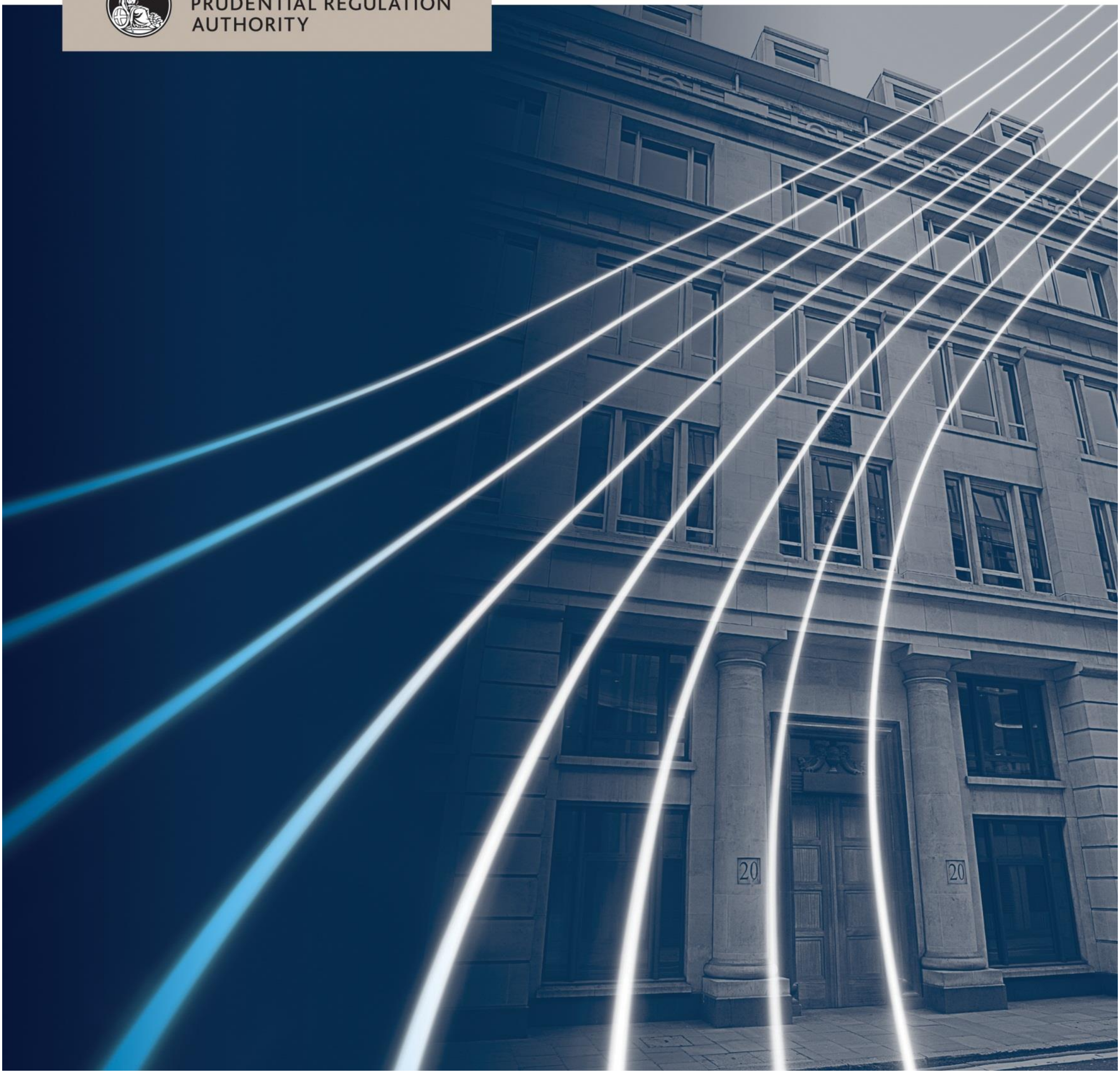
Policy Statement | PS10/20

Solvency II: Group availability of subordinated liabilities and preference shares

April 2020



BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Solvency II: Group availability of subordinated liabilities and preference shares

April 2020

Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 16/19 'Solvency II: Group availability of subordinated liabilities and preference shares'.[1] It also contains the PRA's final policy in an updated version of Supervisory Statement (SS) 9/15 'Solvency II: Group supervision' (see Appendix).

1.2 This PS is relevant to all insurance firms within the scope of group supervision under the Solvency II Directive and to the Society of Lloyd's.[2]

Background

1.3 In CP16/19, the PRA proposed to clarify the PRA's expectations of a firm seeking to demonstrate that the Solvency II assumption that subordinated liabilities and preference shares are not available to absorb losses elsewhere in the group is not appropriate in the firm's specific case.[3]

Summary of responses

1.4 The PRA received four responses to the CP. Respondents made a number of observations and requests for clarification which are set out in Chapter 2.

Changes to draft policy

1.5 The PRA has added additional material to SS9/15 to clarify the final policy after considering points raised by respondents. These and the content consulted on have been inserted in chapters 5A and 5B as paragraphs 5A.2A, and 5B.1A to 5B.1E. Paragraph 5A.2AA in the updated supervisory statement was previously paragraph 5A.2A. The changes are aimed at providing readers with greater clarity on the PRA's assessment of group availability for different types of groups, and on the legal requirements that restrict the ability of subordinated liabilities and preference shares to absorb all types of group losses. Details of the changes are included in Chapter 2.

1.6 A number of syntactic amendments were made to improve the clarity of the SS and are not explicitly addressed in this PS.

1.7 The PRA does not consider that the changes and syntactic amendments have significant impact on firms, including mutuals, in meeting expectations when compared to the cost benefit analysis presented in the CP.

Implementation

1.8 This policy will take effect on the publication of this PS.

1.9 The policy set out in this PS has been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1 July 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-group-availability-of-subordinated-liabilities-and-preference-shares.

2 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking up and pursuit of the Business of Insurance and Reinsurance (Solvency II) (recast).

3 As stated in Article 330(3) of the Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and Reinsurance (Solvency II) Text with EEA relevance.

1.10 The PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018' for further details.[4]

4 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

2 Feedback to responses

2.1 This chapter sets out the PRA's feedback to the responses to the CP, and its final decisions.

2.2 The sections below have been grouped by the areas raised by respondents as follows:

- elements of availability under Solvency II;
- impact on mergers and acquisitions;
- impact on groups headed by companies limited by guarantee and other mutuals; and
- other responses.

Elements of availability under Solvency II

2.3 Two respondents stated that the requirement for each insurance or reinsurance undertaking in the group to have a right to claim on the issuing entity goes beyond the elements that are required to be considered under Article 330 of the Delegated Regulation with potential to damage the competitiveness of the UK insurance industry.[5] One respondent asked the PRA to clarify that approaches such as paying dividends, extending intra-group loans, using capital injections or realising assets within nine months can be relied on to demonstrate availability.

2.4 The PRA considers that firms may demonstrate the availability of other own fund items in different ways. However, the default assumption is that subordinated liabilities and preference shares are not available. The PRA has clarified in paragraph 5B.1A of the SS that these instruments create legal obligations on the issuing entity to their holders. At the same time, the issuing entity would not ordinarily have legal obligations in relation to losses arising in another group undertaking. This restricts the ability of these instruments to absorb losses in other group undertakings. Where firms seek to demonstrate that such an own fund item is effectively available, the PRA considers that these legal obligations must be assessed in the context of the elements listed in Article 330(1) of the Delegated Regulation where they have the effect of restricting the ability of the own fund item to absorb all types of losses wherever they arise in the group. Accordingly, they must be addressed when assessing the availability of subordinated liabilities and preference shares.

2.5 While firms may be able to realise the assets of the issuing entity and make capital available to other group undertakings via dividends, capital injections or other means, these approaches would not, by themselves, address the legal restrictions that hinder subordinated liabilities and preference shares from being able to absorb losses elsewhere in the Solvency II group.

2.6 The policy does not prescribe methods of demonstrating that own funds are available. Instead, it sets out one approach that the PRA may be receptive to, should firms try to demonstrate that the assumption in Article 330(3) of the Delegated Regulation is inappropriate. In order to demonstrate that the assumption of non-availability is inappropriate when considering legal restrictions to group availability, the PRA considers that if each insurance and reinsurance undertaking has the right to claim against the issuing entity, this introduces legal obligations for the issuing entity to meet losses in another group undertaking. The legal obligations of the issuing entity to the holders of the subordinated liabilities or preference shares would have to be subordinated to any claims made by

5 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and Reinsurance (Solvency II) Text with EEA relevance.

the group insurance and reinsurance undertakings. The PRA considers that this would demonstrate that the legal obligations on the issuing entity to its holders would no longer restrict the ability of the subordinated liabilities or preference shares to absorb all types of losses wherever they arise in the group.

2.7 The PRA is receptive to other approaches that firms may wish to propose when seeking to demonstrate availability of subordinated liabilities and preference shares but these must address the legal restrictions associated with such instruments. The PRA will assess such proposals on a case-by-case basis.

Impact on mergers and acquisitions

2.8 One respondent asked the PRA to clarify that existing instruments issued from an ultimate parent would be deemed to be available following a merger or acquisition.

2.9 The PRA considers that special arrangements for existing instruments that would otherwise be assessed for availability at group level would contradict the Solvency II assumption of non-availability. Furthermore, these arrangements would not address the restrictions on the ability of these instruments to effectively absorb losses in a group undertaking in the enlarged group.

Impact on groups headed by companies limited by guarantee and other mutuals

2.10 Three respondents stated that the proposals, together with changes under PS4/19 'Solvency II: Adjusting for the reduction of loss absorbency where own fund items are taxed on write down' would have a disproportionate impact on groups with companies limited by guarantee and other mutuals.[6]

2.11 One respondent also suggested that, in certain circumstances, for groups headed by a company limited by guarantee, the PRA should lower the threshold for demonstrating group availability or prescribe additional defined circumstances in which issuances in such groups will be deemed available.

2.12 The changes under PS4/19 and in this PS reflect the PRA's expectation that the prudential strength of a firm or its group is not overstated. The PRA has clarified in paragraph 5A.2A of the SS that the assessment of availability of own funds to cover the group solvency capital requirement (SCR) should remain on the same basis for different types of groups. In particular, the PRA notes that the scope of the assessment, elements of availability and assumptions as to the availability of different types of own funds under Article 330 of the Delegated Regulation do not differ depending on structure of the group or the type of entity at its head.

2.13 The policy reflects the assumption under Solvency II that subordinated liabilities and preference shares are not available to cover the group SCR when issued by entities within the scope of the assessment of availability. Any firm that seeks to refute the assumption of non-availability must satisfy the PRA that the own fund items are effectively available to absorb losses anywhere in the group. The policy explains that one way that firms may be able to satisfy the PRA that the assumption is not appropriate is through intra-group guarantees, but notes that this is not likely to be appropriate for most groups given specific features.

2.14 Furthermore, the PRA has clarified in paragraph 5A.2A that where a firm faces legal or other restrictions from issuing other types of own funds as a result of being a mutual or company limited

[6] February 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-adjusting-for-reduction-loss-absorbency-where-own-fund-instruments-taxed-on-write-down.

by guarantee, it may place greater reliance on own funds issued by other group undertakings. The PRA considers that it is important that such groups demonstrate that these own funds are not restricted in meeting all types of losses arising anywhere in the group. As noted above, the PRA is receptive to other approaches that firms may wish to propose when seeking to demonstrate the availability of subordinated liabilities and preference shares but these must address the legal restrictions associated with such instruments.

Other responses

2.15 The PRA received a number of questions that do not relate directly to the proposals set out in CP16/19. These are set out below.

2.16 Two respondents requested clarification regarding the undertakings that are in scope of the assessment of availability of own funds at group level. The related undertakings that are in scope of the assessment of availability are specified in Article 330(1) of the Delegated Regulation.

2.17 One respondent asked whether the PRA prefers group own funds to be issued by an insurance or reinsurance undertaking rather than a holding company. The PRA's expectation regarding the location of capital is set out in 'The PRA's approach to insurance supervision'.[7]

2.18 One respondent asked the PRA to clarify that firms should be allowed to include early call provisions for future instruments so they can be replaced with equivalent or better quality capital following a merger or acquisition, where trustee approval of an issuer substitution is not forthcoming. In order to be recognised as own funds, a Tier 2 instrument would need to have the features required in Article 73(1)(c) of the Delegated Regulation and Guideline 10 of EIOPA's 'Guidelines on classification of own funds'.[8] The PRA's approach to a substitution of issuer is covered under SS3/15 'Solvency II: the quality of capital instruments'.[9] Redemption in the first five years out of the proceeds of an issuance in another group entity is not compliant with Solvency II requirements, and so any instrument that allowed this would not be eligible as either solo or group own funds. In order for the own funds requirements to be complied with, any redemption in the first five years needs to be out of the proceeds of a new issuance of the same or higher quality in that same entity. As such, an early call would not remove the need for a firm to demonstrate the availability of the new instrument at group level.

2.19 For questions that relate to an individual firm's specific situation, firms should get in touch with their usual supervisory contact.

7 October 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.
8 February 2015: https://www.eiopa.europa.eu/content/guidelines-classification-own-funds_en.
9 March 2015: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-the-quality-of-capital-instruments-ss.

Appendix

SS9/15 'Solvency II: Group supervision', available at:
https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-group-supervision-ss