of the Solvency II Directive (transposed in Paragraph 7.1, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook).

3. Data Quality Standards

The IM regime specifies statistical quality standards.[517] Accordingly:

- The methods used to calculate the IM must:
  - Be based on adequate, applicable and relevant actuarial and statistical techniques.
  - Be based upon current and credible information and realistic assumptions.
  - Be consistent with the methods used to calculate technical provisions.
  - Allow the IM to rank risk in a way which is sufficient to ensure that it is widely used and plays an important part in the (re)insurer's system of governance and capital allocation.
- Data used must be accurate, complete and appropriate and data sets used in the calculation of the probability distribution forecasts must be updated at least annually.
- The model must cover all of the material risks to which the (re)insurer is exposed, including at a minimum the risks set out in SCR.
- The model must accurately assess particular risks associated with financial guarantees and contractual options, where material, and the risks associated with both policyholder options and the (re)insurer's contractual options, taking into account the impact that future changes in financial and non-financial conditions may have on the exercise of those options.
- The model must take account of all payments to policyholders which it expects to make, whether or not contractually guaranteed.
- Dependencies within and across risk categories can only be taken into account in the IM with respect to diversification effects if the PRA is satisfied that the (re)insurer's system for measuring diversification effects is adequate.
- The effect of risk mitigation techniques can only be taken into account in the IM if and to the extent that credit risk and other risks arising from the use of the technique(s) are properly reflected in the model.
- Future management actions can only be taken into account in the IM if and to the extent that the (re)insurer would reasonably expect to carry them out in specific circumstances and the model makes allowance for the time necessary to implement the actions.

4. Internal Model Approval

A (re)insurer may only use an IM with — and to the extent of — supervisory approval.[518] Once approval has been granted, the (re)insurer is required to use the model to calculate its SCR.

An application for approval of an IM must be decided by the supervisory authority within six months from receipt of the "complete" application. The application should be accompanied by the (re)insurer's IM change policy, which also requires approval.[519] In practice, the overall process is likely to take up to a year, with submissions typically running to thousands of pages — the regulator (in the usual way) will wish to see drafts before final submission, which is a de facto extension of the formal timeline.

[517] Article 121, *ibid* (transposed in Paragraph 11, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook).

[518] Article 112, *ibid* (transposed in Paragraph 3.1, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook).

[519] Article 115, *ibid* (transposed in Paragraph 3.3, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook).

5. Other Requirements

Other requirements for the IM include:[520]

- An annual review of causes and sources of profits and losses and attribution of risk categories to causes and sources of profits and losses.
- A regular cycle of IM validation.
- Documentation of the IM.
- Reporting of the outputs of that model so that the PRA can supervise the IM on an ongoing basis and monitor its performance over time.

6. Changes to Internal Models

Once an IM has been approved, the ability of a (re)insurer to make changes to the model is restricted:[521]

- A (re)insurer may not make any changes to its model which are not in accordance with its IM change policy (which will have been approved as part of the IM approval).
- Minor changes to the model which are in accordance with the policy can be made without PRA approval.
- Major changes to the model — as well as changes to the IM change policy — must be approved in advance by the PRA.
- The PRA expects firms to engage as early as possible with their supervision team about planned changes to their IMs.
- The PRA expects firms to submit no more than one model change application per year, although the application could include several individual major changes.
- In unusual circumstances, there may be more than one application in a year.

Transactions such as an acquisition or investment in a new asset class could lead to a change in the (re)insurer's risk profile requiring a model change application. It may not always be possible to obtain approval prior to the transaction, in which case the (re)insurer should discuss with the PRA a way forward.

Firms should provide a summary of their changes, the reasons for changes, the potential impact and the intended timescales. They should also articulate how they prioritised their changes as opposed to other model improvements.

It is important to include qualitative and quantitative indicators in the model change policy. The PRA encourages firms to consider the appropriateness of having different indicators or threshold levels for different risks or components of the model. It can be helpful if firms provide examples of model changes that meet their major change indicators in order to demonstrate the appropriateness of thresholds chosen.

Once a formal IM application has been submitted to the PRA, there is limited opportunity for firms to make substantive changes. Where changes are material, a new application is likely to be required. Alternatively, firms themselves have an option to "stop the clock" on the current application.

[520] Articles 240 to 244 of the Level 2 Delegated Regulation (transposed in Paragraphs 13 to 15, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook and PRA SS25/15).

[521] (1) Article 115 of the Solvency II Directive (transposed in Paragraph 6, Solvency Capital Requirement — Internal Models Part of the PRA Rulebook); (2) PRA SS12/16; and (3) PRA SS17/16.

If a series of minor model changes would amount to a major change, then they will be regarded as such. That said, an annual reset of minor model change accumulation will apply so that firms may reset, at the end of an annual cycle, minor model changes which, when accumulated, do not trigger the major change threshold. This is subject to an assessment[522] (i) by the (re)insurer pursuant to an established governance procedure as to whether a combination of minor changes would constitute a major model change; and (ii) by the PRA via review of the quarterly minor model change reports, with formal approval not being required.

7. Solvency UK

Following Brexit, the UK is moving away from the EU's Solvency II regime, adapting Solvency II to the needs of the UK insurance market.

As part of this process, on 29 June 2023, the PRA released PRA CP12/23[523] setting out its proposals across a wide range of areas, including IMs.[524]

For IMs, the PRA will move away from a number of prescriptive requirements towards a smaller number of more principles-based requirements, for example, around modelling standards.

In summary, the PRA reforms will:

- Streamline the tests and standards required for new IMs and changes to IMs, while ensuring that appropriate IM standards are maintained.
- Introduce more flexibility when the PRA grants new permissions and variations to enable firms to use IMs to calculate their SCR.
- Implement a range of IM approval safeguards that could be used to bring an IM that is not wholly compliant into compliance with the calibration standards and mitigate the risks arising from such noncompliance in all other circumstances.
- Introduce an ongoing IM review framework, building on the PRA's existing supervisory review processes.
- Introduce an alternative to outright rejection of an IM application, namely imposition of one or two new safeguards: a residual capital add-on tool, and model use requirements.

The PRA has confirmed its intent to determine the outcome of a complete application within six months from the date of receipt of the application, and to provide the (re)insurer with a written notice of that determination, and will make reasonable efforts to do so.[525] The changes to systems and controls will need to be implemented by insurers by 31 December 2024.

[522] PRA SS17/16.

[523] PRA CP12/23.

[524] Skadden, Arps, Slate, Meagher & Flom client alert, "From Solvency II to Solvency UK: The PRA Provides Further Details of Its Post-Brexit Solvency II Reforms", 19 July 2023.

[525] PRA PS2/24.

8. Funded Reinsurance

In PRA SS5/24, which considers the use of funded reinsurance in the context of Solvency II, the PRA re-emphasised that for firms using IMs or partial IMs to calculate their SCR, the "use test" requires the output of such models to play an important role in risk management, decision-making and capital allocation.[526]

The PRA expects firms to undertake robust modelling which takes into account the risks associated with funded reinsurance arrangements and to recognise the importance of the IM or partial IM outputs to the decision-making process, when it comes to deciding whether to enter into a funded reinsurance arrangement as a risk mitigation technique. Failure to do so may incentivise short-term behaviours not compatible with the long-term sustainability of the business.

[526] PRA SS5/24.

Chapter 10

Governance Models

Introduction

Solvency II is organised around three core pillars of prudential regulation, which ensure the safety and soundness of (re)insurers, in line with the scale, nature and complexity of their business:

- **Pillar I** focuses on quantitative measures and regulatory capital requirements, detailed through the capital requirements, technical provisions, the MA and IMs, as detailed in Chapter 1: Own Funds, Chapter 5: Matching Adjustment, Chapter 7: Technical Provisions, Chapter 8: Capital Requirements and Chapter 9: Internal Models.
- **Pillar II** addresses governance and risk management. It obligates (re)insurers to conduct a thorough ORSA and mandates the establishment of robust internal governance frameworks.[527]
- **Pillar III** sets out transparency requirements for (re)insurers to regularly disclose pertinent financial information to regulators and the public.

This chapter focuses on Pillar II, which sets out a system of governance requirements for (re)insurers under the Solvency II framework. This governance framework must integrate sound management practices, effective risk management strategies and clearly defined lines of responsibility. The Solvency II Directive requires the governance system to not only be comprehensive but also dynamic, including regular evaluations to address any significant shifts in the (re)insurer's risk profile or operating conditions.

The EIOPA has supplemented such requirements with detailed guidance, emphasising the necessity of a well-integrated system that aligns with the broader organisational structure.[528] (Re)insurers are expected to ensure that governance practices are not only robust but also adaptive to changes, ensuring that they remain compliant with regulatory expectations.

Central to this governance system are the requirements for regular and systematic reviews. These reviews must be conducted at least annually or whenever there are material changes in the (re)insurer's risk environment. The aim is to ensure that governance structures remain effective and relevant in the face of evolving risks and operational challenges.

In the context of UK (re)insurers, under the SMCR the PRA supplements the governance requirements under Solvency II.[529] Although the SMCR operates independently from Solvency II, it is designed with Solvency II in mind.

1. Own Risk and Solvency Assessment

The ORSA is a fundamental aspect of the Solvency II framework, representing a (re)insurer's own perspective on its risk profile, and the capital and other resources needed to address these risks.[530] This assessment must cover each part of a (re)insurer's business and operations. The EIOPA suggests that such processes should be tailored to and independently developed by a (re)insurer, tailored to its organisational structure, risk management framework and proportionate to its business.[531] According to Guideline 1,

[527] Articles 40 to 49 Solvency II Directive (transposed in (i) the Conditions Governing Business Part of the PRA Rulebook; (ii) the Insurance Part of the PRA Rulebook; and (iii) the FCA Fit and Proper Test for Approved Persons (FIT) 1.2.4BG).

[528] The EIOPA Final Report on Public Consultation No. 14/017 on Guidelines on system of governance (EIOPA-BOS-14/253).

[529] Senior Management Functions Part of the PRA Rulebook.

[530] Article 45 of the Solvency II Directive (transposed in PRA Conditions Governing Business Part 3.8 to 3.11).

[531] The EIOPA, Final Report on Consultation Paper No. 14/017 on Guidelines on System of Governance (EIOPA-BOS-14/253).

Paragraph 1.13 of the EIOPA Guidelines on own risk and solvency assessment (EIOPA-BoS-14/259 EN), each (re)insurer must develop its own processes tailored to its organisational structure and risk management system, reflecting the nature, scale and complexity of the risks inherent in its business.

The ORSA must be comprehensive, involving input from across the organisation and going beyond merely producing a report or completing a template. The assessment should:

- Reflect all material risks, including those arising from assets, liabilities and intragroup and off-balance sheet arrangements.
- Incorporate the firm's management practices, systems and controls, including risk mitigation techniques.
- Evaluate the quality of processes and inputs, particularly the adequacy of the governance system.
- Connect business planning with solvency needs, factoring in the specific risk profile, approved risk tolerance and strategic business objectives of the firm.
- Identify possible future scenarios.
- Address external stress factors.
- Use a consistent valuation basis throughout the solvency needs assessment.

The ORSA should be forward-looking and encompass medium and long-term perspectives to capture all material risks adequately. The PRA expects firms to consider risks over the "ultimate time horizon" — the period until all obligations to policyholders have run off — as part of their ORSA.[532]

The ORSA must also ensure continuous compliance with the firm's capital requirements. This includes assessing deviations from the assumptions underlying the SCR. While firms have some flexibility in conducting this assessment, the PRA has specific expectations regarding compliance with regulatory capital and technical provisions, as well as the assessment of any significant changes in the risk profile. The calculation of technical provisions must be validated annually, particularly through comparison against experience.

The board of a (re)insurer holds ultimate responsibility for the firm's compliance with applicable laws and regulations under Solvency II.[533] The board must interact effectively with any committees, senior management and key function holders, taking an active role in the ORSA process. This includes challenging the assumptions behind SCR calculations to ensure they align with the firm's risk profile. The board should leverage insights from the ORSA when approving the firm's short- and long-term capital plans, and the ORSA should be a standing agenda item in relevant board and committee meetings, with discussions recorded in the minutes.

In addition to maintaining a formal ORSA policy, (re)insurers must keep a record of each ORSA, prepare internal and supervisory reports and assess any deviations from the assumptions underlying SCR calculations. The results and conclusions of the ORSA should be communicated to all relevant staff after board approval.

Firms must also document specific processes involved in the ORSA, such as data collection, quality analysis and the selection of assumptions used in technical provisions calculations.

[532] Paragraph 3.6 of the PRA SS26/15.

[533] Article 41 of the Solvency II Directive (transposed in (i) Sections 137G and 165, FSMA; and (ii) Paragraphs 2.2 to 2.4 and 2.6, Conditions Governing Business Part of the PRA Rulebook).

The PRA states that the ORSA should be a dynamic, iterative process, continuously refined as the business environment and risk landscape evolve.[534] (Re)insurers are expected to establish a "feedback loop" where ORSA outcomes directly influence the firm's risk management framework, strategic decisions and capital planning. This ensures that the ORSA is iteratively improved and remains an integral part of risk management and strategic planning, rather than a mere annual compliance task.

Moreover, the PRA mandates that the board of a (re)insurer must actively engage in the ORSA process.[535] This involves setting the risk appetite, reviewing the ORSA's outcomes and ensuring they are fully integrated within the broader risk management framework. The PRA emphasises that the ORSA should generate meaningful management information, supporting informed decision-making and fostering an organisation-wide culture of risk awareness and strategic alignment regarding the (re)insurer.

Climate Change

In April 2021, the EIOPA issued an opinion on climate risk scenarios.[536] This opinion outlines the EIOPA's expectations for how EU National Competent Authorities should oversee the integration of climate change risk scenarios by undertakings in their ORSA.

Key points from the opinion include that (a) firms should identify material climate change risks relevant to their business, or, if they conclude that climate change is not a material risk, they should provide a rationale for this conclusion; and (b) both physical and transition risks should be considered, mapping these to traditional prudential risk categories such as underwriting and market risk.

The EIOPA expects firms to assess both short-term and long-term climate change risks and to adjust their time horizons for stress testing and scenario analysis accordingly.

Note that this opinion was published after the Brexit transition period and is not directly applicable to UK firms, however, it covers similar topics to those addressed in PRA SS3/19.

2. Risk Management, Compliance and Audit Functions

Solvency II mandates various key governance functions that are critical to ensuring robust risk management within (re)insurers. These functions include risk management, compliance, internal audit and actuarial, each with specific delineated roles and responsibilities defined by the Solvency II Directive:

- **Risk Management:** (Re)insurers must establish an effective risk management system. This system should include strategies, processes and reporting procedures designed to identify, measure, monitor, manage and report risks on a continuous basis. The scope of this function encompasses underwriting, asset-liability management, investment, liquidity, concentration risk, operational risk and reinsurance (or other risk mitigation techniques).[537]

[534] Paragraph 2.4 of the PRA SS5/18.

[535] Paragraph 3.1, *ibid.*

[536] The EIOPA, *Opinion on the Supervision of the Use of Climate Change Risk Scenarios in ORSA* (EIOPA-BoS-21-127, 2021); PRA SS3/19.

[537] Article 44 of the Solvency II Directive (transposed in Paragraphs 3.1 to 3.7, Conditions Governing Business Part of the PRA Rulebook).

- **Compliance Function:** The compliance function is responsible for ensuring that the (re)insurer adheres to applicable laws, regulations and administrative provisions. It must also assess the potential impact of legal and regulatory changes on the (re)insurer's operations, often referred to as "horizon scanning".[538] The function is also responsible for developing and updating internal compliance policies and ensuring that all staff receive adequate training on regulatory changes and compliance requirements.
- **Internal Audit Function:** The internal audit function must be independent from operational activities within the (re)insurer. This function provides the board and senior management with assurance about the adequacy and effectiveness of the internal control system and other governance elements, and must report directly to the board without influence from operational management. The internal audit function must regularly evaluate the firm's governance practices, identify weaknesses and recommend necessary improvements. Its independence ensures objective insights into the firm's operations, free from undue influence.[539]
- **Actuarial Function:** The actuarial function is tasked with the accurate calculation of technical provisions, ensuring the appropriateness of methodologies, models and assumptions. It also assesses the sufficiency and quality of data, compares best estimates against actual experience and reports to the board on the reliability of these calculations. The actuarial function is critical for maintaining sufficient reserves to meet obligations, thereby securing the (re)insurer's solvency and protecting policyholders.[540]

Additional Key Functions

The PRA recognises that additional functions may be classified as key, depending on the specific nature of the (re)insurer's business. These may include the investment function, claims management, information and communication technology (ICT) and (re)insurance. The classification of these functions as key depends on their criticality to the firm's operations, the complexity and materiality of the risks they manage and the potential impact of their failure on the firm's solvency and policyholders.

3. Senior Managers and Certification Regime

Overview

The PRA has introduced the principle of individual responsibility and accountability on the basis that regulation will be more effective if senior individuals at (re)insurers are personally responsible for certain areas.

PRA Fundamental Rules and FCA Principles for Business

A number of high-level principles are imposed on UK (re)insurers, which they are expected to meet at all times, and the breach of which could give rise to enforcement action against the firm by the regulators — the PRA's high level principles are known as "Fundamental Rules", while the FCA has "Principles for Businesses". It is vital that the boards and senior management understand these rules and establish within their firms a culture that supports adherence to them.

The PRA Fundamental Rules are:

- A firm must conduct its business with integrity (FR1).
- A firm must conduct its business with due skill, care and diligence (FR2).

[538] Article 46, *ibid* (transposed in Paragraphs 4.1 and 4.2, Conditions Governing Business Part of the PRA Rulebook).
[539] Article 47, *ibid* (transposed in Paragraph 5.1, Conditions Governing Business Part of the PRA Rulebook).
[540] Article 48, *ibid* (transposed in Paragraph 5.1, Conditions Governing Business Part of the PRA Rulebook).

- A firm must act in a prudent manner (FR3).
- A firm must at all times maintain adequate financial resources (FR4).
- A firm must have effective risk strategies and risk management systems (FR5).
- A firm must organise and control its affairs responsibly and effectively (FR6).
- A firm must deal with its regulators in an open and cooperative way and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice (FR7).
- A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services (FR8).

The FCA's Principles for Business are:

- A firm must observe proper standards of market conduct (PRIN 5).
- A firm must pay due regard to the interests of its customers and treat them fairly (PRIN 6).
- A firm must pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair and not misleading (PRIN 7).
- A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client (PRIN 8).
- A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement (PRIN 9).
- A firm must arrange adequate protection for clients' assets when it is responsible for them (PRIN 10).
- A firm must act to deliver good outcomes for retail customers (PRIN 12).

Note also that the FCA has rules under its Principles for Business overlapping with the PRA's Fundamental Rules set out above — PRIN 1 to 4 and PRIN 11.

Senior Management Functions

Officers, directors and persons who exercise senior management functions (SMFs) or "controlled functions" under FSMA (for example, the director function, chief executive function, actuary function or systems and controls function) must be approved by the FCA or the PRA (or both) before performing such functions.[541]

Once approved to perform such functions, the person in question becomes subject to the SMCR and accompanying conduct rules that impose several significant responsibilities on the individual, including a duty to comply with regulatory requirements, general principles and expectations on an ongoing basis.

In connection with the Risk Management, Compliance and Audit Functions required under Solvency II, the SMCR assigns the responsibility for key governance functions to senior management of (re)insurers, in alignment with Solvency II's broader regulatory framework, reinforcing individual accountability at the highest levels.

These SMFs are the (a) chief compliance officer, (b) chief risk officer, (c) chief internal auditor and (d) chief actuary.

[541] Senior Managers and Certification Regime: Management Responsibilities Map Part of the PRA Rulebook.

SMFs must be approved by the PRA before assuming their roles. The PRA expects firms only to put forward suitable individuals for SMF appointments, assessing their fitness and propriety, experience and qualifications. The PRA will not merely accept any appointments and will challenge appointments that it considers inappropriate or unsuitable, particularly for (re)insurers of certain sizes and systemic importance to the UK (or global) financial system.

The Conduct Rules

Several more detailed requirements are imposed on both firms and individuals in relation to particular areas, including governance.

Further, the conduct rules for senior managers include (in both the FCA Handbook and the PRA Rulebook):

- You must act with integrity (Individual Conduct Rule 1).
- You must act with due skill, care and diligence (Individual Conduct Rule 2).
- You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively (Senior Manager Conduct Standard 1).
- You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant requirements and standards of the regulatory system (Senior Manager Conduct Standard 2).
- You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively (Senior Manager Conduct Standard 3).
- You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice (Senior Manager Conduct Standard 4).
- When exercising your responsibilities, you must pay due regard to the interests of current and potential future policyholders in ensuring the provision by the firm of an appropriate degree of protection for their insured benefits (Senior Manager Conduct Standard 5).

Management Responsibilities Map

Further, (re)insurers are required to put in place a management responsibilities map.[542] The responsibilities map must provide a comprehensive overview of the firm's management and governance arrangements, detailing how responsibilities are allocated among senior managers, and indicating whether these responsibilities are shared or divided.

The map must clearly delineate the roles and responsibilities of each SMF holder. It should specify the individual accountabilities for key areas of the business, ensuring that there is no ambiguity about who is responsible for what.

The map must outline the firm's overall governance structure, including the reporting lines and the interaction between different governance functions. This should encompass the roles of the board, senior management and key functions such as risk management, compliance, internal audit and actuarial. The map should also detail any committees established by the board, including their membership and how they relate to the broader governance framework.

[542] *Ibid.*

The responsibilities map must be documented comprehensively and kept up to date. It should be readily accessible to the PRA upon request, demonstrating the firm's commitment to transparency and regulatory compliance. Regular updates are necessary to reflect any changes in the governance structure, such as new appointments, reassignments or changes in responsibilities. The map must also integrate with the firm's risk management framework, ensuring that all key risks are appropriately managed by designated individuals or functions.

Ultimately, the board holds responsibility for ensuring that the management responsibilities map is accurate and effective. The board must review the map regularly, particularly when there are significant changes to the firm's structure or operations. The map should be used as a tool to facilitate board oversight, enabling the board to ensure that all responsibilities are appropriately allocated and that senior managers are held accountable for their areas of responsibility.

4. Outsourcing

Outsourcing is a critical consideration for global financial groups and regulators, including (re)insurers operating across multiple jurisdictions with dependencies outside their home state. Outsourcing encompasses any function that a (re)insurer could perform internally, such as claims administration, claims management and investment management.

Solvency II mandates that outsourcing must not compromise the quality of a (re)insurer's governance system.[543] (Re)insurers are required to maintain ultimate responsibility for outsourced functions and ensure effective oversight. This involves rigorous due diligence, clear contractual arrangements with robust enforcement and monitoring mechanisms and continuous monitoring of outsourced activities.

European Banking Authority Outsourcing Guidelines

In addition to the rules under Solvency II, (re)insurers are also subject to certain guidelines from the European Banking Authority (EBA) on outsourcing (Outsourcing Guidelines).[544] Note that these apply broadly across the financial services sector (and not just to (re)insurers), including to banks, investment firms, payment institutions and electronic money institutions. The Outsourcing Guidelines set out detailed expectations for how financial institutions should manage outsourcing arrangements, particularly for critical or important functions. The principles established by the EBA are designed to ensure that outsourcing does not compromise the firm's operational resilience, governance or regulatory compliance, making them highly relevant for (re)insurers operating under Solvency II.

The requirements are:

- **Critical and Important Functions:** The Outsourcing Guidelines place significant emphasis on the identification and management of critical or important functions. (Re)insurers must ensure that any outsourced activities deemed critical or important do not adversely affect their overall risk management capabilities or their ability to comply with regulatory obligations. This includes comprehensive risk assessments prior to outsourcing, ensuring that the service provider has the necessary ability and capacity to deliver the services effectively without compromising the (re)insurer's governance or operational resilience.

[543] Article 49(2) Solvency II Directive (transposed in Paragraph 7.2, PRA Conditions Governing Business Part of the PRA Rulebook).

[544] EBA Guidelines on Outsourcing (EBA/GL/2019/02, 2019).

- **Risk Management and Operational Resilience:** The Outsourcing Guidelines stress that outsourcing arrangements should not diminish a firm's control over critical operations. (Re)insurers must establish robust mechanisms to manage outsourcing risks and maintain operational resilience. This includes the implementation of contingency plans and exit strategies to mitigate the risk of service disruptions. Continuous oversight is essential, with (re)insurers required regularly to review and test their resilience against various risk scenarios, particularly those related to critical outsourced functions.
- **Sub-Outsourcing and Oversight:** The Outsourcing Guidelines introduce specific considerations for sub-outsourcing, where a service provider may further outsource a portion of the services it is contracted to deliver. (Re)insurers must ensure that they retain adequate oversight and control over the entire outsourcing chain, including sub-outsourcing arrangements. This involves ensuring that the original service provider remains accountable and that all sub-outsourcing agreements meet the same rigorous standards of governance, risk management and operational resilience as the primary outsourcing agreement.
- **Data Security and Confidentiality:** Another key aspect of the Outsourcing Guidelines is the protection of data. (Re)insurers must ensure that outsourced services, particularly those involving the processing of sensitive or personal data, adhere to stringent data security and confidentiality standards. This includes ensuring compliance with relevant data protection regulations, such as the GDPR, and establishing clear protocols for data access, storage and transfer within the outsourcing arrangements.
- **Governance and Board Accountability:** The Outsourcing Guidelines reinforce the need for governance structures that ensure senior management and the board retain full accountability for outsourced activities. This aligns closely with Solvency II's requirements, where the board must oversee outsourcing arrangements, ensuring they do not dilute the firm's governance framework. Boards are required to approve outsourcing policies, oversee the selection of service providers and ensure that any outsourcing arrangement does not impede the firm's ability to meet its regulatory obligations.[545]
- **Documentation and Reporting:** Comprehensive documentation is crucial under the Outsourcing Guidelines. (Re)insurers must maintain detailed records of all outsourcing arrangements, including the rationale for outsourcing, due diligence processes, risk assessments and ongoing monitoring activities. These records must be readily available for regulatory review, demonstrating that the (re)insurer maintains effective oversight of all outsourced functions. Regular reporting to the board on the performance and risks associated with outsourcing arrangements is also essential, ensuring that the board remains informed and engaged in overseeing these critical aspects of the firm's operations.

In the UK, these requirements remain applicable post-Brexit, by way of PRA SS2/21.[546] Importantly, the PRA and the FCA take the view that an intragroup outsourcing is still considered outsourcing (notably, even within the same entity, *e.g.*, a (re)insurance branch and its head office), and requires such outsourcing to be subject to the same requirements as outsourcing to third-party providers. The regulators caution against assuming that intragroup arrangements carry less risk. Therefore, (re)insurers must approach intragroup outsourcing with the same level of scrutiny and control as external outsourcing. The PRA acknowledges that compliance can be proportional, depending on the level of control and influence the (re)insurer has over the entity providing the outsourced service.

[545] Article 49 of the Solvency II Directive (transposed in Paragraphs 7.1 to 7.3, Conditions Governing Business Part of the PRA Rulebook).

[546] PRA SS2/21.

Connection With the Senior Managers and Certification Regime

Importantly, boards and senior management, especially those in SMFs, cannot delegate their accountability. They remain responsible for the monitoring and supervision of outsourced functions, ensuring that the (re)insurer's governance framework remains robust.

5. Board and Governance Structures

Responsibility for the aforementioned requirements is with the board of a Solvency II (re)insurer, which is ultimately responsible for ensuring that the firm adheres to all regulatory requirements, including the establishment and maintenance of robust governance structures. The board must set the tone at the top, ensuring a culture of risk awareness and regulatory compliance permeates throughout the organisation.[547]

The board must oversee key governance functions set out above (including risk management, compliance, internal audit and actuarial functions), ensuring that these areas operate independently and effectively.

The board must ensure that the governance framework remains effective and is regularly reviewed to adapt to changes in the business environment or regulatory landscape, including setting up appropriate committees, such as audit, risk and compliance committees, to focus on specific areas of governance and provide detailed oversight.

The board is also responsible for ensuring that the firm's governance framework includes measures to ensure operational resilience, particularly in the face of external shocks or disruptions. This involves overseeing the implementation of business continuity plans and ensuring that critical functions can continue to operate effectively under stress conditions.

6. Operational Resilience

Overview

Lastly, operational resilience is a critical component of a (re)insurer's governance framework under Solvency II and the PRA's supervisory expectations. It is also an area of increasing regulatory scrutiny across all financial services sectors. It encompasses a range of strategies and measures designed to ensure that a firm can continue to operate and serve its policyholders, even in the face of significant disruptions.[548]

A foundational element of operational resilience is the identification of critical business services that, if disrupted, could have severe consequences for policyholders and the broader market. This step requires a thorough analysis of the services most essential to the firm's operations and their potential impact if disrupted.

(Re)insurers must develop tailored mitigation and recovery plans that address specific operational risks. These plans should be robust and adaptable, designed to manage and recover from disruptions swiftly, and should include establishing comprehensive business continuity plans, incident response strategies and frameworks to manage risks associated with outsourcing critical functions.

To assess a firm's ability to withstand various risks, (re)insurers must conduct scenario analysis and stress testing. These exercises help identify vulnerabilities and gauge the firm's preparedness to respond to and recover from different types of disruptions, ensuring resilience in adverse conditions.

[547] PRA SS5/18.

[548] PRA SS1/21.

Governance is central to ensuring that operational resilience measures are effective and regularly reviewed. Senior management and the board must be actively involved in overseeing the firm's resilience strategies, ensuring they are continuously updated to reflect changes in the risk environment and operational landscape. This active oversight aligns with the broader governance requirements under Solvency II and is crucial for maintaining the firm's stability and compliance.

Digital Operational Resilience Act

The EU's Digital Operational Resilience Act (DORA),[549] coming into effect on 17 January 2025, introduces additional requirements that (re)insurers in the EU must adhere to, some of which extend beyond the existing Solvency II framework and under the Outsourcing Guidelines. While some of the requirements overlap, DORA goes beyond in many measures, bringing into scope all ICT risks so as to ensure digital resilience and ensuring continuity of operations in a rapidly evolving digital environment.

In-scope (re)insurers are required to:

- Establish and maintain a comprehensive ICT risk management framework that addresses the specific risks associated with digital operations.[550]
- Implement continuous monitoring and control of ICT systems to ensure their resilience against potential threats.[551]
- Conduct advanced digital operational resilience testing, including threat-led penetration testing, to identify and address vulnerabilities.[552]
- Develop a robust third-party risk management function to oversee and mitigate risks associated with outsourcing digital services.[553]
- Establish an incident classification and reporting framework to ensure timely and accurate reporting of ICT-related incidents to regulatory authorities.[554]
- Develop and maintain business continuity and ICT service continuity plans, including secure and segregated backup systems to ensure operations can continue during disruptions.[555]
- Define clear governance structures that hold top management accountable for ICT risk management, ensuring that resilience is embedded at the highest levels of the organisation.[556]

[549] Regulation (EU) 2022/2554 of the European Parliament and of the Council of 14 December 2022 on Digital Operational Resilience for the Financial Sector and amending Regulations (EC) No. 1060/2009, (EU) No. 648/2012, (EU) No. 600/2014 and (EU) No. 909/2014.

[550] Article 10, *ibid.*

[551] Article 11, *ibid.*

[552] Article 23, *ibid.*

[553] Article 25, *ibid.*

[554] Article 17, *ibid.*

[555] Article 13, *ibid.*

[556] Article 5, *ibid.*

Chapter 11

The Valuation of Assets and Liabilities

Introduction

This chapter discusses the valuation of assets and liabilities under Solvency II. Given that strategic asset allocation and investment management are key aspects of an insurer's business, especially for life insurers, this is an important area of focus across the industry.

In addition, given the opportunities for the deployment of sophisticated asset management techniques, and for the gathering of long-term assets under management, insurers have become a significant area of focus for alternative asset managers. Indeed, some alternative asset managers have, in large part, effectively become insurance businesses.

This chapter covers the general principles applicable to valuation, the so-called "valuation hierarchy", the specific rules for some balance sheet items and the interaction with certain accounting standards. Recent trends regarding investments into illiquid or alternative assets are also examined.

Valuation principles applicable to technical provisions are not covered in this chapter. Instead, please consult Chapter 7: Technical Provisions. The rules governing valuation of assets and liabilities are contained in the Valuation Part of the PRA Rulebook, the Solvency II Directive and the Level 2 Delegated Regulation, and are supplemented by (amongst other things) the IFRS and IAS.

1. An Introduction to the Solvency II Valuation Concepts

The valuation of assets and liabilities under Solvency II is based on market value principles, meaning that assets and liabilities should be valued at the amount for which they could be traded in an arm's length transaction.[557]

This approach has a number of upsides. It is based on objective, and in many cases readily ascertainable, data points, and is also intended to reflect the realistic proceeds, which could be achieved on sale. Consequentially, this interacts with the regulatory objectives of ensuring appropriate capitalisation of insurance undertakings, and ultimately policyholder protection and stability in the financial system.

At the same time, this approach is not without its critics — who particularly point out (putting the MA regime and credit risk on one side) that a market valuation ignores a basic premise of asset/liability matching: that assets in some cases simply will not ever be required until maturity, so the day-to-day market value of an asset that has a certain maturity value is less relevant.

The basic framework is supplemented by the general principle that assets and liabilities shall be recognised and valued in according with the IFRS provided that they are consistent with the Solvency II approach.[558] If the IFRS approach is inconsistent, then valuation methods that are consistent must be used.

[557] (1) Recital 45 of the Solvency II Directive; and (2) Article 75 of the Solvency II Directive (transposed in Paragraphs 2.1 and 2.2, Valuation Part of the PRA Rulebook).

[558] Article 9 of the Level 2 Delegated Regulation.

2. Application of the Market Valuation Concept in Practice

Application of the market value concept is, however, not always straightforward. It is important to understand how insurers apply this approach in practice, especially when not all assets and liabilities have readily observable market prices or pricing data, particularly given the trend towards greater investment into illiquids or alternatives, such as private credit and real estate.

Solvency II recognises that the available level of market data varies between asset classes, and is frequently driven by factors including the existence (or not) of a public market and the trading volume and liquidity in the market concerned.

3. The Valuation Hierarchy

The Solvency II regime[559] provides a valuation hierarchy that insurers must follow when valuing their assets and liabilities. The valuation hierarchy consists of four levels, reflecting the degree of reliance on market inputs and permitting the use of alternative valuation methods where necessary. In a PRA CP, the PRA has proposed to restate Articles 7 to 16 (inclusive) of the Level 2 Delegated Regulation into the Valuation Part of the PRA Rulebook.[560]

Level 1 – Quoted Market Prices for the Same Assets[561]

The first level of the valuation hierarchy is the default valuation method. This uses quoted market prices in active markets for the same assets. This is regarded as the most reliable and objective way to value assets, since it reflects actual transactions and the expectations of market participants.

Level 2 – Quoted Market Prices for Similar Assets With Adjustment[562]

Where this is not possible, the second level of the valuation hierarchy is next considered. This uses quoted market prices in active markets for similar assets. It then applies an adjustment to reflect the differences between the assets being valued and the ones for which market prices are available.

The adjustments in the second level should take into account factors such as:

- The condition and location of the asset.
- The extent to which the inputs relate to items that are comparable to the asset or liability.
- The volume or level of activity in the markets within which the inputs are observed.

Level 3 – Use of Market Inputs to Greatest Extent Possible[563]

If the first and second levels are not applicable, assessment moves to the third level. The third level of the valuation hierarchy applies where there are no market prices available for similar assets in active markets. In these circumstances, Solvency II requires that relevant market inputs should be used to the greatest extent possible. Inputs which are specific to the insurer should be relied upon as little as possible.

[559] Article 10, *ibid*.

[560] Paragraph 3.4 of the PRA CP5/24.

[561] Article 10(2), *ibid* (transposed in Paragraph 6.2, Annex S of the PRA CP5/24).

[562] Article 10(3), *ibid* (transposed in Paragraph 6.3, Annex S of the PRA CP5/24).

[563] Article 10(6), *ibid* (transposed in Paragraph 6.6, Annex S of the PRA CP5/24).

Relevant market inputs include:

- Quoted prices for identical or similar assets in inactive markets.
- Inputs other than quoted prices that are observable, including interest rates and yield curves, implied volatilities and credit spreads.
- Market corroborated inputs, which may not be directly observable but are based on observable market data.

These market inputs should be adjusted for the factors that we mentioned before, such as the condition, location, comparability and traded volume of the assets.

Level 4 – Use of Alternative Valuation Techniques[564]

Where no observable inputs are available, the fourth and final level of the valuation hierarchy applies — and alternative valuation techniques may be used. This allows use of unobservable inputs that reflect the assumptions that market participants would use when pricing the assets and liabilities concerned. This includes risk assumptions.

Undertaking-specific data may be used, but where there is reasonable available information indicating that other market participants would use different data or there is something particular to the undertaking that is not available to other market participants, the data should be appropriately adjusted.

Solvency II then provides that alternative valuation techniques should be consistent with one or more of the following approaches:

- First, the market approach, which uses prices and other relevant information generated by market transactions involving identical or similar assets, liabilities or group of assets and liabilities.
- Second, the income approach, which converts future amounts, such as cash flows or income or expenses, to a single current amount. The fair value is to reflect current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option pricing models and the multi-period excess earnings method.
- Third, the cost approach or current replacement cost approach, which reflects the amount that would be required currently to replace the service capacity of an asset. From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable quality adjusted for obsolescence.

4. Prohibited Valuation Methods

Solvency II prohibits the use of valuation methods that are not consistent with the market approach, such as:

- Valuing financial assets or liabilities at cost or amortised cost.
- Using models based on the lower of the carrying amount and fair value less costs to sell.
- Valuing property, investment property, plant and equipment at cost less depreciation and impairment.[565]

[564] Article 10(7), *ibid* (transposed in Paragraph 6.7, Annex S of the PRA CP5/24).

[565] Article 16, *ibid* (transposed in Paragraphs 12.1 to 12.3, Annex S of the PRA CP5/24).

5. Specific Rules for Certain Items

There are also specific valuation rules for certain items, such as contingent liabilities, goodwill and intangibles, holdings in related undertakings and deferred tax assets.

Contingent Liabilities

Contingent liabilities are liabilities that may arise from uncertain future events or existing conditions that are not yet confirmed. Solvency II requires the recognition of material contingent liabilities, based on the risk free discounted present value of future cash flows required to settle the contingent liability concerned.[566]

It is stated that contingent liabilities will be material if they could influence the decision-making of the recipient of the disclosure, for example, the regulator. Note that the Solvency II approach is stricter than under the applicable IAS, where contingent liabilities are disclosed and continuously assessed, rather than recognised.[567] Under the IAS rules, contingent liabilities are provided for if there is a present obligation, where payment is more likely than not and the amount can be estimated reliably. These IAS rules have been integrated into the PRA's draft valuation rules.[568]

Goodwill and Intangibles

For goodwill and intangibles, which are assets that arise from investment, business combinations or non-physical and non-financial transactions, Solvency II requires a valuation of zero, unless the assets can be sold separately and a valuation can be derived from a quoted market price in an active market for the same or a similar intangible asset.[569] An example of this would be an asset related to software development, which would be capable of being realised by separate sale.

Again, it is important to note that this approach is different from (and much stricter than) under IFRS. IFRS allows recognition of goodwill, for example following an M&A transaction, where the consideration paid by the purchaser exceeds the fair value of the assets acquired.[570]

This aspect of the Solvency II regime has become increasingly controversial. The current approach prevents insurers from recognising most technology investments as assets, instead requiring them to expense these investments annually through their profit and loss statements. This method arguably stifles innovation, which is particularly contentious given that the insurance industry could significantly benefit from advancements in artificial intelligence.

Holdings in Related Undertakings

A holding in a related undertaking refers to an insurer that holds a participation in another company with which it has a special relationship, such as a subsidiary, although a range of scenarios can potentially be relevant.

[566] Articles 11 and 14, *ibid* (transposed in Paragraph 10.2, Annex S of the PRA CP5/24).

[567] IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

[568] Paragraph 7, Annex S of the PRA CP5/24.

[569] Article 12 of the Level 2 Delegated Regulation (transposed in Paragraph 8, Annex S of the PRA CP5/24).

[570] (1) IFRS 3 Business Combinations; and (2) IAS 38 Intangible Assets.

Solvency II has a specific valuation hierarchy for holdings in related undertakings:[571]

- The **first level** of this hierarchy is to use quoted market prices in active markets for the same assets, which is the same as in the general hierarchy.
- The **second level** of this hierarchy is to use an adjusted equity method, which is to value the holding based on the share of the excess of assets over liabilities of the related undertaking, as valued by Solvency II.
- Where the first and second levels are not possible, and where the undertaking is not a subsidiary undertaking, the **third level** will apply. This uses market prices for similar assets, adjusted for relevant differences. In certain circumstances, specific alternative valuation methods may also be used, which permit an IFRS-like approach but deduct items like goodwill and other intangible assets.[572]

It is important to note that if the related undertaking is excluded from group supervision, or deducted from the own funds eligible for group solvency, in most cases a valuation of zero must be applied.

Consequently, it is important to remember the treatment of participations in the calculation of own funds. In summary, and save when an exception applies,[573] participations may have to be (to a greater or lesser extent, depending on the circumstances) deducted from the value of group own funds where they involve interests held in financial/credit institutions including investment firms. On a solo basis, a capital charge is instead applied in the equity risk sub-module.

For details on when an entity may be excluded from group supervision, please see Chapter 4: Groups.

Deferred Taxes

Solvency II requires insurers to recognise and value deferred taxes if they relate to an asset or liability that is recognised for solvency or tax purposes under Solvency II.[574] There are some modifications to the IAS 12 rules. Other than in respect of deferred tax assets deriving from the carry forward of unused tax credits or unused tax losses, deferred tax assets are valued as the difference between the tax basis and the Solvency II valuation — not the IFRS valuation.[575]

In addition, a deferred tax asset can only have a positive value if it is probable that the asset can actually be used against future taxable profit. This requires consideration of any legal or regulatory constraints on the time limits relating to the carry forward of unused tax losses or the carry forward of unused tax credits.[576]

Finance Leases

For finance leases, Solvency II generally requires insurers to apply a fair value method. This is slightly different from IFRS, which measures finance leases as an asset and liability using the lower of fair value and present value of the minimum lease payment in some circumstances.[577]

[571] Paragraph 9, Annex S of the PRA CP5/24.

[572] Article 13 of the Level 2 Delegated Regulation.

[573] There is an exception for strategic participations that are included in the group solvency calculation using Method 1.

[574] Article 15(1) of the Level 2 Delegated Regulation (transposed in Paragraph 11.1, Annex S of the PRA CP5/24).

[575] Article 15(2), *ibid* (transposed in Paragraph 11.2, Annex S of the PRA CP5/24).

[576] Article 15(3), *ibid* (transposed in Paragraph 11.3, Annex S of the PRA CP5/24).

[577] IAS 17 Leases.

Property, Plant and Equipment

For property, plant and equipment, Solvency II also requires a fair value method. It does not permit valuations based on cost or cost less depreciation and impairment.[578]

6. Illiquid or Alternative Assets

This subject is of particular interest to many private equity sponsors, other alternative asset managers and insurers, namely the recent trend toward insurers making investments in illiquid or alternative assets.

Background

Illiquid or alternative assets are broadly defined as assets that are more difficult to trade than conventional publicly traded bonds and equities. As they are harder to dispose of, and are therefore comparably illiquid, it can also be more difficult to price these assets accurately as there are not as many obvious precedent transactions available. These assets include types of private credit, commercial real estate and infrastructure.

Insurers are increasingly seeking to invest into assets that offer improved returns. Often, their association with a private equity sponsor, or other alternative asset manager, also brings with it increased sophistication, especially where the incoming manager is familiar with a broader range of illiquid or alternative assets. These assets can offer an investment profile that is similar to traditional assets — for example regarding maturity and the level of risk — while promising higher returns, often driven by illiquidity premium or sourcing premium.

In this area, regulators are looking to strike a balance between two competing considerations. On the one hand, they want to ensure that insurers have fully assessed and understood the risks attached to the acquisition, holding, performance and disposal of these assets. On the other hand, they do not want to deter insurers from investing into these assets, given they often have positive macroeconomic consequences and there is a political tailwind associated with some of them (*e.g.*, investment in public infrastructure).

Regulators are becoming increasingly sceptical about cross-border asset-intensive reinsurance (funded reinsurance) transactions that facilitate greater use of illiquids or alternatives than would be permitted in the home jurisdiction. They are also likely to exercise particular scrutiny over insurers that appear to be used simply as asset gathering vehicles.

Because of this, the PRA has set out considerations for insurers and their asset managers concerning such alternative assets.

Regulatory Concerns

Three key considerations are relevant regarding regulatory concerns:

- First, insurers must consider the application of the PPP. They must ensure they have an appropriate governance framework in place for investing into and holding illiquid or alternative assets. This may include considering at a high level what types of illiquid or alternative assets are appropriate for the insurer to invest in. The insurer should only invest into assets for which it has the relevant knowledge, and where it has thoroughly assessed the risks and rewards.

[578] Paragraph 12.3, Annex S of the PRA CP5/24.

- Second, any investment into illiquid or alternative assets should only be as part of a well-diversified portfolio. Liquidity risk must be appropriately managed. Insurers will need to assess what percentage of their portfolio they can defensibly invest into illiquid or alternative assets. This needs to involve stress-testing the portfolio and identifying cross-contagion risks between assets in stressed scenarios.
- Third, the insurer needs to consider the staff it employs to ensure they are suitably skilled to handle the investments being contemplated. This is also important when the insurer chooses to outsource their investment activities — in that case, this assessment needs to extend to the investment manager.

For additional discussion on this point, please refer to Chapter 6: Investment Rules.

Valuation Considerations

The Solvency II preferred valuation approach relies heavily on publicly available and objectively verifiable market data. By definition, this may be harder to come by for illiquid or alternative assets. There may simply be less data available, or the data may be older or it may be more difficult to establish pricing for comparable assets.

Where market pricing is not available, Solvency II mandates the use of alternative valuation methods. This can include valuation based on pricing or other information from transactions in assets that are comparable, as well as valuation based on the cash flows that will be generated by the asset — a process which alternative asset managers are usually comfortable with and experienced in.

Either way, where quoted market prices are not readily available, insurers should be prepared to justify their valuation approach to the regulator. For insurers that routinely invest in illiquid or alternative assets, it may also be necessary to establish and document a valuation framework and relevant valuation procedures. This is particularly the case in an MA context.

Chapter 12

Undertakings in Difficulty

Introduction

Undertakings in difficulty, in the context of Solvency II, refers to insurers that are either failing or likely to fail to meet their SCR or their MCR. For a more in-depth review of the capital requirements that apply to (re)insurers, please see Chapter 8: Capital Requirements.

This chapter explores the legislative and regulatory framework that applies to (re)insurers facing difficulty complying with their capital requirements, including the consequences of noncompliance, and what enforcement and punitive powers regulatory authorities have to deal with actual or threatened noncompliance.

1. The Applicable Framework

The European Framework

In situations where a (re)insurer is unable to meet its capital requirements, it must inform the relevant supervisory authority and adopt a recovery plan (in case of noncompliance with the SCR)[579] or a finance scheme (in case of noncompliance with the MCR).[580] In these situations, Article 141 of the Solvency II Directive empowers supervisory authorities "to take all measures necessary" to protect policyholders of (re)insurance contracts or the obligations stemming from reinsurance contracts.

If the (re)insurer's solvency situation continues to deteriorate, to the extent that it continues to fail to meet its MCR, the supervisory authority may be allowed to withdraw a (re)insurer's authorisation.[581] More detail on the circumstances under which a (re)insurer's authorisation can be withdrawn is set out below in "Withdrawal of Authorisations".

The Level 2 Delegated Regulation sets out detailed requirements for applying the relevant provisions of the Solvency II Directive, such as the criteria to take into account when considering extensions of the recovery period, as defined below.[582] These are supplemented by the EIOPA Guidelines on the extension of the recovery period in exceptional adverse situations (EASs) (EIOPA-BOS-15/108 EN) (Recovery Guidelines). In order to standardise enforcement actions across all member states, the EIOPA released a supervisory statement outlining supervisory expectations in respect of SCR breaches (EIOPA SCR Breach SS).[583]

The key provisions governing undertakings in difficulty are contained in Chapter VII (Articles 136 to 144) of the Solvency II Directive. Per Article 136 of the Solvency II Directive, (re)insurers must have procedures in place to identify deteriorating financial conditions and must immediately notify the supervisory authorities when such deterioration occurs. Supervisory authorities are under a similar obligation to have monitoring tools in place enabling them to identify deteriorating financial conditions in the (re)insurers they supervise and to monitor how that deterioration is remedied.[584]

[579] Article 138(2) of the Solvency II Directive.

[580] Article 139(2), *ibid.*

[581] Article 144(1), *ibid.*

[582] Articles 288 to 289 of the Level 2 Delegated Regulation.

[583] The EIOPA "Supervisory Statement on Supervisory Practices and Expectations in Case of Breach of the Solvency Capital Requirement" published in July 2021.

[584] Article 36(3) of the Solvency II Directive.

The UK Framework

Chapter VII of the Solvency II Directive has been implemented by the UK through a number of statutory and regulatory instruments including the FSMA and the PRA Rulebook.[585]

The Level 2 Delegated Regulation is also directly applicable in the UK, having effect as retained EU legislation as of 31 December 2023. Sections 206A and 55J of the FSMA enable the FCA and the PRA to withdraw or vary an insurance undertaking's authorisation in situations where they are facing prolonged difficulty.

In a 2015 PRA SS (PRA SS17/15), the PRA sets out its approach toward withdrawing authorisations who breach their MCR obligations and where (i) the proposed finance scheme is inadequate, or (ii) the firm fails to comply with the terms of the approved finance scheme within three months of initial noncompliance with the MCR.[586]

2. Breaches of the Solvency Capital Requirement

Notification Requirement

(Re)insurers are required to promptly notify the relevant supervisory authority if they either (i) become noncompliant with the SCR or (ii) identify a risk of noncompliance with the SCR within the next three months.[587] Although there is limited guidance on the probability threshold that necessitates this notification, it is crucial to understand that even the mere presence of a risk of noncompliance is sufficient to trigger the notification obligation.

The Recovery Period

Once the relevant authorities have been informed that a (re)insurer is either noncompliant or at risk of noncompliance with the SCR over the next three months (being an undertaking in difficulty), the undertaking in difficulty enters a phase of close monitoring and supervision by the relevant supervisory authority. During this period, the relevant supervisory authorities will mandate that the undertaking in difficulty implements all necessary measures to achieve compliance within six months from the date noncompliance was observed (recovery period).[588]

The EIOPA SCR Breach SS clarifies that the date of observation of noncompliance is either (i) the date on which noncompliance with the SCR has been observed and communicated to the supervisory body, or (ii) the date indicated by the supervisory body in its notification to the undertaking in difficulty. The latter scenario occurs when the noncompliance is first detected by the supervisory authority. Compliance can be achieved through the reestablishment of the level of eligible own funds covering the SCR or a reduction of risk profile to ensure compliance with the SCR.[589]

[585] Undertaking in Difficulty Part of the PRA Rulebook.

[586] "Solvency II: Supervision of Firms in Difficulty or Run-Off", Bank of England Prudential Regulation Authority, March 2015.

[587] Article 138(1) of the Solvency II Directive (transposed in Paragraph 3.1, Undertakings in Difficulty Part of the PRA Rulebook).

[588] Article 138(3), *ibid* (transposed in Paragraph 3.1, Undertakings in Difficulty Part of the PRA Rulebook).

[589] *Ibid.*

The Recovery Plan

Within two months of the observation of actual or risked noncompliance with the SCR, an undertaking in difficulty must submit a recovery plan for approval by its relevant supervisory authority.[590] It is worth noting that a recovery plan is not required if the undertaking in difficulty adopts prompt recovery measures which (i) restore its compliance with the SCR within two months, and (ii) these measures are considered adequate by the relevant supervisory authority.[591]

If required, the recovery plan must include the following:

- Estimates of management expenses, in particular current general expenses and commissions.
- Estimates of income and expenditure in respect of direct business, reinsurance acceptances and reinsurance cessions.
- A forecast balance sheet.
- Estimates of the financial resources intended to cover the technical provisions and the capital requirements.
- The firm's overall reinsurance policy.[592]

The EIOPA SCR Breach SS provides further guidance on the contents and preparation of the recovery plan, which should take into account (i) the level of noncompliance with the SCR, and (ii) the possible duration of the undertaking in difficulty's deteriorated financial condition. The EIOPA SCR Breach SS further stresses that the recovery plan must be based on "realistic and timely recovery" measures, having assessed their feasibility,[593] and include a comprehensive implementation plan, with a clear delineation of specific actions and timelines for each step.[594]

Initial Extensions to the Recovery Period

The Solvency II Directive mandates that undertakings in difficulty must reestablish compliance with the SCR within six months from the point of noncompliance. However, supervisory authorities have the discretion to extend this recovery period by an additional three months, making the total possible period nine months.[595]

The UK's extension regime remains for now closely aligned with that of the EU. The PRA grants undertakings in difficulty a six-month period to reestablish compliance with the SCR.[596] The PRA also has the option to extend this period by an additional three months.[597]

[590] Article 138(3), *ibid* (transposed in Paragraph 3.1, Undertakings in Difficulty Part of the PRA Rulebook).

[591] The EIOPA, "EIOPA Supervisory Statement on the Supervisory Practices and Expectations in Case of Breach of the Solvency Capital Requirement".

[592] Article 142(1) of the Solvency II Directive (transposed in Paragraph 5.1, Undertakings in Difficulty Part of the PRA Rulebook).

[593] Paragraph 3.7 of the EIOPA SCR Breach SS.

[594] Paragraph 3.15, *ibid*.

[595] Article 138(3) of the Solvency II Directive.

[596] Paragraph 3.1, Undertakings in Difficulty Part of the PRA Rulebook.

[597] Regulation 4A(1) of the Solvency 2 Regulations 2015.

Further Extensions to the Recovery Period – The UK Regime

Notwithstanding the above, the PRA in the UK is able to extend the initial six-month recovery period by a maximum of seven years, following a declaration of existence of an EAS by the Prudential Regulation Committee of the Bank of England.[598] An EAS exists where the financial situation of (re)insurers representing a significant share of the market or of the affected lines of business are seriously or adversely affected by one or more of the following conditions:

- A fall in financial markets that is unforeseen, sharp and steep.
- A persistent low interest rate environment.
- A high-impact catastrophic event.[599]

The Prudential Regulation Committee of the Bank of England must regularly assess whether the aforementioned conditions still apply and accordingly must declare when the EAS has ceased.[600]

To declare an EAS the Prudential Regulation Committee of the Bank of England must take into account the following factors:

- The impact of possible subsequent decisions by supervisory authorities to extend the recovery period, on financial markets, on the availability of insurance and reinsurance products and on policyholders and beneficiaries.
- The number, size and market share of the (re)insurers affected by the EAS and whether the size and nature of those undertakings could, when taken together, have a negative effect on the financial markets or on insurance and reinsurance markets.
- Possible pro-cyclical effects of reestablishing compliance with the SCR, including distressed sales of assets on financial markets.
- The possibility for (re)insurers to raise additional own funds in financial markets.
- The availability of an active market for assets held by (re)insurers and the liquidity of that market.
- The capacity of the reinsurance market to provide reinsurance or retrocession cover.
- The availability in financial markets of adequate risk mitigation techniques, including financial instruments.
- The availability in financial markets of other means to reduce the risk exposure of (re)insurers.[601]

The mere declaration of existence of an EAS does not automatically entitle any undertaking to an extension of the recovery period.[602] The particular undertaking must be impacted by the situation, and, in making this determination, supervisory authorities must take into account factors mentioned above, as well as the following factors specific to the undertaking in difficulty:

- The impact of an extension on policyholders and beneficiaries of the undertaking.
- The extent to which the (re)insurer is affected by the EAS.

[598] Regulation 4A(3), *ibid.*

[599] *Ibid.*

[600] Regulation 4A(4)-(5), *ibid.*

[601] Article 288 of the Level 2 Delegated Regulation.

[602] The Recovery Guidelines.

- The means available to the undertaking to reestablish compliance with the SCR and the existence of a realistic recovery plan.
- The causes and the degree of noncompliance with the SCR.
- The composition of own funds held by the (re)insurer.
- The composition of the assets held by the (re)insurer.
- The nature and duration of technical provisions and other liabilities of the (re)insurer.
- When applicable, the availability of financial support from other undertakings of the group to which the (re)insurer belongs.
- Any measures taken by the (re)insurer to limit the outflow of capital and the deterioration of its solvency position.[603]

The Recovery Guidelines contain further guidance on the factors and considerations to be taken into account when considering an application for an extension of the recovery period. The PRA has indicated that the Recovery Guidelines are part of a non-exhaustive list of EIOPA guidelines that are complied with in the UK.[604] The Recovery Guidelines also mandate that any decision to extend the recovery period must include a provision allowing the supervisory authority to revoke or shorten the extended period if the circumstances that justified the extension have changed. Under such new circumstances, the supervisory authority might not have approved the extension or might have approved a shorter extension.[605] In the context of the UK, where the Prudential Regulation Committee of the Bank of England declares that the EAS no longer exists, the PRA should promptly reassess any granted extensions.

Further Extensions to the Recovery Period – The EU Regime

For EU (re)insurers, supervisory authorities are able to extend the initial recovery period by a maximum period of seven years, provided the EIOPA has made a declaration of existence of an EAS, after having made the requisite consultation with the European Systemic Risk Board.[606]

The Solvency II Directive empowers the EIOPA to declare the existence of an EAS following a request by the supervisory authority concerned. It must to do so in accordance with the conditions mentioned in Article 138(4) of the Solvency II Directive, which are the same as set out above for the UK regime. In deciding whether to declare the existence of an EAS and whether a particular (re)insurer is impacted by the situation, thus warranting an extension, the EIOPA takes into account the same general and specific conditions as considered under the UK regime and stipulated in the Level 2 Delegated Regulation.

One of the Amendments (discussed in previous chapters) acts upon the advice of the EIOPA in the EIOPA Opinion on the 2020 Review of Solvency II (EIOPA-BoS-20/749) (EIOPA Opinion), suggesting that Article 138(4) be amended to clarify that the responsibility for consulting the European Systemic Risk Board is one for the EIOPA when considering whether to declare an EAS and not one for supervisory authorities when deciding on whether to declare an extension to the recovery period.

[603] Article 289 of the Level 2 Delegated Regulation.

[604] "Appendix 1: Non-exhaustive List of EIOPA Guidelines That Are Complied With in the UK", PRA Rulebook.

[605] Guideline 2, Paragraph 1.15 of the Recovery Guidelines.

[606] Article 138(4) of the Solvency II Directive.

The Recovery Guidelines clarify that the rationale behind the power to extend the recovery period is to provide supervisory authorities with flexibility in a situation where a significant part of the insurance market faces major problems that could lead to serious repercussions for the market as a whole. As such, the Recovery Guidelines require supervisory authorities to balance macroprudential considerations against the need to protect policyholders and beneficiaries of the concerned (re)insurer. When deciding on an extension, supervisory authorities should aim to prevent disproportionate negative effects for the financial market in general or the (re)insurance market in particular.

Progress Reports and Withdrawals of Extensions

Where an extension to the recovery period has been granted, the concerned (re)insurer must submit a progress report to the supervisory authority every three months, setting out any specific measures taken and the progress made toward reestablishing the level of eligible own funds covering the SCR or to reduce the risk profile to ensure compliance with the SCR.[607] According to the EIOPA SCR Breach SS, (re)insurers should notify supervisory authorities of any significant change in the extent of the solvency or liquidity shortfall following submission of the recovery plan.

Importantly, the supervisory authority must withdraw any granted extension where the submitted progress report shows that there was “no significant progress” in reestablishing the level of eligible own funds covering the SCR or the reduction of the risk profile to ensure compliance with the SCR between the date of the observation of noncompliance and the date of the submission of the progress report.[608]

In assessing whether “significant progress” has been made toward compliance with the SCR, the inquiry is primarily focused on whether the (re)insurer is still likely to meet its recovery plan. As part of this assessment, the supervisory authority should consider whether the (re)insurer: “failed without sufficient justification to implement any measures it has committed itself to take; or failed in making significant progress on any of the objectives to be achieved in every three months as a result of the proposed measures that were included in the recovery plan”.[609]

If, following consideration of the factors set out above, the supervisory authority concludes that the extension of the recovery period should be withdrawn, the (re)insurer should be given an opportunity to make submissions on the proposed withdrawal within an appropriate timeframe.[610] Where the supervisory authority withdraws the extension, it must make sure that the concerned (re)insurer publicly discloses this information, along with the reasons for the withdrawal, without delay.[611]

3. Breaches of the Minimum Capital Requirement

(Re)insurers are required to promptly notify the supervisory authority as soon as they detect either (i) noncompliance with the MCR or (ii) a potential risk of noncompliance with the MCR within the next three months.[612] Although there is limited guidance on the probability threshold that necessitates this notification, it is important to note that a mere risk of noncompliance alone triggers the notification requirement.

[607] Article 138(4), *ibid* (transposed in Paragraph 3.2, Undertakings in Difficulty Part of the PRA Rulebook).

[608] Article 138(4), *ibid* (transposed in Regulation 4A(6) of the Solvency 2 Regulation 2015).

[609] Guideline 9 of the Recovery Guidelines.

[610] Guideline 10, *ibid*.

[611] (1) Article 54(1) of the Solvency II Directive; and (2) Guideline 11 of the Recovery Guidelines.

[612] Article 139(1) of the Solvency II Directive (transposed in Paragraph 4.1, Undertakings in Difficulty Part of the PRA Rulebook).

Within one month of identifying noncompliance with the MCR, an undertaking in difficulty must submit a short-term, realistic financial plan for approval by the supervisory authority.[613] This financial plan should aim either to restore the eligible BOF to at least the MCR level or reduce the company's risk profile to ensure MCR compliance within three months of the noncompliance observation (MCR recovery period).[614] Unlike the situation with noncompliance with the SCR, there are no extensions available for the MCR recovery period.

Certain Amendments, as previously mentioned, address proposals from the EIOPA Opinion. These Amendments specify that any noncompliance with the MCR must be reported immediately, rather than waiting for the quarterly reporting period, which is the current practice in some member states. Additionally, they require that a finance scheme be submitted when there is a risk of noncompliance, not just when noncompliance has already occurred. These Amendments have not yet come into effect.

Articles 218 and 230 of the Solvency II Directive clarify that the Directive's rules regarding deteriorating financial conditions and noncompliance with the capital requirements apply equally on a group solvency basis. This means that if a group fails to meet its capital requirements, it must prepare a recovery plan or finance scheme in the same manner as an individual (re)insurer.

4. Consequences of Noncompliance — Regulatory Powers

Article 141 of the Solvency II Directive gives supervisory authorities the general power, in situations where the solvency of the (re)insurer continues to deteriorate, "to take all necessary measures to safeguard the interests of policy holders in the case of insurance contracts, or the obligations arising out of reinsurance contracts". Any measures taken in respect of Article 141 should be proportionate to the level and duration of the deterioration of the solvency position of the undertaking in difficulty concerned. In the UK, the PRA has powers under FSMA to, for a period it considers appropriate, suspend a (re)insurer's permission or impose such limitations or other restrictions that it considers appropriate.[615]

The EIOPA SCR Breach SS encourages supervisory authorities to impose additional measures on the (re)insurer if compliance with the SCR is not restored within the recovery period. These measures should be proportionate and should take into account (i) the level of noncompliance with the SCR, (ii) the duration of the deterioration of the undertaking's financial conditions and (iii) the sustainability of the applied measures by the (re)insurer to restore its solvency. Where there has been no improvement in noncompliance or the measures in place will not allow the recoverability of the solvency position in a sustainable manner protecting interests of all policyholders, supervisory authorities are encouraged to consider withdrawing the (re)insurer's authorisation.

Aside from the aforementioned general authority, there are some specific powers at supervisory authorities' disposal, discussed below.

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[613] *Ibid.*

[614] Article 139(2), *ibid* (transposed in Paragraph 4.1, Undertakings in Difficulty Part of the PRA Rulebook).

[615] Sections 206A and 55M of the FSMA.

Withholding Solvency Certification

Where an undertaking in difficulty fails to submit a recovery plan for noncompliance with its SCR (under Article 138(2)) or a finance scheme for noncompliance with its MCR (under Article 139(2)), supervisory authorities must refrain from issuing a solvency certificate, in accordance with Article 39 of the Solvency II Directive. The solvency certificate can be withheld as long as the supervisory authority considers that the rights of the policyholders, or the contractual obligations of the reinsurer, are threatened.[616]

Restricting Free Disposal of Assets

The Solvency II Directive gives supervisory authorities the power to restrict or prohibit the free disposal of a (re)insurer's assets in the following circumstances:

- In the event of noncompliance with the SCR, where (i) exceptional circumstances exist, and (ii) the supervisory authority is of the opinion that the financial situation of the (re)insurer concerned will deteriorate further.[617]
- In the event of noncompliance with the MCR.[618] It should be noted that the Amendments state that if a winding-up proceeding is not opened with respect to the (re)insurer within two months of notification on noncompliance or risk of noncompliance to the supervisory authority, the supervisory authority may restrict free disposal of assets in the event of noncompliance with the MCR.
- In the event of noncompliance with technical provisions.[619]

If a supervisory authority restricts or prohibits the free disposal of an undertaking's assets in the event of noncompliance with the SCR or MCR, as mentioned above, it must notify the supervisory authorities of host member states about the measures it has taken. Those host supervisory authorities, upon request from the initial authority that imposed the restrictions, are required to implement equivalent measures.[620]

In cases where a supervisory authority restricts or prohibits the free disposal of a (re)insurer's assets in the event of noncompliance with technical provisions, it must first communicate its intentions to the supervisory authorities of the host member states before taking any action.[621]

In all instances, it is the supervisory authority of the home member state that will designate the specific assets to be covered by such measures.

Withdrawal of Authorisations

The supervisory authority of the home member state must withdraw a (re)insurer's authorisation where the (re)insurer does not comply with the MCR and the supervisory authority considers that the finance scheme submitted is manifestly inadequate or the (re)insurer concerned fails to comply with the approved scheme within three months from the observation of noncompliance with the MCR.[622] Any decision to withdraw an authorisation must be communicated to the (re)insurer with full reasons.[623]

[616] Article 142(2) of the Solvency II Directive.
[617] Article 138(5), *ibid.*
[618] Article 139(3), *ibid.*
[619] Article 137, *ibid.*
[620] Articles 138(5) and 139(3), *ibid.*
[621] Article 137, *ibid.*
[622] Article 144(1), *ibid.*
[623] Article 144(3), *ibid.*

There are certain circumstances under which the supervisory authority of the home member state may withdraw a (re)insurer's authorisation, as listed in Article 144(1) of the Solvency II Directive:

- The (re)insurer concerned does not make use of the authorisation within 12 months, expressly renounces it or ceases to pursue business for more than six months, unless the member state concerned has made provision for authorisation to lapse in such cases.
- The (re)insurer concerned no longer fulfils the conditions for authorisation.
- The (re)insurer concerned fails seriously in its obligations under the regulations to which it is subject.

When an authorisation is withdrawn, the supervisory authority of the home member state must inform the supervisory authorities of other member states. These authorities are then required to take appropriate measures to prevent the (re)insurer from commencing new operations within their territories. Additionally, the supervisory authority of the home member state, in collaboration with other supervisory authorities, must take all necessary measures to safeguard the interests of policyholders. This may include exercising the power to restrict the free disposal of the (re)insurer's assets.[624]

The PRA's equivalent power of varying or cancelling a (re)insurer's Part 4A permission is found in Section 55J of the FSMA. The PRA has broad power to cancel a (re)insurer's permission where there has been a serious failure to comply with the requirements imposed by or under FSMA. Additionally, the PRA is obligated to vary a (re)insurer's permission if it fails to comply with the SCR or MCR and either:

- Has failed to submit a finance scheme.
- Has submitted a finance scheme that is manifestly inadequate.
- Has failed to comply with the approved finance scheme within a period of three months from the date it first became aware of noncompliance with the appropriate capital requirement to which the scheme relates.[625]

If any of the aforementioned conditions apply, the PRA is obligated to vary the (re)insurer's permission to remove the regulated activity of effecting insurance contracts as principal.[626]

However, the PRA is not required to withdraw permission to carry out the separate regulated activity of administering insurance contracts unless it is deemed necessary to protect the interests of the (re)insurer's policyholders.[627] The rationale behind this approach is detailed in the PRA SS17/15. While the PRA acknowledges the need to close business rapidly and orderly when there is no realistic prospect of prompt compliance with the MCR, it also recognises that, in many circumstances, a run-off strategy may be in the best interests of policyholders, regardless of whether the firm is solvent or insolvent.

In such situations, the current FSMA framework does not allow a firm in this position "to effect new contracts of insurance but the firm may be permitted to carry out existing contracts in a manner, and for so long as, the PRA considers necessary in order to afford an appropriate degree of protection to policyholders". [628]

If the effect of a variation is to remove all regulated activities to which the Part 4A permission relates, the PRA must instead cancel the permission.[629]

[624] Article 140, *ibid.*
[625] Sections 55J(7B) and 55KA of the FSMA.
[626] Section 55J(7B)(a), *ibid.*
[627] Section 55J(7B)(b), *ibid.*
[628] Paragraph 2.5 of the PRA SS17/15.
[629] Section 55J(7C) of the FSMA.

5. Introducing Recovery and Resolution Procedures

The EU Framework

Currently, there are no harmonised procedures in the EU or UK for the recovery and resolution of insurers, although similar frameworks exist in the banking sector. In the EIOPA Opinion, the EIOPA recommended establishing a minimum harmonised EU recovery and resolution framework for insurers and reinsurers.

The journey towards establishing a recovery and resolution framework began in September 2021, when the European Commission published a legislative proposal for the Insurance Recovery and Resolution Directive (IRRD). In December 2023, the Council of the European Union and the European Parliament reached a provisional political agreement on the latest official text of the IRRD, which was subsequently published in January 2024.

In April 2024, the European Parliament voted in a plenary session to adopt the IRRD which the European Council officially adopted on 5 November 2024. The IRRD will enter into force 20 days after its publication in the Official Journal. Member states will be required to implement the IRRD into national law within 24 months and one day after its entry into force.

The IRRD will create a legislative framework for the recovery and resolution of EU (re)insurers and their groups. It adopts a preemptive approach, requiring (re)insurers to submit recovery plans to supervisory authorities as part of their regular reporting process. These authorities will be granted powers to implement resolutions.

A key distinction from the Solvency II framework is that IRRD preemptive recovery plans are not required when a (re)insurer is noncompliant with its SCR. Some of the key elements of the IRRD regime are as follows:

- The IRRD will apply to all (re)insurers that are established in the European Union. Notably, certain small and non-complex (re)insurers are excluded from the preemptive recovery plans and resolution planning framework, except where such a (re)insurer represents a particular risk at national or regional level. The IRRD mandates member states to establish one or more resolution authorities that will be empowered to apply resolution tools and exercise the resolution powers.
- (Re)insurers that are not part of a group will be required to prepare and submit preemptive recovery plans to the supervisory authorities, which should be updated regularly. For groups, the ultimate parent undertaking must draw up and submit a group preemptive recovery plan. Importantly, supervisory authorities can decide which (re)insurers are to be subject to the IRRD requirements by considering the following factors: size, business model, risk profile, interconnectedness, substitutability and importance for the economy of the member state. However, it must be ensured that at least 60% of the member state's life and non-life insurance and reinsurance market are subject to preemptive recovery planning requirements pursuant to the IRRD.[630]
- The preemptive recovery plans must contain the following:[631]
  - A summary of the key elements of the plan.
  - A summary of any changes to the (re)insurer since their most recent filing.

[630] Article 5(2) of the IRRD.

[631] Article 5(6), *ibid.*

  - A description of the (re)insurer or the group.
  - A recovery indicator framework.
  - A description of how the preemptive recovery plan has been drawn up, how it will be updated and how it will be applied.
  - A range of remedial actions.
  - A communication strategy.
  - Where a recovery plan had been submitted under Article 138(2) of the Solvency II Directive, that recovery plan as well as an assessment of the measures taken to restore the (re)insurer's compliance with the SCR.
- Resolution authorities will have to prepare resolution plans for selected (re)insurers, based on similar eligibility criteria to those used for recovery planning (aforementioned). It should be ensured, however, that at least 40% of the member state's life and non-life (re)insurance market must be subject to resolution planning.[632] Group resolution authorities will responsible for drawing up group resolution plans. The IRRD details specifics to be included in the resolution plans, which includes, on a broad level, resolution actions to be undertaken if certain conditions of resolution (discussed below) are met.
- At the same time resolution authorities are drawing up or updating resolution plans, they will be have to conduct resolvability assessments for a group or individual insurer: *i.e.*, assess the extent to which an insurance group is resolvable without any extraordinary public support.[633] To the extent that it has received a notification from the resolution authority that there is a substantive impediment to the resolvability of a (re)insurer, the relevant (re)insurer will have four months to propose alternate possible measures or remove the impediments identified by the resolution authority.[634]
- The conditions for resolution action, alluded to above, are as follows:
  - The (re)insurer is failing or likely to fail.
  - There is no reasonable prospect that any alternative private sector measures or supervisory action, including preventive and corrective measures, would prevent the failure of the (re)insurer within a reasonable timeframe.
  - Resolution action is necessary in the public interest.[635]
- The resolution tools that can be used by the resolution authorities, in the event the aforementioned resolution conditions are met, are as follows:
  - The solvent run-off tool: place the (re)insurer in a solvent run-off procedure to terminate the activities of that (re)insurer, and withdraw its authorisation to underwrite new insurance and reinsurance business.
  - The asset and liability separation tool: transfer of impaired or problem assets or liabilities (or both) to a management vehicle to allow them to be managed and worked out over time — this tool can only be used in conjunction with another tool.
  - The sale of business tool: sale of all or part of a (re)insurer's business.

[632] Article 9(2), *ibid.*
[633] Article 13(1), *ibid.*
[634] Article 15(3), *ibid.*
[635] Article 19(1), *ibid.*

- The bridge undertaking tool: transfer of all or part of a (re)insurer's business to a publicly controlled entity, with the idea to sell the business to a private purchaser when market conditions are appropriate.
- The write-down or conversion tool: write-down or conversion of capital instruments, debt instruments and other eligible liabilities.[636]

The UK Framework

HM Treasury has proposed a framework for pre-resolution planning that is broadly similar to the EU regime.[637] The proposed regime is preemptive, requiring resolution plans and assessments of resolvability in advance, with the Bank of England serving as the resolution authority. This new resolution authority will determine whether an insurer is failing or likely to fail and should therefore be subject to its stabilisation powers. The scope of the UK regime is intended to be broad, covering all UK-authorised insurers in principle. HM Treasury has indicated that, in practice, only a subset of insurers, such as those providing critical functions, will be subject to the regime.

Similar to the EU regime, the HM Treasury proposal includes specific resolution conditions that must be satisfied before stabilisation tools can be utilised. These conditions are as follows:

- The insurer is failing or is likely to fail.
- It is not reasonably likely that other actions (excluding stabilisation powers) will be taken to prevent the insurer from failing.
- Employing stabilisation powers is necessary in the public interest.
- One or more of the statutory resolution objectives would not be met to the same extent if stabilisation powers were not used.

Once the resolution conditions are satisfied, the proposed regime introduces stabilisation options that can be deployed in respect of a failing insurer. These are broadly similar to those under the EU regime and include:

- Transfer of an insurer's shares or assets to a private purchaser.
- Establishing a bridging institution to allow additional time for a prospective purchaser to perform due diligence and valuation while the insurer maintains critical functions.
- Restructuring, modifying, limiting or writing down the failing insurer's liabilities in order of creditor preference (including insurance liabilities) so the insurer's capital coverage can be restored to a sufficient level to allow a solvent run-off.
- As a last resort and temporary measure, temporary public ownership.

In addition, the resolution authority will have the power to establish an asset management vehicle for the run-down of non-performing or difficult-to-value assets. It will also be able to carry out insurance administration procedures. These capabilities will enable the resolution authority to use its stabilisation tools while ensuring the continued operation of the insurer's critical functions.

[636] Article 26(3), *ibid.*

[637] HM Treasury "Consultation, Introducing an Insurer Resolution Regime", January 2023.

The proposal also contains provisions for pre-resolution planning. For example, insurers will need to conduct ongoing recovery and resolution planning, which should set out the proposed resolution strategy for the insurers and an operational plan for implementation, including what stabilisation powers will be applied and how. The plans will need to be updated annually or more frequently if there are changes to the firm's structure, strategy or operating condition.

6. Proposed UK Exit Planning Regime

On 23 January 2024, the PRA published a PRA CP on solvent exit planning for insurers in the UK.[638] The PRA also published a draft PRA SS setting out its expectations for UK insurers to prepare, as part of their BAU activities, for a solvent exit.[639] The PRA defines a solvent exit as the process through which a firm ceases its insurance business in an orderly manner while remaining solvent throughout. The regime will apply to all UK insurers except for firms in passive run-off and UK branches of overseas insurers.

Under the proposed regime, firms will have to prepare for an orderly solvent exit as part of their BAU activities by producing a Solvency Exit Analysis (SEA), regardless of how unlikely or distant a prospect solvent exit may seem to the firm. The level of detail in the plan should be proportionate to the nature, scale and complexity of the firm.[640] At a minimum, the SEA will have to include solvent exit actions (*i.e.*, how the firm would carry out a solvent run-off of its liabilities), solvent exit indicators (*i.e.*, when it may need to initiate a solvent exit), potential barriers and risks, resources and costs to execute a solvent exit, a communications strategy, clear governance arrangements and assurance that the SEA is approved in accordance with the firm's governance arrangements. The SEA must be updated once every three years and whenever a material change takes place.

Additionally, firms will also have to produce a Solvent Exit Execution Plan (SEEP) within one month, when there is a realistic prospect that the firm may need to execute a solvent exit (which could be informed by its solvent exit indicators). The SEEP will include sufficient detail on how the firm will complete the cessation of its PRA regulated activities. The SEEP should be guided by the SEA and should be appropriate to a firm's s business model, structure, operations, risk strategy and circumstances leading to the initiation of a solvent exit. In particular, the SEEP should set out: (i) how the firm will monitor, and respond to, any emerging barriers and risks throughout the execution of a solvent exit; (ii) details of the financial and non-financial resources needed to execute a solvent exit; and (iii) a clear and detailed communication plan for stakeholders.

7. Introducing Macroprudential Tools

The Amendments will introduce targeted macroprudential rules, which are aimed at ensuring (re)insurers have adequate liquidity to settle their financial obligations towards policyholders and other counterparties when they fall due, even under stressed conditions. The key features of these rules are as follows:

- A newly inserted Article 144a will require (re)insurers to prepare and update a liquidity risk management plan covering liquidity analysis over the short term. Upon the request of supervisory authorities, (re)insurers may be required to extend the liquidity analysis over medium and long term. Notably, small and non-complex undertakings will be exempt from this requirement.

[638] "Appendix 2: Draft Supervisory Statement — Solvent Exit Planning for Insurers", Bank of England PRA, January 2024.

[639] PRA CP2/24.

[640] Paragraph 2.22, *ibid.*

- Article 144b will give supervisory authorities the power to intervene where material liquidity risks are identified and no effective remedies have been taken by the (re)insurer. In particular, supervisory authorities will have the power to temporarily:
  - Restrict or suspend dividend distributions or other payments to shareholders and other subordinated creditors.
  - Restrict or suspend share buy-backs and repayment or redemption of own fund items.
  - Restrict or suspend bonuses or other variable remuneration.
  - Suspend redemption rights of life insurance policyholders.
- Article 144c will introduce supervisory powers to preserve solvency during periods of exceptional sector-wide shocks that have the potential to threaten the financial position of the (re)insurer concerned or the stability of the financial system. These powers are the same as the Article 144b powers aforementioned. The EIOPA will be empowered, after consultation with the European Systemic Risk Board, to develop draft regulatory technical standards to specify the criteria for the identification of exceptional sector-wide shocks.

Chapter 13

Supervision

Introduction

This chapter explores the supervision framework. Specifically, it explores:

- The supervision regime.
- The reporting framework.
- Quantitative reporting.
- Capital add-ons.
- Supervisory convergence and information sharing.
- Obligations under Solvency II.
- Acquisitions involving qualifying holdings.

1. The Supervision Regime

Proportionality

The supervision regime is built on the principle of "proportionality", in an effort to ensure that supervision remains effective and meets its underlying purposes without being overly burdensome. The key obligation with respect to proportionality requires that the provisions of the Solvency II Directive be applied in a manner that is proportionate to the nature, scale and complexity of the risks inherent in the business of a (re)insurance undertaking.[641]

Notwithstanding the proportionality provisions in place, feedback from firms suggests that the implementation of the proportionality principle has been relatively unsuccessful in reducing the regulatory burden: A consultation by the EIOPA on supervisory reporting in June 2019 revealed how the Solvency II regime was criticised for its extensive reporting requirements, unsatisfactory solutions to exempt firms from their quarterly reporting obligations, duplicative reporting requirements and strict reporting timelines.[642]

Legislative efforts to update the principle of proportionality date back to the European Commission's 2021 Legislative Proposals.[643] The proposals aimed to simplify the supervision framework by proposing a regime that would: (i) exclude more small firms from the scope of Solvency II; (ii) ensure that reporting requirements would not go beyond what was necessary; and (iii) enhance proportionality by creating a new category of low-risk profile firms.[644] Under the proposals, this new category of low-risk profile firms would automatically qualify for certain measures, such as less onerous reporting requirements, which contrasts with other firms that are required to obtain prior approval from the supervisory authorities to avail themselves of these proportionality measures.[645]

In respect of supervision and reporting requirements, the Amendments (discussed in previous chapters), which aim to further enhance the proportionality principle and simplify the supervision regime, bring about two key changes. First, the size threshold for firms excluded from the Solvency II regulatory scope is increasing, resulting in a greater number of firms being excluded from reporting and other regulatory

[641] Article 29 of the Solvency II Directive; "PRA's Approach to Supervision of the Banking and Insurance Sectors", 31 July 2023.

[642] Paragraph 33, "Consultation Paper on Proposals for Solvency II 2020 Review", (EIOPA-BoS-19-304 25), June 25 2019.

[643] COM(2021) 581 final, "Proposal for a Directive of the European Parliament and of the Council", 22 September 2021.

[644] Paragraphs 2 and 13, *ibid.*

[645] Paragraph 63, *ibid.*

requirements.[646] Second, the Amendments will also introduce a new classification of "small and non-complex undertakings" together with a new set of criteria and processes for identifying them.[647] Such firms automatically qualify for "proportionality" measures, such as less frequent reporting requirements. In contrast, firms that are not classified as "small and non-complex" will not be prohibited but will be subject to prior approval from the supervisory authority in order to avail themselves of these proportionality measures.[648]

The UK has similarly followed suit by updating the proportionality of its regime. Recent reforms by the PRA increase the size thresholds above which a firm enters the UK Solvency II regime and simplify the overall reporting framework.[649] Firms will only be exempt from the UK Solvency II framework if they have not exceeded the UK Solvency II thresholds for three consecutive years and do not expect to do so in the following five years.[650] Small firms, which are not regulated by the UK Solvency II framework, are instead subject to a simpler UK regime, referred to as the non-directive firm sector rules, which are outside the scope of this chapter. Firms that do not exceed the new increased thresholds will continue to be able to operate within the Solvency II regime should they wish to, by applying for a voluntary requirement.[651] The UK reforms will take effect from 31 December 2024.[652]

Supervisory Authorities

At its core, prudential supervision covers two distinct concepts. First, the supervision process entails initial "verification" whereby supervisory authorities must satisfy themselves as to a firm's state of solvency, establishment of technical provisions, its assets and eligible own funds. Second, once a firm has been authorised, supervision responsibility extends to monitoring a firm's compliance with the supervision regime and the technical resources it has at its disposal for the purpose of carrying out its obligations.[653]

The default position is that the financial supervision of (re)insurance undertakings is the sole responsibility of that firm's home jurisdiction.[654] Where the supervisory authority of another Solvency II state in which a risk is situated has reason to consider that the activities of the firm might affect its financial soundness, it must inform the undertaking's home supervisory authority. The undertaking's home supervisory authority has sole responsibility to determine whether the undertaking is complying with the relevant prudential principles.[655]

[646] Article 1(2), COM(2021)0582, "Proposal for a Directive of the European Parliament and of the Council", 19 January 2024.
[647] Article 1(13), *ibid.*
[648] Article 1(13), *ibid.*
[649] PRA PS2/24.
[650] Paragraph 8.10, *ibid.*
[651] Paragraph 8.11, *ibid.*
[652] Paragraph 10.18, *ibid.*
[653] Article 30(2) of the Solvency II Directive.
[654] Article 30(1), *ibid.*
[655] Article 30(3), *ibid.*

Supervisory authorities must conduct themselves in a transparent and accountable manner, giving due regard to the protection of confidential information. Likewise, supervisory authorities must have transparent procedures for the appointment and dismissal of the members of their governing and managing bodies.[656] They are mandated to publicly disclose, in a way that allows for the comparison of approaches adopted by authorities of different member states, the following information:

- The texts of laws, regulations, administrative rules and general guidance in the field of insurance regulation.
- The general criteria and methods used in the supervisory review process as set out in Article 36 of the Solvency II Directive.
- Aggregate statistical data on key aspects of the application of the prudential framework.
- The manner of exercise of the options provided for in the Solvency II Directive.
- The objectives of the supervision and its main functions and activities.[657]

Supervisory Powers

Supervisory authorities should have the powers to take preventive and corrective measures to ensure that firms comply with applicable laws, regulations and administrative provisions.[658] In this regard, supervisors have the ability to: (i) take "any necessary measures", including administrative and financial measures; (ii) develop necessary quantitative tools under the supervisory process, in addition to the calculation of the SCR, to assess the ability of the firms to cope with possible events or future changes in economic conditions that could have unfavourable effects on their overall financial standing; and (iii) carry out on-site investigations at a firm's premises.[659] These powers also apply in respect of activities that have been outsourced by firms.[660] The only caveat to these broad powers is that they must be exercised in a timely and proportionate manner.[661]

The UK authorities similarly have general supervisory powers, which are similar in nature to those outlined above.[662]

The Supervisory Review Process

The supervision process entails an initial authorisation as well as reviews of a firm's continued operations and regulatory compliance. Supervisory authorities are required to review and evaluate the strategies, processes and reporting procedures of each firm to comply with the laws, regulations and administrative provisions adopted pursuant to the Solvency II Directive.[663] This review should include an assessment of the qualitative requirements relating to the system of governance, the risks the firm faces or may face and the ability of the firm to assess those risks given the environment in which it operates.[664]

[656] Article 31(3) of the Solvency II Directive.

[657] (1) Article 31(2), *ibid*; and (2) Part 1A and 9A of the FSMA for the PRA's obligation to publish certain documents and guidance.

[658] Article 34(1) of the Solvency II Directive.

[659] Article 34, *ibid*.

[660] Article 34(7), *ibid*.

[661] Article 34(6), *ibid*.

[662] Parts 2, 3, 4A, 5, 9A and 14 of the FSMA.

[663] Article 36(1) of the Solvency II Directive.

[664] *Ibid*.

Additionally, supervisory authorities must assess the adequacy of methods and practices that a firm has in place to identify possible events or future changes in economic conditions that could have adverse effects on the overall financial standing of that undertaking.[665] They are required to adopt appropriate monitoring tools to enable them to identify deteriorating financial conditions in firms and to monitor how that deterioration is remedied.[666]

The Solvency II Directive highlights certain elements that should remain the focus of the supervisory authorities' review. These are as follows:

- The system of governance, including the ORSA.
- The technical provisions.
- The capital requirements.
- The investment rules.
- The quality and quantity of own funds.
- Where the (re)insurance undertaking uses a full or partial IM, ongoing compliance with the requirements for full and partial IMs.[667]

The Solvency II Directive leaves it to supervisory authorities of the respective member states to decide the minimum frequency and scope of these reviews, with due regard to nature, scale and complexity of the activities of the firm concerned.[668] The Directive does, however, stipulate that these reviews must be conducted "regularly".[669] The EIOPA has published guidelines to promote consistency in processes and practices within the supervisory review process, while allowing national supervisory authorities sufficient flexibility to adapt their actions to take into account the specificities of the firms involved, their own markets and other supervisory priorities.[670] For the review process to be effective and remedial, supervisory authorities have been given "necessary" powers to require the remediation of any weaknesses or deficiencies identified in the review.[671]

Supervision of Outsourced Activities

While firms are able to outsource activities and functions, they must take necessary steps to ensure that the following conditions are satisfied where they do so:

- The service provider must cooperate with supervisory authorities of the (re)insurance undertaking in connection with the outsourced function or activity.
- The (re)insurance undertaking, its auditors and the supervisory authorities must have effective access to data relating to the outsourced functions or activities.
- Supervisory authorities must have effective access to the business premises of the service provider and must be able to exercise those rights of access.[672]

[665] Article 36(4), *ibid.*

[666] Article 36(3), *ibid.*

[667] Article 36(2), *ibid.*

[668] Article 36(6), *ibid.*

[669] *Ibid.*

[670] The EIOPA Guidelines on supervisory review process (EIOPA-BoS-14/179 EN).

[671] Article 36(5) of the Solvency II Directive.

[672] Article 38(1), *ibid* (transposed in Paragraph 7.4, Conditions Governing Business Part of the PRA Rulebook).

The state where the service provider is located must permit the firm's "home" supervisory authority to carry out on-site inspections at the service provider's premises.[673] However, such inspections may be delegated to the supervisory authority where the service provider is located, subject to agreement among the regulatory bodies.[674]

Where a supervisory authority is unable to exercise its right to carry out an on-site inspection, in accordance with Article 38 of the Solvency II Directive, the supervisory authority may refer the matter to the EIOPA and seek its assistance in resolving the disagreement with the cross-border supervisory authority.[675] The EIOPA is also able to participate in on-site inspections at the premises of service providers where they are carried out jointly by two or more supervisory authorities.[676]

2. The Reporting Framework

The Solvency II Directive allows supervisory authorities to determine the nature, scope and format of the information sought from undertakings, which they may require firms to submit:

- At predefined periods.
- Upon occurrence of predefined events.
- During enquiries regarding the situation of an insurance or reinsurance undertaking.[677]

The Level 2 Delegated Regulation (which is directly applicable in the UK as retained EU law) provides more detail on the reporting obligations of Solvency II firms. The suite of information that firms are required to submit to supervisory authorities can be segregated into four key components. These are as follows:

- The SFCR.
- The Regular Supervisory Report (RSR).
- The ORSA.
- Annual and quarterly quantitative reporting templates (QRTs) specifying in greater detail and supplementing the information presented in the SFCR and RSR.[678]

The RSR and the additional quantitative reporting requirements will be the focus of this chapter. For more information on the ORSA, please see Chapter 10: Governance Requirements.

General Reporting Obligations of (Re)insurance Undertakings

There is a general obligation to provide supervisory authorities with all information that is necessary for the purposes of supervision.[679] Relatedly, supervisory authorities have the power to require all information necessary to conduct supervision. It should be noted that supervisory authorities are empowered to determine the nature, scope and format of the information that they require (re)insurance undertakings

[673] Article 38(2), *ibid.*

[674] *Ibid.*

[675] (1) Article 38(2) of the Solvency II Directive; and (2) Article 19 of Regulation (EU) No 1094/2010 (as amended by Regulation (EU) 2019/2175).

[676] Article 38(2), *ibid.*

[677] Article 35(2)(a), *ibid.*

[678] Article 304 of the Level 2 Delegated Regulation.

[679] Article 35(1) of the Solvency II Directive (transposed in Paragraph 2.1, Reporting Part PRA Rulebook).

to provide.[680] At a minimum, the information supplied must enable supervisory authorities to (i) assess the system of governance applied by the firms, the business they are pursuing, the valuation principles applied for solvency purposes, the risks faced and the risk-management systems, and their capital structure, needs and management; and (ii) make any appropriate decisions resulting from the exercise of their supervisory rights and duties.[681]

The information supplied by firms must be reflective of the nature, scale, complexity of the business and risks inherent to the firm. Such information must also be accessible, complete, consistent, relevant and reliable. Further, firms must have a written policy supported by appropriate systems and structures to allow them to fulfil their reporting requirements. The information supplied by firms must comprise the following:

- Qualitative or quantitative elements, or any appropriate combination thereof.
- Historic, current or prospective elements, or any appropriate combination thereof.
- Data from internal or external sources, or any appropriate combination thereof.[682]

The Regular Supervisory Report

The RSR must be submitted in electronic form at least every three years, notwithstanding the fact that supervisory authorities may require a firm to submit its RSR at the end of any financial year.[683] Notably, even when there is no requirement to submit an RSR in relation to a given financial year, firms must still submit a report setting out any material changes that have occurred in the firm's business and performance, system of governance, risk profile, valuation for solvency purposes and capital management over the given financial year, and provide a concise explanation about the causes and effects of such changes.[684] The deadline to submit the RSR is currently set at no later than 14 weeks after the firm's financial year end.[685]

Supervisory authorities are able to limit regular supervisory reporting, or exempt firms from reporting on an item-by-item basis, where:

- The submission of that information would be overly burdensome in relation to the nature, scale and complexity of the risks inherent in the business of the firm.
- The submission of that information is not necessary for the effective supervision of the firm.
- The exemption does not undermine the stability of the financial systems concerned.
- The firm is able to provide the information on an *ad hoc* basis.[686]

In determining eligibility for available exemptions, supervisory authorities have been instructed to give priority to the smallest of firms.[687]

However, the potential exemption referred to above can only be granted to (re)insurers that do not represent more than 20% of a jurisdiction's life and non-life insurance or reinsurance market respectively, where the non-life market share is based on gross written premiums and the life market share is based on gross

[680] Article 35(2), *ibid.*

[681] Article 35(1), *ibid* (transposed in Paragraph 2.2, Reporting Part of the PRA Rulebook).

[682] Article 35(3)-(5), *ibid* (transposed in Paragraphs 2.3 to 2.5, Reporting Part of the PRA Rulebook).

[683] Article 312 of the Level 2 Delegated Regulation.

[684] *Ibid.*

[685] *Ibid.*

[686] Article 35(7) of the Solvency II Directive.

[687] *Ibid.*

technical provisions.[688] Further, supervisory authorities must not exempt any (re)insurer from reporting on an item-by-item basis that is a part of a "group" for the purposes of the Solvency II Directive, unless the firm can demonstrate that reporting on an item-by-item basis is inappropriate, given the nature, scale and complexity of the risks inherent in the business of the group and taking into account the objective of financial stability.[689]

As part of efforts to make the supervision regime more proportional, the Amendments referred to in Section 1 above will adapt the reporting requirements to be better suited to the size, nature and complexity of each firm. New, simplified reporting requirements for "small and non-complex undertakings" are introduced, facilitating their access to exemptions and limitations for regular supervisory reporting; there is the possibility such undertakings will be given permission to submit their RSR every five years, instead of every three years.[690] The Amendments also extend the submission deadline for all undertakings for the RSR from 14 weeks to no later than 18 weeks after the undertaking's financial year ends.[691]

The UK has already implemented some simplifications to reduce reporting burdens under its Solvency II regime, with some additional reforms taking effect on 31 December 2024.[692] The UK reforms focus on reducing the volume of information that Solvency II firms are required to report, making it less burdensome for firms while ensuring that the PRA still receives the necessary information to conduct effective supervision. In December 2023, the PRA removed the requirement to submit the RSR for all Solvency II firms, including UK branches of international insurers.[693] The PRA recognised that the report was burdensome to prepare and that the triennial reporting frequency of the RSR would not provide timely information.[694] The PRA views that the remainder of the framework allows for collection of information that is important for supervision.[695]

Content Requirements of the Regular Supervisory Report

The Level 2 Delegated Regulation fleshes out in great specificity the content requirements of the RSR, set out in Articles 307 to 311 of the Level 2 Delegated Regulation, and these requirements are summarised below.

Content Requirements

Business and Performance (Article 307)

In relation to the business of the undertaking:

- The main trends and factors that contribute to the development, performance and position of the undertaking over its business planning time period including the undertaking's competitive position and any significant legal or regulatory issues.
- A description of the business objectives of the undertaking, including the relevant strategies and timeframes.

[688] *Ibid.*

[689] *Ibid.*

[690] Article 1(16), COM(2021)0582, "Proposal for a Directive of the European Parliament and of the Council", 19 January 2024.

[691] Article 1(18), *ibid.*

[692] (1) PRA CP12/23; and (2) PRA PS3/24.

[693] PRA PS3/24.

[694] Paragraph 3.29, *ibid.*

[695] *Ibid.*

On the underwriting performance of the undertaking:

- Information on the undertaking's underwriting income and expenses by material line of business and material geographical areas where it writes business during the reporting period, a comparison of the information with that reported on the previous reporting period and the reasons for any material changes.
- An analysis of the undertaking's overall underwriting performance during the reporting period.
- Information on the undertaking's underwriting performance by line of business during the reporting period against projections, and significant factors affecting deviations from these projections.
- Projections of the undertaking's underwriting performance, with information on significant factors that might affect such underwriting performance over its business planning time period.
- Information on any material risk mitigation techniques purchased or entered into during the reporting period.

In relation to the performance of the undertaking's investments:

- Information on income and expenses with respect to investment activities during the last reporting period, a comparison of the information reported in the previous period and reasons for any material changes.
- An analysis of the undertaking's overall investment performance during the reporting period and also by relevant asset class.
- Projections of the undertaking's expected investment performance, with information on significant factors that might affect such investment performance, over its business planning time period.
- The key assumptions that the undertaking makes in its investment decisions with respect to the movement of interest rates, exchange rates and other relevant market parameters, over its business planning time period.
- Information about any investments in securitisation, and the undertaking's risk management procedures in respect of such securities or instruments.

In addition, information of any material income and expenses, other than underwriting or investment income and expenses, over the undertaking's business planning time period should be provided together with any other material information regarding the undertaking's business and performance.

System of Governance (Article 308)

In relation to the governance systems:

- Information allowing the supervisory authorities to gain a good understanding of the system of governance within the undertaking, and to assess its appropriateness to the undertaking's business strategy and operations.
- Information relating to the undertaking's delegation of responsibilities, reporting lines and allocation of functions.
- The remuneration entitlements of the members of the AMSB, over the reporting period and a comparison of the information with that reported on the previous reporting period and the reasons for any material changes.

In relation to fit and proper requirements:

- A list of the persons in the undertaking that are responsible for key functions.

- Information on the policies and processes established by the undertaking to ensure that those persons are fit and proper.

In relation to the risk management system:

- Information on the undertaking's risk management strategies, objectives, processes and reporting procedures for each category of risk.
- Information on significant risks that the undertaking is exposed to over the lifetime of its (re)insurance obligations and how these have been captured in its overall solvency needs.
- Information on any material risks that the undertaking has identified and that are not fully included in the calculation of the SCR.
- Information on how the undertaking fulfils its obligation to invest all its assets in accordance with the PPP.
- Information on how the undertaking verifies the appropriateness of credit assessments from external credit assessments institutions including how and the extent to which credit assessments from external credit assessments institutions are used.
- Results of the assessments regarding the extrapolation of the RFR, the MA and the VA.

In relation to the ORSA:

- A description of how the ORSA is performed, internally documented and reviewed.
- A description of how the ORSA is integrated into the management process and into the decision-making process of the undertaking.

In relation to the internal control system of the undertaking:

- Information on the key procedures that the internal control system includes.
- Information on the activities performed during the reporting period.
- Information on the undertaking's compliance policy, the process for reviewing that policy, the frequency of review and any significant changes to that policy during the reporting period.

In relation to the internal audit function of the undertaking:

- A description of internal audits performed during the reporting period, with a summary of the material findings and recommendations reported to the undertaking's AMSB, and any action taken with respect to these findings and recommendations.
- A description of the undertaking's internal audit policy, the process for reviewing that policy, the frequency of review and any significant changes to that policy during the reporting period.
- A description of the undertaking's audit plan, including future internal audits and the rationale for these future audits.
- Where the persons carrying out the internal audit function assume other key functions in accordance with Article 271(2), a qualitative and quantitative assessment of the criteria set out in points (a) and (b) of Article 271(2) of the Level 2 Delegated Regulation.

In relation to outsourcing:

- Where the undertaking outsources any critical or important operational functions or activities, the rationale for the outsourcing and evidence that appropriate oversight and safeguards are in place.
- Information on the service providers to whom any critical or important operational functions or activities have been outsourced and how the undertaking ensures that the service providers comply with provisions of the Level 2 Delegated Regulation.
- A list of the persons responsible for the outsourced key functions in the service provider.

In relation to the actuarial functions, an overview of the activities undertaken by the actuarial function in each of its areas of responsibility during the reporting period, describing how the actuarial function contributes to the effective implementation of the undertaking's risk management system together with any other material information regarding the undertaking's system of governance.

Risk Profile (Article 309)

Qualitative and quantitative information regarding the risk profile of the (re)insurance undertaking, for all of the following categories of risk:

- Underwriting risk.
- Market risk.
- Credit risk.
- Liquidity risk.
- Operational risk.
- Other material risks.

In relation to each of the risks outlined above, the RSR must include the following:

- On risk exposure of the insurance or reinsurance undertaking, including the exposure arising from off-balance sheet positions and the transfer of risk to SPVs:
  - An overview of any material risk exposures anticipated over the business planning time period given the undertaking's business strategy, and how these risk exposures will be managed.
  - Where the undertaking sells or repledges collateral, the amount of that collateral.
  - Where the undertaking has provided collateral, the nature of the collateral, the nature and value of assets provided as collateral and the corresponding actual and contingent liabilities created by that collateral arrangement.
  - Information on the material terms and conditions associated with the collateral arrangement.
  - A complete list of assets and how those assets have been invested in accordance with the PPP.
  - Where the undertaking has entered into securities lending or borrowing transactions, repurchase or reverse repurchase agreements including liquidity swaps, information on their characteristics and volume.
  - Where the undertaking sells variable annuities, information on guarantee riders and hedging of the guarantees.

- Information regarding the volume and nature of the loan portfolio of the undertaking.
- Information on the material risk concentrations to which the undertaking is exposed and an overview of any future risk concentrations anticipated over the business planning time period given that undertaking's business strategy, and how these risk concentrations will be managed.
- On risk mitigation techniques of the undertaking:
  - Information on the techniques currently used to mitigate risks, and a description of any material risk mitigation techniques that the undertaking is considering purchasing or entering into over the business planning time period given the undertaking's business strategy, and the rationale for and effect of such risk mitigation techniques.
  - Where the (re)insurance undertaking holds collateral, the value of the collateral, and information on the material terms and conditions associated with the collateral arrangement.
- With respect to liquidity risk, information regarding the expected profit included in future premiums for each line of business, the result of the qualitative assessment and a description of methods and main assumptions used to calculate the expected profit included in future premiums.
- On risk sensitivity of the undertaking:
  - A description of the relevant stress tests and scenario analysis carried out by the undertaking, including their outcome.
  - A description of the methods used and the main assumptions underlying those stress tests and scenario analysis.
- Information regarding quantitative data that is necessary for determining dependencies between the risks covered by the risk modules or sub-modules and of the basic SCR.
- Any other material information regarding the risk profile of the undertaking.

Valuation for Solvency Purposes (Article 310)

- Any important information, other than that already disclosed in the SFCR of the (re)insurance undertaking regarding the valuation of its assets, technical provisions and other liabilities for solvency purposes.
- A description of the relevant assumptions about future management actions and policyholder behaviour.
- Information to comply with the reporting requirements of the undertaking in relation to valuation for solvency purposes.[696]

Capital Management (Article 311)

In relation to the own funds of the undertaking:

- Information on the material terms and conditions of the main items of own funds held by the undertaking.
- The expected developments of the undertaking's own funds over its business planning time period given the undertaking's business strategy, and appropriately stressed capital plans and whether there is any intention to repay or redeem any own-fund item or plans to raise additional own funds.
- The undertaking's plans on how to replace BOF items that are subject to the transitional arrangements.

[696] Article 263 of the Level 2 Delegated Regulation.

In relation to deferred taxes:

- A description of the calculated amount of deferred tax assets without assessing their probable utilisation, and the extent to which those deferred tax assets have been recognised.
- For the deferred tax assets that have been recognised, a description of the amounts being recognised as likely to be utilised by reference to probable future taxable profit and by reference to the reversion of deferred tax liabilities relating to income taxes levied by the same taxation authority.
- A detailed description of the underlying assumptions used for the projection of probable future taxable profit.
- An analysis of the sensitivity of the net deferred tax assets to changes in the underlying assumptions referenced in the prior bullet.

In relation to the capital requirements:

- Quantitative information on the undertaking's SCR split by risk modules where the undertaking applies the standard formula, and by risk categories where the undertaking applies an IM.
- The expected developments of the undertaking's anticipated capital requirements over its business planning time period given the undertaking's business strategy.
- An estimate of the undertaking's SCR determined in accordance with the standard formula, where the supervisory authority requires the undertaking to provide that estimate pursuant to Article 112(7) of the Solvency II Directive.
- For the future profit projected for the purpose of the loss-absorbing capacity of deferred taxes:
  - A description, and the relevant amount of each of the components used to demonstrate a positive value of the increase in deferred tax assets.
  - A detailed description of the underlying assumptions used for the projection of probable future taxable profit.
  - An analysis of the sensitivity of the value of the adjustment to changes in the underlying assumptions referred to above.
- Where an IM is used to calculate the SCR:
  - The results of the review of the causes and sources of profits and losses, for each major business unit and how the categorisation of risk chosen in the IM explains those causes and sources of profits and losses.
  - Information on whether, and if so to what extent, the risk profile of the undertaking deviates from the assumptions underlying the undertaking's IM.
  - Information about future management actions used in the calculation of the SCR.
- Information on any reasonably foreseeable risk of noncompliance with the undertaking's capital requirements, and the undertaking's plans for ensuring that compliance with each is maintained.
- Any other material information regarding the capital management of the (re)insurance undertaking.

Reporting Market Risk Sensitivities

While there is no equivalent requirement under the Solvency II Directive, the PRA requires additional reporting on data collection of market risk sensitivities for firms with material exposure to market risk, specifically with respect to sensitivities affecting the solvency position arising out of changes in market conditions.[697] The requirement is addressed to firms holding or intending to hold material quantities of assets exposed to market risk.[698]

The PRA has stated that it will inform firms individually, through their usual supervisory contacts, if they fall within scope.[699] Firms within the scope of the reporting requirement are those most exposed to market risks, *i.e.*, primarily Category 1 and 2 firms in the life sector, and any other category life firm or general insurance firm, or composite insurance firm that demonstrates material market risk exposures.[700]

The PRA requires such in-scope firms to report sensitivities to various changes in market risks twice a year.[701] Market risk covers a range of exposures including equity prices, property prices, swap rates, sovereign rates, spreads on corporate bonds over swap rates, downgrades on credit-risk affected assets, inflation and exchange rates, and may include new risks that develop over time.[702] The report must show the impact of market risks on assets, technical provisions, own funds, the SCR and other liabilities.[703]

A new version of PRA SS7/17 was published on 29 February 2024, which is due to take effect from 31 December 2024.[704] This has been updated to reflect the revised calculation requirements on the Transitional Measure of Technical Provisions following the new PRA PS: PRA PS2/24.

3. Quantitative Reporting

Independent of the RSR, though thematically closely aligned, firms are required to submit to their supervisor information necessary to adequately supervise the firm by way of annual and quarterly quantitative templates, containing specific, detailed information.[705]

Standardised Template Reporting

The PRA requires that quantitative information be submitted in the relevant format as provided in the Solvency II Regulations or in the form of any national specific templates (NSTs). The form and technical content requirements of the quantitative templates were initially set out in the Commission Implementing Regulation (EU) 2015/2450, subsequently repealed and replaced on 31 December 2023.[706] The driving principle was to address the variability in reporting and regulatory supervision within the European Union. In standardising the reporting template, (re)insurance undertakings should have been able to provide consistent and comparable data to supervisory authorities.

[697] PRA SS7/17 was first published in October 2017. The current version in force was published in September 2020.

[698] Paragraph 1.2, *ibid.*

[699] Paragraph 2.1, *ibid.*

[700] *Ibid.*

[701] Paragraph 3.1, *ibid.*

[702] Paragraph 3.2, *ibid.*

[703] Paragraph 3.3, *ibid.*

[704] PRA SS7/17.

[705] Article 35(5) of the Solvency II Directive (transposed in Paragraph 2.5, Reporting Part of the PRA Rulebook).

[706] Commission Implementing Regulation (EU) 2023/894.

There is an extensive set of annexes containing the various reporting templates that cover various aspects of a firm's financial and solvency position. The templates are designed to capture both basic information[707] but also detailed information on assets and liabilities,[708] own funds,[709] technical provisions and other relevant metrics such as the capital requirements.[710] In order to reinforce the standardisation principle, the templates are highly structured, with specific fields and formats that must be adhered to, ensuring uniformity in the data presented to regulators.

In respect of any given firm, the templates are intended to provide an easy, accessible and accurate overview of:

- Its system of governance.
- The business it pursues.
- The valuation principles applied by the firm for solvency purposes.
- The risks faced by the firm.
- Its risk management systems.
- Its capital structure, capital needs and capital management.

In order to effectively achieve the original objective of the quantitative reporting system, the introduction of updated regulations refine the original reporting requirements addressing the evolving needs of the market and also the wider business landscape. The changes revise and expand upon the original set of templates used for reporting; notable changes include the introduction of templates for emerging risks[711] and sustainability-related disclosures[712] and revised templates to align with new market practices. The introduction of sustainability-related reporting reflects the growing cognisance of these areas in the regulatory landscape. The templates themselves are designed to align with international standards and framework, such as the Task Force on Climate-Related Financial Disclosures' recommendations, to ensure consistency and comparability of the reported information.

Subject to certain exemptions outlined below, the general requirement is for the quantitative reporting information to be submitted on both an annual and quarterly basis.[713] Deadlines for submission in the UK of the quantitative reporting analysis are:

- No later than 14 weeks for the UK (or 16 weeks in the case of the EU[714]) after the end of a firm's financial year end in respect of annual reporting.[715]
- No later than five weeks after the end of any quarter.[716]

In any event where such date is not a business day, the reporting must be submitted no later than the business day immediately following such prescribed deadline.

[707] Template S.01.01.
[708] Template S.02.01.
[709] Template S.23.01.
[710] Template S.28.01.
[711] Template S.30.01.
[712] Templates S.40.01/S.41.01.
[713] Paragraph 2.8, Reporting Part of the PRA Rulebook.
[714] Article 1(18), COM(2021)0582, "Proposal for a Directive of the European Parliament and of the Council", 19 January 2024.
[715] (1) Article 312 of the Level 2 Delegated Regulation; and (2) Paragraph 2.10, Reporting Part of the PRA Rulebook.
[716] (1) Article 312 of the Level 2 Delegated Regulation; and (2) Paragraph 2.11, Reporting Part of the PRA Rulebook.

UK-Specific Templates

The PRA maintains a separate suite of NSTs, which can be found on the PRA website,[717] to supplement and address areas that stem from specific national requirements or the intricacies of local markets which were not catered for in the original Solvency II harmonised templates. Subject to particular exceptions,[718] there are specific types of firms that are required to submit specific NSTs, including assessable mutuals, firms writing suretyship business and long-term insurers.[719]

Notwithstanding Brexit, the form of reporting is consistent: eXtensible business reporting language must be used for submission, ensuring data consistency and facilitating automated processing.[720]

The PRA Approach – Simplification and Exemption

The PRA has two main goals: a general goal to enhance the safety and stability of the firms it oversees, and a specific goal for (re)insurance firms, which is to help ensure an adequate level of protection for policyholders. In addition to the mechanical issues with the standardised reporting, feedback from firms suggested that there had been unintended consequences, specifically being required to adhere to a level of detail and quantity of reporting inappropriate to specific kinds of firms.

Beginning in 2021, the PRA consulted on simplifications to the quantitative reporting regime focusing on reducing the volume of financial information firms are required to give to the PRA with a view to implementation with a low administrative burden, removing the requirement to report several QRTs for all firms and reducing the reporting frequency of the MCR templates from quarterly to a semi-annual basis.[721]

To further aid a streamlined approach, the PRA categorises firms according to their potential to adversely affect the stability of the UK financial system by failing, coming under operational or financial stress, or because of the inherent way in which the firm conducts its business.[722] Additionally, the PRA also looks at whether the services provided by a firm can be substituted for another, and to what extent such actions could mitigate the impact of any potential collapse, including in stressed circumstances. The different categories are outlined below.

- **Category 1:** The most significant insurers whose size, interconnectedness, complexity and business type give them the capacity to cause very significant disruption to the UK financial system (and to economic activity more widely) by failing or by carrying on their business in an unsafe manner.
- **Category 2:** Insurers whose size, interconnectedness, complexity and business type give them the capacity to cause some disruption to the UK financial system (and to economic activity more widely) by failing or by carrying on their business in an unsafe manner.
- **Category 3:** Insurers whose size, interconnectedness, complexity and business type give them the capacity to cause minor disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.

[717] Section 1(f): National Specific Templates, "Regulatory Reporting — Insurance Sector".

[718] Paragraph 2.7, Reporting Part PRA Rulebook.

[719] Paragraph 2.6, *ibid.*

[720] Article 3, Commission Implementing Regulation (EU) 2023/894.

[721] PRA CP11/21.

[722] Section 19 of "The PRA's Approach to Supervision of the Banking and Insurance Sectors" Bank of England PRA, published in July 2023.

- **Category 4:** Insurers whose size, interconnectedness, complexity and business type give them almost no capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.

Following on from the categorisation of firms and responding to feedback received, the PRA published a PRA SS confirming the changes to the scope of quantitative reporting requirements in February 2023. In the statement, the PRA considered that some firms would be eligible to apply for a "modification by consent", whereby a firm may limit its regular supervisory reporting where the predefined submission period is less than one year.[723] Generally, firms designated as category three or four by the PRA (whether as an individual entity or part of a group) will be eligible to apply for the quarterly reporting exemption.

While the term "exemption" is used both in this chapter and by the PRA, it should not be considered a complete exemption. At the individual firm level, the exemption from quarterly reporting does not apply to (i) reporting of own funds and balance sheet templates in the second quarter; and (ii) the basic information and content of submission templates. Group level undertakings that meet the relevant criteria in Article 254 of the Solvency II Directive may not be required to submit any group level quarterly reporting templates.[724]

Irrespective of any exemption granted to any category of firm, the PRA may nonetheless still require a firm to provide the information ordinarily required under the quarterly reporting regime, notwithstanding the exemption held. As a matter of good practice, firms should be capable of readily responding to any such requests.

Exemptions may be considered for category one and two firms on an individual basis. Groups should not submit a formal application for the exemption in the first instance but should discuss the merits of their proposal with the relevant supervisor.

Firms are expected to notify their supervisor as soon as they believe there are any reasons that could impact its suitability for holding the reporting exemption. To the extent the PRA revokes any consent, it is expected that the relevant firm will resume reporting within six months from the date of notification of the waiver. It is clear from the guidance that firms should proactively manage their reporting, whether or not they are obliged to share the information with the PRA, as best practice.

4. Capital Add-Ons

In exceptional circumstances, supervisory authorities may require a capital add-on for a (re)insurance undertaking, meaning that such undertaking shall be required to maintain more capital than would otherwise be required pursuant to the SCR. As an overarching principle within the Solvency II Directive, the imposition of a capital add-on is "exceptional" and "should only be used as a measure of last resort, when other supervisory measures are ineffective or inappropriate". "Exceptional" should also be viewed through the lens of the specific firm in question rather than in relation to the total number of capital add-ons in a specific market.[725]

[723] Paragraph 1 of the PRA SS11/15.

[724] (1) Section 165 of the FSMA; (2) Regulation 31 of the Solvency II Regulations; and (3) Paragraph 17.3, Group Supervision Part of the PRA Rulebook.

[725] Recital 27 of the Solvency II Directive.

Given the extraordinary nature for the imposition of a capital add-on, there are very limited circumstances in which it will be imposed, those being in a situation, as judged by the supervisory body, where:[726]

- The risk profile of the insurance or reinsurance undertaking deviates significantly from the assumptions underlying the SCR calculated using the standard formula and either:
  - The requirement to use the IM is inappropriate or ineffective.
  - A full or partial IM is being developed.
- The risk profile of the undertaking deviates significantly from the assumptions underlying the SCR as calculated using an internal or partial model because certain quantifiable risks are captured insufficiently and the adaptation of the model to better reflect the given risk profile has failed within an appropriate timeframe.
- The system of governance of the undertaking deviates significantly from the standards dictated by the Solvency II Directive and those deviations prevent it from being able to properly identify, measure, monitor, manage and report the risks that it is or could be exposed to and that the application of other measures is, in itself, unlikely to improve the deficiencies sufficiently within an appropriate timeframe.
- The undertaking applies the MA, the VA or the transitional measures, and the supervisory authority concludes that its risk profile deviates significantly from the assumptions underlying those adjustments and transitional measures.

Solvency Capital Requirement: Deviation and Calculation of Capital Add-Ons

The PRA will calculate the capital add-on as the difference between:[727]

- The SCR of the undertaking, excluding any previous capital add-ons, if the standard formula or the IM (as appropriate) were to be amended to reflect that undertaking's actual risk profile.
- The SCR of the undertaking, excluding any previous capital add-ons.

The requirement to use an IM is inappropriate where the estimated financial resources necessary to produce the IM are themselves disproportionate to the size of the deviation in the firm's risk profile from the assumptions underpinning the SCR.[728] Similarly, circumstances where the requirement to use an IM is ineffective include where no IM has been developed or where the developed IM fails to meet the approval conditions.[729]

Additionally, in determining the extent of deviations from the SCR (described above), the supervisory body will consider a variety of factors, including:[730]

- The nature, type and size of any deviation.
- The likelihood and severity of any adverse impact on policyholders.
- The level of sensitivity of the assumptions to which the deviation relates.
- The anticipated duration and volatility of the deviation over the duration of the deviation.

[726] Article 37(1), *ibid.*

[727] Article 282 of the Level 2 Delegated Regulation.

[728] Article 280, *ibid.*

[729] Title I, Chapter VI, Section 4, Subsections 1 and 3 of the Solvency II Directive.

[730] (1) Article 280 of the Level 2 Delegated Regulation; and (2) PRA Statement of Policy "Solvency II: Capital Add-Ons", published in February 2024.

In order to provide firms with more comfort, the PRA provides numerical information in addition to situational guidance in its response, which is outlined below.[731] However, this guidance is contained within the Level 2 Delegated Regulation and is applicable to all relevant jurisdictions.[732]

Profile Deviation	PRA Determination
< 10%	There is a possibility that the firm's risk profile may deviate significantly when compared to the original SCR assessment.
10% < 15%	There is a rebuttable presumption that the conclusion will be the firm's risk profile deviates significantly when compared to the original SCR assessment, unless there is evidence to the contrary using the risk factors outlined.
≥ 15%	There is an expectation that the conclusion will be the firm's risk profile deviates significantly when compared to the original SCR assessment.

Governance: Deviation and Calculation of Capital Add-On

When assessing a significant deviation with respect to governance (noted above), the supervisory body will consider a variety of factors, including:[733]

- The effect of the deviation on the sound and prudent management of the business and whether such deviation arises from an inadequate implementation of a requirement relating to the system of governance or a failure to implement such a requirement.
- The likelihood and severity of any adverse impact on policyholders and beneficiaries.
- The different ways of organising an effective system of governance that is proportionate to the nature, scale and complexity of the risks inherent in the business of the firm.
- The probable financial loss the firm could incur as a consequence of the deviation.
- The anticipated duration of the deviation.

In calculating the add-on for a deviation from governance standards, the supervisory authority should take into account the relevant factors outlined in Article 277, summarised above, and also any capital add-ons set in respect of previous deviations of other (re)insurance undertakings with similar risk profiles provided that, in the case of the UK, the PRA is able to state the reasons for their decision and the statement itself is compliant with the provisions of the professional secrecy requirements as set out in Section 348 of the FSMA.[734]

Matching Adjustment: Deviation and Calculation of Capital Add-Ons

In determining whether a firm's risk profile deviates significantly from the assumptions underlying the MA, VA and transitional measures, the factors to be considered by the supervisory body are identical to those concerning the SCR deviation set out in the subsection SCR: Deviation and Calculation of Capital

[731] PRA Statement of Policy "Solvency II: Capital Add-Ons", published in February 2024.

[732] Article 280 of the Level 2 Delegated Regulation.

[733] (1) Article 277 of the Level 2 Delegated Regulation; and (2) PRA Statement of Policy "Solvency II: Capital Add-Ons", published in February 2024.

[734] (1) Article 286 of the Level 2 Delegated Regulation; and (2) PRA Statement of Policy "Solvency II: Capital Add-Ons", published in February 2024.

Add-Ons above. In addition, where the deviation relates to the MA, VA or transitional measures, the PRA may only impose a capital add-on where the deviation underlying those assumptions and transitional measures is temporary and does not justify revoking the supervisory approval for the use of the adjustment or the transitional measure (as appropriate).[735]

The capital add-on calculation in respect of firms applying the MA, VA and transitional measures will be calculated based on the total of:

- The negative of the amount of eligible own funds that would be calculated if the adjustment or transitional measure was modified in such a way that the assumptions underlying the adjustment or transitional measure would fit the actual assets, liabilities and risk profile of the firm.
- The amount of the SCR, excluding any previous or simultaneous capital add-on, that would be calculated if the adjustment or transitional measure was modified in such a way that the assumptions underlying the adjustment or transitional measure would fit the actual assets, liabilities and risk profile of the undertaking.
- The amount of eligible own funds.
- The negative of the amount of the SCR of the firm, excluding any previous or simultaneous capital add-on.[736]

In calculating the amounts referenced in Section 4 above, the relevant considerations are the features of a particular undertaking's assets, liability or risk profile that gave rise to the deviations from the assumptions underlying the adjustment or transitional measure in the first instance.[737]

The PRA: Setting and Removing a Capital Add-On

The PRA should initially notify the relevant firm of its intention to apply a capital add-on, which should include a deadline by which the relevant firm should respond.

The PRA may request the firm to perform a calculation of a capital add-on according to one of the methods set out in this section.

If the PRA receives information it deems to be insufficient, it may request the entity to provide further information necessary for making a decision on setting a capital add-on at a later date to be set by the PRA. If the firm anticipates its inability to meet the deadline, it should notify the PRA immediately.

After having received all pertinent information, the PRA will notify the relevant firm in writing of its decision to set a capital add-on. The decision of the PRA must be sufficiently detailed to enable the firm to understand the steps needed to be taken and remedies implemented in order that the capital add-on be removed. The PRA should supply to the firm:

- The reasons and rationale for setting the capital add-on.
- The methodology for calculating the capital add-on and the amount thereof.
- The date from which the capital add-on is applicable.

[735] (1) Article 278 of the Level 2 Delegated Regulation; and (2) PRA Statement of Policy "Solvency II: Capital Add-Ons", published in February 2024.

[736] (1) Article 286 of the Level 2 Delegated Regulation; and (2) PRA Statement of Policy "Solvency II: Capital Add-Ons", published February 2024.

[737] (1) Article 285 of the Level 2 Delegated Regulation; and (2) "PRA Statement of Policy "Solvency II: Capital Add-Ons", published in February 2024.

- The deadline by which the undertaking is expected to have remedied the deficiency that led to the capital add-on (where appropriate).
- The content and frequency of any progress reports to be provided (where appropriate).

The PRA will continue to review the capital add-on on a regular basis, the frequency of which is to be reviewed on a case-by-case basis. The PRA also expects that the firm make every effort to remedy the deficiencies that led to the imposition of a capital add-on and that the firm inform it in the event that there is a material change to the circumstances that led to the situation causing the capital add-on.[738] The driving goal of all parties will be to have the capital add-on in place for as short a timeframe as possible.

5. Supervisory Convergence and Information Sharing

Supervisory Convergence

In exercising the various supervisory tools and practices under the laws, regulations and administrative requirements adopted pursuant to the Solvency II Directive, supervisory authorities must give due regard to "convergence".[739] For that purpose, it must be ensured that:

- Supervisory authorities participate in the EIOPA's activities.
- Supervisory authorities make every effort to comply with the guidelines and recommendations issued by the EIOPA in accordance with Article 16 of Regulation (EU) No 1094/2010 and state reasons if they do not do so.
- National mandates conferred on the supervisory authorities do not inhibit the performance of their duties as members of the EIOPA or under the Solvency II Directive.[740]

Confidentiality of Information

An obligation of professional secrecy binds all persons who are working or have worked for the supervisory authorities (including auditors and experts acting on behalf of supervisory authorities).[741] Similar restrictions exist on the ability of the PRA and FCA to disclose confidential information.[742]

Persons bound by professional secrecy must not disclose any confidential information received in the course of performing their duties to any person or authority, save for cases covered by criminal law.[743] There is an exception allowing such persons to share a summary or aggregate form of confidential information, such that the individual firm cannot be identified.[744] However, where a firm is placed into insolvency procedures, it is possible to divulge confidential information that does not concern third parties involved in attempts to rescue that firm in civil or criminal proceedings.[745]

[738] Article 37(3) of the Solvency II Directive.
[739] Article 71(2), *ibid.*
[740] *Ibid.*
[741] Article 64, *ibid.*
[742] Section 348 of the FSMA.
[743] Article 64 of the Solvency II Directive.
[744] *Ibid.*
[745] *Ibid.*

Additionally, where supervisory authorities receive confidential information, they may only use it in the course of their duties and for the following purposes:

- To check that the conditions governing the taking-up of the business of (re)insurance are met and to facilitate the monitoring of the conduct of such business, especially with regard to the monitoring of the technical provisions, the SCR, the MCR and the system of governance.
- To impose sanctions.
- In administrative appeals against decisions of the supervisory authorities.
- In court proceedings under the Solvency II Directive.[746]

Permitted Exchange of Information

The obligation of professional secrecy does not preclude the exchange of information between supervisory authorities of different member states. Information exchanged in this manner should, however, be subject to the obligation of professional secrecy.[747] The EIOPA may be provided with all information necessary to enable it to carry out its duties.[748]

Information may also be disclosed to supervisory authorities of third countries but only if the information to be disclosed is subject to guarantees of professional secrecy at least equivalent to those under the Solvency II Directive.[749] Further, this exchange is only permitted where the disclosed information is intended to be used for the performance of supervisory functions of those third country authorities or bodies.[750] Where, however, the information to be disclosed to a third country originates in another member state, it cannot be disclosed without the express agreement of the supervisory authority of that member state.[751]

The PRA has obligations to cooperate with other bodies that have functions similar to the PRA, whether or not situated in the United Kingdom (but noting that the FCA is specifically excluded).[752] Cooperation may include sharing information that the PRA is not prevented from disclosing.[753]

There are additional circumstances where the exchange of information is permitted as follows:[754]

- Exchange of information between several supervisory authorities in the same member state in the discharge of their supervisory functions.
- Exchange of information, in the discharge of their supervisory functions, between supervisory authorities and any of the following that are situated in the same member state:
  - Authorities responsible for the supervision of credit institutions and other financial organisations and the authorities responsible for the supervision of financial markets.

[746] Article 67, *ibid.*
[747] Article 65, *ibid.*
[748] Article 65a, *ibid.*
[749] Article 66, *ibid.*
[750] *Ibid.*
[751] *Ibid.*
[752] Article 354B of the FSMA.
[753] *Ibid.*
[754] Article 68(1) of the Solvency II Directive.

- Bodies involved in the liquidation and bankruptcy of (re)insurance undertakings and in other similar procedures.
- Persons responsible for carrying out statutory audits of the accounts of (re)insurance undertakings and other financial institutions.
- Authorities responsible for supervising credit and financial institutions.[755]

- The disclosure, to bodies that administer compulsory winding-up proceedings or guarantee funds, information necessary for the performance of their duties.

The exchange of information between supervisory authorities noted above can also take place between different member states.[756] Further information may be permitted to be exchanged between supervisory authorities and any of the following:[757]

- The authorities responsible for overseeing the bodies involved in the liquidation and bankruptcy of (re)insurance undertakings and other similar procedures.
- The authorities responsible for overseeing the persons charged with carrying out statutory audits of the accounts of (re)insurance undertakings, credit institutions, investment firms and other financial institutions.
- Independent actuaries of (re)insurance undertakings carrying out legal supervision of those undertakings and the bodies responsible for overseeing such actuaries.

However, in order to exchange information under the circumstances noted in the paragraph above, member states must ensure that the following conditions are met: (i) the information must be for the purpose of carrying out the overseeing or legal supervision; (ii) the information received must be subject to the obligation of professional secrecy; and (iii) where the information originates in another state, it must not be disclosed without the express agreement of the supervisory authority from which it originates and, where appropriate, solely for the purposes for which that authority gave its agreement.[758]

The exchange of information between supervisory authorities and any authorities or bodies responsible may also be authorised for the detection and investigation of breaches of company law. The aim behind allowing such exchanges is to strengthen the stability and integrity of the financial system.[759] To permit this exchange, however, member states must ensure that the following conditions are met: (i) the information must be intended for the purpose of detection and investigation of breaches of company law; (ii) the information received must be subject to the obligation of professional secrecy; and (iii) where the information originates in another member state, it shall not be disclosed without the express agreement of the supervisory authority from which it originates and, where appropriate, solely for the purposes for which that authority gave its agreement.[760]

The Solvency II Directive provides for two additional circumstances where the disclosure of information by supervisory authorities is permitted:

[755] Obliged entities are listed in points (1) and (2) of Article 2(1) of Directive (EU) 2015/849 of the European Parliament and of the Council for Compliance with that directive.

[756] Article 68(1) of the Solvency II Directive.

[757] Article 68(2), *ibid.*

[758] *Ibid.*

[759] Article 68(3), *ibid.*

[760] Article 68(3), *ibid.*

- To other departments of their central government administrations responsible for legislation on the supervision of credit institutions, financial institutions, investment services and (re)insurance undertakings and to inspectors acting on behalf of those departments. Such disclosure is only permitted, however, where necessary for reasons of prudential control.[761]
- To central banks, monetary authorities, payment systems overseers and the European Systemic Risk Board.[762]

6. Obligations of Auditors Under Solvency II

Persons carrying out statutory audits for Solvency II firms are obligated to promptly report, to the relevant supervisory authority, any fact or decision concerning that firm of which they have become aware while carrying out the audit and which is liable to bring about any of the following:

- A material breach of the laws, regulations or administrative provisions that lay down the conditions governing authorisation or which specifically govern pursuit of the activities of the firm.
- The impairment of the continuous functioning of the firm.
- A refusal to certify the accounts or to the expression of reservations.
- Noncompliance with the capital requirements.[763]

Auditors performing statutory audits for firms must also report any facts or decisions of which they become aware in relation to an undertaking, which has close links with the firm for which the audit is being performed, resulting from a control relationship.[764] The Solvency II Directive clarifies that a good faith disclosure by an auditor pursuant to the provisions laid out in this section will not constitute a breach of any confidentiality obligation imposed by contract, or by any legislative, regulatory or administrative provision.[765]

Auditors performing statutory audits for firms in the UK are also under reporting obligations. The circumstances mandating disclosure by auditors in the UK are largely similar to those outlined above.[766]

7. Acquisitions Involving Qualifying Holdings

Notification Requirements

The Solvency II Directive requires the "proposed acquirer" of a "qualifying holding" in a (re)insurance undertaking to notify supervisory authorities in writing when it decides to acquire the firm but before it is actually acquired.[767] This notification must include the size of the relevant holding as well as any other

[761] Article 69, *ibid.*

[762] Article 70, *ibid.*

[763] Article 72(1), *ibid.*

[764] *Ibid.*

[765] Article 72(2), *ibid.*

[766] (1) SI 2001/2587; (2) Regulation 2(2) of the FSMA 2000 (Communications by Auditors); and (3) Regulations 2001 and Section 342(3) of the FSMA.

[767] Article 57 of the Solvency II Directive.

relevant information that is needed to carry out a prudential assessment under Article 58.[768] The information submitted should, however, be proportional to the nature of the proposed acquirer and the proposed acquisition, and the proposed acquirer should not be made to submit information that is not relevant for the prudential assessment.[769]

Under this regime, a proposed acquirer includes any natural or legal person or such persons acting in concert, and a qualifying holding means a direct or indirect holding in an undertaking that represents 10% or more of the capital or voting rights or which makes it possible to exercise a significant influence over the management of that undertaking. A proposed acquisition includes: (i) a direct or indirect acquisition of a qualifying holding in a (re)insurance undertaking, or (ii) an acquisition involving a further direct or indirect increase in a qualifying holding in a (re)insurance undertaking, as a result of which the proportion of voting rights or capital held by the proposed acquirer would reach or exceed 20%, 30% or 50% or where the target (re)insurance undertaking would become a subsidiary of the proposed acquirer.[770]

The notification requirement also applies where a person (natural or legal) decides to reduce their qualifying holding so that the proportion of the voting rights or capital held would fall below 20%, 30% or 50% or where the target (re)insurance undertaking would cease to be a subsidiary of that person.[771]

If a (re)insurance undertaking becomes aware of any acquisitions or disposals of holdings in its capital that cause those holdings to exceed or fall below any of the 20%, 30% or 50% thresholds that trigger the notification requirement outlined above, it must notify the supervisory authority at the point at which it becomes aware of such fact.[772] It must also, at least annually, inform supervisory authorities of the names of shareholders and members possessing qualifying holdings and the size of these holdings.[773]

Assessment Period

Having received the notification required, the supervisory authority must acknowledge receipt promptly in writing to the proposed acquirer within two working days.[774] The following timelines subsequently apply:

- Supervisory authorities have a maximum period of 60 working days from the date of the written acknowledgement of receipt of the notification to carry out the assessment (assessment period). Supervisory authorities must mention this deadline in the acknowledgement of receipt.[775]
- Supervisory authorities may request additional information that is necessary to complete the assessment up until the 50th working day of the assessment period with any such requests for information in writing.[776]

[768] *Ibid.*
[769] Article 59(4), *ibid.*
[770] Article 57, *ibid.*
[771] *Ibid.*
[772] Article 61, *ibid.*
[773] *Ibid.*
[774] Article 58(1), *ibid.*
[775] *Ibid.*
[776] Article 58(2), *ibid.*

- Any responses by the proposed acquirer to the requests for further information must be given within 20 working days. Supervisory authorities may, however, extend this period by up to 30 working days where the proposed acquirer is: (i) situated or regulated outside the European Union, or (ii) not subject to supervision under the Solvency II Directive.[777]
- If the supervisory authority decides to oppose the proposed acquisition on conclusion of the assessment, it must inform the proposed acquirer in writing with the reasons for the decision, within two working days of making the decision.[778]
- If the supervisory authority does not oppose the proposed acquisition within the assessment period in writing, it shall be deemed to be approved.[779]
- Where the supervisory authority approves the proposed acquisition, it may stipulate a maximum period within which the acquisition must be concluded, and extend it where appropriate.[780]

Assessment Criteria

In assessing the proposed acquisition, supervisory authorities should ensure the sound and prudent management of the target firm.[781] In this regard, they must assess the suitability of the proposed acquirer and the financial soundness of the proposed acquisition in light of the following criteria:

- The reputation of the proposed acquirer.
- The reputation and experience of any person who will direct the business of the target firm as a result of the proposed acquisition.
- The financial soundness of the proposed acquirer, in particular in relation to the type of business pursued and envisaged in the target firm.
- Whether the target firm will be able to comply and continue to comply with the prudential requirements under the Solvency II Directive and other applicable directives, in particular, whether the group of which it will become part has a structure that makes it possible to exercise effective supervision, effectively exchange information among the supervisory authorities and determine the allocation of responsibilities among the supervisory authorities.
- Whether there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing is being or has been committed or attempted, or that the proposed acquisition could increase the risk thereof.[782]

Prior conditions may not be imposed with respect to either the level of holding that must be acquired or from examining the proposed acquisition in terms of the economic needs of the market.[783] Supervisory authorities can only oppose the proposed acquisition if there are reasonable grounds for doing so on the basis of the above criteria or if the information provided by the proposed acquirer is incomplete.

[777] Articles 58(2)-(3), *ibid.*
[778] Article 58(4), *ibid.*
[779] Article 58(5), *ibid.*
[780] Article 58(6), *ibid.*
[781] Article 59(1), *ibid.*
[782] *Ibid.*
[783] Article 59(3), *ibid.*

Regulated Financial Undertakings

The relevant supervisory authorities are instructed to work in "full consultation" with each other when carrying out an assessment of an acquisition in which the proposed acquirer is any one of the following:

- A credit institution, (re)insurance undertaking, investment firm or management company[784] authorised in another member state or in a sector other than that in which the acquisition is proposed.
- The parent undertaking of any entity mentioned above.
- A natural or legal person controlling any entity mentioned above.[785]

Under any of the circumstances mentioned in the paragraph above, supervisory authorities are required to cooperate with each other and provide each other with any information that is essential or relevant for the assessment, both on request and on their own initiative.[786]

Supervisory Powers Under the Acquisition Regime

Where the influence exercised by a proposed acquirer is likely to operate against the sound and prudent management of the target firm, the supervisory authority of the target firm must take appropriate measures to put an end to that situation. Such measures may consist, for example, of: (i) injunctions, (ii) penalties against directors and managers, or (iii) suspension of voting rights attached to shares held by the shareholders or members in question.[787] Supervisory authorities are instructed to take similar measures in a situation where a proposed acquirer fails to comply with the notification requirements.[788]

In a situation where a holding is acquired despite opposition from a supervisory authority, member states must ensure their laws provide for suspending the corresponding voting rights or annulling any votes cast.[789]

[784] Article 2(1)(b) of the UCITS Directive (2009/65/EC).
[785] Article 60(1) of the Solvency II Directive.
[786] Article 60(2), *ibid.*
[787] Article 62, *ibid.*
[788] *Ibid.*
[789] *Ibid.*

Chapter 14

The SFCR and Other Public Reporting

Introduction

The Solvency II regime, as legislated in the Solvency II Directive and elaborated upon in Chapter XII of the Level 2 Delegated Regulation, is based on three pillars.

Public reporting is the core of Pillar III, which prescribes that (re)insurers should regularly disclose prudentially pertinent financial information to regulators.[790] (Re)insurers' public reporting duties supplement and bolster the principles of Pillars I and II, which seek to ensure (re)insurers observe capital requirements and risk management requirements. They do so by imposing consistent standards of public disclosure across the EU to foster market discipline and provide regulators with the information necessary to produce a stable and transparent (re)insurance market.

In accordance with Articles 51 to 56 of the Solvency II Directive, which set out the rules for public reporting, the primary mechanism for public reporting under the Solvency II regime is the SFCR, which (re)insurers must publish at least annually.[791] Both specific and general standards of disclosure apply to the SFCR, and in all cases the SFCR must include essential information relating to a (re)insurer's solvency and financial condition.

Under the public reporting standards in the United Kingdom, which are reflected (post-Brexit) in the Reporting Part of the PRA Rulebook alongside the onshored Solvency II Directive and Level 2 Delegated Regulation, there are only limited opportunities for nondisclosure. This is similar to the European Union's regime.

At the EU level, (re)insurers must submit the SFCR to their supervisory authority at the national level. Member states must require all supervisory authorities to send certain of (re)insurers' disclosures to the EIOPA. The EIOPA must in turn compile and publicly disclose such information.

Through this layered system of public reporting, wherein (re)insurers' public reporting duties are mirrored by the EIOPA's duty to publish their information, the Solvency II Directive facilitates market participants' ability to adapt to prevailing market conditions as well as regulators' ability to effect risk-based and proportionate supervision.

This chapter examines the technical details of (re)insurers' public reporting duties and recent developments affecting those duties. Alongside the SFCR, this chapter considers certain additional reporting duties incumbent on (re)insurers. Recent policy and rule changes to the PRA Rulebook are also reviewed.

1. The Solvency and Financial Condition Report — Primary Requirements

The SFCR must contain a summary that provides a clear and concise overview of the report's contents.[792] The summary must be understandable to policyholders and beneficiaries, and should highlight any material changes to the reported information over the reporting period.[793]

Any information included in the SFCR will be deemed material where its omission or misstatement could influence the judgement of SFCR users, including, for instance, the supervisory authority or other stakeholders.[794]

[790] Articles 40 to 49 of the Solvency II Directive (transposed in Conditions Governing Business Part of the PRA Rulebook).

[791] Article 51, *ibid* (transposed in Paragraphs 3.1 to 3.7, Reporting Part of the PRA Rulebook).

[792] Article 292 of the Level 2 Delegated Regulation.

[793] Article 292, *ibid.*

[794] Article 291, *ibid.*

Contents and Structure of the Solvency and Financial Condition Report

(Re)insurers must disclose in the SFCR information falling under the following five categories:

- A description of the business and performance of the undertaking.[795]
- A description of the undertaking's system of governance and an assessment of adequacy of its risk profile.[796]
- A description, separately, for each category of risk, of the undertaking's risk exposure, concentration, mitigation and sensitivity.[797]
- A description, separately, for each of assets, technical provisions and other liabilities of the undertaking, the bases and methods used for their valuation, as well as additional information in relation to any MA applied.[798]
- A description of the undertaking's capital management, including information on the SCR and MCR.[799]

The SFCR must be structured in accordance with the order of each of the aforementioned five categories of information.[800]

Business and Performance

(Re)insurers are required to disclose material information in respect of their financial performance, including on, amongst other things:[801]

- The name and legal form of the undertaking.
- Details of the supervisory authority responsible for financial supervision, the group supervisor (where the undertaking is part of a group) and the external auditor.
- A description of the holders of qualifying holdings in the undertaking.
- The undertaking's material lines of business and material geographical areas where it carries out business.
- Any significant business or other events that have had a material impact on the undertaking over the course of the reporting period.
- Qualitative and quantitative information on the undertaking's underwriting performance, in aggregate and by material line of business and material geographical areas where it carries out its business, and also including a comparison against the same category of information reported in the previous reporting period, as shown in the undertaking's financial statements.
- Qualitative and quantitative information on certain aspects of the undertaking's investment performance over the reporting period alongside a comparison against the same category of information reported in the previous reporting period, as shown in the undertaking's financial statements.

[795] Article 51(1)(a) of the Solvency II Directive (transposed in Paragraph 3.3(1), Reporting Part of the PRA Rulebook).
[796] Article 51(1)(b), *ibid* (transposed in Paragraph 3.3(2), Reporting Part of the PRA Rulebook).
[797] Article 51(1)(c), *ibid* (transposed in Paragraph 3.3(3), Reporting Part of the PRA Rulebook).
[798] Article 51(1)(d), *ibid* (transposed in Paragraph 3.3(4), Reporting Part of the PRA Rulebook).
[799] Article 51(1)(e), *ibid* (transposed in Paragraph 3.3(5), Reporting Part of the PRA Rulebook).
[800] Article 290(1) of the Level 2 Delegated Regulation.
[801] Article 293, *ibid*.

System of Governance

(Re)insurers are required to disclose information in respect of their systems of governance, including on, amongst other things:[802]

- The structure of the undertaking's AMSB, including its main roles and responsibilities.
- Any material changes in the undertaking's system of governance that have taken place during the reporting period.
- Information on the undertaking's remuneration policy and practices regarding its AMSB and, unless otherwise stated, employees, including information on the individual and collective performance criteria on which any entitlement to share options, shares or other variable components of remuneration are based.
- The undertaking's "fit and proper" policy.
- The strategies, processes and reporting procedures of the undertaking's risk management system.
- Information pertaining to the undertaking's process for carrying out an ORSA, including a statement detailing how often the assessment is reviewed.

Risk Profile

(Re)insurers are required to disclose quantitative and qualitative information in respect of their risk profile, including on — separately for each of underwriting risk — market, credit, liquidity, operational and other material risk:[803]

- In respect of the (re)insurer's risk exposure, including that arising from off-balance sheet positions and the transfer of risk to SPVs, all of the following:
  - A description of the measures used to assess such risks.
  - A description of the material risks that the undertaking is exposed to.
  - A description of how assets have been invested in accordance with the PPP, as contained in Article 132 of the Solvency II Directive.
- In respect of risk concentration, a description of the material risk concentrations to which the undertaking is exposed.
- In respect of risk mitigation, a description of the techniques used by the undertaking to mitigate risks.
- In respect of liquidity risk, the total amount of expected profit included in future premiums.
- In respect of risk sensitivity, the methods used, the assumptions made and the outcome of stress testing and sensitivity analysis for material risks and events.
- Any other material information regarding the risk profile of the (re)insurer.

[802] Article 294, *ibid.*
[803] Article 295, *ibid.*

Valuation

(Re)insurers are required to disclose information in respect of their valuation, including on, amongst other information:[804]

i. The valuation of each material class of assets.

ii. The valuation of technical provisions, including the effect of any application of the MA, VA or transitional measures.

iii. The value of other liabilities.

For each of (i) to (iii) immediately above, the bases, methods and assumptions used for their calculation[805] and a quantitative and qualitative explanation of any material differences between the bases, methods and main assumptions used by the (re)insurer for the valuation of each material class of assets for solvency purposes against those used for its valuation in the financial statements[806] should be disclosed in the SFCR.

Capital Management

(Re)insurers are required to disclose information in respect of their capital management, including on, amongst others, the following subcategories:[807]

- **Own Funds:** The amount, structure and quality of own funds; the objectives, processes and methods used to manage own funds; and the amount of own funds available to cover the SCR and MCR.
- **Deferred Taxes:** The calculated amount of deferred tax assets and, with regard to net deferred taxes, their loss-absorbing capacity.
- **The SCR and MCR:** The amount of the (re)insurer's individual SCR and MCR at the end of the reporting period; any material changes to the (re)insurer's individual SCR during the reporting period and the reasons for such changes; as elaborated below, certain instances of noncompliance with the SCR and/or MCR during the reporting period; and any IM used to calculate the SCR.

In respect of all of the categories outlined above, the SFCR must contain narrative information in quantitative and qualitative form, supplemented by QRTs where appropriate.[808] QRTs are templates for (re)insurers to add further detail to quantitative information they are required to disclose in their SFCRs.

However, it is important to note that the form and scope of available QRTs differs between the EU and UK: (Re)insurers falling under the ambit of the EIOPA may find their relevant QRTs and other templates in the annexes of the Reporting Implementing Technical Standards,[809] whilst (re)insurers operating in the UK may find their relevant QRTs in the PRA Rulebook[810] and applicable PRA SSs.

[804] Article 296, *ibid.*

[805] Articles 296(1)(a), 296(2)(a) and 296(3)(a) of the Level 2 Delegated Regulation.

[806] Article 296(1)(b) of the Level 2 Delegated Regulation.

[807] Article 297, *ibid.*

[808] Article 290(2), *ibid.*

[809] For instance, see Implementing Technical Standards Amending Commission Implementing Regulation (EU) No. 680/2014 on Supervisory Reporting of Institutions.

[810] For instance, see Paragraph 8, Reporting Part of the PRA Rulebook.

Furthermore, (re)insurers should consult the EIOPA Guidelines on reporting and public disclosure (EIOPA-BoS-15/109) (Reporting Guidelines),[811] as they become available, for further detail and clarity on the specifics of their reporting obligations under the categories above. The Reporting Guidelines clarify the duties under each of the categories and provide guidance on the additional aspects of (re)insurers' reporting duties discussed below.

Exceptions to Disclosure

Supervisory authorities, including the PRA, may grant permission for nondisclosure in the SFCR to (re)insurers where:

- By disclosing the relevant information, the undertaking's competitors would gain a significant undue advantage.[812]
- The undertaking is bound by secrecy or confidentiality obligations to policyholders or another counterparty.[813]

Permission for nondisclosure cannot be granted in respect of information pertaining to the Capital Management category discussed above. Further, where a (re)insurer wishes to obtain a waiver from the PRA to be exempt from eligible disclosure duties, the (re)insurer must apply to the PRA, identifying which exemption it believes applies to it and explaining the reason(s) for its application.[814]

If permission for nondisclosure is granted by the supervisory authority, the permission will last only for as long as the reason(s) for nondisclosure exist.[815] If and when the reason(s) for nondisclosure no longer exist, the (re)insurer must notify the relevant supervisory authority.[816]

The Reporting Guidelines stipulate that (re)insurers must not bind themselves to secrecy or confidentiality obligations to policyholders or another counterparty in order to obtain exemptions to their public reporting duties.[817]

References to Previous Public Disclosures

Supervisory authorities must permit (re)insurers to make use of or refer to public disclosures made under other legal or regulatory requirements in the SFCR, to the extent that those disclosures are equivalent to the information required under Article 51 of the Solvency II Directive in both nature and scope.[818]

Accordingly, where a (re)insurer has previously made public disclosures equivalent to those required in the SFCR, it need not repeat them and can instead refer to such disclosures therein.

Per the Reporting Guidelines, references to previous public disclosures in the SFCR must lead directly to the information itself and not to a general document.[819] A practical way to achieve this might be to provide hyperlinks or footnotes linking to the document where the relevant information is contained, with a clear indication of what page the information can be found on.

[811] For instance, see Section 1 of the Reporting Guidelines.

[812] Article 53(1)(a) of the Solvency II Directive (transposed in Paragraph 4.1(1), Reporting Part of the PRA Rulebook).

[813] Article 53(1)(b), *ibid* (transposed in Paragraph 4.1(2), Reporting Part of the PRA Rulebook).

[814] For instance, see PRA SS4/19.

[815] Article 299(1) of the Level 2 Delegated Regulation.

[816] Article 299(2), *ibid.*

[817] Guideline 32 of the Reporting Guidelines.

[818] Article 53 of the Solvency II Directive (transposed in Paragraph 3.6, Reporting Part of the PRA Rulebook).

[819] Guideline 35 of the Reporting Guidelines.

2. Group/Single Group Solvency and Financial Condition Report — Primary Requirements

The Group Solvency and Financial Condition Report

The Solvency II Directive provides that (re)insurance groups must produce group SFCRs, to which the requirements pertaining to the SFCR published by individual (re)insurers apply *mutatis mutandis*.[820] The group SFCR is published by each (re)insurer within the (re)insurance group in addition to the individual SFCR.

The contents of a group SFCR are distinct from those of the individual SFCR. Namely, in addition to the contents of the individual SFCR, a group SFCR must contain, amongst other information, the following in respect of the categories discussed above:

- **Business and Performance:** A description of the legal structure and the governance and organisational structure of the group, including a description of all its subsidiaries, and qualitative and quantitative information on relevant operations and transactions within the group.[821]
- **System of Governance:** A description of how risk management and internal control systems are implemented in all of the group's (re)insurers and information on material intragroup outsourcing arrangements.[822]
- **Risk Profile:** Qualitative and quantitative information on any significant risk concentration at group level.[823]
- **Valuation:** A quantitative and qualitative explanation of any material differences between the bases, methods and assumptions used at group level for the valuation for solvency purposes of the group's assets, technical provisions and other liabilities, and those used by any of the group's subsidiaries for the valuation of the same.[824]
- **Capital Management:** Qualitative and quantitative information on any significant restriction to the fungibility and transferability of group own funds and a description of the group's (re)insurers that are in the scope of any IM used to calculate the group SCR, where applicable.[825]

The Single Group Solvency and Financial Condition Report

A (re)insurance group may alternatively agree with its group supervisor to produce a single group SFCR, as opposed to preparing a group SFCR and individual SFCRs.[826] This may ease administrative burdens on certain (re)insurers.

Where a (re)insurance group decides to produce the single group SFCR, it must cover both the relevant information at group level and for each individual (re)insurer within the group.[827] If information in respect of a subsidiary is materially omitted and the relevant supervisory authority requires that information from comparable undertakings, the supervisory authority may compel the subsidiary to disclose the necessary additional information separately to the single group SFCR.[828]

[820] Article 256(1) of the Solvency II Directive (transposed in Paragraph 18.1(1), Group Supervision Part of the PRA Rulebook).
[821] Article 359(a) of the Level 2 Delegated Regulation.
[822] Article 359(b), *ibid.*
[823] Article 359(c), *ibid.*
[824] Article 359(d), *ibid.*
[825] Article 359(e), *ibid.*
[826] Article 256(2) of the Solvency II Directive (transposed in Paragraph 18.1(2), Group Supervision Part of the PRA Rulebook).
[827] *Ibid.*
[828] Article 256(3) of the Solvency II Directive.

The single group SFCR must be structured such that the group level information disclosed is presented separately from any subsidiary information, and must follow the prescribed structure set out in Annex XX of the Level 2 Delegated Regulation.[829]

3. Publishing a Solvency and Financial Condition Report — Deadlines and Methods

Deadlines for Disclosure

The deadline for the disclosure of both the individual and single group SFCR is no later than 14 weeks after the individual (re)insurer's or (re)insurance group's respective financial year-end.[830]

Where a (re)insurance group produces a group SFCR and each undertaking within that group produces an individual SFCR, the deadline for disclosure of the group SFCR is no later than 20 weeks after the end of the group's financial year-end.[831]

Methods of Publication

Individual (re)insurers and (re)insurance groups must disclose their relevant SFCR on their respective websites.[832] Where an individual (re)insurer or (re)insurance group does not have a website, the SFCR must be disclosed on the website of a trade association of which the relevant (re)insurer is a member.[833] In either case, the SFCR must remain on the relevant (re)insurer's or trade association's website for at least five years following the applicable disclosure deadlines above.

If neither the relevant (re)insurer nor a trade association of which it is a member has a website, the SFCR must be sent to any person who, within five years of the applicable disclosure deadlines above, requests a copy.[834] Even where the SFCR has been published on a website, (re)insurers must, within 10 working days, send a copy to any person who requests one within two years of the applicable disclosure deadlines as outlined above.[835]

4. Liability of Directors for the Solvency and Financial Condition Report

Neither the Solvency II Directive nor the PRA Rulebook explicitly set out the liabilities directors may expect to incur where inaccurate, misleading or false information is included in the SFCR. Accordingly, market participants are uncertain whether — and, if so, the extent to which — directors of (re)insurers may be liable for such disclosure.

It is thought that under English law, a claim of negligent misstatement could be brought against directors who sanction untrue or misleading statements in the SFCR. Although claims for negligent misstatements arising in these circumstances are in principle litigable, the high bar for successful negligent misstatement claims is difficult to overcome.

[829] Article 365(3) of the Level 2 Delegated Regulation.
[830] Articles 300 and 362, *ibid.*
[831] Article 362, *ibid.*
[832] Article 301(1), *ibid.*
[833] Article 301(2), *ibid.*
[834] Article 301(4), *ibid.*
[835] Article 301(5), *ibid.*

5. Additional Public Disclosure Requirements

Major Solvency Capital Requirement and Minimum Capital Requirement Developments

(Re)insurers' public disclosure duties extend beyond the SFCR to cover major developments impacting their prior disclosures. Specifically, (re)insurers are required to disclose, on an ongoing basis, any major developments that significantly affect the relevance of previously disclosed information within each category.[836]

Presently, at least the following comprise "major developments":

a. Noncompliance with the MCR is observed and the relevant supervisory authority either considers that the undertaking will not be able to submit a realistic short-term finance scheme or the relevant supervisory authority does not receive such a scheme within one month of the date when noncompliance was observed.[837]

b. Significant noncompliance with the SCR is observed and the relevant supervisory authority does not receive a realistic recovery plan within two months of the date when noncompliance was observed.[838]

In respect of both points above, the relevant supervisory authority must require the afflicted (re)insurer to immediately disclose the extent of the noncompliance and explain its origins and consequences, alongside any remedial action taken to mitigate the development.[839]

However, if noncompliance with the MCR has not been resolved within three months after it is observed, such noncompliance and the explanation of its origins and consequences must be publicly disclosed at the end of that period, together with any planned remedial actions.

The same is required for noncompliance with the SCR, except on a timeline of six months.[840]

Voluntary Disclosure

Further to their duties of disclosure, (re)insurers may choose to voluntarily disclose any information or explanation pertaining to their solvency and financial condition, which they are not already compelled to disclose under the Solvency II Directive and the Level 2 Delegated Regulation.[841] Where (re)insurers elect to make such voluntary disclosures, they must ensure that the information provided therein is consistent with any information disclosed to their supervisory authority pursuant to Article 35 of the Solvency II Directive.[842]

[836] Article 54(1) of the Solvency II Directive (transposed in Paragraph 5.1, Reporting Part of the PRA Rulebook).
[837] Article 54 (1)(a), *ibid* (transposed in Paragraph 5.3, Reporting Part of the PRA Rulebook).
[838] Article 54(1)(b), *ibid* (transposed in Paragraph 5.2(3), Reporting Part of the PRA Rulebook).
[839] Article 54(1), *ibid* (transposed in Paragraph 5.3, Reporting Part of the PRA Rulebook).
[840] Article 54(1), *ibid* (transposed in Paragraphs 5.3 and 5.4, Reporting Part of the PRA Rulebook).
[841] Article 54(2), *ibid.*
[842] Article 298 of the Level 2 Delegated Regulation.

Appropriate Systems and Structures

(Re)insurance undertakings must have in place appropriate systems and structures to comply with their disclosure obligations. As such, the SFCR must first be approved by a (re)insurer's AMSB before it is published,[843] and the (re)insurer must adopt a written policy to ensure the ongoing appropriateness of any information required to be disclosed for the fulfilment of its disclosure duties.[844]

6. EIOPA and the Duty To Disclose

Member states and the EIOPA have duties to disclose certain information relevant to the solvency and financial condition of (re)insurers. Specifically, as further detailed below, these duties, which complement and are contingent on (re)insurers' duties to report information, primarily require member states and the EIOPA to disclose information pertaining to capital add-ons and the limitations to or exemptions from (re)insurers' disclosure duties.

Member states must require their respective supervisory authorities to annually provide the EIOPA with the following information:[845]

- The average capital add-on per undertaking and the distribution of capital add-ons imposed by the supervisory authority throughout the previous year, expressed as a percentage of the SCR, shown separately for:[846]
    i. All (re)insurance undertakings.
    ii. Life insurance undertakings.
    iii. Nonlife insurance undertakings.
    iv. Insurance undertakings pursuing both life and nonlife activities.
    v. Reinsurance undertakings.
- For each of the disclosures above, the proportion of capital add-ons imposed under Article 37(1)(a), (b) and (c) respectively (cases for applying a capital add-on).

Following the submission of the information above, the EIOPA must make an annual public disclosure to the European Parliament, the Council and the Commission alongside a report detailing the extent of supervisory convergence in the use of capital add-ons in the different member states, on the following:[847]

- The total distribution of capital add-ons, expressed as a percentage of the SCR, for each of (i) to (v) above.
- The distribution of capital add-ons, expressed as a percentage of the SCR, for each member state, covering all (re)insurance undertakings in that member state.
- The proportion of capital add-ons mandated under Article 37(1)(a), (b) and (c).

[843] Article 294(4)(b), *ibid.*
[844] Article 55(1) of the Solvency II Directive.
[845] Article 52(1), *ibid.*
[846] Article 52(1)(a), *ibid.*
[847] Article 52(2), *ibid.*

7. Proposed Changes to the Solvency II Regime

Amendments to the Solvency II Directive

Following its 2021 proposals to amend the Solvency II Directive, in April 2024 the European Parliament adopted the Amendments to the Solvency II Directive (COM(2021)0581), which seek to significantly alter Pillar III disclosure requirements.

The most important proposed changes affect:

- The structure and contents of the SFCR.
- The scope of existing nondisclosure exemptions.
- The deadlines for annual reporting.
- The EIOPA's and member states' disclosure duties.
- Requirements to obtain an external audit.

Structure and Contents of the SFCR

Whereas the structure of the SFCR currently mirrors the five broad categories of information required to be disclosed therein, the revised SFCR is expected to include two distinct sections to be disclosed jointly, namely:

- A section addressed to policyholders and beneficiaries.
- A section addressed to market professionals.[848]

The Amendments also effect changes to the content required to be disclosed in the SFCR. More specifically, the content required to be disclosed in the SFCR will now include, as falling under the new sections:

Policyholders and Beneficiaries Section: This section will include:[849]

- A brief description of the business and performance of the (re)insurer.
- A brief description of the capital management and the risk profile of the (re)insurer, including in relation to sustainability risks.
- A statement of whether the undertaking discloses the plans in Article 19a or Article 29a of Directive 2013/34/EU (nonfinancial statements).

Market Professionals Section: This section will include the information in the categories referred to in Section 1 of this chapter and, additionally, the following information:[850]

- An indication of whether the undertaking is materially exposed to climate change risks and whether it has put in place any actions to address such risks.
- A statement of whether the undertaking discloses the plans in Article 19a or 29a of Directive 2013/34/EU.

[848] Paragraph 27 of the Amendments.

[849] Paragraph 27(b), *ibid.*

[850] Paragraph 27(c), *ibid.*

- The elements included in plans to be prepared by (re)insurers to monitor and address financial risks associated with sustainability factors.
- Where applied, a description of the MA and the portfolio of obligations and assets to which it is applied.
- A statement on whether the VA has been used by the undertaking and, where used, certain information regarding its use.

Nondisclosure

Whilst preexisting nondisclosure rules will remain effective, the Amendments extend further nondisclosure permissions specifically to captive (re)insurers, by allowing them to abstain from disclosing specified information in the following situations:

Captive Insurers: Such insurers will not be required to disclose quantitative data required by the implementing technical standards referred to in Article 56 provided that:[851]

- All insured persons and beneficiaries are part of the captive insurer's group or are natural persons eligible to be covered under the group's insurance policies, and the business covering such eligible persons remains below 5% of technical provisions.
- The insurance obligations of the captive insurance undertaking do not consist of any compulsory third-party liability insurance.

Captive Reinsurers: Such reinsurers are not required to disclose the same quantitative data referred to above provided that:[852]

- All insured persons and beneficiaries are part of the captive insurer's group or are natural persons eligible to be covered under the group's insurance policies, and the business covering such eligible persons remains below 5% of technical provisions.
- The insurance contracts giving rise to the reinsurance obligations of the captive reinsurer do not relate to any compulsory third-party liability insurance.
- Loans between the captive reinsurer and its parent or any other group company do not exceed 20% of the assets held by the captive reinsurer.
- The maximum loss resulting from the gross technical provisions can be assessed without using stochastic methods.

Small and Noncomplex Undertakings: Similarly to captive insurers, such undertakings will be able to disclose only the quantitative data required by the implementing technical standards to be included in the Market Professionals Section of the SFCR.[853] For a (re)insurer to qualify as a small and noncomplex undertaking, it must meet the criteria set out in Article 29a of the Amendments.

[851] Paragraph 27(e) of the Amendments.

[852] *Ibid.*

[853] *Ibid.*

Deadlines for Annual Reporting

The Amendments extend the deadlines for annual reporting of the individual and group SFCR, the QRTs and the RSR:[854]

- **The individual SFCR and the RSR** will now need to be disclosed 18 weeks instead of 14 weeks after the (re)insurer's financial year-end.
- **The group SFCR** will now need to be disclosed 22 weeks instead of 18 weeks after the (re)insurance group's year-end.
- **Annual QRTs** will now need to be disclosed 16 weeks instead of 14 weeks after the (re)insurer's financial year-end.

The EIOPA and Member State Disclosure Duties

In addition to the requirement to disclose the information discussed in Section 6 of this chapter, the EIOPA and member states must disclose both:

- The number of (re)insurance undertakings and groups, respectively broken down by small and noncomplex undertakings or groups, using simplifications or proportionality measures.
- The number of (re)insurance undertakings employing specific proportionality measures.[855]

The Amendments will not directly affect UK (re)insurers, who instead will be affected only by the PRA's changes[856] to the PRA Rulebook and the Solvency II Directive and Level 2 Delegated Regulation as they apply in the UK. However, the Amendments may indirectly affect UK (re)insurers by influencing future amendments to the current UK regime and will be relevant to UK groups operating in the EU.

External Audit

Whereas the Solvency II Directive does not presently require (re)insurers to have an external audit of the SFCR, the Amendments introduce an external audit requirement for individual and the single group SFCRs. Other than small and noncomplex undertakings and captive (re)insurance undertakings, all (re)insurers will be required to have an external audit of their balance sheet, which they are mandated to disclose in the individual and single group SFCR, as per Articles 51(1) and 256(2)(b) of the Solvency II Directive, respectively.[857]

Additionally, member states will have discretion to extend the requirement to small and noncomplex undertakings and captive (re)insurance undertakings, as well as extending the scope of the audit requirement to encompass aspects of the SFCR beyond the balance sheet.[858]

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[854] *Ibid.*

[855] Paragraph 29(a), *ibid.*

[856] See (i) PRA PS3/24, (ii) PRA CP14/22; and (iii) PRA CP12/23.

[857] Paragraph 28 of the Amendments.

[858] *Ibid.*

In all cases, a statutory auditor or an audit firm must carry out the audit in accordance with the auditing standards laid down in Article 26 of Directive 2006/43/EC and Article 72 of the Solvency II Directive, respectively.[859] It should be noted that the External Audit Part of the PRA Rulebook already currently requires firms to obtain external audits of certain information disclosed in the SFCR,[860] including the Valuation and Capital Management categories discussed in Section 1 of this chapter.

Relevant PRA Proposed Amendments to the Solvency II Regime

The PRA's recent amendments to the PRA Rulebook should be read in light of its transition to Solvency UK, which seeks to liberalise the existing Solvency II regime to encourage investment into the UK (re)insurance market. For instance, as of 31 December 2023, the PRA softened reporting requirements by removing (re)insurers' obligation to submit RSRs.[861]

Recently, following PRA PS3/24, in which it reviewed the feedback it received on PRA CP14/22 and PRA CP12/23, the PRA released near-final rules effective 31 December 2024 that similarly seek to slim down (re)insurers' reporting duties. In particular, the near-final rules entail:

- Deleting several QRTs, associated NSTs and SCR templates.[862]
- Reducing the reporting frequency of several templates, including QRTs and SCR templates, from quarterly to semiannually or annually.[863]
- Introducing new QRTs and other templates to facilitate disclosure by (re)insurers writing in emerging areas of risk, including cyberrisk underwriting and nonlife product obligation.[864]
- In relation to third country branches, removing expectations of reporting on several templates and introducing new NST reporting requirements on RFFs run by such branches[865] and on the solvency and financial position of the legal entity,[866] amongst other reforms.
- Changing the definition of what constitutes material information under the Reporting Part of the PRA Rulebook, so that information will be material if its omission or misstatement could influence the judgement of the PRA, as opposed to the judgement of SFCR users.[867]

[859] *Ibid.*
[860] Paragraph 2.2, External Audit Part of the PRA Rulebook.
[861] PRA "Solvency II Review — Considerations for Year-End 2023" 8 December 2023.
[862] Paragraph 1.5 of the PRA PS3/24.
[863] Articles 7A and 8 of the PRA Rulebook: Solvency II Reporting Reform Instrument (2024).
[864] Article 11, *ibid.*
[865] Article 42, *ibid.*
[866] Article 48, *ibid.*
[867] Article 4A, *ibid.*

Glossary

2020 Review
The EU's 2020 review of Solvency II.

A

ABCP Programme
Asset-backed commercial paper programme — a programme of securitisations the securities issued by which predominantly take the form of asset-backed commercial paper with an original maturity of one year or less.

Amendments
Amendments to the Solvency II Directive that have been passed but are yet to take effect, and are contained in the Solvency II amending Directive (COM(2021)0581).

AMRE
Aggregate maximum risk exposure — the sum of the maximum payments including expenses that an ISPV may incur (although certain expenses may be excluded).

AMSB
(Re)insurers' administrative, management or supervisory body, whose roles and responsibilities include running the undertaking and who, under the Solvency II public reporting regime, must authorise and approve the SFCR.

AOF
Ancillary own funds.

Assessment Period
The 60-working day period beginning with the date of the written acknowledgement of receipt of the notification, during which supervisory authorities must carry out the assessment of a proposed acquisition.

B

BAU
Business-as-usual.

BEL
Best Estimate of Liabilities.

BOF
Basic own funds.

Branch Guidelines
EIOPA Guidelines on the supervision of branches of third country insurance undertakings (EIOPA BoS-15/110).

Brexit
The exit of the UK from the EU on 31 December 2020.

C

Capital Requirements
The SCR and MCR, collectively.

Classification Guidelines
EIOPA Guidelines on Classification (EIOPA-BoS-14/168 EN).

CLD
Consolidated Life Directive.

COBS
FCA Conduct of Business Sourcebook.

Contract Boundary
The term of the insurance contract over which premiums and benefits are guaranteed.

CRO
Contractual Run-Off regime under the FSCR.

D

DORA
Digital Operational Resilience Act.

E

EAS
Exceptional adverse situation.

EBA
European Banking Authority.

EEA
European Economic Area.

EIOPA
European Insurance and Occupational Pensions Authority.

EIOPA Opinion
EIOPA: Opinion on the 2020 Review of Solvency II (EIOPA-BoS-20/749).

EIOPA SCR Breach SS
Supervisory statement (EIOPA-BoS-21/281) outlining supervisory expectations in respect of SCR breaches.

ERM
Equity release mortgage.

ESG
Environmental, social and governance.

EU
European Union.

EU Securitisation Regulation
EU Securitisation Regulation (Regulation (EU) 2017/2402/EU).

EU-US Bilateral Agreement
The bilateral agreement entered into between the EU and the US on prudential measures regarding insurance and reinsurance.

F

FCA
UK Financial Conduct Authority.

Freedom of Establishment Passporting
The establishment of branches within the EEA by EEA (re)insurers.

Freedom of Services Passporting
Cross-border provision of services within the EEA by EEA (re)insurers.

FS
Fundamental spread.

FSA
UK Financial Services Authority (now UK PRA and FCA).

FSCR
Financial Services Contracts Regime.

FSCS
Financial Services Compensation Scheme.

FSMA
Financial Services and Markets Act 2000.

FSP
First smoothing point.

G

GDPR
General Data Protection Regulation.

Governance Guidelines
EIOPA Guidelines on system of governance (EIOPA BoS-14/253 EN).

H

HM Treasury
His Majesty's Treasury.

HP
Highly predictable.

I

IAS
International Accounting Standard.

ICT
Information and communication technology.

IFRS
International Financial Reporting Standards.

IG
Investment grade.

ILS
Insurance-linked securities.

IM
Internal model.

IRRD
The proposed Insurance Recovery and Resolution Directive.

ISPV
Insurance special purpose vehicle.

L

Level 2 Delegated Regulation
Commission Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC of the European Parliament and of the Council.

M

MA
Matching adjustment.

MCR
Minimum capital requirement.

Method 1
The accounting consolidation method.

Method 2
The deduction and aggregation method.

MISPV
Multi-arrangement insurance special purpose vehicle — an ISPV that assumes risks under more than one separate contractual arrangement from one or more cedants and taking the form of a PCC.

N

NED
Non-executive director.

NST
National specific template.

O

OECD
Organisation for Economic Co-operation and Development.

ORSA
Own risk and solvency assessment.

Outsourcing Guidelines
EBA Guidelines on Outsourcing (EBA/GL/2019/02, 2019).

Own Funds
Capital items with which a (re)insurer must cover its SCR/MCR.

P

PCC
Protected cell company.

Pillar I
The quantitative requirements of the Solvency II regulatory framework.

Pillar II
The qualitative requirements of the Solvency II regulatory framework.

Pillar III
The supervisory reporting and public disclosure requirements of the Solvency II regulatory framework.

PIN
Pre-issuance notification.

PPP
Prudent person principle.

PRA
UK Prudential Regulation Authority.

PRA CP
PRA consultation paper.

PRA CP
11/21: "Review of Solvency II: Reporting (Phase 1)" published in July 2021.

12/23: "Review of Solvency II: Adapting to the UK Insurance Market" published in June 2023.

13/24: "Remainder of CRR: Restatement of Assimilated Law" published in October 2024.

14/22: "Review of Solvency II: Reporting Phase 2" published in November 2022.

19/23: "Review of Solvency II: Reform of the Matching Adjustment" published in September 2023.

2/24: "Solvent Exit Planning for Insurers" published in January 2024.

21/23: "The PRA's Approach to the Authorisation and Supervision of Insurance Branches" published in October 2023.

5/24: "Review of Solvency II: Restatement of Assimilated Law" published in April 2024.

PRA Materials
Any official PRA publication including, but not limited to, the PRA Rulebook, PRA PSs, PRA SSs, PRA CPs, etc.

PRA PS
PRA policy statement.

PRA PS
10/24: Review of Solvency II: Reform of the Matching Adjustment" published in June 2024.

14/20: "Solvency II: Prudent Person Principle" published in May 2020.

2/24: "Review of Solvency II: Adapting to the UK Insurance Market" published in February 2024.

25/19: "Solvency II: Maintenance of the Transitional Measure on Technical Provisions" published in November 2019.

3/24: "Review of Solvency II: Reporting and Disclosure Phase 2 Near-Final" published in February 2024.

5/24: "Solvent Exit Planning for non-systemic banks and building societies" published in March 2024.

8/24: "The PRA's Approach to the Authorisation and Supervision of Insurance Branches" published in May 2024.

PRA SS

PRA supervisory statement.

PRA SS

1/20: "Solvency II: Prudent Person Principle" published in May 2020.

1/21: "Operational Resilience: Impact Tolerances for Important Business Services" published in March 2021.

10/18: "Securitisation: General Requirements and Capital Framework" published in November 2018.

11/15: "Solvency II: Regulatory Reporting and Exemptions" published in March 2015.

12/16: "Solvency II: Changes to Internal Models Used by UK Insurance Firms" published in September 2016.

17/15: "Solvency II: Transitional Measures on Risk-Free Interest Rates and Technical Provisions" published in March 2015.

19/16: "Solvency II: ORSA" published in November 2016.

2/15: "Solvency II: Own Funds" published in March 2015.

2/18: "International Insurers: The Prudential Regulation Authority's Approach to Branch Authorisation and Supervision" published in March 2018.

2/21: "Outsourcing and Third Party Risk Management" published in March 2021.

20/16: "Solvency II: Reinsurance — Counterparty Credit Risk" published in November 2016.

23/15: "Solvency II: Supervisory Approval for the Volatility Adjustment" published in June 2015.

25/15: "Solvency II: Regulatory Reporting, Internal Model Outputs" published in June 2015.

26/15: "Solvency II: ORSA and the Ultimate Time Horizon — Non-Life Firms" published in June 2015.

3/15: "Solvency II: The Quality of Capital Instruments" published in March 2015.

3/17: "Solvency II: Illiquid Unrated Assets" published in July 2017.

3/19: "Enhancing Banks' and Insurers' Approaches to Managing the Financial Risks From Climate Change" published in April 2019.

4/15: "Solvency II: The Solvency and Minimum Capital Requirements" published in March 2015.

4/18: "Financial Management and Planning by Insurers" published in May 2018.

4/19: "Resolution Assessment and Public Disclosure by Firms" published in July 2019.

44/15: "Solvency II: Third-Country Insurance and Pure Reinsurance Branches" published in March 2015.

5/14: "Solvency II: Calculation of Technical Provisions and the Use of Internal Models for General Insurers" published in April 2014.

5/18: "Algorithmic Trading" published in June 2018.

5/24: "Funded Reinsurance" published in July 2024.

6/16: "Maintenance of the 'Transitional Measure on Technical Provisions' Under Solvency II" published in May 2016.

7/17: "Solvency II: Data Collection of Market Risk Sensitivities" published in October 2017.

7/18: "Solvency II: Matching Adjustment" published in July 2018.

8/18: "Solvency II: Internal models — Modelling of the Matching Adjustment" published in July 2018.

9/15: "Solvency II: Group Supervision" published in March 2015.

Q

QRTs
Quantitative Reporting Templates.

R

Recovery Guidelines
EIOPA Guidelines on the extension of the recovery period in exceptional adverse situations (EIOPA-BOS-15/108 EN).

Recovery period
The period during which an undertaking in difficulty must take all necessary measures to achieve compliance with capital requirements.

(Re)insurer
An insurer or a reinsurer.

Reporting Guidelines
EIOPA Guidelines on reporting and public disclosure (EIOPA-BoS-15/109).

RFF
Ring-fenced funds — an asset and liability where fungibility restrictions exist.

RFR
Risk-free interest rate.

RSR
Regular Supervisory Report.

RT1
Restricted Tier 1.

RTTR
Risk Transformation (Tax) Regulations 2017.

S

SCR
Solvency capital requirement.

SEA
Solvency exit analysis.

SFCR
Solvency and financial condition report.

SIG
Sub-investment grade.

SMCR
Senior managers and certification regime.

Solvency II / Solvency II Directive
Directive 2009/138/EC as on-shored by the European Union (Withdrawal) Act 2018, implemented through the PRA Rulebook.

Solvency 2 Regulations 2015
Statutory Instrument 2015 No. 575, Financial Services and Markets.

Solvency UK
The name for the new UK prudential regime for insurers to be adopted by the PRA. Until such time as all references to Solvency II can be changed across relevant policy materials, the PRA will continue to refer to the UK regime as Solvency II for clarity and internal consistency.

SOP
Scope of permission.

SPV
Special purpose vehicle.

SRO
Supervised Run-off regime under the FSCR.

SSPE
Securitisation special purpose entity.

STS Securitisations
Simple, transparent and standardised securitisations.

T

Technical Provisions
The current amount a (re)insurance undertaking would have to pay if it were to transfer its (re)insurance obligations immediately to another (re)insurance undertaking.

Third Country Branch
A branch established in the EEA by a third country (re)insurer.

Third Country (Re)insurer
A non-EEA insurer providing cross-border services in the EEA.

TMTP
Transitional measure on technical provisions.

TPR
Temporary permissions regime.

U

UFR
Ultimate forward rate.

UK
United Kingdom of Great Britain and Northern Ireland.

UK Securitisation Regulations
Securitisation Regulations 2024 (SI 2024/102).

UK-US Bilateral Agreement
The bilateral agreement entered into between the UK and the US on prudential measures regarding insurance and reinsurance.

Undertaking in Difficulty
A (re)insurer that is either noncompliant or at risk of noncompliance with the SCR or MCR over the next three months.

US
United States of America.

USP
Undertaking specific parameter.

V

VA
Volatility adjustment.

In addition to the Amendments defined in this publication, please be advised that from 31 December 2024 certain of the provisions relating to the Level 2 Delegated Regulation may be found in the PRA Materials.

Further, from 31 December 2024, the Solvency 2 Regulations 2015 may also be found in the PRA Materials. Certain elements of the PRA SS4/15 will no longer be in force.

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