Consultation Paper

CP11/22***

Financial Services Authority

Transposition of Solvency II

Part 1

Financial Services Authority

November 2011

Contents

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 15 February 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_22_response.shtml.

Alternatively, please send comments in writing to:

Eleanor Beamond-Pepler
Insurance Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 3114
Fax: 020 7066 3115
Email: cp11_22@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

ABI	Association of British Insurers
APR	Approved persons regime
BTS	Binding Technical Standards
CLD	Consolidated Life Directive
CF	Controlled function
COBS	Conduct of Business sourcebook
CP	Consultation Paper
CP1	This CP – our first consultation paper dealing with the transposition of Solvency II
CP2	Our second planned consultation paper dealing with the transposition of Solvency II
DA	Delegated Acts
EIOPA	European Insurance and Occupational Pensions Authority
ESFS	European System of Financial Supervision
EU	European Union
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act 2000
GENPRU	General Prudential sourcebook
ICAS	Individual Capital Adequacy Standards

ICOBS	Insurance: Conduct of Business sourcebook
INSPRU	Prudential sourcebook for Insurers
IPRU(FSOC)	Interim Prudential sourcebook for Friendly Societies
IPRU(INS)	Interim Prudential sourcebook for Insurers
ITS	Implementing Technical Standards
MCR	Minimum Capital Requirement
ORSA	Own Risk and Solvency Assessment
PRA	Prudential Regulation Authority
PS	Policy Statement
QCP	Quarterly Consultation Paper
RAO	Regulated Activities Order
RDR	Retail Distribution Review
RTS	Regulatory Technical Standards
SCR	Solvency Capital Requirement
SFCR	Solvency and Financial Condition Report
SOLPRU	Prudential sourcebook for Solvency II Insurers
SPV	Special Purpose Vehicle
SUP	Supervision sourcebook
TS	Technical Standards
TFEU	Treaty on the Functioning of the European Union

1

Overview

1.1 This Consultation Paper (CP1) is the first of the planned FSA consultations on rules to transpose the Solvency II level 1 Directive (the Directive). Transposing the Directive into UK law will require a combination of changes to primary legislation (on which HM Treasury is consulting) and changes to the FSA Handbook.

1.2 HM Treasury is responsible for making the necessary legislative amendments to ensure the FSA has the powers necessary to implement Solvency II. The corresponding HM Treasury consultation is the Solvency II Consultation Document.

1.3 Timely consultation on new Handbook text transposing the Directive will enable both firms and the FSA to prepare for the implementation of Solvency II. Under our current planning assumptions, the Directive must be transposed into the Handbook by 1 January 2013. The proposed Handbook rules included in the Appendix of this paper will come into force on day one of Solvency II.[1]

1.4 The Directive is mainly maximum harmonising and we have limited scope for discretion in our transposition and implementation of it. However, we are obliged under the Financial Services and Markets Act 2000 (FSMA) to undertake a cost benefit analysis and consultation on the changes to the FSA Handbook that will be required as a consequence of Solvency II.

1.5 We believe there is sufficient certainty now on the nature of the amendments which will be made by the Omnibus II Directive to consult on the new rules transposing the Directive. However, due to ongoing policy discussions in the European Union (EU), we intend to publish a second consultation paper (CP2) once agreement has been reached on the Omnibus II Directive and level 2 legislation.

1 For the most up to date information on the implementation of Solvency II, please refer to the Solvency II pages of the FSA website: www.fsa.gov.uk/Pages/About/What/International/solvency/index.shtml

Introduction to Solvency II in context

1.6 Solvency II represents a substantial overhaul of European insurance regulation. It will set out new, stronger EU-wide requirements on capital adequacy and risk management for insurers with the key aim of increasing policyholder protection. The strengthened regime should reduce the possibility of consumer loss or market disruption in insurance. Solvency II will replace the current disparate solvency requirements with a harmonised regime, providing consistent prudential regulation across the EU.

1.7 Insurers play an important role in both the financial system and the real economy. While insurers are not systemic in the same way as banks, their behaviour and degree of financial soundness can pose risks to the financial system in their role as significant providers of funds to the banking system and as a result of their investment decisions and strategies, and their interconnectedness with other financial firms.

1.8 In previous episodes of stress for both insurers and the wider financial system, it became apparent that Solvency I was not sufficiently risk-sensitive. This led to the creation of the UK's Individual Capital Adequacy Standards (ICAS) regime. ICAS significantly enhanced the risk sensitivity of the capital that insurers were expected to hold and provided for improved risk identification and management in the insurance sector prior to and during the recent financial crisis.

1.9 In the UK, Solvency II represents a progression of the risk-sensitive capital requirements introduced by ICAS, incorporating strengthened requirements for risk management, applied to groups as well as solo entities, and on a pan-European basis. Solvency II encourages pro-active and integrated risk management and monitoring of firms' individual risk profiles, with a focus on the engagement of senior management. Together with enhanced risk-based capital requirements and improved disclosure, better risk management should reduce the probability of firm failure.

Aims of Solvency II[2]

1.10 Solvency II incorporates three 'Pillars'[3] of requirements, designed to provide greater policyholder protection through a **significantly enhanced prudential regime**.

1.11 Solvency II will result in a **more resilient insurance sector in the long term**, leading to more secure insurance for industry and consumers.

1.12 Solvency II also provides for **enhanced supervisory practices**. Supervisory tools such as the graduated 'ladder of intervention' support timely, pre-emptive and effective action. Increased frequency and quality of firm disclosure and an enhanced group supervision

2 Readers are encouraged to refer also to HM Treasury's Solvency II Consultation Document and the FSA website, www.fsa.gov.uk/Pages/About/What/International/solvency/background/index.shtml, for further description of and discussion on these topics.

3 Pillars are a way of grouping Solvency II requirements.

regime will improve supervisory authorities' understanding of individual firms as well as the sector as a whole. Supervisors' ability to review and compare data across peer groups within and across national boundaries will provide a better, more consistent, view of European group-wide risks.

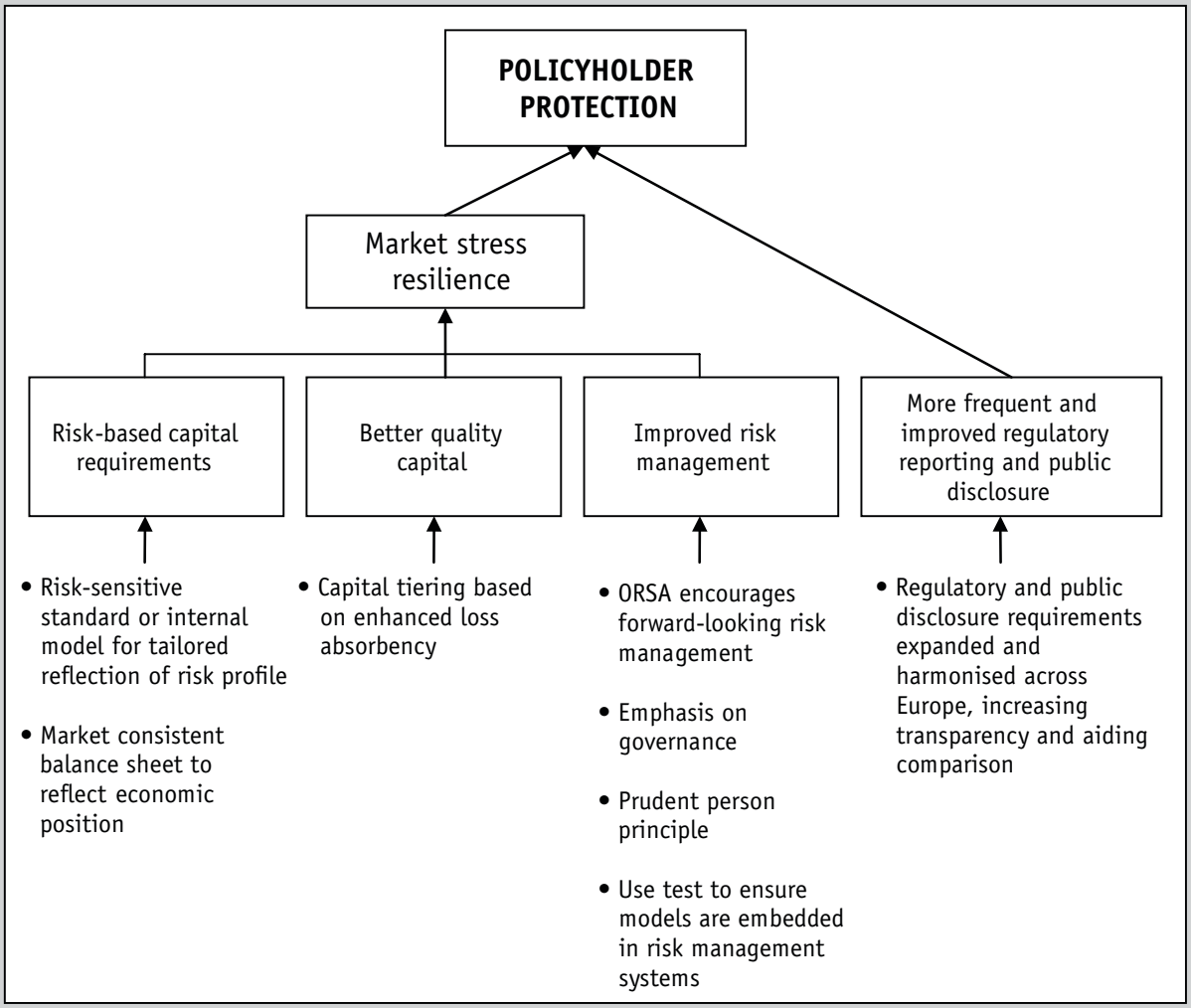
1.13 Harmonisation, increased transparency and disclosure, and the enhanced risk sensitivity and management required under Solvency II will improve the **efficiency and competitiveness** of the industry.[4]

1.14 Consistent regulatory approaches and supervisory practices will create a **level playing field** for firms across Europe. This could increase firms' efficiency by reducing regulatory costs for European groups and facilitating cross-border competition. UK firms in particular could benefit from harmonised risk-based capital requirements, having been subject to an enhanced, risk-based regime in the form of ICAS prior to Solvency II. Under current ICAS requirements, many UK insurers must hold higher levels of capital than the Solvency I requirements, resulting in a lower reduction of free surplus for these firms on moving to the Solvency II requirements than if ICAS did not apply.[5]

4 See Chapter 24 – Benefits in the CBA section (Section IV) of this CP.
5 See Chapter 21 'Solvency II compared to our current regime' sub-section in the CBA section (section IV) of this CP.

Aims of Solvency II

The diagram below illustrates some of the key components of Solvency II which are being introduced for the first time on a pan-European level.



The components of Solvency II (shown at the base level of the diagram) are intended to produce the following outcomes (among others), which contribute towards the overarching benefits of Solvency II. We will expect firm behaviours to demonstrate these under Solvency II:

- Improved risk pricing.
- Improved capital allocation.
- Incentivised matching, hedging and risk transfer.
- Improved governance structures.
- Increased accountability for management.
- Stronger risk management culture.
- Greater market discipline.

Structure of the CP

1.15 **Section I** sets out our approach to consultation and transposition, in the context of the European process and regulatory transition to the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA).

1.16 **Section II** contains an explanation of the draft rules and guidance which will form the new prudential sourcebook for insurers in our Handbook (SOLPRU) (including new or amended Glossary terms for the purpose of the new rules). Each chapter explains the draft Handbook rules and guidance, and outlines, where appropriate:

- the article(s) being transposed;
- where it is clear at this stage, significant requirements in our current Handbook rules that we envisage will be dis-applied for Solvency II insurers, and what (if applicable) will be 'replacing' the current requirements;
- the new requirements firms must comply with under Solvency II, highlighting the policy intention;
- where discretion or a Member State option is provided in the Directive and we are required to make a discretionary decision. There are limited instances of this due to the mainly maximum harmonising nature of Solvency II. Cost benefit analysis (CBA) of these decisions is included within the chapters. Chapters where this occurs are:
  - The Solvency Capital Requirement (SCR) (Chapter 7)
  - The Minimum Capital Requirement (MCR) (Chapter 8)
  - Composites (Chapter 11)
  - Governance (Chapter 12)
  - Groups (Chapter 14)
  - SUP 10 (Chapter 16)
- where level 2 legislation and level 3 EIOPA guidance may be expected; and
- where detailed drafting is not included in this consultation, but is planned for inclusion in further consultation.

1.17 **Section III** contains an explanation of amendments to other, existing sourcebooks, which are necessary to fully transpose the Directive. The description in 3.4 also applies to these amendments.

1.18 **Section IV** contains a CBA for the introduction of Solvency II in the UK. A CBA was originally completed, on our behalf, by Ernst &Young (EY), which is published alongside this CP.[6] In section IV, we have updated this where appropriate, to further evaluate:

6 www.fsa.gov.uk/pubs/other/ey-solvencyii-cba.pdf

- the impact of Solvency II on capital and non-capital compliance costs;
- insurance industry and financial market impacts; and
- the benefits of Solvency II for the UK industry, as well as consumers and markets.

Scope[7]

1.19 Solvency II will apply to about 550-600 UK-based insurance firms covering the retail and wholesale markets. The total net annual premium in the industry is calculated at around £150 billion with total assets and liabilities of around £1.7 trillion – equivalent to 26% of UK total net worth. The retail sector is split between life and pension firms (about 25%) and general insurance firms (about 75%). The 10 largest UK groups account for about 70% to 80% of total business written in the UK.

1.20 Under the Regulatory Reform Bill as it stands, all Solvency II insurers will be prudentially supervised by the PRA. They will also be supervised by the FCA from a conduct perspective.

Non-Directive firms (NDFs)

1.21 There are about 130 small insurance firms (mainly friendly societies) that will fall outside the scope of the Directive. For these firms, our intention is that the current Handbook sourcebooks and provisions that apply to Solvency I insurers will remain in place. Non-Directive firms that are out of scope of Solvency II due to size can, however, apply for authorisation under Solvency II. In that case, the rules in SOLPRU and any other rules that apply to Solvency II scope firms will apply to them. The Handbook as applicable to non-Directive firms will be reviewed post-implementation of Solvency II.

1.22 The draft rules on which we are consulting in this CP apply to Solvency II in-scope firms. For the purposes of transposing Article 4 of the Directive, we have defined 'UK Solvency II firm' as:

- an insurer that is currently in scope of Solvency I and that does not fall out of scope under Article 4(4) of the Directive;
- an insurer that is not currently in scope of Solvency I and that is not excluded from Solvency II under Article 4(1);
- an insurer that does not fall in either the first or second bullets but that opts-in to Solvency II; and

7 Figures correct at time of publication.

- a firm that becomes authorised after the Solvency II implementation date and that is either not excluded under Article 4(1) or if it is excluded under Article 4(1), opts-in to Solvency II.

1.23 Our proposed definition of 'UK Solvency II firm' does not reflect exclusions contained in Articles 5 to 12 of the Directive. Those exclusions have been recast from the Solvency I directives and in some cases they have already been transposed through the Regulated Activities Order. We will consider those exclusions in the scope of our second CP.

1.24 We are currently considering the mechanics of opting-in to Solvency II and we will address this in our second consultation.

Next steps

1.25 Responses to this Consultation Paper are due by 15 February 2012. We intend to publish a Feedback and Policy Statement in Q2 2012. We currently envisage publishing CP2 in Q2/3 2012, with the Feedback and Policy Statement anticipated for Q4 2012.

1.26 Readers are encouraged to refer to the Solvency II pages on the FSA website to keep pace with European and domestic developments on both policy and implementation.

Who should read this CP?

1.27 This paper will be of direct and primary interest to all insurance firms captured within the scope of Solvency II. It will also be of indirect interest to non-Directive firms, representative trade bodies, business advisers and consultants, and other financial advisers involved serving in or linked to the insurance industry.

CONSUMERS

Given the primary objective of the Solvency II Directive is to achieve an appropriate level of policyholder protection, retail and commercial insurance policyholders may wish to take note of the general content of this paper.

Section I

Consultation process

Contents

2

European process

Understanding the legal framework of Solvency II

2.1 Solvency II is being developed in accordance with the Lamfalussy approach, as may be amended by the Omnibus II Directive. The Omnibus II Directive is intended to bring the former process for Solvency II in line with the adoption of the Treaty of Lisbon and the European System of Financial Supervision (ESFS).

Levels of EU legislation under the Treaty of Lisbon

Level 1 (Legislative Acts)	Framework legislation setting out the basic principles is proposed by the Commission and adopted by the European Council and European Parliament. The Solvency II Directive was agreed by the European Parliament and European Council in April 2009 and was published in the Official Journal in December 2009.[8] The Omnibus II Directive will, through amendments to the Solvency II Directive, specify the scope of the delegation of power to the Commission to develop level 2 measures.
Level 2 (Non-legislative Acts)	These are developed by the Commission on the advice of EIOPA, and set out measures of application of the level 1. As with level 2 previously, the European Parliament has the power, by simple majority, to prevent adoption of the package as a whole, while the European Council may do so if it can achieve a qualified blocking majority of votes.
Level 2 Binding Technical Standards (BTS)	The level 1 text may delegate to the Commission the power to adopt delegated acts or implementing acts that have been drafted by EIOPA. These are termed 'regulatory technical standards' (RTS) (if the delegations are made under Article 290) and 'implementing technical standards' (ITS) (if the delegations are made under Article 291). These standards 'should be technical, shall not imply strategic decisions or policy choices and their content shall be delimited by the legislative acts on which they are based'. After the Commission proposes RTS to the European Parliament and the Council, these two bodies may object to the RTS for up to three months. This three month period is extendable by a further three months at the initiative of the European Parliament or Council. For ITS there is no further scrutiny by the European Parliament or the Council once they are adopted by the Commission for four years.
Level 3	Guidance adopted by EIOPA, which is to be treated on a comply-or-explain basis by national supervisory authorities. Guidance is developed and adopted by EIOPA.
Level 4	The Commission, as the guardian of the Treaties, is responsible for ensuring that directives are properly transposed and that EU legal requirements are then applied, pursuing enforcement action where required. Without prejudice to the Commission's powers, the EIOPA Regulation envisages that EIOPA may play a role in investigating alleged breaches of EU law and following up actions.

State of play

2.2 At the time of publication, both the European Council and the European Parliament are holding discussions on the Commission Omnibus II draft proposal. Adoption and agreement on the Omnibus II Directive are necessary for the adoption process of the level 2 (delegated acts and technical standards) to start.[9]

2.3 It is anticipated that the level 2 will be an EU regulation and, as such, will apply directly to firms and supervisory authorities without requiring transposition into domestic law. Level 2 (as a regulation) is therefore not subject to FSA consultation. This is also the case for binding technical standards drafted by EIOPA (whether these are RTS or ITS), which will

8 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:EN:PDF

9 For the most up to date information on European timelines and developments, please refer to the FSA website: www.fsa.gov.uk/Pages/About/What/International/solvency/index.shtml

also be in the form of an EU regulation. It is anticipated that EIOPA will formally consult on the majority of level 3 guidance once level 2 has been agreed.

2.4 Level 3 guidance will continue to be developed by EIOPA after Solvency II is implemented. Therefore our consultation process may extend beyond CP1 and CP2 if level 3 guidance impacts on our rules or if it is appropriate for any level 3 guidance to be reflected in the Handbook.

2.5 The draft Handbook text included in CP1 is based on dates and information as currently exists in the Directive, but square brackets have been used to indicate where this might change given current proposals on Omnibus II.

Why are we choosing to consult now?

2.6 Omnibus II is intended to introduce targeted changes to Solvency II. Amendments to the Directive that are expected to be introduced by Omnibus II will mainly cover:

- the introduction of technical standards and binding mediation mechanisms as set out in the EIOPA Regulation.
- adjustments to the original level 2 empowerments.

2.7 Omnibus II is also expected to introduce transitional provisions to ensure a smooth transition to the new regime.

2.8 It is now clear that the policy set out in the Directive is stable and Omnibus II is not expected to affect the core principles of the Solvency II framework as agreed when the Directive was adopted in 2009. We therefore have a considerable degree of certainty on the level 1 text that must be transposed into the Handbook. To the extent that any changes arising out of the final text of Omnibus II are required, we expect to address these in CP2.

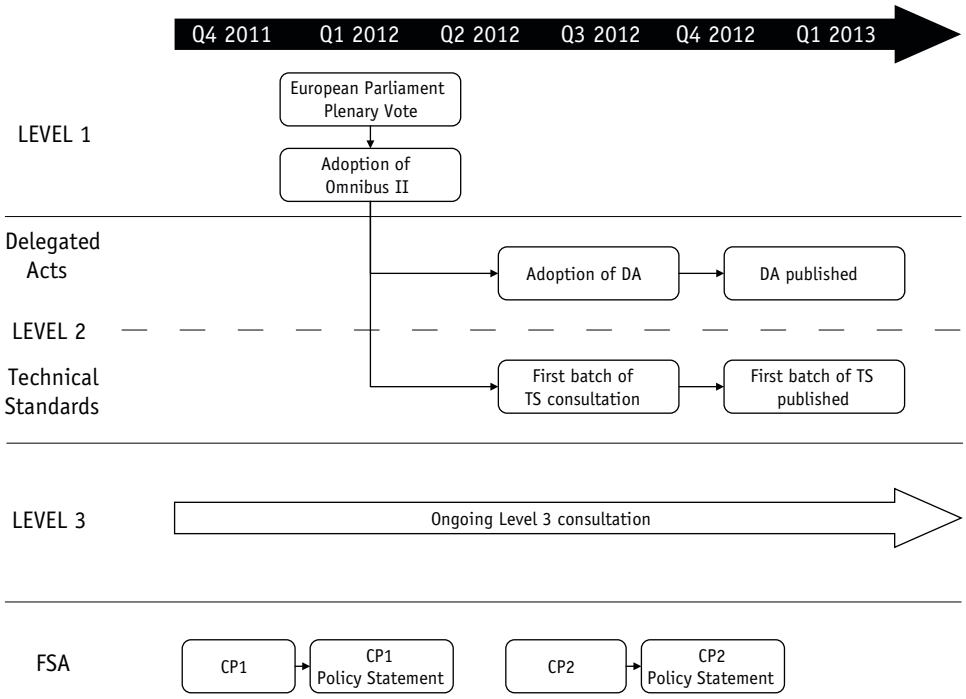
2.9 We have revised our implementation assumptions in light of the discussions in Europe about bifurcation (the potential splitting of the transposition and implementation dates for Solvency II). Our planning assumptions are now that:

- 1 January 2013 will remain the date on which the Directive must be transposed into national law and that certain responsibilities of supervisory authorities and EIOPA would be switched on; and
- 1 January 2014 is when the Solvency II requirements would be switched on for firms.

2.10 If Omnibus II introduces these changes, they would not mean Solvency II is delayed by a year; if our first assumption is correct, it would mean that the FSA would still be required to transpose Solvency II into the Handbook by 1 January 2013 and certain supervisory decisions could progress ahead of 1 January 2014.

What to expect and when[10]

Where our consultation process sits in the current European timeline



10 This is the current position at the time of publication, and is subject to changes in the European timeline.

3

Approach to consultation

3.1 CP1 deals with the transposition of the Directive into the Handbook. CP1 covers new, prudentially focused Handbook text which will form a new prudential sourcebook for insurers – SOLPRU – and also amends Supervision (SUP) 10 in the current Handbook.

3.2 In addition to CP1, we are planning a second consultation (CP2), which is currently scheduled for publication in Q2/3 2012. The exact timing of CP2 depends upon a number of other factors: gaining high certainty on the agreement of Omnibus II and Level 2 and on the final shape of HM Treasury's statutory instrument. Given the ongoing uncertainty around European policy timelines, we are taking an iterative approach to our consultation process. This flexibility is intended to allow optimal time for the implementation of the new rules.

3.3 Solvency II is mainly maximum harmonising, which means that it sets out standards below or beyond which Member States cannot go. We therefore have very limited scope for discretion in our transposition of the Directive requirements. For the majority of the new Handbook text, the underlying principle and the policy it represents are entrenched in the Directive.

3.4 Levels 2 and 3 of Solvency II may also further limit our ability to exercise discretion, by prescribing further detail on the interpretation of the Directive. Our discretionary decisions covered in this paper may therefore need to be revisited in CP2 (to take into account level 2 developments) or in subsequent consultation (for example, to take into account level 3 developments).

3.5 CP1 does not consult on the substantive policies underlying the Directive requirements which have been agreed on a pan-European level and adopted in the Directive. CP1 covers:

- areas of minimum harmonisation where we have discretion on transposition and/or the underlying policy behind our proposed rules;
- explanation of the draft prudential Handbook text and underlying policy; and
- cost benefit analysis on our rules and policy.

3.6 CP2 is expected to include:

- rules transposing Directive requirements which have not been consulted upon in CP1 due to uncertainty in the direction of European policy;
- any amendments to rules and guidance consulted on in CP1 which may be necessary as a result of other legislation yet to be finalised, including where this affects any discretionary decisions we have made;
- other consequential amendments to the Handbook; and
- additional and updated cost benefit analysis on policy and rule changes as appropriate.

3.7 Areas to note which are planned for consultation in CP2 include:

- **Application rules** – these will form 'Chapter 1 – Application' of SOLPRU, and will cover the scope of application of our rules transposing Solvency II. Consequential amendments will also be made to all other affected sourcebooks, for example to dis-apply provisions for Solvency II insurers where appropriate.
- **Lloyd's of London** – As our rules for Lloyd's will likely take the form of a standalone chapter in SOLPRU with cross-references (where appropriate) to other rules in SOLPRU, we will consult on our rules applying the Directive to Lloyd's once consultation in CP1 on our rules transposing the Directive is complete.
- **National specific reporting templates** – national specific reporting requirements and templates will be included in CP2. The templates are being developed with input from the Association of British Insurers (ABI) and other trade bodies, and their members.
- **COBS 20 – With-Profits** – Provisions in COBS (Conduct of business sourcebook) 20 have both prudential and conduct of business implications. All remaining technical issues and drafting for COBS 20 is intended for inclusion in subsequent consultation.

3.8 The following amendments to sourcebooks will be consulted on separately from the CP1/CP2 process, due to their specific focus on conduct of business implications:

- **COBS 21 – Permitted Links** – Proposals concerning amendments to COBS 21 as a result of Solvency II are being addressed in a separate but aligned consultation, CP11/23, *Solvency II and linked long-term insurance business*, published at the same time as this CP and specifically focusing on COB implications. It covers amendments where existing COB rules overlap substantially with the rules in SOLPRU transposing the prudent person principle (see Chapter 10) and amendments to the rules defining permitted links.
- **Information to policyholders – COBS 1 and 13 to 16** –Article 185 of the Directive concerns information to policyholders that will affect text in COBS 1 and 13 to16. The proposed changes to COBS 1 and 13 to16 are included in a separate consultation paper, *Distribution of retail investments – RDR Adviser Charging and Solvency II*

disclosures, scheduled for publication in Q4 2011. Firms will be able to view the changes that will be required to their disclosure documents for Solvency II in alignment with those required for the Retail Distribution Review (RDR), which comes into force on 31 December 2012.

- **ICOBS** – As a consequence of Articles 183 to184 of the Directive, minor amendments are required to ICOBS regarding information to policyholders. The required drafting will be included in a future QCP.

Q1: We welcome views on our approach to the overall consultation process proposed to transpose Solvency II: a first consultation (CP1) on the Directive requirements that have most certainty at this stage in the European process, followed by a second consultation in 2012 (CP2) once there is more certainty on Omnibus II, levels 2 and 3 and the UK legislation has been finalised.

Approach to transposition

3.9 In addition to the creation of SOLPRU, we envisage that transposition of Solvency II into the Handbook will entail a number of changes to other parts of the Handbook, including:

- The dis-application of INSPRU, GENPRU and IPRU(INS) for Solvency II insurers. Provisions in these sourcebooks that must be retained and applied to Solvency II insurers will be contained in SOLPRU.
- We expect to dis-apply most of SYSC for Solvency II insurers as SOLPRU 9 will cover systems of governance requirements (see Chapter 12 of this CP). However, some rules in SYSC may need to continue to apply to Solvency II insurers (including, for example, rules relating to the prevention of financial crime).
- We expect to transpose Solvency II for Lloyd's in a standalone chapter in SOLPRU with cross-references (where appropriate) to other rules in SOLPRU.
- Other, existing sourcebooks such as SUP and FIT will be amended as necessary so they are consistent with Solvency II requirements and our rules transposing them.

3.10 Our general approach to transposing Solvency II is 'intelligent copy-out'. This means following the words of the Directive text as closely as possible in our transposition. The consequence of this approach is that the substance and purpose of the Directive requirements are not altered, and we only depart from copy-out:

- where necessary to provide greater clarity; or
- if necessary, where the Directive requires us to make a discretionary decision.

Q2: Do you have views regarding the clarity of our rules included in CP1, bearing in mind the limited scope for discretion?

Key messages for this CP

An iterative consultation process

Consultation timeline
We are beginning our consultation process now in order to allow both firms and the FSA adequate time to prepare for implementation of Solvency II.

Consulting where we have sufficient certainty
We are consulting where we believe we have sufficient certainty to do so. This consultation focuses on the transposition of level 1 requirements as set out in the Directive.

Further consultation
In light of ongoing developments relating to Omnibus II, level 2 and level 3 and uncertainty around European timelines, we will consult again once Omnibus II and level 2 are agreed, and HM Treasury's statutory instrument is finalised.

Limited scope for discretion

Intelligent copy-out
We have taken an intelligent copy-out approach to transposition, following the words of the level 1 text as closely as possible.

Maximum harmonisation
This consultation does not reopen discussions on policy (as set out in the Directive and reflected in our proposed rules) which has been agreed in Europe.

Where we have discretion
Where Member State discretion is given in the Directive, comment is invited on our policy decision as explained in the CP and reflected in the proposed rules.

4

Alignment with regulatory reform[11]

Objectives

4.1 While the FSA must prepare for Solvency II and the transposition of the Directive into our Handbook, the PRA will have the ongoing responsibility of delivering its objectives within the Solvency II framework. It is also anticipated that the PRA will continue to play an active role in the development of international regulatory standards.

4.2 In addition to its stated general objective, 'to promote the safety and soundness of PRA-authorised persons', the PRA's stated insurance objective is proposed to be to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders. Inherent in this is an objective to seek to ensure that an insurer has sufficient financial resources to meet its obligations, which aligns with the intention and purpose of Solvency II.

4.3 The FCA will also have some responsibility in the implementation of Solvency II and achieving appropriate policyholder protection. It is envisaged that the FCA will work with the PRA to ensure that the objectives of Solvency II are met with regard to the broader context of the UK's regulatory objectives.

Approach to insurance supervision – judgement-based supervision

4.4 It is expected that the PRA will form its **judgements** based on a comprehensive, forward-looking view of the firm in order to assess all potential risks which could affect policyholder protection. Under Solvency II, the Own Risk and Solvency

11 Prudential Regulation Authority: the future approach to insurance supervision: www.fsa.gov.uk/pages/Library/Communication/PR/2011/054.shtml

Assessment (ORSA) will provide valuable information on a firm's forward-looking risk management.

4.5 The expectation for the PRA to exercise early and pro-active supervisory interventions builds upon the **ladder of intervention** codified within Solvency II.

4.6 In addition to this, examples of how key features of Solvency II are expected to align with the proposed approach of the PRA include:

- Strengthened **co-operation and co-ordination** between national regulators, through harmonised regulatory approaches and supervisory practices across Europe, and involvement in supervisory colleges.
- Emphasis on the primary role played by firms' management in understanding the risks their firm faces and ensuring policyholder protection. This is apparent in the general governance provisions under Solvency II, including the **ORSA** and the **prudent person principle**.
- Emphasis on the importance of both regulatory and public disclosure, reflected in Solvency II by improved frequency and quality of **harmonised reporting.**

Section II

The new prudential sourcebook for insurers – SOLPRU

Contents

5 Valuation

5.1 Article 75 of the Directive prescribes the method by which assets and liabilities must be valued. Articles 76 to 85 then prescribe specific rules for the calculation of technical provisions. SOLPRU 2 transposes these requirements of the Directive.

General valuation rules

5.2 Under Solvency II, and in contrast with the current approach, valuations for assets and liabilities for all Solvency II insurers must be determined using a market-consistent balance sheet approach which is similar to the fair value reporting approach used in international financial reporting standards.

5.3 To achieve this, firms must value:

- assets at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction; and
- liabilities at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction.

5.4 As with all the rules transposing the Directive, these rules will need to be read alongside the level 2 legislation. It is expected that level 2 legislation on valuation and technical provisions will include requirements covering:

- the scope of the technical provisions;
- data quality standards;
- calculation methodologies and treatment of particular risks;
- calculation of the risk margin;
- the risk-free rate term structure; and
- use of simplifications.

5.5 The rules represent a significant change from the existing methods of valuing assets and liabilities (including technical provisions) both for life firms (which currently calculate mathematical reserves) and non-life firms (which currently calculate claims provisions differently, and hold unearned premium reserves and claims equalisation reserves). However, for certain life firms (currently subject to realistic basis reporting), the changes are less marked as these firms already use a market-consistent balance sheet approach.

Specific rules covering the valuation of technical provisions

5.6 Technical provisions must correspond to the current amount that the firm would have to pay in order to transfer its insurance and reinsurance obligations immediately to another Solvency II firm.

5.7 The technical provisions are made up of the best estimate of the probability-weighted average of the future cash flows relating to the insurance or reinsurance obligations of the firm plus a risk margin representing the cost of holding regulatory capital in respect of those insurance and reinsurance obligations.

5.8 SOLPRU 2.3 and 2.4 set out the rules and guidance transposing Articles 76 to 85 of the Directive, including rules relating to:

- which cashflows must be included;
- the requirement that the valuation of technical provisions must be market consistent;
- the calculation of the best-estimate;
- the calculation of the risk margin;
- the valuation of financial guarantees and contractual options;
- the treatment of recoverables from reinsurance and insurance special purpose vehicles;
- requirements relating to data quality; and
- requirements relating to the assessment of the appropriateness of the technical provisions, including comparison against experience.

6

Own funds (SOLPRU 3)

6.1 Articles 88 to 90 and 93 to 98 of the Directive prescribe how own funds are to be determined and classified. SOLPRU 3 transposes these requirements. We have adopted the Directive terminology of 'own funds' rather than 'capital resources' as currently used in GENPRU.

Determination of own funds

6.2 The proposed rules define own funds as the aggregate of basic own funds (the excess of assets over liabilities less own shares held, plus subordinated liabilities) and ancillary own funds.

6.3 Ancillary own funds are items not yet called up and therefore not on the balance sheet. They must be capable of providing basic own funds when called up. An example is unpaid share capital. Some items that will now be ancillary own funds were permitted under Solvency I under limited circumstances. Some items were agreed by waiver. The draft rules extend to all firms the ability to use ancillary own fund items as capital, but the nature of ancillary own funds necessitates certain safeguards including prior approval by the supervisor and eligibility limits.

Adjustments for ring-fenced funds

6.4 The Directive introduces the concept of ring-fenced funds. These are the result of a restriction on own-fund items so they can only be used to cover losses arising from a particular segment of liabilities, from particular risks or in respect of particular policyholders. An adjustment to own funds is required to reflect the fact that items within the ring-fenced fund are not available to absorb losses outside the ring-fenced fund. The details of this adjustment will be contained in the level 2 legislation, and are therefore not included in the draft rules. However, we have included guidance in our draft rules referring to the level 2 legislation to remind firms that these adjustments will be required.

Classification of own funds

6.5 The rules classify own funds items into three tiers. The introduction of tiers is a new feature of Solvency II compared with Solvency I. In the UK, we have already applied a tiering system to all firms including insurers under GENPRU 2.2. However, there is no direct mapping of the current GENPRU structure to the draft SOLPRU rules.

6.6 The classification of own funds items into tiers under Solvency II is based on the extent to which the own funds items possess certain characteristics. These include:

- the capability to fully absorb losses on a going concern basis as well as in the case of winding up; and
- their subordination to obligations to policyholders and beneficiaries in the case of a winding up.

6.7 Classification will also have regard to other factors such as the duration of the item and the absence of features which could undermine its quality.

Eligibility and limits applicable to tiers

6.8 In addition to eligibility criteria the Directive introduces quantitative limits on the proportion of each tier which can be treated as eligible to cover the Solvency Capital Requirement (SCR) (see Chapter 7) and the Minimum Capital Requirement (MCR) (see Chapter 8). These limits require a minimum proportion of eligible own funds to be Tier 1 and permit a maximum proportion of Tier 3. This ensures that the quality of capital held by all firms reaches a minimum standard, since not all own funds items provide the same level of loss absorbency in the case of going concern or upon winding up.

6.9 The limits specified in the Directive are minimum standards and the level 2 legislation is expected to increase the amount represented by Tier 1 – the highest quality of capital – and reduce the amount represented by Tier 3. In order to make the text more coherent and useable we have included guidance referring to the relevant level 2 legislation.

Surplus funds

6.10 Article 91 of the Directive provides for a Member State option that permits surplus funds to be eligible for inclusion in a firm's Tier 1 capital under certain conditions, rather than being included as insurance or reinsurance liabilities in the firm's technical provisions. Surplus funds are accumulated profits that have not been made available for distribution to policyholders (and which satisfy specified criteria). We are currently considering the extent to which (if any) surplus funds should be recognised and will address this in CP2. For this reason, references to surplus funds in our draft rules appear in square brackets.

7

The Solvency Capital Requirement (SOLPRU 4)

7.1 Articles 100 to 127 of the Directive prescribe how the Solvency Capital Requirement (SCR) shall be calculated. SOLPRU 4.1 to 4.27 transposes the requirements placed on firms by these Articles.

7.2 Under Solvency II, capital requirements may be assessed using a standard formula or an approved internal model (as appropriate to the risks faced by the firm). The standard formula approach defines the shocks and stresses and methodologies which must be applied in order to calculate the capital requirement. The internal model requirements prescribe the tests and standards which must be met for a model to be approved.

7.3 The rules require that a firm's SCR must correspond to the value-at-risk of its basic own funds subject to a confidence level of 99.5% over a one year period. The rules also require that a firm's SCR be calibrated to take into account all quantifiable risks to which the firm is exposed for existing business. New business expected to be written over the following 12 months must be included in the SCR calculated using an internal model. New business expected to be written over the following 12 months must also be included in the calculation of the non-life underwriting risk module within the standard formula.

7.4 The draft Handbook text sets out the minimum risk modules the SCR must cover, subject to the lines of business written by the firm.

7.5 Further detail on the application of the SCR requirements to health insurance is expected to be set out in the level 2 legislation and level 3 guidance.

The standard formula

7.6 In addition to the risk modules, the design of the standard formula includes an adjustment for the loss-absorbing capacity of discretionary benefits and deferred taxes. SOLPRU 4.5 to 4.11 will contain the rules and guidance on the standard formula, including rules on:

- the calculation of the basic SCR, the operational risk capital requirement, and the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes;
- the circumstances in which the supervisory authority may permit or require the use of undertaking specific parameters in the calculation of the standard formula;
- particular features of each of the risk modules in turn. Where applicable, this includes an explanation of the sub-modules of risk that must be covered in the calculation for each module; and
- the use of simplifications in the standard formula.

Approval of full and partial internal models

7.7 Under Solvency II, firms may use an internal model for the calculation of their SCR. Groups may also use an internal model to calculate the group SCR. Internal models are subject to approval by the Member State supervisory authority, and for a group the decision to approve may involve a college of supervisors.

7.8 SOLPRU 4.12 to 4.27 covers matters related to the approval of full or partial internal models to calculate the SCR. The section includes rules on:

- applications for approval to use a full or partial internal model including the evidence to be provided in order to gain internal model approval;
- the circumstances in which a partial internal model may be used;
- the provision of a transitional plan to extend the scope of a partial internal model;
- the internal model change policy, including the specification of major (supervisory approval required) and minor changes to the internal model, and that supervisory approval is required in order to change a firm's approved internal model change policy;
- major changes to a firm's internal model, for which supervisory approval is required;
- responsibilities of the firm's governing body to approve the firm's internal model application and any application for approval to make a major change to the internal model;
- supervisory approval being required for reversion to the standard formula;

- required actions and consequences following non-compliance of the internal model with the internal model tests and standards;
- the circumstances in which the supervisory authority may require a firm to use an internal model to calculate its SCR; and
- the tests and standards required to be met in order for an internal model to be approved by the supervisory authority.

Capital add-ons

7.9 SOLPRU 4.28 transposes the requirements in Article 37 of the Directive, which prescribes the limited circumstances in which a capital add-on can be applied.[12]

7.10 The existing capital guidance rules forming the ICAS regime (INSPRU 7.1) will be dis-applied for Solvency II insurers when Solvency II comes into effect. Although there are some similarities between our current use of Individual Capital Guidance and the new capital add-on requirements, Article 37 sets out an approach and methodology to capital add-ons that is different from ICAS.

7.11 Following the supervisory review process, a supervisor may impose a capital add-on when a firm's:

- risk profile deviates significantly from the assumptions underlying the SCR, as calculated using the standard formula, and the requirement to use an internal model is inappropriate or has been ineffective, or where an internal model is still being developed (a standard formula significant risk profile deviation).
- risk profile deviates significantly from the assumptions underlying the SCR, as calculated using a full or partial internal model, because certain quantifiable risks are captured insufficiently and the adaptation of the model to better reflect the given risk profile has failed within a given timeframe (an internal model significant risk profile deviation).
- system of governance deviates significantly from the Solvency II system of governance standards, which prevents the firm from being able to properly identify, measure, monitor, manage and report the risks that it is or could be exposed to, and the application of other measures is unlikely to improve the deficiencies within an appropriate timeframe (a significant system of governance deviation).

7.12 When a capital add-on is imposed, the amount of the capital add-on is added to the firm's SCR to generate the new SCR for the firm. Once imposed, a capital add-on is to be reviewed at least annually by the regulatory authority. If the deficiencies that led to the imposition of the capital add-on have been remedied, then the capital add-on is to be

12 As Article 37 is mostly directed towards regulatory authorities, SOLPRU 4.28 covers only a small part of the Article that relates to requirements placed upon firms.

removed. Where a capital add-on has been imposed because of an internal model significant risk profile deviation or a significant system of governance deviation, the firm is required to make every effort to remedy the deficiencies that led to the capital add-on being imposed.

7.13 The method and process for calculating and imposing capital add-ons are expected to be set out in level 2 legislation and further explained in level 3 guidance.

Duration-based equity risk sub-module – equity dampener

7.14 Article 304 allows Member States the option of applying an equity risk sub-module to life insurers in respect of insurance business that meets very specific criteria. We do not intend to exercise this option. We consider there is little, if any, business in the UK which meets the criteria. Even if there is, we nonetheless intend not to implement this option. We consider that the treatment permitted under the discretion does not appropriately and fully reflect the equity risks to which UK life insurance business is exposed, and believe it could result in firms holding insufficient levels of capital to mitigate equity market falls, if equity prices do not revert to the level expected. Consequently, we do not believe that implementing this option would provide benefits relating to UK business.

Q3: Do you agree with our approach to the Member State option outlined in Article 304?

8

The Minimum Capital Requirement (SOLPRU 5)

8.1 Articles 128 to131 of the Directive prescribe how the Minimum Capital Requirement (MCR) shall be calculated.

8.2 The MCR is intended to represent the minimum level of capital below which policyholders and beneficiaries would be exposed to unacceptable risks were the firm to continue its operations. The rules require that a firm's MCR must correspond to the value-at-risk of its basic own funds subject to a confidence level of 85% over a one year period.

8.3 The MCR must be determined on the basis of a simple factor-based calculation, the details of which will be set out in level 2 legislation. It is further subject to a corridor of 25% to 45% of the firm's SCR. The MCR shall have an absolute minimum level – the 'absolute floor', the amount of which is based on the type of firm and prescribed in the rules.

8.4 The rules highlight the minimum euro amounts to which the MCR is subject, and how these amounts, applicable Europe-wide, are derived and revised. The rules also state the prescribed frequency of the calculation and reporting requirements of a firm's MCR under the Directive.

8.5 Under Article 129(3), Member States have the option, for a limited time, to use a cap and floor for the calculation of the MCR that relates to the standard formula even if the firm has an approved internal model. There are certain practical considerations as to when this option would be exercised, especially around how burdensome the calculations would be for firms. For this reason, we intend to implement this option on a case-by-case basis, and it is unlikely to be the norm. An example referred to in our guidance is where the output from the firm's internal model has deviated from the firm's risk profile and where the standard formula provides a better fit. Since we would apply this option on a case-by-case basis where proportionate and only for a limited period, we do not expect material costs or benefits to arise.

Q4: Do you agree that we should exercise the case-by-case option in Article 129(3), for example when the internal model result has temporarily deviated from the risk profile for the firm and the standard formula is a better fit? Do you have views on any other situations where it would be appropriate to use this option?

9

Insurance undertakings in difficulty/in an irregular situation (SOLPRU 6)

9.1 SOLPRU 5 transposes Articles 136 to 144 of the Directive, which prescribe the requirements that insurers must follow when they are in breach of the MCR or SCR (or at risk of being so within the following three months). The rules include:

- The procedures which must be in place to identify deteriorating financial conditions in the firm and notify the supervisory authority.
- Requirements around notifying the supervisory authority of non-compliance with capital requirements, and the actions which must be taken by a firm following non-compliance.
- Transposition of the transitional measure in Article 131 regarding compliance with the MCR and provisions relating to non-compliance with pre-Solvency II capital requirements during this transitional period.
- Rules relating to the preparation of a recovery plan or finance scheme and its minimum requirements.

9.2 It is expected that there will be harmonised level 2 legislation specifying the factors to be considered when determining an exceptional fall in financial markets, including the maximum period to re-establish compliance with the SCR. Further details about the recovery plan and financial scheme may also be provided in level 2.

10

Investments (SOLPRU 7)

10.1 A number of fundamental changes under Solvency II will introduce greater freedom and responsibility for firms regarding their investment decisions. The underlying intention of these changes is to enable firms to better meet their business objectives by developing more efficient and effective investment portfolios, while ensuring the necessary prudence.

10.2 The Consolidated Life Directive (CLD) sets out a list of assets with which insurers are permitted to cover their technical provisions. Three key changes that Solvency II will bring about are:

- the removal of the current requirement for firms to invest only in specified categories of assets to cover technical provisions;
- the removal of asset and counterparty exposure limits; and
- the application of the prudent person principle to all assets of firm.

10.3 Our existing rules in INSPRU for investments will be replaced with the 'prudent person' investment principle in Article 132, as well as the risk management and governance requirements set out in SOLPRU 9. This will manage the increased risks that may arise from the greater investment freedom under Solvency II. The fundamental concepts included in these requirements are:

- insurers shall only invest in assets and instruments whose risks they can properly identify, measure, monitor, manage, control and report;
- all assets are to be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole;
- assets held to cover technical provisions shall be invested in a manner appropriate to the nature and duration of the insurance and reinsurance liabilities; and
- assets shall be invested in the best interest of policyholders and beneficiaries taking into account any disclosed policy objectives.

10.4 SOLPRU 7 transposes the prudent person principle in Article 132 of the Directive. The principles are already largely reflected in some of our existing rules in INSPRU 1.1.34 and INSPRU 2.1. We have also already transposed the prudent person investment principle in our Handbook for pure reinsurers when we transposed the Reinsurance Directive. Solvency II extends these principles to all insurance firms.

10.5 The prudent person investment principle in Solvency II largely recasts existing provisions in the CLD for linked business requiring linked benefits to be covered by close-matching assets.

10.6 Level 3 is also expected to include more detailed guidance regarding the application of the prudent person principle.

Implications for Conduct of Business policy

10.7 The prudent person investment principles occupy the same space as our existing high-level rules in the current COBS 21.2 that apply to linked insurance business (for example, the requirement to cover linked benefits with close matching assets). As Article 132 will be transposed in SOLPRU 7 and will apply to all Solvency II insurers (including to linked insurance business), the rules in COBS 21.2 that overlap with the rules in SOLPRU 7 will be dis-applied for Solvency II firms. This will be addressed in CP11/23, *Solvency II and linked long term insurance business*, referred to in paragraph 3.8.

11

Composites (SOLPRU 8)

11.1 SOLPRU 8 contains rules transposing requirements in Articles 73 and 74 of the Directive, which relate to the pursuit of both life and non-life insurance activities by insurance firms (composite firms).

11.2 Most of the text in these Articles is recast from existing EU directives, and so the draft rules are largely similar to our current rules.

11.3 There is, however, a significant new requirement in these Articles (and hence, in our proposed rules), for the calculation of separate notional MCRs for life and general insurance activities, and for firms to maintain an amount of eligible basic own funds attributable to each of these activities sufficient to cover these notional MCRs. If one of these notional MCRs is no longer met, the supervisory intervention measures in our rules will be applied in the same way as for any breach of an MCR, but with the possibility that the firm may seek approval for a transfer of eligible own funds between the two activities.

11.4 The method for the calculation of the notional MCRs is expected to be set out in level 2 legislation, and is expected to draw on the methods of calculation of the MCR for life and general insurance firms respectively.

11.5 As under our current rules, the main underlying purpose of the requirement for the separate management of life and general insurance activities within composite firms is to ensure that the respective interests of life and non-life policyholders shall not be prejudiced. In particular, profits from life insurance must benefit life policyholders as if the firm only pursued the activity of life insurance.

11.6 A key specific risk in composite firms is the management of potential conflicts of interest in the treatment of general insurance and life insurance policyholders. This may arise because of the different business models and durations of policies, and the uncertainties over the size and incidence of claims, which also differ for the two types of business.

11.7 Therefore, a different investment policy would normally need to be applied, in accordance with the prudent person principle (see Chapter 10), for life and general insurance business. This minimises the risk that firms may focus on short-term earnings, cashflow or balance

sheet considerations, to the detriment of the interests of policyholders that have longer duration policies; in particular, those policyholders who cannot surrender (e.g. annuitants), or can only leave after incurring a surrender penalty.

11.8 Under current Handbook rules in INSPRU 1.1 and 1.5, this is largely achieved through the requirements and restrictions that apply to the long-term fund. That is, our existing Handbook rules require firms to apply long-term assets only for the purposes of their long-term business. However, under Solvency II this would likely result in ring-fencing, as described in recital 49 of the Directive (which would result in the application of the adjustments to own funds and SCR that flow from ring-fencing). Ring-fencing of all long-term business is not the policy intention, and would place an unreasonable commercial disadvantage on composite firms. Therefore, the long-term fund concept will be dis-applied for Solvency II insurers and will not be recast in SOLPRU (see Chapter 17). Where ring-fenced funds arise either in relation to the life insurance business or the general insurance business of a composite firm (for example, ring-fenced funds relating to the firm's with-profits business), the firm's own funds and solvency capital requirements will also be subject to adjustments for ring-fencing (which are expected to be set out in the level 2 legislation).

11.9 In the draft rules, guidance explains that, in order to comply with the requirement to manage life and non-life business separately, firms are expected to maintain separate assets and liabilities for their life and non-life insurance activities. The proposed rules do not prohibit a composite firm from using the assets of one activity for the other activity (subject to meeting the minimum notional MCR requirements and managing each activity separately).

11.10 Separation of assets for life and general insurance business respectively is a continuation of the practice under our current rules. It will make allocation of investment returns easier for firms and more transparent and so help to ensure that the respective interests of life and non-life policyholders are not prejudiced (Article 74(1)). This separation will also make it easier for firms and supervisors to ascertain whether the investment policy being followed is appropriate for the nature and duration of the insurance liabilities, and is in the best interest of all policyholders and beneficiaries, as required by the prudent person investment principle (in Article 132). When compared to current market practice, the costs of continuing the implementation of this separation should be minimal.

Q5. Do you agree with the approach suggested in this chapter for the separate management of life and non-life business for composite firms?

11.11 Articles 73 and 74 of the Directive do not apply to pure reinsurers. Therefore, our proposed rules for composite firms do not apply to pure reinsurer composites.

11.12 This represents a change from our current rules. However, even if pure reinsurers are not subject to the rules transposing Article 73 and 74, they will nevertheless be required to

manage their business in a way that satisfies the governance requirements that apply to them, including the risk management requirements and the prudent person principle.

11.13 Under the regulatory permissions regime prescribed by FSMA and the Regulated Activities Order (RAO), no distinction is made between direct business and reinsurance business. Accordingly, a Part IV permission includes both direct and reinsurance business, unless there is some specific restriction made at the time of authorisation (e.g. a restriction that the firm may only write reinsurance business). The proposed rules reflect a continuation of our current practice that reinsurance and direct business in each class are treated together for the purpose of the application of our rules.

11.14 The Directive continues to prohibit allowing any more 'old-style' composite direct insurers, writing both life and general insurance business, to be authorised. However, the authorisation of 'new-style' composites, writing life and health business, or of new composite pure reinsurers, continues to be permissible.

11.15 The Directive leaves it to Member States to decide the scope of reinsurance activities that an insurer may be authorised to pursue. We propose to continue allowing general insurance firms to be given permission to also write life reinsurance business, but not allowing life insurance firms to write general reinsurance business. This is because of the sizeable risks that are often attached to general reinsurance business, and the past experience of losses that were incurred through the underwriting of such business by life insurers. This may pose an opportunity cost for any life insurance firms wishing to apply this business model, but we believe this would be outweighed by the benefits of added protection for life insurance policyholders.

Q6. Do you have any further comments on our proposals for the Handbook rules relating to composite firms?

12

Conditions governing business (SOLPRU 9)

12.1 SOLPRU 9 transposes part of Article 38 and Articles 40 to 50 of the Directive regarding governance and risk management procedures. The application of these requirements by firms may require a change in firm culture to bring about a greater focus on governance and risk management within the firm, particularly from the board. The requirements described in the Articles are also relevant to other areas of Solvency II so it is important to take them into consideration when implementing all areas of the Directive.

12.2 Solvency II insurers should review all policies and procedures relating to systems of governance, including a review of the governance and risk management culture within firms, to ensure that the rules transposing the Directive requirements are being met in full. The following are the major differences between Solvency II and our current requirements:

- Solvency II introduces a new requirement for an Own Risk and Solvency Assessment (see paragraph 12.3);
- Solvency II will not require the actuarial function holder to be a qualified actuary (see paragraphs 12.4-5);
- the Directive does not contain a specific requirement for external audit. Ongoing discussion with EIOPA may result in the specification of an audit requirement in level 3 guidance; if applicable, we will update firms on this in CP2 (see paragraph 12.6);
- Solvency II identifies four key functions which all firms must have, with key function holders nominated for each function and who must be 'fit and proper'. These are: the risk management; compliance; internal audit; and, actuarial functions. The internal audit function needs to be independent from the other functions. Solvency II also requires that individuals who perform any key function – including the four set out above – or who 'effectively run' the insurer must be 'fit and proper' (see paragraphs 12.7 to 12.11); and

- Solvency II introduces the option for supervisors to apply a capital add-on in specified circumstances when the system of governance deviates significantly from the Solvency II standards (see paragraphs 7.9 to 7.13).

The ORSA

12.3 Each firm must conduct an Own Risk and Solvency Assessment (ORSA) as part of its risk management system. Although it contains some elements found in current practice, the ORSA is one of the most important developments of Solvency II and in many cases the ORSA will require a cultural change within a firm. The ORSA is to be taken into account in strategic decisions taken by the firm, and the results of the ORSA are to be reported to the supervisory authority. If it is used properly, the ORSA should become a central part of the everyday life and business strategy of the firm. Although some elements of the ORSA are to be found in the current ICAS process, it requires significantly more information to be provided. The increased level of information should give a comprehensive picture of all the risks the firm faces (both currently and over the full business planning period) and how capital management relates to these risks.

The actuarial function

12.4 A significant change to our current requirements is that the Directive does not require holders of the actuarial function to be qualified actuaries. However, individuals responsible for this function will still need to demonstrate that they have the necessary skills to be able to undertake the duties of an actuary. This will be assessed as part of the fit and proper requirements by the firm and the supervisory authority. Solvency II requires that all firms provide for an effective actuarial function; this includes non-life insurance companies.

12.5 Any Handbook drafting concerning the with-profits actuarial function will be included in wider Handbook drafting on with-profits in CP2.

Requirements for external audit

12.6 There is no clear requirement for external audit specified in the Directive. However, we are considering whether it is appropriate to require external audit or assurance in some circumstances (particularly in relation to the Solvency and Financial Condition Report). Discussions are still taking place within EIOPA, and we shall provide further information in CP2, taking into account the relevant level 2 legislation and level 3 guidance that may be adopted.

Key governance functions

12.7 A part of having an effective system of governance, all firms will be required under Solvency II to establish risk management, compliance, internal audit and actuarial functions, and to appoint a key function holder for each. For some firms, this will involve a change to our current requirements – e.g. currently not all insurers are required to have an actuarial function or appoint someone with specific responsibility for compliance. The persons who are responsible for these and other key functions must be fit and proper.

Fit and proper requirements

12.8 Fit and proper requirements under Solvency II are set out in Article 42. Article 42 requires firms to make fit and proper assessments, to notify us of any changes to the identity of persons holding specific roles and to assess the fitness and propriety of those persons. We have carefully compared the notification obligation and our requirement to carry out assessments with our current procedures under the Approved Persons Regime (APR).[13] Our conclusion is that the APR is an appropriate means by which to implement the requirements in Article 42.

12.9 Although the Directive does not explicitly require pre-approval (i.e. that an individual must have approval from the supervisory authority before they begin to perform a key function) we propose to retain this aspect of the APR under Solvency II. We believe that the dialogue between firms and the FSA prior to an individual being employed, and the formal notification and pre-approval process ensure that appropriate people are employed in significant roles within firms. Moreover, this gives firms the assurance that, on the basis on information received, we do not object to the personnel they are intending to employ in advance of them taking up the position. This reduces the risk that someone is appointed and then must subsequently be removed if they do not satisfy the regulatory requirements – which could have a destabilising effect on the firm and its credibility in the market.

12.10 Solvency II provides that a fit and proper assessment is required for those holding key functions and for those who effectively run the firm (these latter roles are also considered to be key functions). The onus is on the firm to ensure these checks are carried out properly in the first instance. The categories of effectively running the firm or holding other key functions as described in the Directive are less specific than the controlled functions under the APR, so we have included rules and guidance in SOLPRU 9 as to how these broad categories relate to the categories of roles that are controlled functions. We also expect the level 3 guidance to contain further detail on who is considered to be performing key functions or effectively running the firm.

12.11 Amendments to SUP 10 are required to ensure that Article 42 is properly transposed. As part of the development of the Supervisory Review Process, additional amendments may be

13 As set out in Section 59 of FSMA and SUP 10 in the FSA Handbook.

required to SUP and FIT, which will be included in CP2. See Chapter 16 for further detail on the treatment of existing controlled functions under Solvency II, which will inform responses to the question below.

12.12 When compared with existing FSA requirements, using the current APR to implement Article 42 of the Directive will not impose additional incremental costs. We believe that foregoing the potential cost-saving to firms and us associated with the Directive minimum could be justified because an effective pre-approval process and more specific functions are likely to yield materially higher benefits. For example, preventing inappropriate appointments from being made appears to be a more effective way of protecting policyholders' interests than acting on individuals' shortcomings afterwards.

Q7: Do you consider that the APR is the appropriate method for us to implement the Article 42 requirements regarding receiving notifications and making assessments on personnel?

Outsourcing of key functions with regard to fit and proper

12.13 Solvency II contains specific provisions on outsourcing that we have transposed into SOLPRU 9.

12.14 While the firm is ultimately responsible for ensuring that all individuals performing an outsourced key function role are fit and proper, we may, where appropriate, conduct an additional fit and proper assessment of the individual in the third party provider that is responsible for the function. In these cases we do not propose that this assessment is conducted using the APR, partly because such an individual may not always be performing a controlled function as defined in FSMA, and partly because the requirements of the APR may not always be proportionate in such cases. However, we are unable to set out any further details on the assessment process we will use until the level 3 guidance has been finalised.

12.15 The requirements for the written notification of a key functions being outsourced, including information on the fitness and propriety of third party providers where a key function has been outsourced, will be further set out in level 3 guidance.

Q8: Do you agree with our approach to assessing third party providers where a key function has been outsourced?

Finite reinsurance

12.16 Article 210 of the Directive requires firms that conclude contracts of finite reinsurance or pursue finite reinsurance activities to have adequate systems of governance in place in order to identify, measure, monitor, manage, control and report the risks arising from that contract or those activities.

12.17 Although 'finite re' was referred to in the Reinsurance Directive, there was no requirement to transpose this concept in the UK. When we consulted on our rules transposing the Reinsurance Directive, we expressly considered whether we should prescribe a detailed set of rules for specific types of transactions, including specific types of reinsurance transactions (such as financial reinsurance). However, we rejected this approach on the basis that 'in an innovative environment, trying to differentiate types of transactions through prescriptive rules can be inefficient and cause competitive distortions'.[14] Therefore, although our current regime does not prescribe detailed rules for specific types of reinsurance, Article 210 of the Directive requires us to incorporate the concept of 'finite re' in the Handbook.

12.18 Therefore, we have included a rule in SOLPRU 9 to transpose this provision.

14 CP06/12 *Implementing the Reinsurance Directive* (June 2006) pg. 24.

13

Insurance Special Purpose Vehicles (ISPVs) (SOLPRU 10)

13.1 SOLPRU 10 transposes the requirement in Article 211 of the Directive that Member States must allow the establishment of insurance special purpose vehicles (ISPVs), subject to supervisory approval.

13.2 In contrast, the current regime under the Reinsurance Directive enables (but does not require) Member States to allow the establishment of SPVs in their jurisdiction provided that if they do, they must establish a regime for their authorisation and regulation.

13.3 We exercised this option by introducing a regime for ISPVs in INSPRU 1.6.

13.4 Whereas the Reinsurance Directive allowed Member States to define the conditions of authorisation of ISPVs, under Solvency II these will be harmonised in level 2 legislation prescribing:

- the scope of authorisation;
- the mandatory conditions to be included in ISPVs' contracts;
- fit and proper requirements for persons running the ISPV and for shareholders or members with a qualifying holding in the ISPV;
- administrative and accounting procedures;
- governance and risk management;
- information requirements; and
- solvency requirements.

13.5 Therefore, our current ISPV rules will be dis-applied for Solvency II insurers.

13.6 In addition to the level 2 legislation for ISPVs, EIOPA is developing additional level 3 guidance to assist with clarity.

13.7 As most of the substantive requirements for ISPVs will be contained in level 2 legislation, which are expected to be directly applicable, SOLPRU will contain few rules and guidance relating to ISPVs. The rules in SOLPRU 10 reflect the new regime, but the possibility of grandfathering the existing ISPV arrangements in the UK will be considered further and is expected to be addressed in CP2.

13.8 The management of ISPVs will be subject to fit and proper requirements. Currently, persons who run ISPVs in the UK are subject to the APR, which will not change under Solvency II (see section on ISPVs with regard to fit and proper requirements, paragraph 16.10).

14

Groups (SOLPRU 11)

14.1 The draft rules for insurance groups in SOLPRU 12 implement Articles 213 to 246, 256, 257 and 260 to 266 of the Directive, and closely follow the format of the groups provisions in these Articles. The drafting includes requirements regarding:

- the application of group supervision;
- the levels of group supervision;
- the group solvency calculation, including the calculation of the group SCR and group own funds;
- the group-specific risk management and internal control requirements;
- provisions relating to intra-group transactions and risk concentrations;
- group disclosure requirements; and
- provisions relating to third countries and mixed-activity insurance holding companies.

14.2 The group provisions are consistent with the relevant solo provisions, with some additional requirements addressing group-specific issues such as group structures and intra-group transactions.

14.3 Where an insurance group spans multiple jurisdictions it may be subject to more than one supervisory authority. While the transposition for groups is generally in line with our overall intelligent copy-out approach, the transposition of Directive provisions reflect the FSA's jurisdictional constraints.

14.4 Our rules will require UK insurers that are part of an insurance group to comply with the Solvency II provisions. If the group supervisor is a supervisory authority other than the FSA, the FSA still requires the UK insurers to comply with the Directive provisions.

14.5 The term 'relevant insurance group undertaking' is used in some instances, and means those insurance undertakings in the group that are UK authorised. It is used to ensure that the UK-regulated entities of a group are subject to the rules intended to apply at group level and must ensure that group level requirements are met.

14.6 The following paragraphs highlight areas where the requirements in the Directive are significantly different to our current insurance group requirements.

14.7 The amount of capital that is required to be held by the group will now be called the group Solvency Capital Requirement (group SCR). The amount of capital resources that are available to meet the amount of required capital will now be called 'eligible own funds', in line with new rules on capital requirements for solo entities. The eligible own funds requirements set out the amount of capital resources required to cover the required capital for the group.

14.8 Under Solvency II, the default method of calculation of the group solvency calculation will be accounting consolidation. This is different to INSPRU 6.1, where the default method is deduction and aggregation.

14.9 For groups that include insurance firms based in third countries that have been approved to use the deduction and aggregation method of calculation, there are rules for the contribution to the group solvency calculation for those firms. For these third-country insurance firms, the rules in SOLPRU 11.3 must be used to calculate its contribution to the group solvency calculation unless the Member State has exercised its discretion to allow the group solvency calculation to take account of the SCR and own funds requirements as laid down in that third country (local rules). These local rules can only be used if the third country has received a positive equivalence decision as set out in Article 227 of the Directive. A positive equivalence decision deems the third country's insurance regime as having an equivalent level of protection as Solvency II. We intend to exercise the Member State discretion referred to above by allowing the use of local rules, where equivalent. We have exercised the discretion in this manner to reduce the burden and costs on groups with third country firms.

Q9: Do you agree with the way we are proposing to exercise the option in Article 227?

14.10 Equivalence decisions can also be made under Article 260 of the Directive, which involve assessing the equivalence of the third country's group supervision regime.

14.11 Under Article 225 of Solvency II, Member States have the discretion to decide, for groups that include an insurance firm based in another Member State, whether to allow the group solvency calculation to take account of the SCR and own funds requirements as laid down in that other Member State for the firm's contribution to the group solvency. We intend to exercise the discretion by allowing the use of other Member States' rules. Given that Member States have limited discretion in respect of the solvency calculation under Solvency II, we

consider that there is benefit in allowing the use of local Member State rules to ease the burden and costs on pan-European groups.

Q10: Do you agree with the way we are proposing to exercise the option in Article 225?

14.12 Existing specific rules on composites and long-term insurance business have not been reproduced in the draft rules for the group level. This is because, other than the specific treatment of composites in SOLPRU 8, composites are treated as insurance firms under groups supervision and within the group solvency calculation. The concept of the 'long-term fund' will not be recast from our current rules under Solvency II (see Chapter 17). The treatment of business currently residing within long-term funds at the group level will be consistent with its treatment at solo level under Solvency II.

14.13 Current rules regarding exposure limits for risk concentrations will be dis-applied for Solvency II insurers. These will be replaced by transposition of Article 132, the prudent person principle in SOLPRU 7 – Investments (Chapter 10) and the market risk concentration charge in SOLPRU 4 – The SCR (Chapter 7), which operate towards the same outcome.

14.14 Current rules regarding ineligible surplus capital and restricted assets will be replaced with rules transposing Directive requirements in Articles 87 to 99 on the eligibility and availability of capital in SOLPRU 3 – Own Funds (Chapter 6) and SOLPRU 11.2. Additional requirements in respect of capital instruments intended to contribute at the group level as well as in respect of a solo issuer are expected to be specified in the level 2 legislation.

14.15 There are additional group specific reporting requirements for the reporting of intra-group transactions and risk concentrations. These are in addition to the solo requirements that will apply at group level, and will be addressed in group-specific templates developed at the European level.

14.16 The group solvency calculation, including the use of internal models, as well as more detailed rules around the criteria for centralised risk management, how colleges will operate and group reporting, will be further developed in the level 2 legislation and level 3 guidance.

14.17 The criteria for assessing equivalence of third-country subsidiaries and parents for the purposes of group supervision and the group solvency calculation will also be further set out in the level 2 legislation and level 3 guidance.

15

Reporting (SOLPRU 12)

15.1 The rules in SOLPRU 12 implement Article 35, 51 and 53 to 55 of the Directive. The Directive introduces new reporting requirements which are intended to replace existing reporting requirements in the Handbook. The new requirements constitute a significant change to the current reporting regime, in terms of the content and the frequency of reporting.

Information to be provided for supervisory purposes

15.2 The Directive details the information firms must submit in order to facilitate their supervision as required by the Directive. It sets out high-level requirements as to when the information must be submitted and certain qualitative principles with which it must comply. Firms are also required to have appropriate systems and structures enabling them to fulfil the reporting requirements. Level 2 legislation will contain further details of the specific items that firms must address in their regulatory supervisory reporting.

15.3 Firms that are part of an insurance group should also be aware of the Directive's group-level reporting requirements, as dealt with in SOLPRU 11 – Groups (Chapter 14).

The Solvency and Financial Condition Report (SFCR)

15.4 The SFCR is a public report required under Article 51 of the Directive. The SFCR must be disclosed annually. Level 2 legislation will contain further details of the specific items that firms must address in their SFCR as well as quantitative reporting templates that must be annexed to the report. The SFCR must contain the following information:

- the business and the performance of the insurer;
- the system of governance and an assessment of its adequacy for the risk profile of the firm;
- a description, separately for each category of risk, of risk exposure, risk concentration, risk mitigation and risk sensitivity;

- a description, separately for assets, technical provisions and other liabilities of the firm, of the bases and methods used for their valuation; and
- a description of the firm's capital management, including information on the amount and structure of own funds, the amount of the MCR and SCR, any non-compliance with the MCR or significant non-compliance with the SCR during the reporting period, and information as to the main differences between the underlying assumptions of the standard formula and those of any internal model used by the firm.

Member State option

15.5 Member States have the option under Article 51(2) of the Directive to activate a transitional provision providing that firms would not need to disclose any capital add-ons imposed or the required use of undertaking-specific parameters (USPs) during a specified time period up expiring on 31 October 2017. The default requirement under Solvency II is for public disclosure of any capital add-on and USPs as part of the SFCR.

15.6 We are currently considering whether to utilise the option provided by Article 51(2). However, any decision to activate the temporary non-disclosure permitted by this provision would not affect the manner and frequency in which capital add-ons or USPs are applied, only their public disclosure during the disclosure period outlined above. Market pressures may nonetheless encourage voluntary disclosure regardless of whether the temporary non-disclosure permitted by Article 51(2) was implemented in our Handbook rules. The Handbook drafting currently reflects the default requirements for public disclosure which will apply from 2017 (that is, separate public disclosure of capital add-ons and USP's which are required by the supervisory authority). Our decision on the exercise of this option will be reflected in CP2.

UK-specific reporting

15.7 In addition to the prescribed harmonised reporting required by the Directive, we will develop certain quantitative reporting templates designed to address aspects of the UK market that are not specifically reflected in the Directive's reporting requirements.

15.8 The UK-specific templates are being developed with the engagement of the ABI and other insurance industry trade bodies, and their members. They are expected to be included in CP2.

Section III:

Changes to other areas of the current Handbook

Contents

16

SUP 10

16.1 Amendments to SUP10 are required to be made in order for us to use the APR for the fit and proper assessment as set out in Articles 42 and 43 of the level 1 Directive (the Directive). These proposed amendments should be borne in mind by firms when responding to the question in Chapter 12 of this CP.

16.2 In September 2010, our Policy Statement *Effective corporate governance: Significant influence controlled functions and the Walker Review* (PS10/15) made a number of changes to the APR, including the introduction of a number of new controlled functions (CFs) and the deletion of the systems and controls function (CF28). However, as reported in Handbook Notice 108 (March 2011), some of these changes have been postponed. As we are not yet certain when the remainder of these changes will be in force, the changes to the Handbook as shown in the Appendix will be based on the current version of SUP 10 – i.e. assuming the changes introduced in PS10/15 have not taken effect.

16.3 The controlled functions will include four key functions required by Solvency II. However, we believe that the other controlled functions detailed in the current Handbook will fall within the scope of Article 42, either as effectively running the firm or because they are considered to be an 'other key function'. As a result, there are only minor changes to the current roles included in the APR.

16.4 The compliance function (CF10) is currently only required for firms who conduct designated investment business. Under Solvency II, all Solvency II insurers will need to have a compliance function and the person performing it must be assessed as fit and proper. Therefore, the scope of CF10 will be widened to include Solvency II firms. The focus of the controlled function will also shift for Solvency II firms, as the emphasis will be on compliance with the requirements of Solvency II.

16.5 The significant management function (CF29) is expanded to include any individual who is effectively running the firm or performing any other key function where that individual's role is not within the scope of any other controlled function.

16.6 The risk function (CF14) and internal audit function (CF15) will be implemented for Solvency II firms as these are specifically set out in the Directive as key functions.

16.7 The systems and controls function (CF28) will no longer be relevant to Solvency II firms. This function includes individuals with responsibility for reporting on financial affairs. A separate finance function was due to be introduced for all firms by PS10/15, but this has been delayed. As the Directive does not specifically include the finance function, we propose not to implement this for Solvency II firms (as we have with the risk and internal audit functions) until it is introduced for all firms. However, this may still be a key function in firms and in these cases we would expect firms to consider whether the person performing it would be performing the significant management function (CF29).

16.8 We recognise that this may require more administrative work for firms, as they may need to re-assign certain individuals from CF28 to CF29, and then quite possibly move them again to CF13 when it is implemented for all firms. Another option would be to retain an amended CF28 function for Solvency II insurers (which only applies to those with responsibility for reporting to the firm's governing body on the firm's financial affairs). Another option would be to say that we will introduce CF13 specifically for Solvency II insurers if it has not already been implemented as part of the PS10/15 changes – i.e. treat CF13 as we propose to treat CF14 and CF15.

Q11: Do you agree with our proposed approach to those currently approved for CF28 because of their finance responsibilities? Or do you think one of the alternative options discussed above would be preferable?

16.9 The specific controlled function for the Lloyd's Actuarial Function will also not apply under Solvency II; it is considered that the actuarial function is considered to be sufficient and any amendments required to this function as it applies to Lloyd's will be included in CP2.

ISPVs with regard to fit and proper

16.10 The level 2 legislation is expected to include fit and proper requirements for persons running ISPVs. We currently apply the APR to ISPVs and propose that we continue to do so. We have included in the draft Handbook text rules and guidance setting out which of the controlled functions apply to insurance ISPVs so that our rules are consistent with the Directive and level 2 legislation.

17

The long-term fund

17.1 The current Handbook includes prudential and conduct of business provisions built around the concept of the long-term fund. Existing long-term fund provisions aim to mitigate the potential risk of proceeds from long-term insurance business (e.g. life, critical illness) being used for the benefit of shareholders or certain classes of policyholders, at the expense of long-term policyholders.

17.2 In line with our intelligent copy-out approach to the Directive, we do not propose to apply our existing prudential requirements relating to the long-term fund to Solvency II firms. Some of the protections afforded by our current requirements relating to the long-term fund are achieved in a different way under the Directive, including through the composites requirements (Chapter 11), the 'prudent person principle' (Chapter 10), the governance and risk management requirements (Chapter 12) and the ring-fenced funds adjustments for own funds and the SCR (Chapter 6).

17.3 We are considering the extent to which some of our existing protections relating to with-profits business may need to be retained to ensure that our rules transposing the Directive, together with our conduct of business rules, result in an appropriate with-profits regime in the UK. Detailed rules in this area will be included in subsequent consultation, as consequential amendments to COBS20 – With-Profits.

17.4 Solvency II, and our rules transposing it, do not prevent firms from setting up a long-term fund, or from continuing to have their business organised in this way. However, firms should be aware that this may lead to the creation of a ring-fenced fund for the purposes of Solvency II. This will occur if the arrangements result in restrictions on the use of assets and own funds outside that fund. The precise arrangements that give rise to ring-fenced funds are subject to developments in level 2 legislation and level 3 guidance.

Section IV

Cost benefit analysis

Contents

18

Introduction and key messages

18.1 In proposing new rules or general guidance on rules, we are obliged, under sections 155 and 157 of FSMA, to publish a cost benefit analysis (CBA), unless we consider costs to be of minimal significance. The CBA must set out an estimate of the costs and an analysis of the benefits if the rules and guidance are made.

18.2 The CBA is a statement of the differences between the baseline and the position that will arise if the new rules and guidance are introduced. The baseline for this CBA is the UK's current prudential regime for insurers, which includes our application of the existing Solvency I regime and also our ICAS regime.

18.3 When transposing EU Directives into our rules, we also seek to adopt the minimum level of regulation required by the relevant Directive, or necessary for the effective implementation and operation of the Directive.

18.4 The CBA relates to the draft rules in the Appendix to transpose the Directive. However, we will need to update our CBA to take into account subsequent developments, including:

- changes to the Directive introduced by the proposed Omnibus II Directive;
- level 2 legislation; and
- policy matters on which we intend to consult in CP2.

18.5 We will include an updated CBA in CP2.

Approach to the CBA

18.6 In 2009, we commissioned independent consultants, Ernst & Young (EY), to carry out a major study, on our behalf, of the effects of Solvency II on UK insurance firms and the industry. EY conducted its analysis during 2010, finalising its report in June 2011.

18.7 At the outset, EY agreed three workstreams with us:

- the compliance impact;
- the capital impact; and
- the wider insurance and financial market impact.

18.8 As a subsequent step, we updated their compliance cost estimates and undertook further analysis of the potential change in available capital relative to required capital. We incorporated the findings from this work in our analysis of the impact on insurance and financial markets.

18.9 We reviewed published academic, governmental, and business research on the expected impacts of Solvency II and on the relationship between regulatory capital requirements and capital held by insurers.

18.10 We report the results in our standard structure for cost benefit analysis, identifying the costs and benefits incremental to current regulation and market practice:

- direct costs to the FSA;
- non-capital compliance costs to UK industry;
- capital compliance costs to UK industry;
- wider impacts on UK insurance market:
  - impacts on the quantity of products sold;
  - impacts on the quality of products sold;
  - impacts on the variety of products sold;
  - impact on the efficiency of competition; and
- benefits to the UK.

18.11 We also look at whether Solvency II might have an impact on financial markets.

Scope of the EY report

18.12 EY's analysis of compliance and capital impacts was based on data from 26 firms representing a cross-section of the insurance market and a variety of business models. The firms included in the analysis accounted for between 37%–47% of all UK insurance liabilities as currently calculated.

18.13 The compliance impact survey sought data about the one-off and ongoing costs of implementing Solvency II requirements, and included questions about the expected benefits.

The survey covered the impact of all three pillars of Solvency II on insurers' business models, insofar as the details were known in the third quarter of 2010.[15]

18.14 To assess the capital impact, EY analysed the results of the Fifth Quantitative Impact Study (QIS5)[16] for their sample of firms, identifying the potential change in both available and required capital under Solvency II, (expressed as a change in the 'free surplus').[17] Its analysis took 'UK Solvency I' as the baseline for comparison.[18]

18.15 EY analysed the wider impacts on insurance and financial markets using the findings from the compliance and capital impact analysis together with other research.[19]

Updating the EY report

18.16 We have updated EY's estimates of incremental non-capital compliance costs because firms have updated their estimates as they have gained more detailed knowledge about proposed requirements in the past year. We re-surveyed all 26 firms that took part in EY's survey, receiving updated information from 12 firms. We have also been assisted by our supervisors in their knowledge of firms' plans and preparations for Solvency II.

18.17 We updated EY's analysis of the change in the capital position under Solvency II by estimating the amount of additional funds that may be raised by firms, recognising that many firms hold more than the Solvency I minimum requirement due to our ICAS regime.

18.18 We analysed the impact of Solvency II on insurance and financial markets in light of the findings of the new non-capital and capital compliance costs estimates, as well as other published analysis of the impact of Solvency II.

18.19 In preparing this CBA, we have assumed an implementation date of 1 January 2013. We will expect to update our CBA in line with developments in Europe on bifurcation in CP2.

15 See Volume II of EY's report – *Solvency II Cost Benefit Analysis*
16 FSA (2011) FSA UK Country Report: *The Fifth Quantitative Impact Study (QIS 5) for Solvency II*
17 See Volume I of EY's report – *Solvency II Cost Benefit Analysis*
18 See page 10 of Volume I of EY's report – *Solvency II Cost Benefit Analysis*
19 See Volume III of EY's report – *Solvency II Cost Benefit Analysis*

Key messages

- Overall, the introduction of Solvency II in the UK is expected to promote financial stability and consumer protection and to facilitate increased business opportunities abroad.
- The total direct costs to the FSA of implementing Solvency II are estimated at £178m up to 2016, representing the largest programme it has ever undertaken for a European directive.
- Our estimates indicate that implementation of Solvency II will cost UK insurance firms £1.9 billion. We have forecast annual on-going costs to maintain compliance to be about £200m per year.
- In general, the industry will not have to raise extra capital to meet the new solvency requirements. The UK QIS5 results suggested that only about 20% of solo firms were unable to meet the standard formula calculated SCR, with a combined deficit of around £12.5 billion.
- However, intra-group transfers of capital held in excess of requirements and the use of internal models for calculating capital requirements mean this deficit would not necessarily lead to fresh capital raising on that scale.
- Small firms should not be disadvantaged by Solvency II, though their challenge of implementing the new regime is not under-estimated.
- On current assumptions, the Solvency II regime is unlikely to have a major impact on either the insurance or financial markets, although some product sectors may find business more challenging.
- Identified benefits include improved risk management, better capital allocation, lower probability of default and increased transparency leading to an enhanced level of protection for policyholders.
- As the UK is already operating the risk-based ICAS regime, some of the benefits of risk-based regulation have already been realised. Other of the benefits of Solvency II, such as improved governance and risk management, are as yet hard to quantify.
- Although implementing Solvency II will result in costs to firms, particularly in the short run, we expect material benefits to arise over the medium and longer term.

19

Direct costs

19.1 Implementing Solvency II has been and will continue to be a major piece of work for us. We have been heavily engaged in the development of Solvency II policy, including contributing to discussions in different European forums. Within the UK we have consulted regulated firms (through the FSA-Industry Standing Groups, for example) and engaged with firms as they progress their implementation plans. We have prepared for the review of applications for internal model approval.

19.2 We have budgeted for implementation costs over the period 2008 to 2013 of the Solvency II programme to be in the region of £110m.

19.3 Solvency II will also impose costs on the FSA in the first few years of the new regime over and above what we would have incurred otherwise. We estimate these additional costs to be approximately £23m in financial years 2013/14 to 2015/16. Around half of these costs are attributed to assessing internal models developed by insurers. These costs also include increases in resource requirements in supervising insurers and from 2014/15 investment in IT to capture and process the new regulatory reports. In total, we estimate costs of £178m up to 2016.

19.4 After 2016 we expect the incremental on-going costs of operating and supervising Solvency II requirements to be minimal compared to the costs of our current ICAS regime.

20

Non-capital compliance costs

Total industry implementation costs

20.1 Solvency II applies to about 550–600 UK-based insurance and re-insurance firms covering retail and wholesale markets. We estimate the one-off cost to the industry of implementing Solvency II in the UK to be £1.9 billion[20] from 2008 to 2013. The average annual expenditure over the five years of implementation is £380m. Our estimate is up to £200m higher than EY's estimate because firms supplied higher cost estimates to us in response to our more recent survey. Firms cited two main factors for the change in their estimates: greater complexity of projects, particularly those relating to IT changes, and greater reliance on external contractors than they had envisaged when they estimated their implementation costs for EY's survey.

Table 1 One-off implementation costs

Type of insurer	Estimated cost £ million
Reinsurance	150
Commercial London Market	213
General insurance	309
Life and pensions	825
Composites	366
Mutuals	27
Health	112
Run-offs	42
Total	**2044**
Less FSA Special Project Fees	110
Net total	**1934**

Source: FSA

20 Ernst & Young estimated implementation costs to be £1.8 billion, which included some allowance being made by Solvency II programmes for the FSA's Special Project Fees. We have accounted for the £110m Special Project Fee in direct costs to the FSA; to avoid double counting these costs we have deducted them from our estimated implementation costs.

20.2 From firms' responses to EY, it is clear that firms are making significant investments to ensure they will be ready for the Solvency II requirements. In general, this investment is focused on improving risk management capability and reporting information about risks more quickly and in a more detailed way than currently.

20.3 EY sought to identify the specific incremental costs of Solvency II. In practice it is difficult to estimate incremental costs because some firms are undertaking joint projects. For example, in a survey conducted earlier this year by Deloitte[21], 43% of insurers planned to integrate International Financial Reporting Standards (IFRS) and Solvency II changes. Larger firms were less likely to report that they would combine projects (36%). It is possible therefore that we have overestimated incremental compliance costs.

Total industry implementation costs by activity

20.4 EY reported that the majority of large firms had mobilised structured Solvency II programmes and budgets and that one half of resource costs were accounted for by business and technical resources including risk and actuarial professional input (survey responses suggested over half of the resources deployed on the Solvency II programmes were external to insurers). A further 22% was dedicated to upgrading technology and data systems with the remaining 10% reflecting the cost of programme governance. Non-resource costs were mainly for toolsets and associated infrastructure and upfront licence fees and support.

20.5 Within these programmes, many insurers are making significant investments in internal models in preparation for meeting the standards that must be satisfied under Solvency II for the regulatory approval of models.

20.6 Looking at the costs for different sectors of the industry, life insurers are upgrading their models to improve their capacity to report regulatory balance sheet and capital information more frequently than currently, for instance by improving levels of automation, and by overcoming the problems of integrating legacy systems.

20.7 General insurers (including the Commercial London Market) and reinsurers equally have in place models to capture risks which in many cases may be non-standard. The focus for these firms is on improving data quality and accounting for risks, and diversification between risks, where these are not fully captured by the current standard formula calculation of the SCR.

20.8 As virtually all of the EY survey participants stated they would be expecting to use internal models, it was not possible to provide a meaningful comparison of the costs of deploying internal models compared to the standard formula. Only two small firms within the sample were planning to use the standard formula. We intend to conduct further analysis of this issue in CP2 when more information on respective costs should be available.

21 Deloitte (2011) *Solvency II Survey 2011 Insurers' Responses to Evolving Rules*

20.9 In our follow-up survey, large complex groups estimated implementation costs in excess of £50m and some large firms up to £10m. Our estimates appear in line with those of the recent study by Deloitte which found that:

- 20% of insurers expected to incur implementation costs of less than £1m;
- 33% expected costs of £1m to £5m; and
- 27% expected costs of £5m to £10m.

20.10 In addition, a small proportion of insurers expected to incur costs significantly above £10m while 12% of insurers had not yet decided their budget. The majority of large insurers expected the implementation costs of Solvency II to be less than £10m, although 36% of them had not yet decided their budget.

20.11 The available supervisory data on small firms' budgeting for Solvency II implementation shows budgets ranging from tens to hundreds of thousands of pounds. Adjusting for their size we found that costs for large insurers in the non-life sector were proportionately higher than those for small non-life insurers, highlighting the significant investments large firms are making in developing internal models. We did not find such a difference in implementation cost estimates relative to size between small and large life firms.

Ongoing compliance costs

20.12 When EY conducted its survey the majority of firms sampled were unable to quantify the ongoing costs of maintaining compliance beyond the implementation date. Using the results of our recent follow-up survey, we estimate ongoing non-capital compliance costs to be approximately £200m a year across all the affected firms. For most insurance sub-sectors, ongoing costs were approximately 10% of one-off costs. There was, however, some variation. The percentage for general insurers was slightly lower, but slightly higher for composite insurers.

21

Capital compliance costs

21.1 The capital compliance cost is the cost of raising and servicing any additional capital that insurers expect to hold as a result of Solvency II implementation. The ongoing cost of holding additional capital can be estimated by applying a weighted average cost of capital (WACC) to an estimate of the additional amount of capital to be raised.

21.2 EY estimated the potential reduction of 'free surplus'[22] for UK insurers under Solvency II to be £34 billion. This estimate was based on a comparison between the 'UK Solvency I' and standard formula results from QIS5. EY's report indicated that, on the basis of QIS5 results, some firms would need to raise additional capital, but most firms already have sufficient resources to meet the new regulatory or required capital.

21.3 EY estimates of the notional change in free surplus are presented in Table 2.

Table 2: Reduction in free surplus comparing "UK Solvency I" and QIS5 standard formula, by insurance sub-sector

Subsector	Reduction of free surplus as % of Solvency I free surplus
Life and pensions	41%
General insurers	25%
Pension management/investment firms	94%
Mutual firms	11%
Reinsurers	45%
Total	**31%**

21.4 EY noted that in the life and pensions subsector, due to the lower discount rate and large risk margin requirement, annuity businesses will account for a significant proportion of the reduction in available capital relative to required capital. On the non-life side, the Commercial London Market would experience the largest reduction in available capital relative to required capital due to the size of the catastrophe risk loadings for business written outside the EEA.

22 'Free surplus' is the excess of available capital over required capital.

21.5 As an overall observation, EY commented that insurers are likely to re-evaluate their portfolios of assets and liabilities to better reflect the costs of capital requirements imposed by the Solvency II regime, and to manage their assets and liabilities pro-actively to minimise the volatility of the capital position under different financial conditions.

FSA update

21.6 We have updated EY's analysis to take into account several factors that affect the amount of additional funds that will need to be raised to meet the requirements of Solvency II, namely:

- taking account of firms' current resources which, given our ICAS regime, are already representative of their risk profile;
- the extent to which insurers hold capital buffers over minimum regulatory requirements;
- the effect of using internal models to calculate capital requirements, rather than the standard formula;
- groups achieving capital efficiencies; and
- de-risking and risk shifting.

Solvency II compared to our current regime

21.7 Since its introduction in 2004, UK insurers' levels of capital have been subject to our ICAS system, which is more risk sensitive than Solvency I requirements. As a result, many insurers hold higher levels of regulatory capital meaning that they would incur a lower reduction in 'free surplus' in meeting Solvency II requirements than under 'UK Solvency I'.

21.8 Analysis of QIS5 standard formula results based on end of 2009 accounting year suggested the following:

- About 80% of firms, on a solo basis, would not require any incremental change in capital held to meet Solvency II requirements.
- About 20% of firms, on a solo basis, would have to raise extra capital of about £12.5 billion to meet their SCR. However, it is likely that much of this shortfall could be reduced where solo entities are part of an insurance group that is able to transfer capital held in excess of requirements to those entities with a shortfall.
- The majority of the shortfall in capital for the 20% of firms is accounted for by life firms (87%), with non-life accounting for the remaining 13%. Medium size firms account for 51% of the shortfall, with large firms accounting for 35% and small firms 13%.

21.9 We estimate the ongoing cost of remunerating (e.g. interest and dividend payments) any capital raised by insurers to be approximately 4% annually, deducting the return that could be earned from investing the raised capital in high quality financial assets.[23] Applying this annual cost to a capital shortfall of £12.5 billion would produce an annual compliance cost of capital of approximately £500m. We estimate the one-off cost of raising £12.5 billion of capital from the market to be in the range of £250m to £625m. The cost of underwriting the issuance of capital is in the region of 2% of the sum raised but discounts on the price of the capital issued could push total cost up to 5%. However, this range of costs could be an overestimate because we would expect insurers to raise capital from retained earnings where this is possible.

21.10 As explained in a previous paper on strengthening capital standards[24], the estimate of the ongoing cost of capital provided here should be seen as an upper bound. This is because the cost of increased capital will be offset, to some extent, by a reduction in the cost of issuing new debt. The cost of new debt should fall because insurers have a lower risk of default.[25]

The effect of capital buffers

21.11 EY mentioned several reasons why firms may wish to hold and maintain capital buffers over regulatory requirements, including:

- to satisfy the risk appetite of the firm;
- to obtain a higher credit rating from rating agencies;
- to avoid the costs and management overhead of regulatory intervention;
- to prevent the risk of falling immediately below SCR when markets are more volatile; and
- to take advantage of expected growth and business opportunities.

21.12 Research on capital holding by banks indicates that changes in individual capital requirements are very likely to be accompanied by an increase in capital or a reduction in lending by banks even when they have a buffer of capital in excess of the capital requirements.[26] However, the limited economic literature on capital buffers held by insurers suggests that for insurers, in general, buffers do not move with changes in regulatory capital

23 To calculate the weighted-average cost of capital we used the Capital Asset Pricing Model to calculate the cost of equity and we used debt market indices to calculate the average cost of debt.

24 www.fsa.gov.uk/pages/Library/Policy/CP/2009/09_29.shtml

25 The Modigliani-Miller theorem suggests that a change in the source of a firm's funding from equity finance to debt would not affect the value of the firm. It also suggests that, if a firm raises additional capital and holds this capital in market securities, the value of the firm is the sum of the original firm plus the value of the assets purchased. This is because the underlying income streams of the firm plus the additional assets are unaffected by the change and hence the value attached to them by investors is the same. However it has been shown that Modigliani Miller does not normally hold in practice (see NIESR (2009) *Optimal Regulation of Bank Capital and Liquidity: How to Calibrate New International Standards*, FSA Occasional Paper 39). This means that while the cost of funding for insurers will increase as they either raise additional capital, or swap debt for equity, the cost would not be expected to be as large as presented above, as the analysis fails to take into account the fall in capital costs arising from the reduction in risk to bondholders.

26 FSA (2009) *Banking Regulation, Capital and Credit Supply: Measuring the Impact of Prudential Standards*, Occasional Paper 38

requirements in the same way as banks.[27] Risk appetite and business planning decisions typically dominate regulation as a reason to hold a capital buffer. However, those insurers that hold capital close to the level of regulatory requirements will change their position and hold a capital buffer above these requirements. We believe that these findings are in line with the way rating agencies take capital requirements into account in their ratings.

21.13 Consequently, our view is that insurers whose level of available capital is close to their capital requirement under Solvency II are likely to change their position and hold a buffer, but for other firms such decisions are likely to be driven by a mix of business and market-related factors.

The effect of internal models

21.14 Our QIS5 results showed that capital requirements calculated with an internal model were 20% lower than those calculated using the standard formula for non-life insurers. For life insurers, capital requirements were broadly equivalent using the two calculation methods.[28] These results should, however, be treated with caution because these estimates were not based on approved internal models. Moreover, supervisors will only approve internal models if they adequately capture the risks of the business. This means that capital requirements derived from approved internal models would not necessarily be significantly lower than those based on the standard formula.

Groups achieving capital efficiencies

21.15 Some insurance groups may be able to take advantage of internal transfers of capital held in excess of Solvency II requirements by some entities to those entities with a deficit. Alternatively, some groups may choose to restructure to reduce the impact of capital requirements and reductions in available capital experienced by solo entities. EIOPA's QIS5 report shows that, under different scenarios, solo entities across Europe would experience a considerably larger drop in free surplus than groups.[29] However, groups that do transfer excess capital, or otherwise restructure will face opportunity costs and other costs from these transactions. In addition, some groups may not have capital in excess of regulatory requirements available for transfer. These costs, or lack of capital held in excess of requirements by entities within a group, mean that we cannot assume that all of the deficits of solo entities belonging to groups would be eliminated in the ways we have described.

27 Shin (2010) *Capital-based Regulation, Portfolio Risk and Capital Determinations: Empirical Evidence form the US Property-liability Insurers,* Journal of Banking and Finance; De Nederlandsche Bank (2007) *Are Non-risked Based Capital Requirements for Insurance Companies Binding?* Working Paper No. 145

28 The Bank for International Settlements (BIS) compared capital requirements for life companies and pension funds, calculated using internal models and the standard formula from QIS5 submissions. It found that across Europe use of an internal model could reduce capital requirements by 20%. www.bis.org/publ/cgfs44.pdf

29 EIOPA (2011) *EIOPA Report on the Fifth Quantitative Impact Study (QIS5) for Solvency II*

De-risking and risk shifting

21.16 Firms can be expected to review their business models in anticipation of changes in their regulatory capital requirements and make adjustments as appropriate. This could include changes to the management of liabilities, such as reducing the volume of business written for some lines of business, or taking measures to transfer risk, such as greater use of reinsurance or of swaps to hedge the payment of claims. Insurers can adjust their business models by changing their asset-liability mix, for example by investing in assets with lower risk stresses or factors under Solvency II, or by improving the matching between the duration of assets or liabilities.

Conclusions on capital compliance costs

21.17 In summary, the results of QIS5 suggested that approximately 20% of solo firms would require extra capital, in the region of £12.5 billion in total, to meet the standard formula calculated SCR. The cost of financing this amount of fresh capital is estimated at around £500m annually and the one-off cost in the range of £250m to £625m. However, at this stage, it is difficult to arrive at an estimate for the capital compliance costs because of a variety of prevailing uncertainties and qualifications that need to be made, including:

- QIS5 results are based on 2009 reporting year end and represent point-in-time estimates;
- the level 2 requirements are likely to be different from the QIS5 specifications;
- firms may wish to maintain capital buffers at higher levels than those required to meet their SCR, in response to market pressures or internal business strategies;
- QIS5 results are based on solo firms' figures and do not take account of the extent to which additional capital requirements at solo level can be met by transferring capital that is held in excess of requirements from entities within the group to those entities that do not meet the requirements; and
- industry re-structuring and other management actions taken by firms will impinge on final capital calculations.

22

Insurance market impacts

22.1 This section presents our analysis of the indirect effects of Solvency II on the insurance market. We consider the possible effects on the quantity, quality and variety of insurance products, and on the dynamics of competition, that could occur when firms change their behaviour in response to the compliance costs associated with implementing Solvency II.

22.2 EY identified three possible drivers of changes in the marginal costs of providing insurance products: capital requirements, the extent of diversification benefits in capital requirements, and the risk weighting of assets. EY concluded that the sunk costs of implementing Solvency II and the fixed costs of maintaining compliance with it will not raise marginal costs, but they are likely to affect profitability and the decision whether to remain in product markets or enter new ones.

22.3 In practice, from our assessment of compliance costs, it is unlikely that the marginal cost of providing insurance will increase dramatically across the whole sector as a result of Solvency II so we therefore do not expect there to be major impacts on insurance markets. To put the potential price changes in context, we estimate that the ongoing yearly combined cost (non-capital and capital compliance costs) of Solvency II could be up to £700m[30] per year (although this may well be significantly lower in reality given the uncertainties about the amount of capital that could be raised) while the gross operating expenses of the UK insurance industry are around £22.5 billion, according to the latest available estimate.[31] So, even if such compliance costs were passed through in full to consumers they would appear to be too small compared to the overall industry cost base to result in material changes to prices.

22.4 Nevertheless, it is possible that in some markets there could be material increases in marginal costs resulting in higher prices and material impacts on the quality, quantity and variety of insurance products sold in those markets. The dynamics of competition in these markets could also be materially affected.

30 £200m of non-capital compliance costs and £500m of capital compliance cost (assuming £12.5 billion of fresh capital is raised)
31 OECD (2011) OECD StatExtracts http://stats.oecd.org/Index.aspx?DatasetCode=INSIND

Impact on quantity of products

22.5 Where the cost of a specific insurance product rises, we would expect to see fewer of them sold, unless the insurance is compulsory. As we do not expect the marginal cost of providing insurance to change dramatically on aggregate, we therefore do not expect Solvency II to significantly change the size of the UK insurance market as a whole.

22.6 Nevertheless, some markets could experience material changes in size, with some growing and some potentially shrinking. Depending on the details of the level 2 requirements, the cost of providing guaranteed income or investment products (such as annuities) and some specialist types of cover (such as for catastrophe risk and those provided by P&I clubs) could increase significantly. If this occurs, we would expect it to lead to a reduction in the size of the market for these products and an increase in the size of the market for substitute products, where they exist, as a result of consumers switching products. If the price of cover for catastrophe risk or the risks covered by P&I clubs rise considerably, it could have knock-on effects on the industries they insure, such as shipping and construction.

22.7 Solvency II is likely to increase the price insurers are willing to pay for reinsurance, as the cost of the alternative of holding risk has increased. However, the cost of reinsurance will also increase for reinsurers. It seems likely that demand for reinsurance will increase by more than the costs of supply given that reinsurers are likely to be more diversified and able to access cheaper sources of capital. They will also be better able to raise extra capital and absorb fixed cost increases given their typically large size.

Impact on quality of products

22.8 For product markets subject to material increases in marginal costs as a result of Solvency II, firms' responses will vary. Where competition is largely based on price and insurers have the capacity to reduce quality, because the consumer is not sensitive to changes in quality, they may respond by reducing cover. In markets in which cover is compulsory or consumers focus on the quality of cover, prices are likely to increase instead. If higher prices or lower cover causes lower-risk individuals to buy less insurance, leaving a larger proportion of higher-risk individuals in the market, this could have a further negative effect on price and quality of cover.

22.9 Although we do not expect large market-wide changes in the quality of products, we do expect some products to be affected. In the life insurance and pensions markets, the increase in the risk sensitivity of capital requirements may lead insurers to pass more risk onto consumers by modifying their products, for example by offering more unit or index-linked products and lower returns for guaranteed return policies and annuities.

22.10 We expect Solvency II to improve the quality of risk management and governance of insurance companies, with a positive impact on their ability to meet claims. We would expect commercial buyers of insurance and brokers to be aware of improvements in

insurers' ability to meet claims. To the extent that these buyers factor this type of quality improvement into their purchasing decisions, it can counteract the potential negative impacts on the quality of cover available.

Impact on variety of products

22.11 If any increases in marginal costs for specific products are significant enough and cannot be passed onto the consumer through higher prices or lower quality, we could see a short-term reduction in the variety of products, as products with narrow profit margins cease to be economically viable and are withdrawn from the market. In the long term, however, we expect Solvency II to foster innovation, by encouraging more capital efficient ways of product manufacture or encouraging firms to enter new markets in the search for diversification benefits. This latter effect is expected to be supported further by reduced barriers to cross-border expansion.

22.12 As risk becomes better reflected in capital requirements and in some cases more expensive for insurers to hold, we expect an increase in the variety of the levels of cover available in the market. This would allow consumers greater choice in the level and detail of cover they desire, but increases in the level of cover would be reflected in higher prices.

Impact on competition

22.13 The impact of Solvency II on particular insurance product markets will depend on the distribution of the cost changes facing the insurers within each market and how this affects how insurers compete, such as the products and prices they offer, and whether it affects the structure of the market, namely insurers' ability and willingness to compete in the market.

22.14 We agree with EY's conclusion that Solvency II is unlikely to substantially reduce competition in the general insurance market, although, as noted above, some products might be particularly affected, depending on the final regime. We reach this conclusion for a number of reasons. The increase in costs is a small proportion of the overall size of the industry and while the costs of Solvency II are significant they do not appear large enough to significantly change the costs of providing insurance and therefore will not cause widespread changes in market participation or the competition with these markets. Insurance markets tend to be competitive, meaning insurers are not able to earn profits in excess of the cost of capital, and barrier to entry and exit are not high. Exit by some competitors, as the costs of Solvency II makes them uncompetitive, may not affect competition greatly as new competitors may arise as insurers diversify into new markets to benefit from lower capital costs.

23

Financial market Impacts

Asset allocation

23.1 Solvency II imposes a risk-based system of capital requirements. As the EY report recognises this could be expected to push insurers' allocation of assets away from those deemed to be high risk and carrying larger capital requirements and into assets that trigger lower capital charges. For firms that use the standard formula, this could involve moving away from equities, lower-rated and longer-term corporate debt and structured products, and into government bonds and high-quality corporate debt, although investment incentives will depend on the final form of the level 2 measures. However, EY does not expect Solvency II to result in large-scale reallocations of the assets insurers hold, for a number of reasons:

- the UK already has a risk-based system of capital requirements through ICAS, reducing the magnitude of Solvency II for UK insurers compared to insurers in other European countries;
- many large insurers may use an internal model, which would tailor capital requirements better than the standard formula;
- regulatory capital requirements are only one driver of an insurer's asset allocation decision, with considerations such as matching asset maturities to liabilities, their own risk profile and strategic investment decisions being important factors;
- increased diversification benefits provide an incentive to maintain a range of investments, including equities and other assets that attract higher capital requirements;
- any increase in the use of reinsurance would enable insurers to transfer risk; and
- unit or index-linked products, which we expect to be increasingly used, enable insurers to pass investment risk onto consumers.

23.2 While it is possible that we will see some movement between long-term to short-term debt, EY does not expect this to be large or sudden because insurers already take into account

matching assets to liabilities in their investment decision-making. It would be possible for insurers to use derivatives to match their liabilities while investing in short-term debt; however, derivatives incur capital charges as well, limiting this approach.

23.3 As EY point out, we have seen a movement out of equities into debt over the last few years. Solvency II could accelerate this change, but for the reasons mentioned, we do not expect this effect to be large.

23.4 EY does anticipate some reduction in insurers' exposure to structured products and lower-rated debt, both as a response to Solvency II and because of their perceived increase in risk over the last few years. However, these do not account for a large proportion of insurers' holdings and, for the reasons mentioned, any reallocation is likely to be limited.

23.5 Our overall conclusion – that while Solvency II has the potential to affect insurers' asset allocations, it is unlikely to cause large-scale changes – is supported by the EY report.

Impact on capital markets

23.6 If we see insurers move their investments away from equities, lower-quality debt and structured products, it is possible that entities that use the instruments to raise finance will face an increased cost of capital because of the reduction in demand. However, we do not expect this effect to be large, as we do not expect a large-scale reallocation of assets.

23.7 If insurers need to raise significant levels of capital in response to Solvency II, this could raise the cost of capital and 'crowd out' investment, especially in combination with Basel III. However, recent studies suggest a gradual adjustment to the new regulatory regimes, so we believe crowding out is unlikely to occur.[32]

32 See page 62 of Volume III of EY's report – *Solvency II Cost Benefit Analysis*

24 Benefits

Introduction

24.1 Solvency II is a risk-based regulatory framework. By requiring insurance firms to evaluate risks on both the asset and liability sides of the balance sheet and assess the true costs attached to them, Solvency II aims to better align regulatory supervision with business practice, and improved risk management. Solvency II is therefore likely to encourage a shift in the focus of firms' senior management from underwriting results to integrated risk management. Better risk management could in turn reduce the probability of firm failure.

24.2 EY considered whether it might be possible to quantify the impact of higher capital requirements on the probability of firm default and thereby on the expected costs of the failure of insurers. They also explored ways of quantifying wider economy impacts. However, EY concluded that it was not possible to quantify such benefits because of data limitations, for example a lack of quantitative firm-specific information on key variables such as the quality of management and corporate governance improvements which might be expected to affect rating agencies' evaluation of the probability of firm default.

24.3 We developed a model-based methodology for quantifying the relationship between changes in bank capital requirements and national output, so we sought external expert advice on whether the approach could be extended to cover the impact on the macroeconomy of changes in insurers' capital requirements.[33] However, we were advised that this would not be possible, again because of data constraints.

Risk management and governance

24.4 In their response to EY's survey of compliance impacts, insurers reported that they expected to realise commercial benefits as a result of the improvements in risk management and governance associated with Solvency II. Although the insurers could not quantify these benefits, they confirmed that they expected improvements in both risk modelling as well as governance to materially improve decision making. They also told EY that better

33 NIESR (2009) *Optimal Regulation of Bank Capital and Liquidity: How to Calibrate New International Standards*, FSA Occasional Paper 38

documentation, stronger internal controls and higher quality management information were also important benefits of Solvency II.

Risk pricing and capital allocation

24.5 The SCR under Solvency II is designed to better reflect an insurance company's true risk profile than current regulatory requirements across Europe. Moreover, insurers will also be able to use internal models to calculate their capital requirements, and we know that firms are investing heavily to improve model and data quality. Whether firms use the standard formula or an internal model to calculate capital requirements, it is reasonable to expect improvements in risk modelling to be reflected in better pricing of insured risks. EY noted, for instance, that a possible outcome of the increased alignment between risk pricing and capital allocation would be a reduction in the scope for cross-subsidisation. Similarly, we might reasonably expect improvements in risk pricing, governance and risk management to result in a more efficient allocation of capital by insurers.

24.6 The benefit of improved capital allocation is realised in the form of improved profitability within the risk tolerances set by firms. Such gains accrue either to policyholders, in the case where profits are retained, or to shareholders, where capital can be appropriately released through dividends (without a material reduction in policyholder protection). The extent of these gains is likely to be lower for UK insurers than for insurers based in other EEA countries because our current regime is more risk-sensitive. Nevertheless, the gains to UK insurers are still likely to be material given the potential for improvements in the accuracy of risk modelling and in the effectiveness of governance procedures.

24.7 To the extent to which mis-pricing of risks contributes to the insurance underwriting cycle, improvements in risk pricing, together with improvements in governance arrangements and risk management, could have a dampening effect on the cycle.

24.8 The changes introduced by Solvency II can lead to improvements of capital allocation across the insurance sector by investors. In the longer term improved disclosure to the market of the risks taken by firms should enable analysts and investors to understand the risk-return profile of insurance companies better. This should help investors select insurers that offer the best level of return relative to the risk, enabling more productive insurers to grow. This supports opportunities for insurers to expand underwriting while maintaining effective risk management and underwriting controls, allowing competitive forces to work to the benefit of policyholders, and the wider economy.

Probability of default and policyholder benefits

24.9 EY argued that the Solvency II three-pillar approach is likely to reduce the probability of firm default. Firstly, better alignment of capital requirements to firms' asset and liability profiles (Pillar 1) together with more pro-active risk management and monitoring of firms'

individual risk profiles (Pillar 2) should encourage insurers to re-evaluate and restructure their product/risk portfolios, in terms of the trade-off between profitability and risk.

24.10 Secondly, public disclosure and transparency (Pillar 3) are likely to facilitate the effective exercise of market discipline, since analysts and rating agencies will have significantly better information on firms' risk exposures.

24.11 Thirdly, Solvency II is designed to facilitate more effective supervision of insurers, not only on a solo basis but also on a group basis, for example through the effective use of supervisory colleges. The ORSA, in presenting a forward-looking assessment of risks to the firm's business model, together with more detailed reporting to supervisors, should yield material benefits by helping supervisors to build up a more detailed picture of the risks faced by individual firms and groups, and of emerging risks across the sector. It is also expected to raise the quality of supervision through improvements in the benchmarking of firms across different types of business model.

24.12 Taken together, these effects yield benefits to policyholders by addressing problems that arise because purchasers of insurance, especially retail consumers, find it difficult to assess the likelihood that their insurer will default and be unable to meet all their claims. As a result the risk of insurer default is not taken into account by consumers and priced into the insurance premium. So insurers have an incentive to take higher risks of default which can result in unexpected costs being imposed on policyholders and potentially the Financial Services Compensation Scheme (FSCS). By reducing the probability of default it is less likely that these unanticipated costs will occur.

24.13 In practice, our analysis of capital impacts suggests that the majority of firms are unlikely to have to hold extra capital as a result of Solvency II implementation. This suggests that increased capital levels are unlikely to contribute significantly to a lower likelihood of failure by firms. We expect, however, that in the longer term improvements in risk management and governance will reduce this likelihood of failure.

Cost of capital

24.14 A reduced likelihood of failure could be reflected in a lower cost of capital for insurance firms since rating agencies will take these elements of a firm's business model into account when determining its credit rating.

Volatility of financial markets

24.15 EY concluded that firms are likely to be more proactive in their asset-liability management to mitigate and retain capital buffers against the risk of volatile capital requirements arising from a market consistent Solvency II balance sheet, limiting sudden shifts in their portfolio of assets. By using the symmetric adjustment mechanism for equities built into Solvency II and the extension of the period of recovery to meet capital requirements following a crisis, the actions of supervisory authorities should also help to mitigate the risk of amplifying

financial volatility. So there should be more consistent decision-making across supervisory authorities than currently. The actions of firms and supervisory authorities combined with improved public disclosure of assets and communication of the supervisory approach should help to mitigate some of the effects of financial volatility.

Competitiveness

24.16 Solvency II has the potential to affect the competitiveness of UK insurers, both in relation to other EEA-based insurers and in relation to insurers in markets across the world. Within the European market, complying with Solvency II may present less of a challenge for UK insurers compared to firms in other countries, for example because UK-based insurers already have to meet risk-based capital requirements. The greater extent of the transition required in other Member States could put UK firms at a competitive advantage in the short run.[34] The extent of these benefits will, in practice, depend on factors such as the extent of insurance market integration across the EU, which is itself expected to increase as a result of the harmonising aspects of Solvency II. The competitiveness benefits from harmonisation are, nevertheless, likely to be limited largely to commercial insurance product markets.

24.17 The competitive position of EEA insurers relative to insurers in other jurisdictions is likely to be affected positively as a result of cost savings, particularly for groups, arising from harmonised reporting requirements but negatively by the extent of other implementation and on-going compliance costs. Several key overseas jurisdictions have signalled their intention to apply for equivalence with Solvency II. We would then expect firms operating in third country regimes deemed as equivalent to have similar costs to firms based in the EEA. Another mitigating factor is that commercial buyers of insurance and brokers could trade off price increases against the improved ability of UK insurers to meet claims.

34 Fitch (2011) *Solvency II Set to Reshape Asset Allocation and Capital Markets*

Annex 1

Diversity Impact Assessment

Overall conclusion

1. The Directive makes no direct reference to equality or diversity issues, either in terms of capital requirements, internal governance or in how they treat their customers and policyholders. However, in transposing and implementing EU legislation on to the UK statute book, we are obliged to consider any equality issues that may arise.

2. The implementation of the Directive is not considered to have any direct or indirect discriminatory impact under existing UK equality law.

Consideration

3. In line with its public sector duty under the Equality Act 2010, we identified the following areas where the impact of Solvency II might require comment:

- the burden on firms, particularly small firms, in having to hold and maintain higher levels of capital relative to their portfolios;
- the need for firms to institute/maintain an effective internal system of governance for sound and prudent management of the business; and
- any other areas that might impact on discriminatory practices by firms in relation to their policyholders and shareholders.

Higher capital requirements

4. Firms' upgrading of capital to meet new solvency requirements should not directly impinge on the pricing and underwriting of insurance contracts to the detriment of consumers. Whilst such actions may be more critical for smaller or niche firms with limited capital-raising ability and customer base, there is still no suggestion that this will lead to discrimination

either between different types of policy holders or against 'protected groups' of people defined under the Equality Act.

5. HM Treasury guidance in 2008, on the application of the EU Gender Directive in the UK, specifically excluded loadings from capital and solvency requirements in the assessment of risk relating to the differences between men and women.

Effective system of governance

6. Although we do not believe that the Directive will have any direct or indirect discriminatory effects on firms' internal governance, firms will be expected to have in place appropriate procedures and persons plus a remuneration policy that promotes sound risk management and does not induce excessive risk taking.

7. We have therefore carried out a compatibility study with the Remuneration Code EIA under the Capital Requirements Directive (CRD) legislation to determine whether there are any aligned or common factors. As a result, we are considering actions under our 'due regard' duty to promote equality and foster good relations by:

- ensuring as part of our on-going supervisory responsibilities that firms' Boards are familiar with their equality obligations under existing legislation; and
- taking the opportunity, in a proportionate way, when looking at specific governance arrangements mandated under Solvency II to consider diversity related points.

Other areas

8. We do not believe that there are any other areas of Solvency II implementation that would need to be assessed under Equality Act provisions.

Annex 2

Compatibility Statement

1. This Annex sets out our views on how the proposals to transpose Solvency II into UK law are compatible with our objectives and the principles of good regulation. This statement applies to the population of insurance firms covered by Solvency II.

Compatibility with our statutory objectives

2. The transposition of the Directive in our Handbook as set out in this CP aims, primarily, to meet our objective of consumer protection. However, other statutory objectives are also relevant.

Consumer protection

3. Our objective here is to secure the appropriate degree of protection for consumers. Transposing Solvency II into UK law provides a significantly enhanced prudential regime with the key aim of providing greater policyholder protection.

Market confidence

4. Solvency II provides for a foundation of:

- market-consistent valuation for assets and liabilities;
- risk-sensitive capital requirements;
- a requirement to apply stresses to both assets and liabilities;
- a much stronger emphasis on risk management and forward-looking governance; and
- greater market discipline through increased public disclosure.

5. This will give supervisors and markets greater clarity of firms' solvency positions and business models. The harmonised regime means this will now also apply across Europe.

This will enhance supervisors' and markets' understanding of the sector as a whole as well as of individual firms.

6. The requirements of Solvency II should also result in improved stress resilience and a reduced risk of firm failure. Ensuring the stability of UK insurance firms should maintain trust and confidence in UK insurance markets.

Financial stability

7. There are also macroeconomic benefits linked to a more resilient insurance sector, due to a risk-based regime. Long-term benefits include stable financing to industry arising from the investment activities of insurers and more secure insurance for industry and consumers.

Reduction in financial crime

8. Solvency II is not directly aimed at reducing the incidence of financial crime.

Compatibility with the need to have regard to the principles of good regulation

9. Under Section 2 (3) of FSMA, we must consider the specific matters set out below, when carrying out our functions.

Efficiency and economy

10. This is the first consultation paper in a more extensive and iterative process on the transposition of Solvency II. This approach allows us to consult in a timely manner, providing as much clarity as possible in preparation for implementation of Solvency II. We are consulting in CP1 where we have sufficient certainty to do so – on the level 1 Directive principles. A second planned consultation provides an opportunity to make amendments to CP1 following ongoing European policy developments.

11. Our approach to implementation is designed to ensure that we use our resources efficiently. These include:

- using 'intelligent copy-out' wherever appropriate, adhering to the wording of the Directive as closely as possible; and
- having due regard, where appropriate, to the decisions and/or work of other supervisory authorities and international forums.

Role of management

12. Solvency II emphasises the role of management in ensuring pro-active and forward looking risk management and the incorporation of risk management in all strategic decisions. Solvency II introduces the prudent person investment principle across the insurance market (currently already implemented for reinsurers). This grants firms greater investment freedom, but places greater responsibility on management by requiring them to assess the risks posed by those investments and exercise the necessary prudence.

Principle that a burden or restriction should be proportionate to the benefits, considered in general terms, expected to result from imposing that burden or restriction

13. We have undertaken a comprehensive cost benefit analysis to help inform this consultation and commissioned external experts (EY) to provide input. The EY report is published alongside this CP and the additional cost benefit analysis undertaken by us is found in Section IV.

14. The results of our CBA indicate that the costs of implementing Solvency II requirements transposed in this CP will be proportionate to the benefits provided.

15. Differences of opinion may arise over the nature and extent of some of the impacts we have covered. We would welcome the input of respondents in helping us identify such areas, and other potentially significant areas.

Desirability of facilitating innovation in connection with regulated activities

16. By aligning capital requirements more closely with risks, Solvency II will encourage improvement in the insurance industry's risk management practices. This should improve the efficiency of capital allocation and facilitate innovation, both for risk management and product development.

International character of financial services and markets and the desirability of maintaining the competitive position of the UK

17. The harmonised Solvency II regime across Europe aims to develop a level playing field for insurers operating across different Member States. It also seeks to achieve consistent regulatory approaches and supervisory practices, and improved frequency and quality of disclosure.

18. Although Solvency II is mainly maximum harmonising, in the areas where we have the option to make a discretionary decision we have taken account of the competitive implications between firms based in the UK and in other countries.

Need to minimise the adverse effects on competition that may arise from anything done in the discharge of the FSA's functions

19. The cost benefit analysis undertaken indicates that the proposed changes resulting from transposition of Solvency II should not have material adverse effects on competition. We would welcome comments on this.

Desirability of facilitating competition between those who are subject to any form of regulation by us

20. Solvency II is designed to introduce more risk-sensitive capital requirements and promote effective risk management and governance across the insurance sector. This, in turn, should facilitate more effective competition across the wider financial sector.

Annex 3:
List of Questions

Chapter 3 – Approach to consultation

Q1: We welcome views on our approach to the overall consultation process proposed to transpose Solvency II: a first consultation (CP1) on the Directive requirements that have most certainty at this stage in the European process, followed by a second consultation in 2012 (CP2) once there is more certainty on Omnibus II, levels 2 and 3 and the UK legislation has been finalised.

Chapter 4 – Approach to transposition

Q2: Do you have views regarding the clarity of our rules included in CP1, bearing in mind the limited scope for discretion?

Chapter 7 – The Solvency Capital Requirement (SOLPRU4)

Q3: Do you agree with our approach to the Member State option outlined in Article 304?

Chapter 8 – The Minimum Capital Requirement (SOLPRU5)

Q4: Do you agree that we should exercise the case-by-case option in Article 129(3), for example when the internal model result has temporarily deviated from the risk profile for the firm and the standard formula is a better fit? Do you have views on any other situations where it would be appropriate to use this option?

Chapter 11 – Composites (SOLPRU8)

Q5: Do you agree with the approach suggested in this Chapter in relation to separate management of life and non-life business for composite firms?

Q6: Do you have any further comments on our proposals for the Handbook rules relating to composite firms?

Chapter 12 – Conditions governing business (SOLPRU9)

Q7: Do you consider that the APR is the appropriate method for us to implement the Article 42 requirements regarding receiving notifications and making assessments on personnel?

Q8: Do you agree with our approach to assessing third party providers where a key function has been outsourced?

Chapter 14 – Groups (SOLPRU11)

Q9: Do you agree with the way we are proposing to exercise the Member State option in Article 227?

Q10: Do you agree with the way we are proposing to exercise the Member State option in Article 225?

Chapter 16 – SUP 10

Q11: Do you agree with our proposed approach to those currently approved for CF28 because of their finance responsibilities? Or do you think one of the alternative options discussed above would be preferable?

Annex 1: Diversity Impact Assessment

Q12. Do stakeholders agree with our findings of this Diversity Impact Assessment?

Appendix

Draft Handbook text

SOLVENCY II INSTRUMENT 2012

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 141 (Insurance business rules);
(3) section 149 (Evidential provisions);
(4) section 150(2) (Action for damages);
(5) section 156 (General supplementary powers); and
(6) section 157(1) (Guidance).

B. The provisions listed above relevant to making rules are specified for the purposes of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Making the Prudential sourcebook for Solvency II Insurers (SOLPRU)

D. The Financial Services Authority makes the rules and gives the guidance in Annex A to this instrument.

Amendments to the Handbook

E. The Glossary of definitions is amended in accordance with Annex B to this instrument.

F. The Supervision manual (SUP) is amended in accordance with Annex C to this instrument.

Notes

G. In the Annexes to this instrument, the "notes" (indicated by "**Note:**") are included for the convenience of readers but do not form part of the legislative text.

Citation

H. This instrument may be cited as Solvency II Instrument 2012.

I. The sourcebook in Annex A to this instrument (including its schedules) may be cited as the Prudential sourcebook for Solvency II Insurers (or SOLPRU).

By order of the Board
[*date*]

Annex A

Making the Prudential sourcebook for Solvency II Insurers (SOLPRU)

In this Annex all of the text is new and is not underlined.

1 Application and purpose

[Editorial note: text on the broad application and purpose of the sourcebook will be included in the second consultation paper on the *Solvency II Directive*, along with any further amendments to the individual application provisions already drafted at the beginning of each chapter.]

2 Valuation

2.1 Application

2.1.1 R *SOLPRU* 2 applies to a *UK Solvency II firm*.

2.2 Valuation of assets and liabilities

2.2.1 R *Firms* must value:

(1) assets at the amount for which they could be exchanged between knowledgeable willing parties in an arms' length transaction; and

(2) liabilities at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arms' length transaction.

[**Note**: article 75(1) of the *Solvency II Directive*]

2.2.2 R For the purposes of *SOLPRU* 2.2.1R(2), when valuing liabilities no adjustment must be made to take account of the own credit standing of the *firm*.

[**Note**: article 75(1) of the *Solvency II Directive*]

2.2.3 G Articles [ ] of the *Solvency II Regulation* lay down the methods and assumptions that must be used when valuing assets and liabilities.

2.3 Rules relating to technical provisions

General provisions

2.3.1 R *Firms* must establish adequate *technical provisions* with respect to all of

their insurance and reinsurance obligations towards *policyholders*.

[**Note**: article 76(1) of the *Solvency II Directive*]

2.3.2 R The value of *technical provisions* must correspond to the current amount that the *firm* would have to pay if it were to transfer its insurance and reinsurance obligations immediately to another *Solvency II undertaking*.

[**Note**: article 76(2) of the *Solvency II Directive*]

2.3.3 R *Firms* must calculate their *technical provisions*:

(1) such that the calculation makes use of and is consistent with information provided by the financial markets and generally available data on *underwriting risks* (market consistency);

(2) in a prudent, reliable and objective manner;

(3) taking into account the principles set out in *SOLPRU* 2.2; and

(4) in accordance with *SOLPRU* 2.4.1R to *SOLPRU* 2.4.13R.

[**Note**: article 76(3)–(5) of the *Solvency II Directive*]

2.4 Calculation of technical provisions

2.4.1 R The value of *technical provisions* must be equal to the sum of a *best estimate* and a *risk margin* which must be calculated in accordance with *SOLPRU* 2.4.2R to *SOLPRU* 2.4.6R.

[**Note**: article 77(1) of the *Solvency II Directive*]

2.4.2 R (1) Where:

(a) future cash flows associated with insurance or reinsurance obligations can be replicated reliably; and

(b) that replication is provided using financial instruments; and

(c) those financial instruments have a reliable market value which is observable;

then the value of *technical provisions* associated with those future cash flows must be determined on the basis of the market value of those financial instruments.

(2) Where (1) does not apply, then *firms* must value the *best estimate* and the *risk margin* separately.

[**Note**: article 77(4) of the *Solvency II Directive*]

The best estimate

2.4.3 R The *best estimate* must:

(1) correspond 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 risk-free interest rate term structure*; and

(2) be calculated:

(a) based upon up-to-date and credible information and realistic assumptions;

(b) using adequate, applicable and relevant actuarial and statistical methods; and

(c) gross, without deduction of the amounts recoverable from *reinsurance contracts* and *ISPV*s, which *firms* must calculate separately in accordance with *SOLPRU* 2.4.11R.

[**Note**: article 77(2) of the *Solvency II Directive*]

2.4.4 R The cashflow projection used in the calculation of the *best estimate* (whether valued separately or determined on the basis of financial instruments in accordance with *SOLPRU* 2.4.2R) must take into account all the cash in- and out-flows required to settle the insurance and reinsurance obligations over their lifetime.

[**Note:** article 77(2) of the *Solvency II Directive*]

The risk margin

2.4.5 R Where *firms* value the *best estimate* and *risk margin* separately, the *risk margin* must be an amount equal to the cost that a *Solvency II undertaking* would incur in order to hold *eligible own funds* to cover the *SCR* necessary to support the insurance and reinsurance obligations over their lifetime, determined using the *cost-of-capital rate*.

[**Note**: article 77(5) of the *Solvency II Directive*]

2.4.6 R The *risk margin* must be such as to ensure that the value of the *technical provisions* is equivalent to the amount that a *Solvency II undertaking* would be expected to require in order to take over and meet the insurance and reinsurance obligations over their lifetime.

[**Note**: article 77(3) of the *Solvency II Directive*]

2.4.6A G *Firms* should note the requirement set out in *SOLPRU* 4.28.6R. *SOLPRU* 4.28.6R provides that, for the purposes of calculating the *risk margin*, the *SCR* of a *firm* must not include any *capital add-on* imposed as a result of a *significant system of governance deviation*.

Other elements to be taken into account in the calculation of technical provisions

2.4.7 R When calculating *technical provisions*, *firms* must take into account:

(1) all expenses that will be incurred in servicing insurance and reinsurance obligations;

(2) inflation, including expenses and *claims* inflation; and

(3) all payments to *policyholders*, including future discretionary bonuses, which *firms* expect to make, whether or not those payments are contractually guaranteed.

[**Note**: article 78 of the *Solvency II Directive*]

[2.4.8 G For the purposes of *SOLPRU* 2.4.7R(3), a *firm* may exclude *approved surplus funds* if it obtains a *waiver* of *SOLPRU* 2.4.7R(3) under section 148 of the *Act*.]

Valuation of financial guarantees and contractual options included in insurance and reinsurance contracts

2.4.9 R (1) When calculating *technical provisions*, *firms* must take account of the value of financial guarantees and any contractual options included in *contracts of insurance* and *reinsurance contracts*.

(2) Any assumptions used by a *firm* to determine the likelihood that *policyholders* will exercise contractual options, including lapses and surrenders, must:

(a) be realistic and based on current and credible information; and

(b) take into account, either explicitly or implicitly, the impact that future changes in financial and non-financial conditions may have on the exercise of those options.

[**Note**: article 79 of the *Solvency II Directive*]

Segmentation

2.4.10 R When calculating *technical provisions, firms* must segment their insurance and reinsurance obligations into homogenous risk groups and, as a minimum, by lines of business.

[**Note**: article 80 of the *Solvency II Directive*]

Recoverables from reinsurance contracts and insurance special purpose vehicles

2.4.11 R (1) *Firms* must calculate amounts recoverable from *reinsurance contracts* and *ISPV*s in accordance with *SOLPRU* 2.4.1R to *SOLPRU* 2.4.10R.

(2) For the purposes of (1), *firms* must take into account the time

difference between amounts becoming recoverable and the actual receipt of those amounts.

(3) *Firms* must adjust the calculation referred to in (1) to take into account expected losses due to the default of the counterparty. That adjustment must be based on an assessment of the probability of default of the counterparty and the average loss that would result from that default (loss-given-default).

[**Note**: article 81 of the *Solvency II Directive*]

Data quality and application of approximations, including case-by-case approaches, for technical provisions

2.4.12 R *Firms* must ensure that the data used in the calculation of their *technical provisions* is appropriate, complete and accurate.

2.4.13 R Where *firms* have insufficient data of appropriate quality to apply a reliable actuarial method to a set or subset of their insurance and reinsurance obligations, or amounts recoverable from their *reinsurance contracts* and *ISPVs, firms* may use appropriate approximations, including case-by-case approaches, in the calculation of the *best estimate.*

[**Note**: article 82 of the *Solvency II Directive*]

2.4.13A G Article [ ] of the *Solvency II Regulation* sets out the specific circumstances in which it would be appropriate to use approximations to calculate the best estimate.

Comparison against experience

2.4.14 R (1) *Firms* must ensure that the *best estimate*, and the assumptions underlying the calculation of the *best estimate*, are regularly compared against experience.

(2) Where a systematic deviation exists between the *firm's best estimate* calculation and experience, the *firm* must make appropriate adjustments to the actuarial methods being used and/or the assumptions being made to ensure that the *best estimate* is calculated in accordance with *SOLPRU* 2.3 and *SOLPRU* 2.4.1R to *SOLPRU* 2.4.13R.

[**Note**: article 83 of the *Solvency II Directive*]

2.4.15 G *SOLPRU* 9.4.3R and *SOLPRU* 9.4.4R set out internal control requirements relating to the data used in the calculation of *technical provisions* and the comparison against experience.

Appropriateness of the level of technical provisions

2.4.16 R Upon request by the *FSA*, the *firm* must demonstrate to the *FSA*:

(1) the appropriateness of the level of the *firm's technical provisions*;

(2) the applicability and relevance of the methods applied; and/or

(3) the adequacy of the underlying statistical data used.

[**Note:** article 84 of the *Solvency II Directive*]

Increase of technical provisions

2.4.17 G If a *firm's* calculation of *technical provisions* does not comply with *SOLPRU* 2.4.1R to *SOLPRU* 2.4.14R, the *FSA* may use its powers under the *Act* to require the *firm* to increase the amount of *technical provisions* so that they correspond to the level determined in accordance with those *rules*.

[**Note:** article 85 of the *Solvency II Directive*]

3 Own funds

3.1 Application

3.1.1 R *SOLPRU* 3 applies to a *UK Solvency II firm.*

3.2 Determination of own funds

3.2.1 R A *firm's own funds* must comprise the sum of its *basic own funds* and *ancillary own funds*.

[**Note:** article 87 of the *Solvency II Directive*]

3.2.2 R The *firm's basic own funds* must consist of the following items:

(1) the excess of assets over liabilities, less the amount of own *shares* held by the *firm*; and

(2) subordinated liabilities.

[**Note:** article 88 of the *Solvency II Directive*]

3.2.3 G *SOLPRU* 2 sets out *rules* and *guidance* relating to the valuation of a *firm's* assets and liabilities.

3.2.4 R The *firm's ancillary own funds* must, subject to *SOLPRU* 3.2.6R, consist of items (other than items of *basic own funds*) which can be called up to absorb losses, including the following (to the extent that they are not items of *basic own funds*):

(1) unpaid *share* capital or *initial fund* that has not been called up;

(2) letters of credit and guarantees;

(3) any other legally binding commitments received by the *firm*; and

(4) for a *mutual*, any future claims which it may have against its members by way of a call for supplementary contribution within the next 12 *months*.

[**Note:** article 89(1) of the *Solvency II Directive*]

3.2.5 R Where an item of *ancillary own funds* becomes paid in or called up, the proceeds paid in or the amount due in respect of the call must be treated as an asset and the item must cease to be treated as an item of *ancillary own funds*.

[**Note:** article 89(2) of the *Solvency II Directive*]

3.2.6 R When determining its *own funds*, a *firm* must not take into account any item of *ancillary own funds* unless, subject to *SOLPRU* 3.2.7R, it has received the *FSA's* approval of either:

(1) a monetary amount for the relevant item of *ancillary own funds*; or

(2) the method by which to determine the amount of the relevant item of *ancillary own funds*, together with the amount determined in accordance with that method for a specified time period.

[**Note:** article 90(1) and (3) of the *Solvency II Directive*]

3.2.7 R Where a *firm* has received approval:

(1) under *SOLPRU* 3.2.6R(1), it may only include in its *own funds* the item of *ancillary own funds* for an amount up to the amount approved; or

(2) under *SOLPRU* 3.2.6R(2), it may only include in its *own funds* the item of *ancillary own funds* up to the amount determined using the method approved, and only for the time period for which approval is granted.

[**Note:** article 90(3) of the *Solvency II Directive*]

3.2.8 R A *firm* may only attribute an amount to an item of *ancillary own funds* to the extent that it:

(1) reflects the loss-absorbency of the item; and

(2) is based upon prudent and realistic assumptions.

[**Note:** article 90(2) of the *Solvency II Directive*]

3.2.9 G The *FSA* would not approve an amount under *SOLPRU* 3.2.6R(1) or a method under *SOLPRU* 3.2.6R(2) unless it was satisfied that the amount approved or determined using the approved method reflects the loss absorbency of the item of *ancillary own funds* and is based on prudent and

realistic assumptions. Therefore, where an item of *ancillary own funds* has a fixed nominal value the amount of that item that can be included in a *firm's own funds* will only be equal to its nominal value where that value appropriately reflects its loss-absorbency.

[**Note:** article 90(2) of the *Solvency II Directive*]

3.2.10 G Articles [ ] of the *Solvency II Regulation* set out further requirements relating to applications for the approval of *ancillary own funds* and their assessment.

3.2.11 G Articles [ ] of the *Solvency II Regulation* set out the adjustments that must be made to *own funds* to reflect the lack of transferability of *ring-fenced funds* that can only be used to cover losses arising from a particular segment of liabilities or from particular risks.

[Surplus funds]

3.3 Classification and eligibility of own funds

Classification of own funds into tiers

3.3.1 G The *Solvency II Directive* classifies *own funds* into three tiers, reflecting differences in the quality of *own funds* based on whether the items are *basic own funds* or *ancillary own funds* and the extent to which the *own funds* possess the characteristics of permanent availability and subordination described in article 93 of the *Solvency II Directive. Own funds* which are classified as *Tier 1 own funds* can be used to cover a *firm's MCR* and *SCR* without limit. Other *own funds* items are only eligible to cover the *SCR* and the *MCR* subject to limits and, in the case of *ancillary own funds*, may only be included with the express approval of the *FSA*.

3.3.2 R A *firm* may only include an *own funds* item in its *Tier 1 own funds* if:

(1) it is an item of *basic own funds*; and

(2) it substantially possesses the characteristics set out in *SOLPRU* 3.3.8R(1) and *SOLPRU* 3.3.8R(2), taking into consideration the features set out in *SOLPRU* 3.3.9R.

[**Note**: article 94(1) of the *Solvency II Directive*]

3.3.3 R A *firm* may only include an *own funds* item in its *Tier 2 own funds* if:

(1) where it is an item of *basic own funds*, it substantially possesses the characteristics set out in *SOLPRU* 3.3.8R(2), taking into consideration the features set out in *SOLPRU* 3.3.9R; or

(2) where it is an item of *ancillary own funds*, it substantially possesses the characteristics set out in *SOLPRU* 3.3.8R(1) and *SOLPRU* 3.3.8R(2), taking into consideration the features set out in *SOLPRU*

3.3.9R.

[**Note:** article 94(2) of the *Solvency II Directive*]

3.3.4 R A *firm* may only include in its *Tier 3 own funds* an item of:

(1) *basic own funds* that does not fall within *SOLPRU* 3.3.2R or *SOLPRU* 3.3.3R; and

(2) *ancillary own funds* that does not fall within *SOLPRU* 3.3.3R.

[**Note:** article 94(3) of the *Solvency II Directive*]

3.3.5 G Articles [ ] of the *Solvency II Regulation* set out a list of *own funds* items and the criteria for classifying them as *Tier 1 own funds*, *Tier 2 own funds* or *Tier 3 own funds*.

3.3.6 R (1) In classifying its *own funds* items, a *firm* must refer to the list of *own funds* items set out in articles [ ] of the *Solvency II Regulation*.

(2) A *firm* must not include an *own funds* item in its *Tier 1 own funds*, *Tier 2 own funds* or *Tier 3 own funds* if that *own funds* item is not covered by the list referred to in (1), unless it has received the *FSA's* approval.

(3) When seeking approval to classify an *own funds* item referred to in (2) in its *Tier 1 own funds*, *Tier 2 own funds* or *Tier 3 own funds*, a *firm* must demonstrate that the *own funds* item satisfies the criteria laid down in *SOLPRU* 3.3.2R to *SOLPRU* 3.3.4R for that classification.

[**Note:** article 95 of the *Solvency II Directive*]

3.3.7 G Article 96 of the *Solvency II Directive* contemplates that:

(1) [*approved surplus funds* will normally be classified as *Tier 1 own funds*;]

(2) letters of credit and guarantees which are held on trust for the benefit of *policyholders* by an independent trustee and are provided by credit institutions authorised in accordance with the *Banking Consolidation Directive* will normally be classified as *Tier 2 ancillary own funds*;

(3) any future claims which a *mutual* of shipowners with variable contributions solely insuring risks listed in *general insurance business class* 6 (ships), *class* 12 (liability of ships) and *class* 17 (legal expenses), may have against their members by way of a call for supplementary contributions within the next 12 *months* will normally be classified as *Tier 2 ancillary own funds*; and

(4) any future claims which a *mutual* with variable contributions may have against their members by way of a call for supplementary

contributions within the next 12 *months* which do not fall within *SOLPRU* 3.3.7R(3) will normally be classified as *Tier 2 ancillary own funds* where they substantially possess the characteristics set out in *SOLPRU* 3.3.3R(2).

The classification of the items referred to in (1) to (4) will depend on the extent to which they satisfy the requirements in *SOLPRU* 3.3.2R to *SOLPRU* 3.3.6R and articles [ ] of the *Solvency II Regulation*, which set out requirements relating to the classification of *own funds*.

[**Note:** article 96 of the *Solvency II Directive*]

3.3.8 R The characteristics referred to in *SOLPRU* 3.3.2R to *SOLPRU* 3.3.3R are:

(1) the item is available, or can be called up on demand, to fully absorb losses on a going-concern basis as well as in the case of winding up (permanent availability); and

(2) 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 (subordination).

[**Note:** article 93(1) of the *Solvency II Directive*]

3.3.9 R When assessing the extent to which *own fund* items possess the characteristics set out in *SOLPRU* 3.3.8R, currently and in the future, a *firm* must consider:

(1) 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);

(2) whether the item is free from requirements or incentives to redeem the nominal sum (absence of incentives to redeem);

(3) whether the item is free from mandatory fixed charges (absence of mandatory servicing costs); and

(4) whether the item is clear of encumbrances (absence of encumbrances).

[**Note:** article 93(2) of the *Solvency II Directive*]

Eligibility and limits applicable to tiers

3.3.10 G *SOLPRU* 4.2.1R requires a *firm* to hold *eligible own funds* to cover its *SCR* and *SOLPRU* 5.2.1R requires a *firm* to hold *eligible own funds* to cover its *MCR*.

3.3.11 R As far as compliance with its *SCR* is concerned*:*

(1) more than one-third of the total amount of the *firm's eligible own funds* must be accounted for by *Tier 1 own funds*; and

(2) less than one-third of the *firm's eligible own funds* must be accounted for by *Tier 3 own funds.*

[**Note:** article 98(1) of the *Solvency II Directive*]

3.3.12 R As far as compliance with its *MCR* is concerned, more than 50% of the *firm's eligible own funds* must be accounted for by *Tier 1 own funds*.

[**Note:** article 98(2) of the *Solvency II Directive*]

3.3.13 G Article [ ] of the *Solvency II Regulation* sets out further limits regarding the proportion of certain *Tier 1 own funds, Tier 2 own funds* and *Tier 3 own funds* which can be included in a *firm's eligible own funds* to cover the *firm's SCR* and *MCR*.

4 Solvency capital requirement

General

4.1 Application

4.1.1 R *SOLPRU* 4 applies to a *UK Solvency II firm.*

4.2 Requirement to hold eligible own funds covering the SCR

4.2.1 R A *firm* must hold *eligible own funds* covering its *SCR*.

4.3 General provisions for the calculation of the SCR

4.3.1 R A *firm* must calculate its *SCR* either in accordance with the *standard formula* or using an *internal model* for which *internal model approval* has been granted.

[**Note:** article 100 of the *Solvency II Directive*]

4.3.2 R A *firm* must calculate its *SCR* on the presumption that it will pursue its business as a going concern.

[**Note**: article 101(2) of the *Solvency II Directive*]

4.3.3 R A *firm's SCR*:

(1) must be calibrated to ensure that all quantifiable risks to which the *firm* is exposed are taken into account, including at least the non-life

underwriting risk; life *underwriting risk*; health *underwriting risk*; *market risk*; *credit risk*; and *operational risk*; and

(2) with respect to existing business, must cover only unexpected losses.

[**Note**: article 101(3)–(4) of the *Solvency II Directive*]

4.3.4 R A *firm's SCR* must correspond to the value-at-risk of its *basic own funds* subject to a confidence level of 99.5% over a one-year period.

[**Note**: article 101(3) of the *Solvency II Directive*]

4.3.5 R When calculating the *SCR*, *firms* must take account of the effect of *risk-mitigation techniques*, provided that *credit risk* and other risks arising from the use of *risk-mitigation techniques* are properly reflected in the *SCR*.

[**Note:** article 101(5) of the *Solvency II Directive*]

4.3.6 G *SOLPRU* 4.6.1R to *SOLPRU* 4.10.2G contain provisions relating to the calculation of the *SCR* in accordance with the *standard formula*. Provisions relating to the calculation of the *SCR* with a full or partial *internal model* are contained in *SOLPRU* 4.12 to *SOLPRU* 4.27.

4.3.7 G Article [ ] of the *Solvency II Regulation* sets out requirements in respect of the calculation of the *SCR*.

4.3.8 G *SOLPRU* 4.28.5R provides that, except as specified in *SOLPRU* 4.28.6R, the *SCR* prior to the imposition of a *capital add-on*, together with the amount of the *capital add-on*, must constitute a *firm's SCR*.

4.4 Frequency of calculation of SCR

4.4.1 R A *firm* must calculate its *SCR* and report the results of that calculation to the *FSA* at least once a year.

[**Note**: article 102(1) of the *Solvency II Directive*]

4.4.2 R For the purposes of *SOLPRU* 4.2.1R, a *firm* must hold *eligible own funds* which cover its last reported *SCR*.

[**Note**: article 102(1) of the *Solvency II Directive*]

4.4.3 R A *firm* must monitor the amount of its *eligible own funds* and its *SCR* on an ongoing basis.

[**Note**: article 102(1) of the *Solvency II Directive*]

4.4.4 R If a *firm's* risk profile deviates significantly from the assumptions underlying its last reported *SCR*, the *firm* must recalculate its *SCR* without delay and report it to the *FSA*.

[**Note**: article 102(1) of the *Solvency II Directive*]

4.4.5 R If requested by the *FSA* where there is evidence to suggest that the risk profile of a *firm* has altered significantly since the date on which the *SCR* was last reported by it, the *firm* must recalculate its *SCR*.

[**Note:** article 102(2) of the *Solvency II Directive*]

Standard formula

4.5 SCR standard formula: structure of the standard formula

4.5.1 R For a *firm*, the *SCR* on the basis of the *standard formula* is the sum of the following items:

(1) the *basic SCR*;

(2) the capital requirement for *operational risk*, as set out in *SOLPRU* 4.8.1R to *SOLPRU* 4.8.3R; and

(3) the adjustment for the loss-absorbing capacity of *technical provisions* and deferred taxes, as set out in *SOLPRU* 4.9.1R to *SOLPRU* 4.9.2R.

[**Note:** article 103 of the *Solvency II Directive*]

4.6 The basic SCR

4.6.1. G The *basic SCR* for a *firm* comprises individual risk modules which are aggregated in accordance with a formula contained in article [ ] of the *Solvency II Regulation*. The *basic SCR* covers the non-life *underwriting risk* module, the life *underwriting risk* module, the health *underwriting risk* module, the *market risk* module, the counterparty default risk module and the intangible asset risk module.

4.6.2 EU The formula for the calculation of the *basic SCR* contained in article [ ] of the *Solvency II Regulation* is;

$$Basic\ SCR = \sqrt{\sum_{i,j} Corr_{i,j} \times SCR_i \times SCR_j} + SCR_{\text{intangibles}}$$

4.6.3 R For the purposes of the formula referred to in *SOLPRU* 4.6.2EU:

(1) 'SCR_i' and 'SCR_j' denote the non-life *underwriting risk* module, the life *underwriting risk* module, the health *underwriting risk* module, the *market risk* module and the counterparty default risk module;

(2) 'i,j' means that the sum of the different terms should cover all possible combinations of 'i' and 'j';

(3) the factor ' $Corr_{i,j}$ 'denotes the item set out in row 'i' and column 'j' of the correlation matrix in (4).

(4)

i \ j	Market	Default	Life	Health	Non-life
Market	1	0,25	0,25	0,25	0,25
Default	0,25	1	0,25	0,25	0,5
Life	0,25	0,25	1	0,25	0
Health	0,25	0,25	0,25	1	0
Non-life	0,25	0,5	0	0	1

[**Note:** Annex IV point (1) of the *Solvency II Directive*]

4.6.4 R For the purposes of the *basic SCR*, a *firm* must calculate the capital requirement for the non-life *underwriting risk* module so that it:

(1) reflects the risk arising from its non-life insurance obligations, in relation to the perils covered and the processes used in the conduct of business; and

(2) takes into account the uncertainty in its results related to existing insurance and reinsurance obligations, as well as to new business expected to be written within the next 12 *months*.

[**Note:** article 105(2) of the *Solvency II Directive*]

4.6.5 G Provisions relating to the calculation of the capital requirement for the non-life *underwriting risk* module for the *basic SCR* are set out in article [ ] of the *Solvency II Regulation*. The non-life *underwriting risk* module consists of three sub-modules: the non-life premium and reserve risk sub-module, the non-life catastrophe risk sub-module and the non-life lapse risk sub-module.

4.6.6 R For the purposes of calculating the non-life *underwriting risk* module for the *basic SCR*:

(1) the non-life premium and reserve risk sub-module covers 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; and

(2) the non-life catastrophe risk sub-module covers 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.

[**Note:** article 105(2) of the *Solvency II Directive*]

4.6.7 R For the purposes of the *basic SCR*, a *firm* must calculate the capital requirement for the life *underwriting risk* module so as to reflect the risk

arising from its life insurance obligations, in relation to the perils covered and the processes used in the conduct of business.

[**Note:** article 105(3) of the *Solvency II Directive*]

4.6.8 R A *firm* must calculate the life *underwriting risk* module for the purposes of the *basic SCR* as equal to:

$$SCR_{\text{life}} = \sqrt{\sum_{i,j} Corr_{i,j} \times SCR_i \times SCR_j}$$

[**Note:** Annex IV point (3) of the *Solvency II Directive*]

4.6.9 R For the purposes of *SOLPRU* 4.6.8R:

(1) 'SCR_i' and 'SCR_j' denote the mortality risk sub-module, the longevity risk sub-module, the disability-morbidity risk sub-module, the life expense risk sub-module, the revision risk sub-module, the lapse risk sub-module and the life catastrophe risk sub-module;

(2) 'i,j' means that the sum of the different terms should cover all possible combinations of 'i' and 'j'.

[**Note:** Annex IV point (3) *Solvency II Directive*]

4.6.10 G The items 'i' and 'j' for the purposes of the correlation coefficient '$Corr_{i,j}$' referred to in *SOLPRU* 4.6.9R are set out in a correlation matrix in article [ ] of the *Solvency II Regulation*.

4.6.11 R For the purposes of *SOLPRU* 4.6.8R to *SOLPRU* 4.6.9R:

(1) the mortality risk sub-module covers the risk of loss, or of adverse change, in the value of insurance liabilities, resulting from changes in 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;

(2) the longevity risk sub-module covers the risk of loss, or of adverse change, in the value of insurance liabilities, resulting from changes in 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;

(3) the disability-morbidity risk sub-module covers the risk of loss, or of adverse change, in the value of insurance liabilities, resulting from changes in the level, trend or volatility of disability, sickness and morbidity rates;

(4) the life-expense risk sub-module covers the risk of loss, or of adverse change, in the value of insurance liabilities, resulting from changes in the level, trend or volatility of the expenses incurred in servicing insurance or reinsurance contracts;

(5) the revision risk sub-module covers the risk of loss, or of adverse change, in the value of insurance liabilities, resulting from changes in the level, trend or volatility of the revision rates applied to annuities, due to changes in the legal environment or in the state of health of the person insured;

(6) the lapse risk sub-module covers the risk of loss, or of adverse change, in the value of insurance liabilities, resulting from changes in the level or volatility of the rates of *policy* lapses, terminations, renewals and surrenders; and

(7) the life-catastrophe risk sub-module covers the risk of loss, or of adverse change, in the value of insurance liabilities, resulting from the significant uncertainty of pricing and provisioning assumptions related to extreme or irregular events.

[**Note:** article 105(3) of the *Solvency II Directive*)]

4.6.12 R (1) For the purposes of the *basic SCR*, a *firm* must calculate the capital requirement for the health *underwriting risk* module to reflect the risk arising from its underwriting of health insurance obligations, whether it is pursued on a similar technical basis to that of life insurance or not, following from both the perils covered and the processes used in the conduct of business.

(2) The health *underwriting risk* module must cover at least the risk of loss, or of adverse change, in the value of insurance liabilities resulting from:

(a) changes in the level, trend, or volatility of the expenses incurred in servicing *contracts of insurance* or *reinsurance contracts*;

(b) fluctuations in the timing and amount of *claim* settlements at the time of provisioning; and

(c) 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.

[**Note**: article 105(4) of the *Solvency II Directive*]

4.6.13 G Provisions relating to the calculation of the capital requirement for the health *underwriting risk* module for the *basic SCR* are set out in articles [ ] of the *Solvency II Regulation*. The health *underwriting risk* module consists of three sub-modules: the NSLT (Non-Similar to Life Techniques) health insurance *underwriting risk* sub-module, the SLT (Similar to Life Techniques) health insurance *underwriting risk* sub-module and the health catastrophe risk sub-module.

4.6.14 R For the purposes of the *basic SCR*, a *firm* must calculate the capital

requirement for the *market risk* module so that it:

(1) reflects the risk arising from the level or volatility of market prices of financial instruments which have an impact upon the value of the assets and liabilities of the *firm*;

(2) properly reflects the structural mismatch between assets and liabilities, in particular with respect to the duration of assets and liabilities.

4.6.15 G Provisions relating to the calculation of the capital requirement for the *market risk* module for the *basic SCR* are set out in article [ ] of the *Solvency II Regulation*. The *market risk* module is calculated as a combination of the capital requirements for the following sub-modules: interest rate risk, equity risk, property risk, spread risk, *market risk* concentrations, currency risk.

4.6.16 R For the purposes of the calculation of the *market risk* module for the *basic SCR*:

(1) 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;

(2) the equity 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 market prices of equities;

(3) the property 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 market prices of real estate;

(4) the spread 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 credit spreads over the risk-free interest-rate term structure;

(5) 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; and

(6) the *market risk* concentrations sub-module covers additional risks to a *firm* stemming either from lack of diversification in the asset portfolio or from large exposure to default risk by single *issuer* of *securities* or a *group* of related *issuers*.

[**Note:** article 105(5) of the *Solvency II Directive*]

4.6.17 R For the purposes of the calculation of the *market risk* module for the *basic SCR*, the counterparty default risk module:

(1) must reflect possible losses due to unexpected default, or deterioration in the credit standing, of the counterparties and debtors

of the *firm* over the following 12 *months*;

(2) must cover risk-mitigating contracts, such as reinsurance arrangements, *securitisations* and *derivatives*, and receivables from intermediaries, as well as any other credit exposures which are not covered in the spread risk sub-module;

(3) must take appropriate account of collateral or other security held by, or for the account of, the *firm* and the associated risks;

(4) for each counterparty, must take account of the overall counterparty risk exposure of the *firm* concerned to that counterparty, irrespective of the legal form of the counterparty's contractual obligations to that *firm*.

[**Note:** article 105(6) of the *Solvency II Directive*]

4.7 Calculation of the equity risk sub-module: symmetric adjustment mechanism

4.7.1 R For the purposes of calculating the equity risk sub-module in accordance with the *basic SCR* for the *standard formula*, a *firm* must apply a symmetric adjustment to the standard equity capital charge calculated to cover equity risk.

[**Note:** article 106(1) of the *Solvency II Directive*]

4.7.2 G Articles [ ] of the *Solvency II Regulation* set out requirements relating to the calculation of the standard equity capital charge.

4.7.3 G The *Solvency II Regulation* sets out further requirements relating to the symmetric adjustment to be applied for the purposes of *SOLPRU* 4.7.1R.

4.8 Capital requirement for operational risk

4.8.1 R (1) A *firm's* capital requirement for *operational risk* must reflect its *operational risks* to the extent that they are not already reflected in the risk modules used to calculate its *basic SCR*.

(2) A *firm's* capital requirement for *operational risk* must be calibrated in accordance with *SOLPRU* 4.3.3R to *SOLPRU* 4.3.4R.

[**Note:** article 107(1) of the *Solvency II Directive*]

4.8.2 R With respect to *linked long-term contracts of insurance*, the calculation of the capital requirement for *operational risk* must take into account the amount of annual expenses incurred in respect of those insurance obligations.

[**Note:** article 107(2) of the *Solvency II Directive*]

4.8.3 R (1) With respect to *insurance business* operations other than those referred to in *SOLPRU* 4.8.2R, the calculation of the capital requirement for *operational risk* must take into account the volume of those operations, in terms of earned *premiums* and *technical provisions* which are held in respect of that *insurance business*.

(2) For *insurance business* operations falling within (1), the capital requirement for *operational risk* must not exceed 30% of the *basic SCR* relating to those operations.

[**Note:** article 107(3) of the *Solvency II Directive*]

4.9 Adjustment for loss-absorbing capacity of technical provisions and deferred taxes

4.9.1 R The adjustment for the loss-absorbing capacity of *technical provisions* and deferred taxes as referred to in *SOLPRU* 4.5.1R(3):

(1) must reflect potential compensation of unexpected losses through a simultaneous decrease in *technical provisions* or deferred taxes, or a combination of the two; and

(2) must take account of the risk-mitigating effect provided by future discretionary benefits of *contracts of insurance*.

[**Note**: article 108 of the *Solvency II Directive*]

4.9.2 R For the purposes of *SOLPRU* 4.9.1R(2):

(1) a *firm* must take account of the risk-mitigating effect provided by future discretionary benefits to the extent that it can establish that a reduction in future discretionary benefits may be used to cover unexpected losses when they arise;

(2) the risk-mitigating effect provided by future discretionary benefits must be no higher than the sum of *technical provisions* and deferred taxes relating to those future discretionary benefits; and

(3) the value of future discretionary benefits under adverse circumstances must be compared to the value of those benefits under the underlying assumptions of the *best estimate* calculation.

[**Note:** article 108 of the *Solvency II Directive*]

4.10 Simplifications in the standard formula

4.10.1 R (1) A *firm* may use a simplified calculation for a specific sub-module or risk module where the nature, scale and complexity of the risks it

faces justifies it.

(2) A *firm* must calibrate its simplified calculation in accordance with *SOLPRU* 4.3.3R to 4.3.4R.

[**Note:** article 109 of the *Solvency II Directive*]

4.10.2 G The principal provisions governing the availability and use of simplified calculations are contained in articles [ ] of the *Solvency II Regulation*.

4.11 Significant deviations from the assumptions underlying the standard formula calculation

4.11.1 G (1) Where the *FSA* [gives its approval], a *firm* may, within the design of the *standard formula*, replace a subset of its parameters by *undertaking specific parameters*.

(2) A *firm's undertaking specific parameters* will be calibrated on the basis of the *firm's* internal data or on the basis of data which is directly relevant for the operations of the *firm* using standardised methods.

[**Note:** article 104(7) of the *Solvency II Directive*]

4.11.2 G The *FSA* may also require a *firm* to replace a subset of the parameters used in the *standard formula* by *undertaking specific parameters* when calculating the life, non-life and health *underwriting risk* modules, where it is inappropriate to calculate the *SCR* in accordance with the *standard formula* because the *firm's* risk profile deviates significantly from the assumptions underlying the *standard formula*.

[**Note:** article 110 of the *Solvency II Directive*]

4.11.3 G [Placeholder for guidance on USP approvals process].

Internal models

4.12 Approval of full and partial internal models

General provisions: full and partial internal models

4.12.1 R (1) A *firm* with *internal model approval* must calculate the *SCR* using a full or partial *internal model.*

(2) In addition to the requirements set out in *SOLPRU* 4.3.3R, where a firm uses an internal model for which *internal model approval* has been granted, the *firm's SCR* (or that part of the *SCR* calculated using the *internal model* where a partial *internal model* is used) must cover new business expected to be written over the following 12

months.

[**Note:** articles 101(3) and 112(1) of the *Solvency II Directive*]

4.12.1A G *SOLPRU* 4.3.2R to *SOLPRU* 4.3.5R and *SOLPRU* 4.12.1R(2) implement the requirements of article 101 of the *Solvency II Directive* for *firms* using an *internal model* in respect of which *internal model approval* has been granted.

4.12.2 R To the extent permitted by its *internal model approval*, a *firm* may:

(1) use a partial *internal model* for the calculation of one or more of the following:

(a) one or more risk modules, or sub-modules, of the *basic SCR*;

(b) the capital requirement for *operational risk* set out in *SOLPRU* 4.8.1R to *SOLPRU* 4.8.3R;

(c) the adjustment for the loss-absorbing capacity of *technical provisions* and deferred taxes set out in *SOLPRU* 4.9.1R and *SOLPRU* 4.9.2R; and

(2) apply a partial *internal model* to the whole of its *insurance business*, or only to one or more of its *major business unit*s.

[**Note:** article 112(2) of the *Solvency II Directive*]

4.13 Applications for approval: full and partial internal models

4.13.1 R A *firm* making an *internal model approval application* must submit, as a minimum, documentary evidence that demonstrates to the *FSA's* satisfaction that the *internal model* and, if the context requires, the *firm* satisfies the requirements set out in *SOLPRU* 4.21 to *SOLPRU* 4.26.

[**Note:** article 112(3) of the *Solvency II Directive*]

4.13.2 R A *firm* making an *internal model approval application* must demonstrate to the *FSA's* satisfaction that its systems for identifying, measuring, monitoring, managing and reporting risk are adequate.

[**Note:** article 112(5) of the *Solvency II Directive*]

4.13.3 R When making an *internal model approval application*, a *firm* must submit its *internal model change policy* to the *FSA* for approval.

[**Note:** article 115 of the *Solvency II Directive*]

4.13.4 R When required to do so by the *FSA*, a *firm* with an *internal model approval* must provide the *FSA* with an estimate of the *SCR* determined in accordance with the *standard formula*.

[**Note:** article 112(7) of the *Solvency II Directive*]

4.13.5 G Articles [ ] of the *Solvency II Regulation* contain additional requirements which a *firm* is required to meet in making an *internal model approval application*.

4.14 Applications: partial internal models

4.14.1 R A *firm* making an *internal model approval application* to use a partial *internal model* must adapt the requirements in *SOLPRU* 4.21 to *SOLPRU* 4.26 to take account of the limited scope of the application of the *internal model*.

[**Note:** article 112(3) of the *Solvency II Directive*]

4.14.2 R A *firm* making an *internal model approval application* to use a partial *internal model* must also:

(1) explain, and properly justify, the reason for the limited scope of application of the *internal model*;

(2) explain how the resulting *SCR* reflects more appropriately the risk profile of the *firm* and complies with *SOLPRU* 4.2 to *SOLPRU* 4.4 and *SOLPRU* 4.12.1R(2); and

(3) demonstrate that the design of its partial *internal model* is consistent with the principles in *SOLPRU* 4.2 to *SOLPRU* 4.4 and *SOLPRU* 4.12.1R(2) so as to allow the partial *internal model* to be fully integrated into the *standard formula*.

[**Note:** article 113(1) of the *Solvency II Directive*]

4.15 Transitional plan to extend the scope of the model

4.15.1 R When required to do so by the *FSA*, a *firm* which has made an *internal model approval application* in respect of a partial *internal model* that only covers certain sub-modules of a specific risk module, or some of the business units of the *firm* with respect to a specific risk module, or parts of both, must submit a realistic transitional plan to extend the scope of the proposed partial *internal model*.

[**Note:** article 113(2) of the *Solvency II Directive*]

4.15.2 R The realistic transitional plan referred to in *SOLPRU* 4.15.1R must set out the manner in which the *firm* plans to extend the scope of the proposed partial *internal model* to other sub-modules or business units of the *firm*, in order to ensure that the *internal model* covers a predominant part of the *firm's insurance business* with respect to that specific risk module.

[**Note:** article 113(2) of the *Solvency II Directive*]

4.16 Changes to an internal model or internal model change policy

4.16.1 R A *firm* with *internal model approval* must not change its *internal model* otherwise than in accordance with the *firm's internal model change policy*.

[**Note:** article 115 of the *Solvency II Directive*]

4.16.2 R A *firm's internal model change policy* must include a specification of minor and major changes to the *internal model*.

[**Note:** article 115 of the *Solvency II Directive*]

4.16.3 R A firm with *internal model approval* must not:

(1) make any major change to its *internal model*; or

(2) make any change to its *internal model change policy;*

without obtaining the prior approval of the *FSA* in accordance with the procedures set out in *SOLPRU* 4.13 to *SOLPRU* 4.15 for obtaining *internal model approval*.

[**Note:** article 115 of the *Solvency II Directive*]

4.16.4 G The effect of *SOLPRU* 4.16.3R is that a *firm* seeking *FSA* approval to make a major change to its *internal model* or a change to its *internal model change policy* must comply with the requirements set out *SOLPRU* 4.13 to *SOLPRU* 4.15. Article [ ] of the *Solvency II Regulation* sets out further requirements relevant to a *firm* seeking *FSA* approval to make a major change to its *internal model* or a change to its *internal model change policy*.

4.16.5 G Minor changes to a *firm's internal model* do not require prior *FSA* approval, provided that any minor change is made in accordance with the *firm's internal model change policy*, as approved by the *FSA* in accordance with *SOLPRU* 4.13.3R.

[**Note:** article 115 of the *Solvency II Directive*]

4.17 Responsibilities of the firm's governing body

4.17.1 R A *firm's*:

(1) *internal model approval application*; and

(2) application to the *FSA* for approval to make a major change to its *internal model* for which it has received *internal model approval*;

must be approved by the *firm's governing body*.

[**Note:** article 116 of the *Solvency II Directive*]

4.17.2 R A *firm* must put in place systems which ensure that its *internal model* operates properly on a continuous basis.

[**Note:** article 116 of the *Solvency II Directive*]

4.18 Reversion to the standard formula

4.18.1 R A *firm* with an *internal model approval* must not, in respect of the *internal model* for which that *internal model approval* has been granted, revert to calculating the whole or any part of the *SCR* in accordance with the *standard formula*, except in duly justified circumstances and with the *FSA's* prior approval.

[**Note:** article 117 of the *Solvency II Directive*]

4.19 Non-compliance of the internal model

4.19.1 R If a *firm* with *internal model approval* ceases to comply with the requirements of *SOLPRU* 4.21 to *SOLPRU* 4.26, the *firm* must, without delay, either present to the *FSA* a plan to restore compliance within a reasonable period of time, or demonstrate to the *FSA* that the effect of non-compliance is immaterial.

[**Note:** article 118(1) of the *Solvency II Directive*]

4.19.2 G If a *firm* fails to implement the plan to restore compliance referred to in *SOLPRU* 4.19.1R, the *FSA* may require the *firm* to revert to calculating the *SCR* in accordance with the *standard formula*.

[**Note:** article 118(2) of the *Solvency II Directive*]

4.20 Significant deviations from the assumptions underlying the standard formula calculation

4.20.1 G Where it is inappropriate for a *firm* to calculate the *SCR* in accordance with the *standard formula*, because its risk profile deviates significantly from the assumptions underlying the *standard formula* calculation, then the *FSA* may require the *firm* to use an *internal model* to calculate the *SCR*, or the relevant risk modules of the *SCR*.

[**Note:** article 119 of the *Solvency II Directive*]

Internal model requirements

4.21 Use test

4.21.1 R A *firm* must demonstrate to the *FSA* that its *internal model* is widely used, and plays an important role, in its system of governance (referred to in *SOLPRU* 9.2.3R to *SOLPRU* 9.8) and particularly in its:

(1) risk-management system, as set out in *SOLPRU* 9.3.1R to *SOLPRU* 9.3.4R, and decision-making processes; and

(2) economic and solvency capital assessment and allocation processes, including its *ORSA,* as set out in *SOLPRU* 9.3.5R to *SOLPRU* 9.3.8R.

[**Note:** article 120 of the *Solvency II Directive*]

4.21.2 R A *firm* must also demonstrate to the *FSA* that the frequency of calculation of its *SCR* using the *internal model* is consistent with the frequency with which it uses its *internal model* for the purposes set out in *SOLPRU* 4.21.1R.

[**Note:** article 120 of the *Solvency II Directive*]

4.21.3 R A *firm* must ensure the ongoing appropriateness of the design and operations of its *internal model*, and that the *internal model* continues to appropriately reflect the risk profile of the *firm*.

[**Note:** article 120 of the *Solvency II Directive*]

4.22 Statistical quality standards

4.22.1 R A *firm* must ensure that its *internal model* and, in particular, the calculation of the *probability distribution forecast* underlying it, complies with *SOLPRU* 4.22.2R to *SOLPRU* 4.22.9R.

[**Note:** article 121(1) of the *Solvency II Directive*]

4.22.2 R The methods used to calculate the *probability distribution forecast* must be:

(1) based on adequate, applicable and relevant actuarial and statistical techniques;

(2) based upon current and credible information and realistic assumptions; and

(3) consistent with the methods used to calculate *technical provisions*.

[**Note:** article 121(2) of the *Solvency II Directive*]

4.22.3 R A *firm* must be able to justify the assumptions underlying its *internal model* to the *FSA*.

[**Note:** article 121(2) of the *Solvency II Directive*]

4.22.4 R (1) Data used for the *internal model* must be accurate, complete and appropriate.

(2) A *firm* must update the data sets used in the calculation of the *probability distribution forecast* at least annually.

4.22.5 R Without limiting the operation of *SOLPRU* 4.22.2R, irrespective of the method chosen to calculate the *probability distribution forecast*, the ability of the *internal model* to rank risk must be sufficient to ensure that it is widely used, and plays an important role, in the system of governance of the *firm*, in particular in its risk-management system and decision-making processes, and capital allocation in accordance with *SOLPRU* 4.21.1R.

[**Note:** article 121(4) of the *Solvency II Directive*]

4.22.6 R The *internal model* must cover all of the material risks to which the *firm* is exposed, including at least the risks set out in *SOLPRU* 4.3.3R(1).

[**Note:** article 121(4) of the *Solvency II Directive*]

4.22.7 G *SOLPRU* 4.3.3R(1) sets out the risks which are required to be covered by a *firm's SCR*.

4.22.8 R In its *internal model*, a *firm* must:

(1) accurately assess:

(a) the particular risks associated with financial guarantees and any contractual options, where material; and

(b) the risks associated with both *policyholder* options and the *firm'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; and

(2) take account of all payments to *policyholders* which it expects to make, whether or not those payments are contractually guaranteed.

[**Note:** article 121(7) and (9) of the *Solvency II Directive*]

4.22.9 R Except to the extent permitted by this *rule*, a *firm's internal model* must not take the following into account:

(1) as regards diversification effects, dependencies within and across risk categories, unless the *FSA* is satisfied that the *firm's* system for measuring those diversification effects is adequate;

(2) the effect of *risk-mitigation techniques*, unless *credit risk* and other risks arising from the use of *risk-mitigation techniques* are properly reflected in the *internal model*; and

(3) future management actions the *firm* would reasonably expect to carry out in specific circumstances, unless it makes allowance for the time necessary to implement those actions.

[**Note:** article 121(5), (6) and (8) of the *Solvency II Directive*]

4.23 Calibration standards

4.23.1 R *A firm* may use, for internal modelling purposes, a different time period or *risk measure* than that set out in *SOLPRU* 4.3.4R only where the outputs of the *internal model* can be used by the *firm* to calculate the *SCR* in a manner that provides *policyholders* with a level of protection equivalent to that set out in *SOLPRU* 4.3.2R to *SOLPRU* 4.3.5R and *SOLPRU* 4.12.1R(2).

[**Note:** article 122(1) of the *Solvency II Directive*]

4.23.2 R A *firm* must derive the *SCR* directly from the *probability distribution forecast* generated by its *internal model*, using the value-at-risk *risk measure* set out in *SOLPRU* 4.3.4R.

[**Note:** article 122(2) of the *Solvency II Directive*]

4.23.3 G If a *firm* cannot derive the *SCR* directly from the *probability distribution forecast* generated by its *internal model*, then the *firm* may apply to the *FSA* for a *waiver* of *SOLPRU* 4.23.2R so that approximations may be used in the process to calculate the *SCR*. In considering whether to grant such a *waiver*, the *FSA* will consider whether *policyholders* are provided with a level of protection equivalent to that set out in *SOLPRU* 4.3.2R to *SOLPRU* 4.3.5R and *SOLPRU* 4.12.1R(2). Article [ ] of the *Solvency II Regulation* contains additional requirements relevant to a *firm* seeking a waiver of *SOLPRU* 4.23.2R.

[**Note:** article 122(3) of the *Solvency II Directive*]

4.23.4 R When required to do so by the *FSA*, a *firm* must run its *internal model* on relevant benchmark portfolios, using assumptions based on external rather than internal data in order to verify the calibration of the *internal model* and to check that its specification is in line with generally accepted market practice.

[**Note:** article 122(4) of the *Solvency II Directive*]

4.24 Profit and loss attribution

4.24.1 R A *firm* with *internal model approval* must review, at least annually, the causes and sources of profits and losses for each *major business unit*.

[**Note:** article 123 of the *Solvency II Directive*]

4.24.2 R (1) A *firm* must demonstrate to the *FSA* how the categorisation of risk chosen in its *internal model* explains the causes and sources of profits and losses.

(2) The categorisation of risk and attribution of profits and losses must reflect the risk profile of the *firm*.

[**Note:** article 123 of the *Solvency II Directive*]

4.25 Validation standards

4.25.1 R (1) A *firm* must have in place a regular cycle of *internal model* validation which includes:

(a) monitoring the performance of the *internal model*, reviewing the ongoing appropriateness of its specification and testing its results against experience;

(b) an effective statistical process for validating the *internal model* which enables the *firm* to demonstrate to the *FSA* that the resulting capital requirements are appropriate;

(c) an analysis of the stability of the *internal model* and, in particular, the testing of the sensitivity of the results of the *internal model* to changes in key underlying assumptions; and

(d) an assessment of the accuracy, completeness and appropriateness of the data used by the *internal model*.

(2) The statistical methods applied for the purposes of (1)(b) must test the appropriateness of the *probability distribution forecast* compared to loss experience, all material new data and information relating thereto.

[**Note:** article 124 of the *Solvency II Directive*]

4.26 Documentation standards

4.26.1 R A *firm* must document the design and operational details of its *internal model*.

[**Note:** article 125 of the *Solvency II Directive*]

4.26.2 R The documentation produced under *SOLPRU* 4.26.1R must:

(1) demonstrate compliance with:

(a) *SOLPRU* 4.21.1R to *SOLPRU* 4.21.3R (Use test);

(b) *SOLPRU* 4.22.1R to *SOLPRU* 4.22.9R (Statistical quality standards);

(c) *SOLPRU* 4.23.1R to *SOLPRU* 4.23.4R (Calibration standards);

(d) *SOLPRU* 4.24.1R and *SOLPRU* 4.24.2R (Profit and loss attribution); and

(e) *SOLPRU* 4.25.1R (Validation standards);

(2) provide a detailed outline of the theory, assumptions, and mathematical and empirical bases underlying the *internal model*;

(3) indicate any circumstances under which the *internal model* does not work effectively; and

(4) include all major changes to the *internal model*, as referred to in *SOLPRU* 4.16.2R and *SOLPRU* 4.16.3R.

[**Note:** article 125 of the *Solvency II Directive*]

4.27 External models and data

4.27.1 R In circumstances where a *firm* uses a model or data obtained from a third party, the *internal model* and, if the context requires, the *firm* must continue to satisfy the requirements in *SOLPRU* 4.21 to *SOLPRU* 4.26.

[Note: article 126 of the *Solvency II Directive*]

Capital add-on

4.28 Application

4.28.1. R *SOLPRU* 4.28 applies to a *UK Solvency II firm*.

4.28.2 G Article 37 of the *Solvency II Directive* contemplates the *FSA* applying a *capital add-on* to a *firm* in circumstances where there has been a *standard formula significant risk profile deviation*, an *internal model significant risk profile deviation*, or a *significant system of governance deviation* in circumstances where the conditions stipulated in article 37(1)(a), (b) or (c) have been met. The *FSA* will exercise the power to apply a *capital add-on* under the *Act*. Articles [ ] of the *Solvency II Regulation* also apply in relation to the imposition of a *capital add-on*.

Remedy of deficiencies leading to imposition of capital add-on

4.28.3 R A *firm* must make every effort to remedy the deficiencies that led to the imposition of a *capital add-on* arising as a result of an *internal model*

significant risk profile deviation or a *significant system of governance deviation*.

[**Note**: article 37(3) of the *Solvency II Directive*]

4.28.4 G A *capital add-on* applied to a *firm* will be reviewed at least once a year by the *FSA* and removed by the *FSA* in circumstances where the *firm* has remedied the deficiencies which led to its imposition.

[**Note**: article 37(4) of the *Solvency II Directive*]

New Solvency Capital Requirement

4.28.5 R Except as provided in *SOLPRU* 4.28.6R, the *SCR* prior to the imposition of the *capital add-on*, together with the amount of the *capital add-on* imposed by the *FSA*, will constitute the *firm's SCR*.

[**Note:** article 37(5) of the *Solvency II Directive*]

4.28.6 R For the purposes of calculating the *risk margin*, the *SCR* of a *firm* must not include any *capital add-on* imposed as a result of a *significant system of governance deviation*.

[**Note:** article 37(5) of the *Solvency II Directive*]

5 Minimum Capital Requirement

5.1 Application

5.1.1 *SOLPRU* 5 applies to a *UK Solvency II firm.*

5.2 General provisions

5.2.1 R A *firm* must hold *eligible own funds* covering the *MCR*.

[**Note:** article 128 of the *Solvency II Directive*]

5.3 Calculation of the MCR

5.3.1 R The function used to calculate the *firm's MCR* must be calibrated to the value-at-risk of its *basic own funds* subject to a confidence level of 85% over a one-year period.

[**Note:** article 129(1)(c) of the *Solvency II Directive*]

5.3.2 R The *MCR* must have an absolute floor of:

(1) 2,200,000 euro for *firms*, including *captive insurers*, which have *permission* to *effect* or *carry out contracts of insurance* that are *general insurance contracts*, except in the case where all or some of the *general insurance business classes* 10 to 15 are covered, in which case it must be no less than 3,200,000 euro;

(2) 3,200,000 euro for *firms*, including *captive insurers*, which have *permission* to *effect* or *carry out contracts of insurance* that are *long-term insurance contracts*;

(3) 3,200,000 euro for *pure reinsurers*, except in the case of *captive reinsurers* that are *pure reinsurers*, in which case the *MCR* must be no less than [1,000,000 euro];

(4) the sum of the amounts set out in (1) and (2) for *firms* other than *pure reinsurers* which as of 15 March 1979 carried on both *long-term insurance business* and *general insurance business*.

[**Note:** article 129(1)(d) of the *Solvency II Directive*]

5.3.3 G For *firms* engaging in *long-term insurance business* and with *permission* to *effect* or *carry out contracts of insurance* in *general insurance business class* 1 (accident) and *class* 2 *(*sickness), the absolute floor of the *MCR* is set out in the *Solvency II Regulation*.

5.3.4 R Without prejudice to the requirements on the absolute floor in *SOLPRU* 5.3.2R, the *MCR* must neither fall below 25% nor exceed 45% of the *firm's SCR*, calculated in accordance with *SOLPRU* 4.6 or *SOLPRU* 4.12 to *SOLPRU* 4.27, and including any *capital add-on* which has been imposed.

[**Note:** article 129(3) of the *Solvency II Directive*]

5.3.5 G Article [ ] of the *Solvency II Regulation* sets out further requirements in respect of the calculation of the *MCR*.

5.3.6 G The *FSA* may, for a period ending no later than [31 October 2014], require a *firm* to apply the percentages referred to in *SOLPRU* 5.3.4R to the *firm's SCR* calculated in accordance with the *standard formula*. An example of when the *FSA* may require this would be where the output from the *firm's internal model* has deviated from the *firm's* risk profile and where the *standard formula* provides a better fit to the *firm's* risk profile.

[**Note:** article 129(3) of the *Solvency II Directive*]

5.3.7 G Under article 300 of the *Solvency II Directive* the euro amounts specified in *SOLPRU* 5.3.2R are subject to review every five years. The relevant amounts will be increased by the percentage change in the Harmonised Indices of Consumer Prices (comprising all EU member states, as published by Eurostat) starting from [31 October 2012] until the date of revision and rounded up to a multiple of 100,000 euro, provided that where the percentage change since the previous revision is less than 5% the amounts will not be revised.

5.3.8 R For the purposes of *SOLPRU* 5.3.2R the exchange rate from the euro to the pound sterling for each year beginning on 31 December is the rate applicable on the last day of the preceding October for which the exchange rates for the currencies of all of the *EU* member states were published in the Official Journal of the *EU*.

[**Note:** article 299 of the *Solvency II Directive*]

5.4 Frequency and reporting in relation to MCR

5.4.1 R A *firm* must calculate the *MCR* and report the results of that calculation to the *FSA* at least quarterly.

[**Note:** article 129(4) of the *Solvency II Directive*]

5.4.2 R Where either of the limits referred to in *SOLPRU* 5.3.4R determines a *firm's MCR* the *firm* must provide the *FSA* with sufficient information to enable the *FSA* to understand the reasons why that is the case.

[**Note:** article 129(4) of the *Solvency II Directive*]

6 Insurance and reinsurance undertakings in difficulty or in an irregular situation

6.1 Application

6.1.1 R *SOLPRU* 6 applies to a *UK Solvency II firm*.

6.2 Identification and notification of deteriorating financial conditions

6.2.1 R A *firm* must have procedures in place to identify deteriorating financial conditions and must immediately notify the *FSA* when such deterioration occurs.

[**Note:** article 136 of the *Solvency II Directive*]

6.3 Non-compliance with the SCR

6.3.1 R A *firm* must:

(1) immediately inform the *FSA* as soon as it observes that the *SCR* is no longer complied with, or where there is a risk of non-compliance within the next three *months*;

(2) within two *months* from the observation of non-compliance with the

SCR, submit a realistic *recovery plan* for approval by the *FSA*; and

(3) take the measures determined by the *FSA* as necessary to achieve, within six *months* (or such longer period as the *FSA* may determine) from the observation of non-compliance with the *SCR*, the re-establishment of the level of *eligible own funds* covering the *SCR* or the reduction of its risk profile to ensure compliance with the *SCR*.

[**Note**: article 138(1)–(3) of the *Solvency II Directive*]

6.3.2 G The *FSA* may, if it considers it appropriate, extend the six-*month* period referred to in *SOLPRU* 6.3.1R(3):

(1) by up to three *months*; or

(2) in the event of an exceptional fall in financial markets, by an appropriate period of time taking into account all relevant factors.

[**Note**: article 138(3)–(4) of the *Solvency II Directive*]

6.3.3 G Articles [ ] of the *Solvency II Regulation* set out provisions on the maximum time period for extension in the event of an exceptional fall in financial markets and the factors to be taken into account in granting that extension.

6.3.4 R If the *FSA* has determined a longer period in relation to *SOLPRU* 6.3.1R(3) by reason of an exceptional fall in financial markets and notified the *firm* that such longer period applies, the *firm* must submit a progress report to the *FSA* every three *months* setting out the measures taken and the progress made to re-establish the level of *eligible own funds* covering the *SCR* or to reduce its risk profile to ensure compliance with the *SCR*.

[**Note:** article 138(4) of the *Solvency II Directive*]

6.4 Non-compliance with the MCR

6.4.1 R A *firm* must:

(1) inform the *FSA* immediately where it observes that the *MCR* is no longer complied with or where there is a risk of non-compliance within the next three *months*; and

(2) within one *month* from the observation of non-compliance with the *MCR*, submit, for approval by the *FSA,* a short-term realistic *finance scheme* to restore, within three *months* of that observation, the *eligible own funds*, at least to the level of the *MCR* or to reduce its risk profile to ensure compliance with the *MCR*.

[**Note:** article 139(1)–(2) of the *Solvency II Directive*]

6.5 Recovery plan and finance scheme

6.5.1 R Any *recovery plan* or *finance scheme* must at least include particulars or evidence concerning the following:

(1) estimates of management expenses, in particular current general expenses and commissions;

(2) estimates of income and expenditure in respect of direct business, reinsurance acceptances and reinsurance cessions;

(3) a forecast balance sheet;

(4) estimates of the financial resources intended to cover the *technical provisions* and the *SCR* and the *MCR*; and

(5) the overall reinsurance policy.

[**Note:** article 142(1) of the *Solvency II Directive*]

6.6 Transitional arrangements regarding compliance with the MCR

6.6.1 R If a *firm* complies with the *pre-Solvency II MCR* but does not hold sufficient *eligible own funds* to cover the *MCR* then:

(1) the *firm* must comply with *SOLPRU* 5.2.1R (MCR requirement) by [31 October 2013]; and

(2) *SOLPRU* 6.4.1R will apply from [1 November 2014].

[**Note:** article 131 of the *Solvency II Directive*]

6.6.2 R If a *firm* complies with the *pre-Solvency II MCR* but does not hold sufficient *eligible own funds* to cover the *MCR* then, until [31 October 2013] a *firm* must:

(1) inform the *FSA* immediately where it observes that the *pre-Solvency II MCR* is no longer complied with or where there is a risk of non-compliance within the next three *months*; and

(2) within one *month* from the observation of non-compliance with the *pre-Solvency II MCR*, submit, for approval by the *FSA,* a short-term realistic *finance scheme* to restore, within three *months* of that observation, its capital resources, at least to the level of the *pre-Solvency II MCR* or to reduce its risk profile to ensure compliance with the *pre-Solvency II MCR*.

6.6.3 R Any *finance scheme* submitted under *SOLPRU* 6.6.2R(2) must at least include particulars or evidence concerning the following:

(1) estimates of management expenses, in particular current general

expenses and commissions;

(2) estimates of income and expenditure in respect of direct business, reinsurance acceptances and reinsurance cessions;

(3) a forecast balance sheet;

(4) estimates of the capital resources intended to cover the *pre-Solvency II MCR*; and

(5) the overall reinsurance policy.

7 Investments

7.1 Application

7.1.1 R *SOLPRU* 7 applies to a *UK Solvency II firm*.

7.2 Prudent person investment principle

All assets

7.2.1 R A *firm* must invest its assets in accordance with the following requirements:

(1) 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 *SOLPRU* 9.3.5R(2)(a);

(2) all the assets of the *firm* must be:

(a) 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

(b) localised such as to ensure their availability; and

(3) 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*.

[**Note**: article 132(1)–(2) of the *Solvency II Directive*]

Assets covering technical provisions

7.2.2 R In addition to meeting the requirements set out in *SOLPRU* 7.2.1R, a *firm* must ensure that assets held to cover its *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.

[**Note**: article 132(2) of the *Solvency II Directive*]

Additional requirements for assets covering linked long-term liabilities

7.2.3 R In addition to the requirements set out in *SOLPRU* 7.2.1R and *SOLPRU* 7.2.2R, where a *firm* carries out *linked long-term contracts of insurance*, it must also satisfy the requirements in *SOLPRU* 7.2.4R.

7.2.4 R Where *SOLPRU* 7.2.3R applies, the *firm* must cover its *technical provisions* in respect of its *linked long-term liabilities* as closely as possible with:

(1) where the *linked benefits* are linked to the value of *units*, those *units*;

(2) where the *linked benefits* are linked to the value of assets contained in an internal fund of the *firm*:

(a) in a case where the internal fund is divided into notional units, the assets represented by those notional units; or

(b) in a case where notional units are not established, those assets; and

(3) where the *linked benefits* are linked to a *share* index or other reference value not mentioned in (1) or (2), assets of appropriate security and marketability which correspond as closely as possible to the assets on which the reference value is based.

[**Note:** article 132(3) of the *Solvency II Directive*]

7.2.5 G If a *firm's technical provisions* for a *linked long-term liability* cannot be covered by appropriate assets that exactly match the assets on which the reference value is based (for example the Limited Price Index (LPI)), then the *firm* must hold appropriate assets that match them as closely as possible, having regard to the *linked benefit* that has been promised in the *linked long-term contract of insurance*.

7.2.6 G In selecting the appropriate cover, the *firm* should take into account the *credit risk* and the risk that the value or yield in the assets will not, in all circumstances, match fluctuations in the relevant index.

7.2.7 G *SOLPRU* 7.2.4R sets out the requirements that apply in respect of the assets that must be held to cover a *firm's technical provisions* for *linked long-term liabilities*. *COBS* 21 sets out the *rules* defining the assets or reference values to which a firm may link benefits under *linked long term contracts of insurance*.

7.2.8 R *SOLPRU* 7.2.4R does not apply to a *pure reinsurer*.

[**Note**: article 132(3) of the *Solvency II Directive*]

Additional requirements where the investment risk is not borne by the

policyholder

7.2.9 R Subject to *SOLPRU* 7.2.10R, a *firm* must invest its assets in accordance with the requirements in *SOLPRU* 7.2.11R.

7.2.10 R *SOLPRU* 7.2.11R does not apply in respect of assets covering *technical provisions* for *linked long-term contracts of insurance* unless, and to the extent that, the assets are held to cover the *technical provisions* in respect of any guarantee of investment performance or other guaranteed benefit provided under those *linked long-term insurance contracts of insurance*.

[**Note**: article 132(3)–(4) of the *Solvency II Directive*]

7.2.11 R The requirements referred to in *SOLPRU* 7.2.10R are:

(1) the *firm* must not invest in a *derivative* or *quasi-derivative* unless, and to the extent that, it contributes to a reduction of risks or facilitates efficient portfolio management;

(2) investments and assets which are not admitted to trading on a *regulated market* must be kept to prudent levels;

(3) assets must be properly diversified in such a way as to avoid:

(a) excessive reliance on any particular asset, *issuer*, *group* of *undertakings* or geographical area; and

(b) excessive accumulation of risk in the portfolio as a whole;

(4) investments in assets issued by the same *issuer,* or *issuers* belonging to the same *group*, must not expose the *firm* to excessive risk concentration.

[**Note**: article 132(4) of the *Solvency II Directive*]

8 Composites

8.1 Application

8.1.1 R *SOLPRU* 8.2 to *SOLPRU* 8.4 apply to a *composite firm* that is a *UK Solvency II firm*, other than a *pure reinsurer*.

8.1.2 R *SOLPRU* 8.5 applies to a *UK Solvency II firm.*

8.2 Pursuit of life and non-life activity

8.2.1 G Under section 19 of the *Act*, a *firm* may not carry on a *regulated activity* unless it has *permission* to do so (or is exempt in relation to the particular activity). Both *general insurance business* and *long-term insurance business*

are *regulated activities* and *permission* will extend to the *effecting* or *carrying out* of *contracts of insurance* for one or more particular *classes*.

8.2.2 G A *firm's permission* can be varied so as to add other *classes*. The *permission* of an existing *composite firm* may be varied by adding *classes* of both *general insurance business* and *long-term insurance business*.

8.2.3 G It is *FSA* policy, in compliance with the *Solvency II Directive*, not to grant or vary *permission* if that would allow a newly established *firm*, or an existing *firm* engaging solely in *general insurance business* or solely in *long-term insurance business*, to engage in both *general insurance business* and *long-term insurance business*. This does not apply where a *firm's permission* to carry on *long-term insurance business* is or is to be restricted to *reinsurance*. It also does not apply where a *firm's permission* to carry on *general insurance business* is or is to be restricted to *effecting* or *carrying out contracts of insurance* in *general insurance business class* 1 (accident) or *class* 2 (sickness).

[**Note**: article 73(2) of the *Solvency II Directive*]

8.2.4 G Where a *firm's permission* extends to *effecting* or *carrying out insurance contracts* in *long-term insurance business class* I (life and annuity) this will normally include *permission* to *effect* or *carry out contracts of insurance* in *general insurance business class* 1 (accident) and *class* 2 (sickness) on a supplementary basis.

8.3 Long-term and general insurance activities to be separately managed

8.3.1 R A *composite firm* must separately manage the activities relating to its *general insurance business* and the activities relating to its *long-term insurance business* in such a way that:

(1) its *long-term insurance business* and its *general insurance business* are distinct from one another;

(2) the interests of *policyholders* of *long-term insurance contracts* are not prejudiced by activities relating to the *firm's general insurance business* and the interests of *policyholders* of *general insurance contracts* are not prejudiced by activities relating to the *firm's long-term insurance business*; and

(3) profits from the activities relating to the *composite firm's long-term insurance business* benefit *policyholders* of *long-term insurance contracts* as if the *composite firm* was engaged only in *long-term insurance business*.

[**Note**: article 74(1) of the *Solvency II Directive*]

8.3.2 G For the purposes of *SOLPRU* 8.3.1R, the *FSA* would expect the *firm* to:

(1) comply with the governance requirements set out in *SOLPRU* 9 separately in respect of its *general insurance business* activities and its *long-term insurance business* activities to the extent that it is practicable to do so; and

(2) separately identify the assets attributable to each of its *long-term insurance business* and its *general insurance business* on the basis of the accounts referred to in *SOLPRU* 8.4.1R; and

(3) maintain the assets attributable to its *long-term insurance business* and the assets attributable to its *general insurance business* separate from each other.

8.4 Minimum financial obligations

8.4.1 R A *composite firm* must maintain separate accounts for each of its *long-term insurance business* and its *general insurance business* to show the sources of the results for each activity separately.

[**Note**: article 74(6) of the *Solvency II Directive*]

8.4.2 R For the purposes of *SOLPRU* 8.4.1R, the *firm* must:

(1) break down, according to origin, all income (including *premiums*, recoverables from *reinsurance contracts* and investment income) and all expenditure (including insurance settlements, additions to *technical provisions*, reinsurance *premiums* and operating expenses) in respect of its *general insurance business* and its *long-term insurance business*, respectively; and

(2) if items are shared between the *firm's long-term insurance business* and its *general insurance business*, apportion those items appropriately between the two activities and enter them into the accounts on the basis of that apportionment.

[**Note**: article 74(6) of the *Solvency II Directive*]

8.4.3 G The *firm* should consider the appropriateness of the apportionment referred to in *SOLPRU* 8.4.2R(2), having regard to the requirements in *SOLPRU* 8.3.1R.

8.4.4 R The *firm* must record the methods on the basis of which the apportionment referred to in *SOLPRU* 8.4.2R(2) has been made and be able to demonstrate to the *FSA* the appropriateness of those methods of apportionment.

[**Note**: article 74(6) of the *Solvency II Directive*]

8.4.5 G In order to comply with *SOLPRU* 8.4.1R and *SOLPRU* 8.4.2R, the *firm* should prepare a notional balance sheet for each of its *long-term insurance business* and *general insurance business*, identifying the assets and

liabilities relating to its *long-term insurance business* and its *general insurance business*, respectively. *SOLPRU* 2 applies to the valuation of a *firm's* assets and liabilities.

8.4.6 R Without prejudice to *SOLPRU* 4 and *SOLPRU* 5, the *firm* must calculate a notional MCR on the basis of the accounts referred to in *SOLPRU* 8.4.1R:

(1) with respect to its *long-term insurance business*, calculated as if the *firm* carried on *long-term insurance business* only; and

(2) with respect to its *general insurance business*, calculated as if the *firm* carried on *general insurance business* only.

[**Note**: article 74(2) of the *Solvency II Directive*]

8.4.7 G Article [ ] of the *Solvency II Regulation* sets out the method for calculating the notional MCR referred to in *SOLPRU* 8.4.6R.

8.4.8 R The *firm* must cover:

(1) its *notional life MCR* with *eligible own funds* attributable to its *long-term insurance business*, as identified on the basis of the accounts referred to in *SOLPRU* 8.4.1R; and

(2) its *notional non-life MCR* with *eligible own funds* attributable to its *general insurance business*, as identified on the basis of the accounts referred to in *SOLPRU* 8.4.1R.

[**Note**: article 74(3) of the *Solvency II Directive*]

8.4.9 R For the purposes of *SOLPRU* 8.4.8R, the *firm* must not cover:

(1) its *notional life MCR* with *eligible own funds* attributable to its *general insurance business*; and

(2) its *notional non-life MCR* with *eligible own funds* attributable to its *long-term insurance business.*

[**Note**: article 74(3) of the *Solvency II Directive*]

8.4.10 R The *firm* must prepare a statement on the basis of the accounts referred to in *SOLPRU* 8.4.1R identifying the *eligible own funds* covering the *notional life MCR* and the *notional non-life MCR*, respectively.

[**Note:** article 74(6) of the *Solvency II Directive*]

8.4.11 R Provided the *firm* satisfies the requirements in *SOLPRU* 8.4.8R and *SOLPRU* 8.4.9R, and subject to the requirement in *SOLPRU* 8.4.12R, a *firm* may use:

(1) *eligible own funds* attributable to its *general insurance business* that are in excess of its *notional non-life MCR*; and

(2) *eligible own funds* attributable to its *long-term insurance business* that are in excess of its *notional life MCR*.

[**Note**: article 74(4) of the *Solvency II Directive*]

8.4.12 R For the purposes of *SOLPRU* 8.4.11R, a *firm* must give notification to the *FSA* before using:

(1) *eligible own funds* referred to in *SOLPRU* 8.4.11R(1) to cover the portion of the difference referred to in *SOLPRU* 8.4.11R that relates to the difference between the *notional life SCR* and the *notional life MCR*; or

(2) *eligible own funds* referred to in *SOLPRU* 8.4.11R(2) to cover the portion of the difference referred to in *SOLPRU* 8.4.11R that relates to the difference between the *notional non-life SCR* and the *notional non-life MCR*.

[**Note**: article 74(4) of the *Solvency II Directive*]

8.4.13 R If a *composite firm* is in breach of either *SOLPRU* 8.4.8R(1) or *SOLPRU* 8.4.8R(2), the provisions of *SOLPRU* 6.4 apply to the activity in respect of which the breach has occurred, as if the words "*MCR*" in *SOLPRU* 6.4 were substituted with the words "*notional life MCR*" or "*notional non-life MCR*", as applicable, regardless of whether any breach has occurred in respect of the other activity.

[**Note**: article 74(7) of the *Solvency II Directive*]

8.4.14 G As a result of *SOLPRU* 8.4.8R and *SOLPRU* 8.4.9R, a *firm* may not use *eligible own funds* attributable to its *general insurance business* to cover its *notional life MCR* or its *eligible own funds* attributable to its *long-term insurance business* to cover its *notional non-life MCR*.

8.4.15 G Article 74(6) of the *Solvency II Directive* provides that, in the circumstances referred to in *SOLPRU* 8.4.13R, supervisory authorities may authorise the transfer of *eligible own funds* from one activity to the other. Therefore, if a *composite firm* that is in breach of either *SOLPRU* 8.4.8R(1) or *SOLPRU* 8.4.8R(2) wishes, as part of its finance scheme referred to in *SOLPRU* 6.4, to use *eligible own funds* attributable to its *long-term insurance business* to cover its *notional non-life MCR* or *eligible own funds* attributable to its *general insurance business* to cover its *notional life MCR*, it may only do so if it obtains a *waiver* of *SOLPRU* 8.4.8R and *SOLPRU* 8.4.9R under section 148 of the *Act*.

8.4.16 G In deciding whether to grant a *waiver* to authorise the transfer of *eligible own funds* from one activity to the other, in addition to the statutory tests under section 148 of the *Act*, the *FSA* will have regard to whether the interests of *policyholders* of *long-term insurance contracts* would be prejudiced by a transfer of *eligible own funds* attributable to the *long-term insurance business* to cover the *notional non-life MCR* and whether the interests of *policyholders* of *general insurance contracts* would be

prejudiced by a transfer of *eligible own funds* attributable to the *general insurance business* to cover the *notional life MCR*.

8.4.17 G For the purposes of complying with its minimum financial obligations in *SOLPRU* 8.4, a *firm* should consider whether it has any *ring-fenced funds* which would result in adjustments to its *eligible own funds* attributable to its *long-term insurance business* or to its *general insurance business*.

8.4.18 G Articles [ ] of the *Solvency II Regulation* require adjustments that must be made to *own funds* to reflect the lack of transferability of *ring-fenced funds* that can only be used to cover losses arising from a particular segment of liabilities or from particular risks.

8.5 Links between general insurers and long-term insurers

8.5.1 R If a *general insurer* and a *long-term insurer* have financial, commercial or administrative links with each other, each of those *firms* must ensure that its accounts are not distorted by an agreement between them or by any arrangement which could affect the apportionment of expenses and income.

[**Note**: article 73(4) of the *Solvency II Directive*]

9 Conditions governing business

9.1 Application

9.1.1 R *SOLPRU* 9 applies to a *UK Solvency II firm*.

9.2 General governance requirements

Responsibility of the governing body

9.2.1 R A *firm* must ensure its *governing body* is ultimately responsible for the *firm's* compliance with the *rules* and other laws, regulations and administrative provisions adopted in accordance with the *Solvency II Directive*.

[**Note**: article 40 of the *Solvency II Directive*]

9.2.2 G For the purposes of *SOLPRU* 9.2.1R, in addition to the *FSA's rules* and *guidance,* other laws, regulations and administrative provisions adopted in accordance with the *Solvency II Directive* include the *Solvency II Regulation* and [specify relevant HMT instrument(s)].

System of governance

9.2.3 R (1) A *firm* must have in place an effective system of governance which

provides for sound and prudent management of its business.

(2) The system of governance must include:

(a) an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities; and

(b) an effective system for ensuring the transmission of information.

(3) The system of governance must include compliance with the requirements laid down in:

(a) *SOLPRU* 9.2.8R;

(b) *SOLPRU* 9.3 (Risk management);

(c) *SOLPRU* 9.4 (Internal control);

(d) *SOLPRU* 9.5 (Internal audit);

(e) *SOLPRU* 9.6 (Actuarial function);

(f) *SOLPRU* 9.7 (Outsourcing); and

(g) *SOLPRU* 9.8 (Fit and proper requirements for persons who effectively run the undertaking or have other key functions).

(4) The system of governance must be subject to regular internal review.

[**Note**: article 41(1) of the *Solvency II Directive*]

Systems and controls (financial crime and money laundering)

9.2.4 G A *firm* should also have regard to its obligations in *SYSC* 3.2.6R to *SYSC* 3.2.6JG regarding systems and controls in relation to *financial crime* and *money laundering*.

Principle of proportionality

9.2.5 R A *firm* must ensure that its system of governance is proportionate to the nature, scale and complexity of its operations.

[**Note**: article 41(2) of the *Solvency II Directive*]

9.2.6 G Subject to the *rules,* a *firm* may choose to staff the *functions* referred to in this chapter with its own staff, to rely on advice from outside experts or to *outsource* those *functions* to experts.

[**Note**: recital 31 of the *Solvency II Directive*]

9.2.7 R A *firm* must:

(1) have written policies in relation to at least risk management, internal control, internal audit and, where relevant, *outsourcing*;

(2) make those policies subject to prior approval of its *governing body*;

(3) ensure those policies are implemented;

(4) review those policies at least annually; and

(5) adapt those policies in view of any significant change in the system or area concerned.

[**Note**: article 41(3) of the *Solvency II Directive*]

9.2.8 R The written policy on risk management (*SOLPRU* 9.2.7R(1)) must comprise policies relating to points (i) to (vi) in *SOLPRU* 9.3.1R(2)(c).

[**Note**: article 44(2) of the *Solvency II Directive*]

Business continuity and contingency planning

9.2.9 R A *firm* must take reasonable steps to ensure continuity and regularity in the performance of its activities, including the development of contingency plans. To that end, the *firm* must employ appropriate and proportionate systems, resources and procedures.

[**Note**: article 41(4) of the *Solvency II Directive*]

9.3 Risk management

General provisions

9.3.1 R (1) A *firm* must have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report on a continuous basis the risks, at an individual and at an aggregated level, to which it is or could be exposed, and their interdependencies.

(2) That risk-management system must:

(a) be effective and well integrated into the organisational structure and decision-making processes of the *firm* with proper consideration of the persons who effectively run the *firm* or have other key functions;

(b) cover the risks to be included in the calculation of the *SCR* as set out in *SOLPRU* 4.3.3R(1), as well as the risks which are not, or not fully, included in the calculation thereof;

(c) cover at least the following areas:

(i) underwriting and reserving;

(ii) asset–liability management;

(iii) *investment*, in particular *derivatives*, *quasi-derivatives* and similar commitments;

(iv) *liquidity risk* and *concentration risk* management;

(v) *operational risk* management;

(vi) *reinsurance* and other *risk-mitigation techniques*.

[**Note**: article 44(1)–(2) of the *Solvency II Directive*]

9.3.2 R As regards investment risk, a *firm* must demonstrate that it complies with *SOLPRU* 7.

[**Note**: article 44(3) of the *Solvency II Directive*]

9.3.3 R A *firm* must provide for a risk management *function* that is structured in such a way as to facilitate the implementation of the risk-management system.

[**Note**: article 44(4) of the *Solvency II Directive*]

The risk management function of a firm using an internal model

9.3.4 R A *firm* that has received *internal model approval* must ensure that its risk-management *function* covers the following additional tasks:

(1) to design and implement the *internal model*;

(2) to test and validate the *internal model*;

(3) to document the *internal model* and any subsequent changes made to it;

(4) to analyse the performance of the *internal model* and to produce summary reports thereof; and

(5) to inform the *governing body* about the performance of the *internal model*, suggesting areas needing improvement, and updating that body on the status of efforts to improve previously identified weaknesses.

[**Note**: article 44(5) of the *Solvency II Directive*]

Own risk and solvency assessment (ORSA)

9.3.5 R (1) A *firm* must conduct an *ORSA* as part of its risk management system.

(2) The *ORSA* must include at least the following:

(a) the *firm's* overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the *firm*;

(b) the compliance, on a continuous basis, with:

(i) the capital requirements, as set out in *SOLPRU* 4 and *SOLPRU* 5; and

(ii) the requirements regarding *technical provisions*, as set out in *SOLPRU* 2; and

(c) the significance with which the risk profile of the *firm* deviates from the assumptions underlying the *SCR* calculated with the *standard formula* or with its *internal model*.

(3) For the purposes of 2(a), the *firm* must have in place processes which are proportionate to the nature, scale and complexity of the risks inherent in its business and which enable it to properly identify and assess the risks it faces in the short and long term which it is, or could be, exposed to. The *firm* must demonstrate the methods used in that assessment.

(4) In the case referred to in (2)(c), when an *internal model* is used, the assessment must be performed together with the recalibration that transforms the internal risk numbers into the *SCR risk measure* and calibration.

[**Note**: articles 45(1)–(3) of the *Solvency II Directive*]

9.3.6 R A *firm* must make the *ORSA* an integral part of its business strategy and take the *ORSA* into account on an ongoing basis in its strategic decisions.

[**Note**: article 45(4) of the *Solvency II Directive*]

9.3.7 R A *firm* must perform the *ORSA* regularly and without delay following any significant change in its risk profile.

[**Note**: article 45(5) of the *Solvency II Directive*]

9.3.8 R A *firm* must inform the *FSA* of the results of each *ORSA* as part of the information reported under *SOLPRU* 12.2.1R.

[**Note**: article 45(6) of the *Solvency II Directive*]

9.4 Internal control

9.4.1 R (1) A *firm* must have in place an effective internal control system.

(2) That system must include administrative and accounting procedures, an internal control framework, appropriate reporting arrangements at

all levels of the *firm* and a compliance *function*.

[**Note**: article 46(1) of the *Solvency II Directive*]

9.4.2 R The compliance *function* must include advising the *governing body* on compliance with the *rules* and other laws, regulations and administrative provisions adopted in accordance with the *Solvency II Directive*. It must also include an assessment of the possible impact of any changes in the legal environment on the operations of the *firm* concerned and the identification and assessment of compliance risk.

[**Note**: article 46(2) of the *Solvency II Directive*]

9.4.3 R *Firms* must have internal processes and procedures in place to ensure the appropriateness, completeness and accuracy of the data used in the calculation of their *technical provisions*.

[**Note**: article 82 of the *Solvency II Directive*]

9.4.4 R *Firms* must have processes and procedures in place to ensure that the *best estimate*, and the assumptions underlying the calculation of the *best estimate*, are regularly compared against experience.

[**Note**: article 83 of the *Solvency II Directive*]

9.5 Internal audit

9.5.1 R (1) A *firm* must provide for an effective internal audit *function*.

(2) The internal audit *function* must:

(a) include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance;

(b) be objective and independent from the operational *functions*.

(3) A *firm* must ensure that any findings and recommendations of the internal audit *function* are reported to the *firm's governing body* which must:

(a) determine what actions are to be taken with respect to each of the internal audit findings and recommendations; and

(b) ensure that those actions are carried out.

[**Note**: article 47 of the *Solvency II Directive*]

9.6 Actuarial function

9.6.1 R (1) A *firm* must provide for an effective actuarial *function* to:

(a) coordinate the calculation of *technical provisions*;

(b) ensure the appropriateness of the methodologies and underlying models used, as well as the assumptions made in the calculation of *technical provisions*;

(c) assess the sufficiency and quality of the data used in the calculation of *technical provisions*;

(d) compare *best estimates* against experience;

(e) inform the *governing body* of the reliability and adequacy of the calculation of *technical provisions*;

(f) oversee the calculation of *technical provisions* in the cases set out in *SOLPRU* 2.4.12R and 2.4.13R;

(g) express an opinion on the overall underwriting policy;

(h) express an opinion on the adequacy of *reinsurance* arrangements; and

(i) contribute to the effective implementation of the risk-management system, in particular with respect to the risk modelling underlying the calculation of the capital requirements set out in *SOLPRU* 4 and *SOLPRU* 5 and to the *firm's ORSA*.

(2) The actuarial *function* must be carried out by *persons* who have knowledge of actuarial and financial mathematics, commensurate with the nature, scale and complexity of the risks inherent in the *firm's* business, and who are able to demonstrate their relevant experience with applicable professional and other standards.

[**Note**: article 48 of the *Solvency II Directive*]

9.7 Outsourcing

9.7.1 R If a *firm outsources* a *function* or any insurance or *reinsurance* activity, it remains fully responsible for discharging all of its obligations under the *rules* and other laws, regulations and administrative provisions adopted in accordance with the *Solvency II Directive*.

[**Note**: article 49(1) of the *Solvency II Directive*]

9.7.2 R A *firm* must not *outsource* a critical or important operational *function* or activity in such a way as to lead to any of the following:

(1) materially impairing the quality of the *firm's* system of governance;

(2) unduly increasing the *operational risk*;

(3) impairing the ability of the *supervisory authorities* to monitor the *firm's* compliance with its obligations;

(4) undermining continuous and satisfactory service to *policyholders*.

[**Note**: article 49(2) of the *Solvency II Directive*]

9.7.3 R A *firm* must, in a timely manner, notify the *FSA* prior to the *outsourcing* of critical or important *functions* or activities as well as of any subsequent material developments with respect to those *functions* or activities.

[**Note**: article 49(3) of the *Solvency II Directive*]

9.7.4 R Without prejudice to *SOLPRU* 9.7.1R to *SOLPRU* 9.7.3R, a *firm outsourcing* a *function* or an insurance or *reinsurance* activity must take the necessary steps to ensure that the following conditions are satisfied:

(1) the service provider must co-operate with the *FSA* and, where relevant, any other *supervisory authority* of the *firm* in connection with the *outsourcing* of the *function* or activity;

(2) the *firm*, its auditors, the *FSA* and, where relevant, any other *supervisory authority* of the *firm* must have effective access to data related to the *outsourcing* of the *functions* or activities; and

(3) the *FSA* and, where relevant, any other *supervisory authority* of the *firm* must have effective access to the business premises of the service provider and must be able to exercise those rights of access.

[**Note:** article 38(1) of the *Solvency II Directive*]

9.8 Fit and proper requirements for persons who effectively run the undertaking or have other key functions

9.8.1 R A *firm* must ensure that all persons who effectively run the *firm* or have other key *functions* at all times fulfil the following requirements:

(1) their professional qualifications, knowledge and experience are adequate to enable sound and prudent management of the *firm* (fit); and

(2) they are of good repute and integrity (proper).

[**Note**: article 42(1) of the *Solvency II Directive*]

9.8.2 R A *person* who effectively runs the *firm* will be performing at least one of the *governing functions* or the *significant management function*.

9.8.3 G A *person* who effectively runs the *firm* may also be performing other *controlled functions* applicable to a *UK Solvency II firm*.

9.8.4 R A *person* who is responsible for a key *function* will be performing at least one of the *controlled functions* applicable to a *UK Solvency II firm*.

9.8.5 G In accordance with section 59 of the *Act*, approval is necessary in respect of a *controlled function* which is performed under an *arrangement* entered into by a *firm*, or its contractor, in relation to a *regulated activity*. A *firm* should refer to *SUP* 10 (Approved persons) which sets out the boundaries of the "approved persons regime" and includes *rules* as to the notifications that must be made to the *FSA* in respect of *approved persons*.

9.9 Finite reinsurance

Requirements: finite reinsurance

9.9.1 R A *firm* must not enter into a contract of *finite reinsurance* (either as a cedant or a *reinsurer*) or pursue *finite reinsurance* activities unless it is able to properly identify, measure, monitor, manage, control and report the risks arising from that contract or those activities.

[**Note**: article 210 of the *Solvency II Directive*]

9.10 Further system of governance requirements

9.10.1 G Articles [ ] of the *Solvency II Regulation* contain further requirements on a *firm's* system of governance.

10 Insurance special purpose vehicles

10.1 Application and purpose

10.1.1 R *SOLPRU* 10 applies to a *UK ISPV*.

10.1.2 G An *ISPV* is a special purpose vehicle which assumes risks from *Solvency II undertakings* and which fully funds its exposure to those risks through the proceeds of a debt issuance or some other financing mechanism where the repayment rights of the providers of that debt or other financing mechanism are subordinated to the *undertaking's* obligations to the *Solvency II undertakings* in respect of those risks.

10.1.3 G Under section 19 of the *Act*, a *firm* may not carry on a *regulated activity* unless it has permission to do so (or is exempt in relation to a particular activity). An *ISPV* that accepts risks from *Solvency II undertakings* under a contract of *reinsurance* will require *permission* to *effect* and *carry out*

contracts of insurance.

10.1.4 R A *UK ISPV* must ensure that at all times it is fully funded.

10.1.5 G Articles [ ] of the *Solvency II Regulation* set out requirements relating to *ISPVs*, including in relation to the authorisation of *ISPVs*, conditions that must be included in *ISPVs'* contracts, fit and proper requirements of the persons running the *ISPVs* and shareholders or members having a qualifying holding in the *ISPV*, governance and risk management requirements, information requirements and the fully funded requirement.

11 Group supervision

11.1 Application

11.1.1 R *SOLPRU* 11 (Group supervision) applies to every *UK Solvency II firm* that is a member of an *insurance group*.

[**Note:** article 213 of the *Solvency II Directive*]

11.1.2 R An *insurance group* exists where:

(1) either:

(a) a *UK Solvency II firm* holds a *participation* in at least one other *Solvency II undertaking*, *third country insurance undertaking* or *third country reinsurance undertaking*; or

(b) the *parent undertaking* of a *UK Solvency II firm* is a *Solvency II undertaking* (other than a *UK Solvency II firm*); or

(2) the *parent undertaking* of a *UK Solvency II firm* is an *insurance holding company* which has its head office in an *EEA State*; or

(3) the *parent undertaking* of a *UK Solvency II firm* is an *insurance holding company* which does not have its head office in an *EEA State* or is a *third country insurance undertaking* or a *third country reinsurance undertaking*; or

(4) the *parent undertaking* of a *UK insurer* is a *mixed activity insurance holding company*.

[**Note:** article 213(2) of the *Solvency II Directive*]

11.1.3 R Where, in accordance with *SOLPRU* 11.1.2R, an *insurance group* exists, that *insurance group* consists of all *undertakings* within the relevant *group*, subject to *SOLPRU* 11.1.4R and *SOLPRU* 11.2 (Levels) and provided that:

(1) where *SOLPRU* 11.1.2R(1) applies, the definition of a *group* must be applied to the *participating Solvency II undertaking*, its *subsidiary undertakings*, the *undertakings* in which it holds a *participation* and

undertakings to which it is linked by a *consolidation Article 12(1) relationship* or, where applicable, to the *undertakings* in a *mutual-type group*;

(2) where *SOLPRU* 11.1.2R(2) applies, the definition of a *group* must be applied to the *insurance holding company*, its *subsidiary undertakings*, the *undertakings* in which it holds a *participation* and *undertakings* to which it is linked by a *consolidation Article 12(1) relationship* or, where applicable, to the *undertakings* in a *mutual-type group*;

(3) where *SOLPRU* 11.1.2R(3) applies, the definition of a *group* must be applied to the *insurance holding company*, *third country insurance undertaking* or *third country reinsurance undertaking* (as applicable), its *subsidiary undertakings*, the *undertakings* in which it holds a *participation* and *undertakings* to which it is linked by a *consolidation Article 12(1) relationship* or, where applicable, to the *undertakings* in a *mutual-type group*; and

(4) where *SOLPRU* 11.1.2R(4) applies, the definition of a *group* must be applied to the *mixed activity insurance holding company*, its *subsidiary undertakings*, the *undertakings* in which it holds a *participation* and *undertakings* to which it is linked by a *consolidation Article 12(1) relationship* or, where applicable, to the *undertakings* in a *mutual-type group*.

[**Note:** article 213(2) of the *Solvency II Directive*]

11.1.4 R Where the *group supervisor* has decided, in accordance with article 214 of the *Solvency II Directive*, not to include an *undertaking* in the group supervision referred to in *SOLPRU* 11.1.3R:

(1) that *undertaking* must be excluded from the *insurance group* for the purposes of *SOLPRU* 11.1.3R; and

(2) if that *undertaking* is a *UK Solvency II firm* and is excluded under article 214(b) or (c) of the *Solvency II Directive*, the *UK Solvency II firm* which is at the head of the *insurance group* of which that *UK Solvency II firm* would otherwise be a part, or any other *UK Solvency II firm* which the *FSA* may specify, must provide any information in relation to the excluded *UK Solvency II firm* that the *FSA* may require to facilitate its supervision of the excluded *UK Solvency II firm*.

[**Note:** article 214(2) of the *Solvency II Directive*]

11.1.5 R (1) Where a *supervisory authority* has decided, in accordance with article 212(2) of the *Solvency II Directive*, that an *undertaking* ("first undertaking") effectively exercises a *dominant influence* over another *undertaking* ("second undertaking") then, for the purposes of *SOLPRU* 11 (Group supervision), the first undertaking must be treated as a *parent undertaking* in relation to the second undertaking

and the second undertaking must be treated as a *subsidiary undertaking* in relation to the first undertaking.

(2) Where a *supervisory authority* has decided, in accordance with article 212(2) of the *Solvency II Directive*, that an *undertaking* ("first undertaking") effectively exercises a significant influence over another *undertaking* ("second undertaking") then, for the purposes of *SOLPRU* 11 (Group supervision), the first undertaking must be treated as a *participating undertaking* in relation to the second undertaking and the second undertaking must be treated as an *undertaking* in relation to which the first undertaking holds a *participation*.

[**Note:** article 212(2) of the *Solvency II Directive*]

11.1.6 R The provisions of *SOLPRU* concerning the supervision of *Solvency II undertakings* taken individually continue to apply to those *undertakings*, except where otherwise provided under *SOLPRU* 11 (Group supervision).

[**Note:** article 213(1) of the *Solvency II Directive*]

11.1.7 G (1) Where the *FSA* is the *group supervisor* of an *insurance group*, references in *SOLPRU* 11 (Group supervision) to the *group supervisor* are to the *FSA* acting in that capacity.

(2) Where a *supervisory authority* other than the *FSA* is *group supervisor* in relation to an *insurance group*, the *FSA* may give effect to the exercise of that *group supervisor's* supervision of the *insurance group* by taking such measures as it considers appropriate in relation to the members of that *insurance group* that have their head offices in the *United Kingdom*.

11.2 Levels

11.2.1 R If the *participating Solvency II undertaking* or the *insurance holding company* referred to in *SOLPRU* 11.1.2R(1) or (2) (instances of group supervision) is itself a *subsidiary undertaking* of another *Solvency II undertaking* or of another *insurance holding company* which has its head office in an *EEA State*, then *SOLPRU* 11.3 to *SOLPRU* 11.9 (Group solvency) applies only at the level of the *ultimate EEA insurance parent undertaking*.

[**Note:** article 215(1) of the *Solvency II Directive*]

11.2.2 R If the *FSA* makes the decision referred to in article 216(1) of the *Solvency II Directive* (group supervision at national level) then *SOLPRU* 11.3 to *SOLPRU* 11.9 (Group solvency) apply with any necessary changes, subject to articles 216(6) and 217 of the *Solvency II Directive* and the following:

(1) if the *FSA* so determines, group supervision of the *ultimate insurance parent undertaking* at national level is restricted to those

sections of *SOLPRU* 11.3 to *SOLPRU* 11.9 (other than *SOLPRU* 11.9.5G) that the *FSA* specifies; and

(2) no *undertaking* in the *insurance group* may introduce, in accordance with *SOLPRU* 11.7.1R(5) (criteria for centralised risk management), an application for permission to subject any *subsidiary undertakings* in the *insurance group* to *SOLPRU* 11.7.3R (*SCR* for subsidiaries with centralised risk management).

[**Note:** article 216(2) and (5) of the *Solvency II Directive*]

11.3 Group solvency: general provisions

11.3.1 R Where *SOLPRU* 11.1.2R(1)(a) (instances of group supervision) applies, each *participating Solvency II undertaking* in the *insurance group* must ensure that *eligible own funds* are available in the *insurance group* which are always at least equal to the *group SCR* as calculated in accordance with *SOLPRU* 11.4 to *SOLPRU* 11.5.

[**Note:** article 218(2) of the *Solvency II Directive*]

11.3.2 R Where *SOLPRU* 11.1.2R(2) (instances of group supervision) applies, each *Solvency II undertaking* in the *insurance group* must ensure that *eligible own funds* are available in the *insurance group* which are always at least equal to the *group SCR* as calculated in accordance with *SOLPRU* 11.6.

[**Note:** article 218(3) of the *Solvency II Directive*]

11.3.3 R *Relevant insurance group undertakings* must have procedures in place to identify deteriorating financial conditions within the *insurance groups* of which they are members and must immediately notify the *FSA* when that deterioration occurs.

[**Note:** articles 218(4) and 136 of the *Solvency II Directive*]

11.3.4 G *SOLPRU* 11.3.3R does not require each *relevant insurance group undertaking* within an *insurance group* to operate procedures separate from those of the *insurance group* as a whole.

11.3.5 R *Relevant insurance group undertakings* must:

(1) immediately inform the *FSA* as soon as they observe that the *group SCR* is no longer complied with, or where there is a risk of non-compliance within the next three *months*;

(2) within two *months* from the observation of non-compliance with the *group SCR*, submit a realistic *recovery plan* in accordance with *SOLPRU* 6.5.1R (recovery plans) for approval by the *FSA*;

(3) take the measures determined by the *FSA* to achieve, within six *months* (or such longer period as the *FSA* may determine) from the

observation of non-compliance with the *group SCR*, the re-establishment of the level of *eligible own funds* covering the *group SCR* or the reduction of the risk profile to ensure compliance with the *group SCR*; and

(4) if the *FSA* has determined a longer period in relation to (3) by reason of an exceptional fall in financial markets (as determined by *EIOPA* under article 138 of the *Solvency II Directive*), submit a progress report to the *FSA* every three *months* setting out the measures taken and the progress made to re-establish the level of *own funds* covering the *group SCR* or to reduce the risk profile to ensure compliance with the *group SCR*.

[**Note:** articles 218(4) and 138(1)–(4) of the *Solvency II Directive*]

11.3.6 G (1) *UK Solvency II firms* must comply with the requirements of *SOLPRU* 5.3.1R, notwithstanding that they may be members of an *insurance group* that has complied with *SOLPRU* 11.3.5R.

(2) It is sufficient, for the purposes of *SOLPRU* 11.3.5R, for one *relevant insurance group undertaking* within an *insurance group* to undertake the matters referred to in that *rule* on behalf of the *insurance group* as a whole.

Frequency of calculations

11.3.7 R The calculations referred to in *SOLPRU* 11.3.1R and *SOLPRU* 11.3.2R (*eligible own funds* at group level to meet the *group SCR*) must be carried out at least annually by the *relevant insurance group undertakings*.

[**Note:** article 219(1) of the *Solvency II Directive*]

11.3.8 G It is sufficient, for the purposes of *SOLPRU* 11.3.7R, for one *relevant insurance group undertaking* within an *insurance group* to undertake the calculation referred to in that *rule* on behalf of the *insurance group* as a whole.

11.3.9 R The relevant data for, and the results of, the calculations referred to in *SOLPRU* 11.3.1R and *SOLPRU* 11.3.2R must be submitted to the *group supervisor* by the *relevant insurance group undertakings,* or by any one of them on behalf of the *insurance group* as a whole, or by such other *undertaking* in the *insurance group* as may be determined by the *group supervisor* in accordance with article 219(1) of the *Solvency II Directive*.

[**Note:** article 219(1) of the *Solvency II Directive*]

11.3.10 R (1) The *relevant insurance group undertakings* must monitor the *group SCR* on an ongoing basis.

(2) Where the risk profile of the *insurance group* deviates significantly from the assumptions underlying the last reported *group SCR*, the *group SCR* must be recalculated without delay and reported to the

group supervisor.

(3) If the *group supervisor* so requires, in accordance with article 219(2) of the *Solvency II Directive*, the *group SCR* must be recalculated without delay and reported to the *group supervisor*.

[**Note:** article 219(2) of the *Solvency II Directive*]

11.4 Group solvency: choice of calculation method and basic principles

11.4.1 R The calculation of the solvency at the level of the *insurance group* of the *Solvency II undertakings* referred to in *SOLPRU* 11.1.2R(1) (instances of group supervision) must be carried out:

(1) in accordance with the technical principles in *SOLPRU* 11.4.2 to *SOLPRU* 11.4.20 (inclusion of proportional shares, elimination of double use of eligible own funds, elimination of intra-group creation of capital and deduction of certain *undertakings*); and

[**Note:** article 220(1) of the *Solvency II Directive*]

(2) in accordance with *method 1*, unless the *group supervisor* has determined under article 220(2) of the *Solvency II Directive* that *method 2* or a combination of *method 1* and *method 2* must be applied.

[**Note:** article 220(2) of the *Solvency II Directive*]

11.4.2 R The calculation of the solvency of an *insurance group* must take account of the proportional share held by the *participating undertaking* in its *related undertakings*.

[**Note:** article 221(1) of the *Solvency II Directive*]

Proportional shares

11.4.3 R For the purposes of *SOLPRU* 11.4.2R, the proportional share must comprise either of the following, subject to *SOLPRU* 11.4.4R:

(1) where *method 1* is used, the percentages used for the establishment of the consolidated accounts; or

(2) where *method 2* is used, the proportion of the subscribed capital that is held, directly or indirectly, by the *participating undertaking*.

[**Note:** article 221(1) of the *Solvency II Directive*]

11.4.4 R Notwithstanding *SOLPRU* 11.4.3R:

(1) where the *related undertaking* is a *subsidiary undertaking* and does not have sufficient *eligible own funds* to cover its *SCR*, the total

solvency deficit of the *subsidiary undertaking* must be taken into account (or a proportional share of that *solvency deficit*, if the *group supervisor* so determines under article 221(1) of the *Solvency II Directive*); and

[**Note:** article 221(1) of the *Solvency II Directive*]

(2) the proportional share must be as determined by the *group supervisor* if such a determination is made under article 221(2) of the *Solvency II Directive*.

[**Note:** article 221(2) of the *Solvency II Directive*]

Elimination of double use of eligible own funds

11.4.5 R *Own funds eligible for the SCR* must not be taken into account more than once among the different *Solvency II undertakings* taken into account in the calculation of the solvency of an *insurance group*. For that purpose, when calculating the solvency of an *insurance group* and where *method 1* and *method 2* do not provide for it, the following amounts must be excluded:

(1) the value of any asset of the *participating Solvency II undertaking* which represents the financing of *own funds eligible for the SCR* of one of its *related Solvency II undertakings*;

(2) the value of any asset of a *related Solvency II undertaking* of the *participating Solvency II undertakings* which represents the financing of *own funds eligible for the SCR* of that *participating Solvency II undertakings*; and

(3) the value of any asset of a *related Solvency II undertaking* of the *participating Solvency II undertaking* which represents the financing of *own funds eligible for the SCR* of any other *related Solvency II undertaking* of that *participating Solvency II undertaking*.

[**Note:** article 222(1) of the *Solvency II Directive*]

11.4.6 R Without prejudice to *SOLPRU* 11.4.5R or *SOLPRU* 11.4.7R, the following may be included in the calculation of the solvency of an *insurance group* only insofar as they are eligible for covering the *SCR* of the *related undertaking* concerned:

(1) surplus funds falling under article 91(2) of the *Solvency II Directive* arising in a *related Solvency II undertaking* of the *participating Solvency II undertaking* for which the solvency of an *insurance group* is calculated; and

(2) any subscribed but not paid-up capital of a *related Solvency II firm* of the *participating Solvency II undertaking* for which the solvency of an *insurance group* is calculated.

[**Note:** article 222(2) of the *Solvency II Directive*]

11.4.7 R Without prejudice to *SOLPRU* 11.4.5R, the following must, in any event, be excluded from the calculation:

(1) subscribed but not paid-up capital which represents a potential obligation on the part of the *participating undertaking*;

(2) subscribed but not paid-up capital of the *participating Solvency II undertaking* which represents a potential obligation on the part of a *related Solvency II undertaking*; and

(3) subscribed but not paid-up capital of a *related Solvency II undertaking* which represents a potential obligation on the part of another *related Solvency II undertaking* of the same *participating Solvency II undertaking*.

[**Note:** article 222(2) of the *Solvency II Directive*]

11.4.8 R Where the *FSA* considers that certain *own funds eligible for the SCR* of a *related Solvency II undertaking* (other than those referred to in *SOLPRU* 11.4.6R and *SOLPRU* 11.4.7R) cannot effectively be made available to cover the *SCR* of the *participating Solvency II undertaking* for which the solvency of an *insurance group* is calculated, those *own funds* may be included in the calculation of the group solvency of the *insurance group* only in so far as they are eligible for covering the *SCR* of the *related undertaking*.

[**Note:** article 222(3) of the *Solvency II Directive*]

11.4.9 R The sum of the own funds included under *SOLPRU* 11.4.6R and *SOLPRU* 11.4.8R must not exceed the *SCR* of the *related Solvency II undertaking*.

[**Note:** article 222(4) of the *Solvency II Directive*]

11.4.10 R Any *eligible own funds* of a *related Solvency II undertaking* of the *participating Solvency II undertaking* for which the solvency of an *insurance group* is calculated that are subject to prior authorisation from the *supervisory authority* of the *related Solvency II undertaking*, in accordance with article 90 of the *Solvency II Directive*, must be included in the calculation of the group solvency only in so far as they have been duly authorised by that *supervisory authority*.

[**Note:** article 222(5) of the *Solvency II Directive*]

11.4.11 R When calculating solvency of an *insurance group*, no account must be taken of any *own funds eligible for the SCR* arising out of reciprocal financing between the *participating Solvency II undertaking* and any of the following:

(1) a *related undertaking*;

(2) a *participating undertaking*; and

(3) another *related undertaking* of any of its *participating undertakings*.

[**Note:** article 223(1) of the *Solvency II Directive*]

11.4.12 R When calculating solvency of an *insurance group*, no account must be taken of any *own funds eligible for the SCR* of a *related Solvency II undertaking* of the *participating Solvency II undertaking* for which the group solvency of the *insurance group* is calculated where the *own funds* concerned arise out of reciprocal financing with any other *related undertaking* of that *participating Solvency II undertaking*.

[**Note:** article 223(2) of the *Solvency II Directive*]

11.4.13 G Reciprocal financing is deemed to exist at least where a *Solvency II undertaking*, or any of its *related undertakings*, holds shares in, or makes loans to, another *undertaking* which, directly or indirectly, holds *own funds eligible for the SCR* of the first undertaking.

[**Note:** article 223(3) of the *Solvency II Directive*]

11.4.14 R The value of the assets and liabilities of an *insurance group* must be assessed in accordance with *SOLPRU* 2.2 (Valuation of assets and liabilities).

[**Note:** article 224 of the *Solvency II Directive*]

11.4.15 R Where a *Solvency II undertaking* has more than one *related Solvency II undertaking*, the group solvency calculation of the *insurance group* must be carried out by including each of those *related Solvency II undertakings*.

[**Note:** article 225 of the *Solvency II Directive*]

Application of the calculation methods

11.4.16 R In respect of a *related Solvency II undertaking* with its head office in an *EEA State* other than that of the *Solvency II undertaking* for which the group solvency calculation of the *insurance group* is carried out, the group solvency calculation must take account of the *SCR* and the *own funds eligible for the SCR* as laid down in the *Solvency II EEA implementing measures* of that other *EEA State*.

[**Note:** article 225 of the *Solvency II Directive*]

11.4.17 R (1) When calculating the group solvency of a *Solvency II undertaking* in an *insurance group* which holds a *participation* in a *related Solvency II undertaking*, a *third country insurance undertaking* or a *third country reinsurance undertaking*, through an *insurance holding company*, the situation of such an *insurance holding company* (an "intermediate insurance holding company") must be taken into account.

(2) For the sole purpose of that calculation, the intermediate *insurance holding company* must be treated as if it were a *Solvency II undertaking* subject to the rules laid down in *SOLPRU* 4 (SCR) in

respect of the *SCR* and were subject to the same conditions as are laid down in *SOLPRU* 3 (Own funds) in respect of *own funds eligible for the SCR*.

(3) In cases where an intermediate *insurance holding company* holds subordinated debt or other *eligible own funds* subject to limitation in accordance with *SOLPRU* 3.3.10R to *SOLPRU* 3.3.13G (eligibility limits), they must be recognised as *eligible own funds* up to the amounts calculated by application of the limits in *SOLPRU* 3.3.10R to *SOLPRU* 3.3.13G to the total *eligible own funds* outstanding at group level of the *insurance group* as compared to the *group SCR*.

(4) Any *eligible own funds* of an intermediate *insurance holding company*, which would require prior authorisation from a *supervisory authority* in accordance with *SOLPRU* 3.2.6R (approval of ancillary own funds) or the applicable *Solvency II EEA implementing measures* if they were held by a *Solvency II undertaking*, may be included in the calculation of the group solvency of the *insurance group* only in so far as they have been duly authorised by the *group supervisor*.

[**Note:** article 226 of the *Solvency II Directive*]

11.4.18 R (1) Subject to (2), when calculating, in accordance with *method 2*, the group solvency of a *Solvency II undertaking* in an *insurance group* which is a *participating undertaking* in a *third country insurance undertaking* or *third country reinsurance undertaking*, that *third country insurance undertaking* or *third country reinsurance undertaking* must, solely for the purposes of that calculation, be treated as a *related Solvency II undertaking*.

(2) If the third country in which that *third country insurance undertaking* or *third country reinsurance undertaking* has its head office makes it subject to authorisation and imposes on it a solvency regime that is assessed to be equivalent under article 227 of the *Solvency II Directive*, the calculation in (1) must take into account, as regards that *undertaking*, the requirement equivalent to the *SCR* and the capital items eligible to satisfy that requirement as laid down by that third country.

[**Note:** article 227 of the *Solvency II Directive*]

11.4.19 R When calculating the group solvency of a *Solvency II undertaking* in an *insurance group* which is a *participating undertaking* in a *credit institution*, *investment firm* or *financial institution*, the *participating Solvency II undertaking* must either:

(1) apply *method 1* or *method 2* in Annex I to Directive 2002/87/EC with any necessary changes, provided that *method 1* in that Annex must be applied only where the *group supervisor* is satisfied as to the level of integrated management and internal control regarding the *undertakings* which would be included in the scope of consolidation

and provided always that the method chosen must be applied in a consistent manner over time; or

(2) if the *group supervisor* so determines (either at the request of the *participating undertaking* or on its own initiative), deduct any such *participation* from the *own funds eligible for the group SCR* of the *participating undertaking*.

[**Note:** article 228 of the *Solvency II Directive*]

11.4.20 R Where the information necessary for calculating the group solvency of a *Solvency II undertaking* in an *insurance group*, concerning a *related undertaking* with its head office in an *EEA State* or a third country, is not available to the *group supervisor* then:

(1) the book value of that *related undertaking* in the *participating Solvency II undertaking* must be deducted from the *own funds eligible for the group SCR*; and

(2) the unrealised gains connected with that *participation* must not be recognised as *own funds eligible for the group SCR*.

[**Note:** article 229 of the *Solvency II Directive*]

11.5 Calculation methods

Method 1

11.5.1 R (1) The calculation of the group solvency of the *participating Solvency II undertaking* in an *insurance group* must be carried out on the basis of the consolidated accounts.

(2) The group solvency of the *participating Solvency II undertaking* in an *insurance group* is the difference between the following:

(a) the *own funds eligible for the group SCR*, calculated on the basis of consolidated data; and

(b) the *group SCR* calculated on the basis of consolidated data.

(3) *SOLPRU* 3 (Own funds) and *SOLPRU* 4 (SCR) apply to the calculation of the *own funds eligible for the group SCR* and of the *group SCR* based on consolidated data.

[**Note:** article 230(1) of the *Solvency II Directive*]

11.5.2 R The *group SCR* of an *insurance group* based on consolidated data (consolidated *group SCR*) must be calculated on the basis of either the *standard formula* or an approved *internal model*, in a manner consistent with the general principles contained in *SOLPRU* 4 (SCR).

[**Note:** article 230(2) of the *Solvency II Directive*]

11.5.3 R (1) The consolidated *group SCR* of an *insurance group* must have as a minimum the sum of the following:

(a) the *MCR* of the *participating Solvency II undertaking*; and

(b) the proportional share of the *MCR* of the *related Solvency II undertakings*.

(2) That minimum must be covered by *eligible own funds* within paragraph 2 of the definition of "*eligible own funds*".

(3) For the purposes of determining whether those *eligible own funds* qualify to cover the minimum consolidated *group SCR* of an *insurance group*, the principles in *SOLPRU* 11.4.2R to *SOLPRU* 11.4.20R (inclusion of proportional shares, elimination of double use of eligible own funds, elimination of intra-group creation of capital, valuation, related Solvency II undertakings, intermediate insurance holding companies, certain related firms, non-availability of information) apply with any necessary changes. *SOLPRU* 6.4 (Non-compliance with the MCR) also applies with any necessary changes.

[**Note:** article 230(2) of the *Solvency II Directive*]

11.5.4 R Any application for permission to calculate the consolidated *group SCR*, as well as the *SCR* of *Solvency II undertakings* in the *insurance group*, on the basis of an *internal model*, submitted by a *Solvency II undertaking* and its *related undertakings*, or jointly by the *related Solvency II undertakings* of an *insurance holding company*, must be submitted to the *group supervisor*.

[**Note:** article 231(1) of the *Solvency II Directive*]

Method 2

11.5.5 R The group solvency of the *participating Solvency II undertaking* in an *insurance group* is the difference between the following:

(1) the aggregated group *eligible own funds*, as provided for in *SOLPRU* 11.5.6R; and

(2) the value in the *participating Solvency II undertaking* of the *related Solvency II undertaking* and the aggregated *group SCR*, as provided for in *SOLPRU* 11.5.7R.

[**Note:** article 233(1) of the *Solvency II Directive*]

11.5.6 R The aggregated group *eligible own funds* of an *insurance group* is the sum of the following:

(1) the *own funds eligible for the SCR* of the *participating Solvency II undertaking*; and

(2) the proportional share of the *participating Solvency II undertaking* in the *own funds eligible for the SCR* of the *related Solvency II undertakings*.

[**Note:** article 233(2) of the *Solvency II Directive*]

11.5.7 R The aggregated *group SCR* of an *insurance group* is the sum of the following:

(1) the *SCR* of the *participating Solvency II undertakings*; and

(2) the proportional share of the *SCR* of the *related Solvency II undertakings*.

[**Note:** article 233(3) of the *Solvency II Directive*]

11.5.8 R Where, in an *insurance group*, the *participation* in the *related Solvency II undertaking* consists, wholly or in part, of an indirect ownership, the value in the *participating Solvency II undertaking* of the *related Solvency II undertaking* must incorporate the value of that indirect ownership. The value of that indirect ownership must take into account the relevant successive interests, and the items referred to in *SOLPRU* 11.5.6R(2) (group *eligible own funds* under *method 2*) and *SOLPRU* 11.5.7R(2) (*group SCR* under *method 2*) must include the corresponding proportional shares, respectively, of the *own funds eligible for the SCR* of the *related Solvency II undertaking* and of the *SCR* of the *related Solvency II undertakings*.

[**Note:** article 233(4) of the *Solvency II Directive*]

11.5.9 R Any application for permission to calculate the *SCR* of *Solvency II undertakings* in the *insurance group*, on the basis of an *internal model*, submitted by a *Solvency II undertaking* and its *related undertakings*, or jointly by the *related undertakings* of an *insurance holding company*, must be submitted to the *group supervisor*.

[**Note:** article 233(5) of the *Solvency II Directive*]

Capital add-ons

11.5.10 G Article 232 of the *Solvency II Directive* contemplates the *FSA* applying a *capital add-on* to an *insurance group* if the circumstances referred to in *SOLPRU* 4.28.2G arise at group level, in particular where either a specific risk existing at group level would not be sufficiently covered by the *standard formula* or the *internal model* used (because it is difficult to quantify) or where a *capital add-on* is imposed under articles 37 or 231(7) of the *Solvency II Directive* in relation to a *Solvency II undertaking* in the *insurance group*. The *FSA* will exercise the power to apply a *capital add-on* under the *Act*. Articles [ ] of the *Solvency II Regulation* also apply in relation to the imposition of a *capital add-on*.

11.5.11 R An *insurance group* must make every effort to remedy the deficiencies that led to the imposition of a *capital add-on* arising as a result of an *internal*

model significant risk profile deviation or a *significant system of governance deviation* at group level.

[**Note**: articles 232 and 37(3) of the *Solvency II Directive*]

11.5.12 G A *capital add-on* applied to an *insurance group* will be reviewed at least once a year by the *FSA* and removed by the *FSA* in circumstances where the *insurance group* has remedied the deficiencies which led to its imposition.

[**Note**: articles 232 and 37(4) of the *Solvency II Directive*]

11.5.13 R The *group SCR* prior to the imposition of the *capital add-on*, together with the amount of the *capital add-on* imposed by the *FSA* at group level, will constitute the *insurance group's group SCR*.

[**Note:** articles 232 and 37(5) of the *Solvency II Directive*]

11.6 Supervision of group solvency for Solvency II firms that are subsidiaries of an insurance holding company

11.6.1 R (1) Where *Solvency II undertakings* in an *insurance group* are *subsidiary undertakings* of an *insurance holding company*, the calculation of the solvency of the *insurance group* must be carried out at the level of the *insurance holding company* applying *SOLPRU* 11.4.1R(2) to 11.5.9R (choice of method, inclusion of proportional shares, elimination of double use of *eligible own funds*, elimination of the intra-group creation of capital, valuation, *related undertakings*, intermediate *insurance holding companies*, related *third country insurance and reinsurance undertakings*, certain *related undertakings*, non-availability of information, *method 1*, group internal models, group capital add-ons and *method 2*).

(2) For the purpose of that calculation, the *insurance holding company* must be treated as if it were a *Solvency II undertaking* subject to *SOLPRU* 4 (SCR) as regards the *SCR* and *SOLPRU* 3 (Own funds) as regards the *own funds eligible for the SCR*, provided that the *relevant insurance group undertakings* remain responsible for discharging any obligations arising from the application of this paragraph (2).

[**Note:** article 235 of the *Solvency II Directive*]

11.7 Groups with centralised risk management

11.7.1 R *SOLPRU* 11.7.3R applies to any *Solvency II undertaking* in an *insurance group* which is a *subsidiary undertaking* of another *Solvency II undertaking* or of an *insurance holding company* where all of the following conditions are satisfied:

(1) the *subsidiary undertaking*, in relation to which the *group supervisor* has not made a decision under article 214(2) of the *Solvency II Directive*, is included in the *group supervision* carried out by the *group supervisor* at the level of the *parent undertaking* in accordance with *SOLPRU* 11 (Group supervision);

(2) the risk-management processes and internal control mechanisms of the *parent undertaking* cover the *subsidiary undertaking* and the *parent undertaking* satisfies the *FSA* regarding the prudent management of the *subsidiary undertaking*;

(3) the *parent undertaking* is or one or more *relevant insurance group undertaking* that is permitted, under *SOLPRU* 11.9.2R(3) (group ORSA), to produce a single document covering all relevant *ORSAs*;

(4) the *parent undertaking* is or one or more *relevant insurance group undertaking* that is permitted, under *SOLPRU* 11.9.4R(2) (group SFCR), to produce a single *SFCR* covering all relevant *Solvency II undertakings* and *insurance holding companies*; and

(5) an application for permission to be subject to *SOLPRU* 11.7.3R has been submitted by the *parent undertaking* or one or more *relevant insurance group undertakings* and a favourable decision has been made on that application in accordance with the procedure in article 237 of the *Solvency II Directive*.

[**Note:** article 236 of the *Solvency II Directive*]

11.7.2 R An application for permission to be subject to *SOLPRU* 11.7.3R must be made to the *FSA* if the *subsidiary undertaking* is a *UK Solvency II firm*.

[**Note:** article 237(1) of the *Solvency II Directive*]

11.7.3 R Without prejudice to *SOLPRU* 11.5.4R (group internal model) and subject to *SOLPRU* 11.7.4R, if the conditions referred to in *SOLPRU* 11.7.1R are satisfied, the *SCR* of the *subsidiary undertaking* in the *insurance group* must be calculated in accordance with any decisions taken in accordance with article 238 of the *Solvency II Directive*.

[**Note:** article 238 of the *Solvency II Directive*]

11.7.4 R (1) *SOLPRU* 11.7.3R ceases to apply where:

(a) the condition referred to in *SOLPRU* 11.7.1R(1) is no longer complied with;

(b) the condition referred to in *SOLPRU* 11.7.1R(2) is no longer complied with and the *insurance group* does not restore compliance with this condition in an appropriate period of time.

(2) The *parent undertaking* or *relevant insurance group undertakings* of an *insurance group* to which *SOLPRU* 11.7.3R applies must ensure that the conditions referred to in *SOLPRU* 11.7.1R(2), (3) and (4) are complied with on an ongoing basis and in the event of non-compliance must:

(a) inform the *group supervisor* and the *supervisory authority* of the *subsidiary undertaking* concerned without delay; and

(b) present a plan to the *supervisory authorities* to restore compliance within an appropriate period of time.

[**Note:** article 240 of the *Solvency II Directive*]

11.7.5 G It is sufficient, for the purposes of *SOLPRU* 11.7.4R(2), for one *relevant insurance group undertaking* within an *insurance group* to undertake the matters referred to in that *rule* on behalf of the *insurance group* as a whole.

11.8 Risk concentration and intra-group transactions

11.8.1 R (1) *Solvency II undertakings* within an *insurance group* must report on a regular basis and at least annually to the *group supervisor* any significant risk concentration at the level of the *insurance group*.

(2) The necessary information must be submitted to the *group supervisor* by the *Solvency II undertaking* which is at the head of the *insurance group* or by such other *Solvency II undertaking* in the *insurance group* as the *group supervisor* may specify.

[**Note:** article 244 of the *Solvency II Directive*]

11.8.2 R (1) *Solvency II undertakings* within an *insurance group* must report on a regular basis, and at least annually, to the *group supervisor* all significant intra-group transactions by *Solvency II undertakings* within an *insurance group*, including those performed with a natural *person* with close links to an *undertaking* in the *insurance group*.

(2) Where an intra-group transaction falling within (1) is very significant, it must be reported to the *group supervisor* as soon as practicable.

(3) The necessary information must be submitted to the *group supervisor* by the *Solvency II undertaking* which is at the head of the *insurance group* or by such other *Solvency II undertaking* in the *insurance group* as the *group supervisor* may specify.

[**Note:** article 245 of the *Solvency II Directive*]

11.9 Risk management and internal control

11.9.1 R (1) The requirements in *SOLPRU* 9.3 to *SOLPRU* 9.8 (Conditions governing business) apply with any necessary changes at the level of the *insurance group*.

(2) Without prejudice to (1), the risk management and internal control systems and reporting procedures must be implemented consistently in all the *undertakings* included in the scope of *insurance group* supervision under *SOLPRU* 11.1.3R (scope of group supervision) so that those systems and reporting procedures can be controlled at the level of the *insurance group*.

(3) Without prejudice to (1), the group internal control mechanisms must include at least the following:

(a) adequate mechanisms as regards group solvency to identify and measure all material risks incurred and to appropriately relate *eligible own funds* to risks; and

(b) sound reporting and accounting procedures to monitor and manage the intra-group transactions and the risk concentration.

[**Note:** article 246(1) and (2) of the *Solvency II Directive*]

11.9.2 R (1) A *participating Solvency II undertaking* in an *insurance group*, or if there is none, the *relevant insurance group undertakings*, must undertake at the level of the *insurance group* the assessment required by *SOLPRU* 9.3.5R to *SOLPRU* 9.3.8R (ORSA).

(2) Where the calculation of the solvency at the level of the *insurance group* is carried out in accordance with *method 1*, the *participating Solvency II undertaking* or the *relevant insurance group undertakings* (as appropriate) must provide to the *group supervisor* a proper understanding of the difference between the sum of the *SCR* of all the *related Solvency II undertakings* in the *insurance group* and the consolidated *SCR* of the *insurance group*.

(3) Where the *participating Solvency II undertaking* or the *relevant insurance group undertakings* (as appropriate) so decide, and subject to the agreement of the *group supervisor*, they may undertake any assessments required by *SOLPRU* 9.3.5R to *SOLPRU* 9.3.8R (ORSA) at the level of the *insurance group* and at the level of any *subsidiary undertaking* in the *insurance group* at the same time, and may produce a single document covering all the assessments.

(4) Where the *insurance group* exercises the option provided in (3), it must submit the document to all *supervisory authorities* concerned at the same time.

(5) The exercise of the option provided in (3) does not exempt the *subsidiary undertakings* concerned from the obligation to ensure that

the requirements of *SOLPRU* 9.3.5R to *SOLPRU* 9.3.8R (ORSA) are met.

[**Note:** article 246(4) of the *Solvency II Directive*]

11.9.3 R *SOLPRU* 12.2 (Reporting to the FSA) applies with any necessary changes.

[**Note:** article 254(2) of the *Solvency II Directive*]

Group SFCR

11.9.4 R (1) *Participating Solvency II undertakings* within an *insurance group* or, if there are none, the *relevant insurance group undertakings* must disclose publicly, on an annual basis, a report on the solvency and financial condition at the level of the *insurance group*. *SOLPRU* 12.3 to *SOLPRU* 12.6 (SFCR) applies with any necessary changes.

(2) Where a *participating Solvency II undertaking* or the *relevant insurance group undertakings* (as appropriate) so decide, and subject to the agreement of the *group supervisor*, they may provide a single *SFCR* which must comprise the following:

(a) the information at the level of the *insurance group* which must be disclosed in accordance with (1); and

(b) the information for any of the subsidiaries within the *insurance group* which must be individually identifiable and disclosed in accordance with *SOLPRU* 12.3 to *SOLPRU* 12.6 (SFCR).

[**Note:** article 256 of the *Solvency II Directive*]

Administrative, management or supervisory body of insurance holding companies

11.9.5 G Where a person effectively runs an *insurance holding company*, each *related Solvency II undertaking* of the *insurance holding company* that is a *UK Solvency II firm* should consider whether that person will also be exercising the *director function* or the *non-executive director function* in relation to that *UK Solvency II firm*.

[**Note:** article 257 of the *Solvency II Directive*]

11.10 Third countries

11.10.1 R When calculating the solvency of an *insurance group* falling within *SOLPRU* 11.1.2R(3) (instances of group supervision), the *parent undertaking* (being an *insurance holding company* which does not have its head office in an *EEA State* or a *third country insurance undertaking* or a *third country reinsurance undertaking*) must, solely for the purposes of that calculation, be treated as a *related Solvency II undertaking* unless:

(1) the third country in which that *undertaking* has its head office is assessed to be equivalent under article 260 of the *Solvency II Directive*; or

(2) in the absence of equivalent group supervision referred to in article 260 of the *Solvency II Directive*, the *FSA* has specified other methods in accordance with article 262 of the *Solvency II Directive*.

[**Note:** article 262 of the *Solvency II Directive*]

11.10.2 R Where the *parent undertaking* referred to in *SOLPRU* 11.1.2R(3) (instances of group supervision) is itself a *subsidiary undertaking* of an *insurance holding company* which does not have its head office in an *EEA State* or a *third country insurance undertaking* or a *third country reinsurance undertaking*, *SOLPRU* 11.10.1R applies at the level of either:

(1) the *ultimate parent undertaking* which is an *insurance holding company* which does not have its head office in an *EEA State* or a *third country insurance undertaking* or a *third country reinsurance undertaking*; or

(2) such other parent *undertaking* as the *FSA* may determine in accordance with article 263 of the *Solvency II Directive*.

[**Note:** article 263 of the *Solvency II Directive*]

11.11 Mixed-activity insurance holding companies

11.11.1 R *SOLPRU* 11.8.2R (supervision of intra-group transactions) applies, with any necessary changes, to *insurance groups* falling within *SOLPRU* 11.1.2R(3) (instances of group supervision).

[**Note:** article 265 of the *Solvency II Directive*]

12 Reporting

12.1 Application

12.1.1 R *SOLPRU* 12 applies to every *UK Solvency II firm*.

12.2 Reporting to the *FSA*

12.2.1 R A *firm* must submit to the *FSA* information which is necessary for the purposes of the *FSA* supervising the *firm* in accordance with the requirements of the *Solvency II Directive*, including information which is necessary for the *FSA* to make any appropriate decisions resulting from the

exercise of its supervisory rights and duties.

[**Note**: article 35(1) of the *Solvency II Directive*]

12.2.2 R The information referred to in *SOLPRU* 12.2.1R must include at least the information necessary to enable the *FSA* to assess the matters set out below when performing the supervisory review process referred to in article 36 of the *Solvency II Directive*:

(1) the *firm's* system of governance;

(2) the business pursued by the *firm*;

(3) the valuation principles applied by the *firm* for solvency purposes;

(4) the risks faced by the *firm*;

(5) the risk management systems of the *firm*; and

(6) the capital structure, capital needs and capital management of the *firm*.

[**Note**: article 35(1) of the *Solvency II Directive*]

12.2.3 E A *firm* submitting to the *FSA* regular supervisory reporting information which complies with articles [ ] of the *Solvency II Regulation*, comprising the *firm's SFCR* and any update thereto, a regular supervisory report, and annual and quarterly quantitative reporting templates, may rely on this as tending to establish compliance with the requirements of *SOLPRU* 12.2.1R and *SOLPRU* 12.2.2R. A *firm* may also be subject to UK national-specific regular reporting requirements, as set out in *SOLPRU* 12.2.6R and SOLPRU 12.2.7R.

12.2.4 R The information which a *firm* submits to the *FSA* in accordance with *SOLPRU* 12.2.1R and 12.2.2R must comply with the following principles:

(1) it must reflect the nature, scale and complexity of the business of the *firm*, and in particular the risks inherent in that business;

(2) it must be accessible, complete in all material respects, comparable and consistent over time; and

(3) it must be relevant, reliable and comprehensive.

[**Note**: article 35(4) of the *Solvency II Directive*]

12.2.5 R A *firm* must have in place appropriate systems and structures to fulfil the requirements set out in *SOLPRU* 12.2.1R to *SOLPRU* 12.2.4R, including a written policy approved by its *governing body* ensuring the ongoing appropriateness of the information submitted by the *firm* to the *FSA*.

[**Note**: article 35(5) of the *Solvency II Directive*]

12.2.6 R A *firm* falling within any of the following categories must submit to the *FSA* the corresponding quantitative reporting templates identified below:

(1) [placeholder for UK-specific reporting requirements to be set out in the *FSA's* second consultation paper on the *Solvency II Directive*]

12.2.7 R (1) [placeholder for UK-specific reporting requirements – submission timeframes (annual reporting)]

(2) [placeholder for UK-specific reporting requirements – submission timeframes (quarterly reporting)]

12.2.8 G The submission of the quantitative reporting templates referred to in *SOLPRU* 12.2.6R, constituting UK national-specific reporting requirements, are in addition to those set out in articles [ ] of the *Solvency II Regulation,* and as referred to in *SOLPRU* 12.2.3E.

12.3 Public disclosure – solvency and financial condition report

12.3.1 R A *firm* must disclose publicly, on an annual basis, a *SFCR*.

[**Note:** article 51(1) of the *Solvency II Directive*]

12.3.2 R The information which a *firm* discloses in its *SFCR* must comply with the principles set out in *SOLPRU* 12.2.4R.

[**Note**: article 51(1) of the *Solvency II Directive*]

12.3.3 R A *firm's SFCR* must contain the following information, either in full or by way of reference to equivalent information, both in nature and scope, disclosed publicly under other legal or regulatory requirements:

(1) a description of the business and performance of the *firm*;

(2) a description of the system of governance of the *firm* and an assessment of its adequacy for the risk profile of the *firm*;

(3) a description of the risk exposure, risk concentration, risk mitigation and risk sensitivity for each category of risk of the *firm*;

(4) a description, separately for assets, *technical provisions* and other liabilities, of the bases and methods used for their valuation, together with an explanation of any major differences in the bases and methods used for the valuation of those assets, *technical provisions* and other liabilities in financial statements of the *firm*;

(5) a description of the capital management of the *firm*, including at least the following:

(a) the structure, amount and quality of *own funds* of the *firm*, together with the information specified in *SOLPRU* 12.3.4R;

(b) the amount of the *MCR* and *SCR* of the *firm,* together with the information specified in *SOLPRU* 12.3.5R;

(c) where the *firm* is a *long-term insurer*, whether the *firm* has received approval from the *FSA* to apply an equity risk sub-module of the *SCR* in accordance with article 304 of the *Solvency II Directive*;

(d) information showing the main differences between the underlying assumptions of the *standard formula* and the underlying assumptions of any *internal model* for which the *firm* has received *internal model approval*;

(e) the amount of any non-compliance with the *MCR* or any significant non-compliance with the *SCR* during the reporting period, even if subsequently resolved, with an explanation of the origin of that non-compliance and its consequences, as well as any remedial measures taken in respect of that non-compliance.

[**Note:** article 51(1)(a)–(e) of the *Solvency II Directive*]

12.3.4 R The disclosure required by *SOLPRU* 12.3.3R(5)(a) must include the following:

(1) an analysis of any significant change in the structure, amount and quality of *own funds* of the *firm* as compared to the previous reporting period of the *firm*;

(2) an explanation of any major differences in relation to the value of elements of *own funds* items in the financial statements of the *firm*;

(3) a brief description of the capital transferability of the *own funds* of the *firm*.

[**Note:** article 51(2) of the *Solvency II Directive*]

12.3.5 R The disclosure required by *SOLPRU* 12.3.3R(5)(b) must include the following:

(1) the amount of the *SCR* calculated by the *firm* using the *standard formula* and, where the *firm* has received *internal model approval*, the amount of the *SCR* calculated using its *internal model*;

(2) the amount of any *capital add-on* imposed upon the *firm* in accordance with article 37 of the *Solvency II Directive*, together with concise information on the justification given by the *FSA* for its imposition;

(3) the impact of any *undertaking specific parameters* the *firm* is required to use in calculating the *standard formula* in accordance with article 110 of the *Solvency II Directive* and as referred to in

SOLPRU 4.11.2G, together with concise information on the justification given by the *FSA* for requiring the use of those *undertaking specific parameters*.

[**Note:** article 51(2) of the *Solvency II Directive*]

12.3.6 R The disclosure of the *SCR* required by *SOLPRU* 12.3.3R(5)(b) must be accompanied, where applicable, with a statement indicating that the final amount of the *SCR* is subject to supervisory assessment.

[**Note:** article 51(2) of the *Solvency II Directive*]

12.3.7 R Where a *firm*, in its *SFCR*, makes use of, or refers to, public disclosures made by the *firm* under other legal or regulatory requirements, those disclosures must be equivalent to the information required to be disclosed under *SOLPRU* 12.3.3R to *SOLPRU* 12.3.6R, in both their nature and scope.

[**Note:** article 53(3) of the *Solvency II Directive*]

12.3.8 E A *firm* meeting the public disclosure requirements of articles [ ] of the *Solvency II Regulation* may rely on this as tending to establish compliance with the requirements of *SOLPRU* 12.3.3R to *SOLPRU* 12.3.5R. Articles [ ] of the *Solvency II Regulation* set out the specific reporting requirements for a *firm's SFCR*, its structure, the reporting timeframe, reporting deadlines and means of disclosure. The quantitative reporting templates referred to in those articles of the *Solvency II Regulation* are set out in [relevant delegated act or Level 3 guidance].

12.4 Report on solvency and financial condition: permitted non-disclosure

12.4.1 G Except in relation to the information required to be disclosed by *SOLPRU* 12.3.3R(5), a *firm* may apply to the *FSA* for a *waiver* under section 148 of the *Act* permitting the *firm* not to disclose information otherwise required to be disclosed in its *SFCR*. When considering whether to grant such a *waiver* the *FSA* will take into account whether:

(1) the disclosure of that information would enable competitors of the *firm* to gain a significant, undue advantage; or

(2) the *firm* has obligations to *policyholders* or other counterparty relationships which bind the *firm* to secrecy or confidentiality.

[**Note:** article 53(1) and (4) of the *Solvency II Directive*]

12.4.2 R Where a *firm* is granted a *waiver* referred to in *SOLPRU* 12.4.1G, the *firm* must make a statement to this effect in its *SFCR* and state whether the non-disclosure is permitted for the reason specified in *SOLPRU* 12.4.1G(1) or *SOLPRU* 12.4.1G(2).

[**Note:** article 53(2) of the *Solvency II Directive*]

12.4.3 G The statement made by the *firm* in its *SFCR* as required by *SOLPRU* 12.4.2R should also identify the relevant item in Chapter [ ] of the *Solvency II Regulation* in respect of which disclosure will not be made as a consequence of the *firm* being granted the *waiver* referred to in *SOLPRU* 12.4.1G.

12.5 Report on solvency and financial condition: updates and additional voluntary information

12.5.1 R In the event of any major development affecting significantly the relevance of the information disclosed in accordance with:

(1) *SOLPRU* 12.3.3R to *SOLPRU* 12.3.7R; or

(2) *SOLPRU* 12.4.2R;

a *firm* must disclose publicly appropriate information on the nature and effects of that major development.

[**Note:** article 54(1) of the *Solvency II Directive*]

12.5.2 G *SOLPRU* 12.5.1R implements article 54(1) of the *Solvency II Directive*. The *FSA* considers that the effect of this provision, for a *firm* which has previously received a *waiver* not to disclose certain information in its *SFCR* for one of the reasons specified in *SOLPRU* 12.4.1G, is that the *firm* will need to assess, if relevant, whether it should seek a further *waiver* from the *FSA*.

12.5.3 R Without limiting the general application of *SOLPRU* 12.5.1R, for the purposes of that *rule* the following will be regarded as a major development:

(1) non-compliance with the *MCR* by the *firm* and either the *FSA* considers that the *firm* will not be able to submit, or the *FSA* does not receive within one month of the date of observation by the *firm* of non-compliance with the *MCR*, a *finance scheme* in accordance with *SOLPRU* 6.4.1R(2);

(2) significant non-compliance with the *SCR* by the *firm* and the *FSA* does not receive, within two *months* from the date when non-compliance with the *SCR* was first observed by the *firm*, a *recovery plan* as required by *SOLPRU* 6.3.1R(2).

[**Note:** article 54(1) of the *Solvency II Directive*]

12.5.4 R Where the circumstances described in *SOLPRU* 12.5.3R(1) or *SOLPRU* 12.5.3R(2) take place, the *firm* must immediately publicly disclose the amount of non-compliance with the *MCR* or *SCR* as the case may be, together with an explanation of the origin and consequences of that non-compliance, and a description of any remedial measures taken.

[**Note:** article 54(1) of the *Solvency II Directive*]

12.5.5 R Where compliance with the *MCR* has not been restored by a *firm* within three *months* after the first observation of non-compliance by the *firm*, then the *firm* must publicly disclose at the end of that three-*month* period the non-compliance with the *MCR*, together with an explanation of the origin and consequences of that non-compliance, a description of any remedial measures taken and of any further remedial measures planned.

[**Note:** article 54(1) of the *Solvency II Directive*]

12.5.6 R Where compliance with the *SCR* has not been restored by a *firm* within six *months* after the first observation of non-compliance by the *firm*, then the *firm* must publicly disclose at the end of that six-*month* period the non-compliance with the *SCR*, together with an explanation of the origin and consequences of that non-compliance, a description of any remedial measures taken and of any further remedial measures planned.

[**Note:** article 54(1) of the *Solvency II Directive*]

12.5.7 G *SOLPRU* 6.3.1R(3), which implements part of article 138 of the *Solvency II Directive*, requires a *firm* to take the measures determined by the *FSA* to achieve, within six months from the *firm's* observation of non-compliance with the *SCR*, the re-establishment of the level of *eligible own funds* covering the *firm's SCR*, or a reduction in the *firm's* risk profile to ensure compliance with the *SCR*. The *FSA* has power to extend this six-*month* period by a period of up to three *months*, and for a longer period where there has been an exceptional fall in financial markets. Notwithstanding this power on the part of the *FSA* to extend the period for re-establishing compliance with the *SCR*, the *FSA* considers that *SOLPRU* 12.5.6R requires a *firm* to comply with the public disclosure requirement specified in that *rule* within six *months* after the first observation of non-compliance by the *firm* with its *SCR*.

12.5.8 G A *firm* may disclose on a voluntary basis any information or explanation related to its solvency and financial condition which is not already required to be disclosed in accordance with *SOLPRU* 12.3.3R to *SOLPRU* 12.3.7R, *SOLPRU* 12.4.2R, *SOLPRU* 12.5.1R and *SOLPRU* 12.5.3R to *SOLPRU* 12.5.6R. Article [ ] of the *Solvency II Regulation* requires that any such additional information voluntarily provided by the *firm* must, where relevant, be consistent with any information provided to a *supervisory authority* in accordance with article 35 of the *Solvency II Directive*.

[**Note:** article 54(2) of the *Solvency II Directive*]

12.6 Report on SFCR: policy and approval

12.6.1 R (1) A *firm* must have in place appropriate systems and structures to fulfil the requirements of *SOLPRU* 12.3.1R to *SOLPRU* 12.3.7R, *SOLPRU* 12.4.2R, *SOLPRU* 12.5.1R and *SOLPRU* 12.5.3R to

SOLPRU 12.5.6R.

(2) A *firm* must have in place a written policy ensuring the ongoing appropriateness of any information disclosed in accordance with *SOLPRU* 12.3.1R to *SOLPRU* 12.3.7R, *SOLPRU* 12.4.2R, *SOLPRU* 12.5.1R, *SOLPRU* 12.5.3R to *SOLPRU* 12.5.6R, and *SOLPRU* 12.5.8G.

[**Note:** article 55(1) of the *Solvency II Directive*]

12.6.2 R A *firm* must ensure that its *SFCR* is:

(1) subject to approval by its *governing body*; and

(2) not publicly disclosed until the approval referred to in (1) is received.

[**Note:** article 55(2) of the *Solvency II Directive*]

13 Actions for damages

13.1 Application

13.1.1 R A contravention of the *rules* in *SOLPRU* does not give rise to a right of action by a *private person* under section 150 of the *Act* (and each of those *rules* is specified under section 150(2) of the *Act* as a provision giving rise to no such right of action).

Schedules

Sch 1 Record keeping requirement

Sch 1.1 G The aim of the *guidance* in the following table is to give the reader a quick overall view of the relevant record keeping requirements

Sch 1.2 G It is not a complete statement of those requirements and should not be relied on as if it were.

Sch 1.3 G

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
SOLPRU 2.3.3R(1)	Financial markets information and *underwriting risk* data	Information provided by the financial markets and generally available data on *underwriting risk* used for the calculation of *technical provisions*	Not specified	Not specified

SOLPRU 2.4.3R(2)	Information and realistic assumptions for calculation of the *best estimate*	Up-to-date and credible information and realistic assumptions supporting the calculation of a *firm's best estimate*	Not specified	Not specified
SOLPRU 2.4.9R(2)	Information supporting assumptions of *policyholder* behaviour	Current and credible information which is evidenced to be realistic supporting any assumptions used by a *firm* to determine the likelihood that *policyholders* will exercise contractual options	Not specified	Not specified
SOLPRU 2.4.12R and 2.4.16R(3)	Data for calculating *technical provisions*	Appropriate, complete and accurate data, including underlying statistical data, used by a *firm* in the calculation of its *technical provisions*	Not specified	Not specified
SOLPRU 2.4.14R	Evidence of experience for comparisons of *best estimate*	Record of a *firm's* relevant experience that it uses as comparisons against its *best estimate*	Not specified	Not specified
SOLPRU 3.2.6R(2)	Method for determining amount of *ancillary own funds*	Documented method used by a *firm* in determining the amount of the relevant item of *ancillary own funds* when determining its *own funds*	Not specified, but before the method is submitted to the *FSA* for approval	Not specified
SOLPRU 3.3.6R(3)	Evidence of eligibility of *own funds* item	Documented evidence supporting the *own funds* item's classification of a *firm's Tier 1 own funds*, *Tier 2 own funds* or *Tier 3 own funds*, respectively	Not specified, but before the evidence is submitted to the *FSA* for consideration	Not specified
SOLPRU 4.3.3R(1)	Record of quantifiable risks	Documented quantifiable risks to which a *firm* is exposed used for the calibration of its *SCR*, including at least the non-life *underwriting risk*, life *underwriting risk*, health	Not specified	Not specified

		underwriting risk, *market risk*, *credit risk* and *operational risk*		
SOLPRU 4.4.5R	Record of risk profile	Documented evidence of a *firm's* risk profile over time for the purpose of assessing if there is evidence of significant alteration	Not specified, but before reporting its *SCR* for the first time	Not specified
SOLPRU 4.11.1G(2)	Internal data related to *undertaking specific parameters*	Documented internal data or other data directly relevant to a *firm's* operations which is the basis for calibration of its *undertaking specific parameters*	Not specified, but before the evidence is submitted to the *FSA* for consideration	Not specified
SOLPRU 4.13.1R	Record of *internal model* compliance	Documented evidence that demonstrates to the *FSA* that a *firm's internal model* satisfies the requirements set out in *SOLPRU* 4.12 to *SOLPRU* 4.26	Not specified, but before the evidence is submitted to the *FSA* for consideration	Not specified
SOLPRU 4.13.3R	Documented *internal model change policy*	A record of a *firm's internal model change policy*, and any change from time to time	Not specified, but before the evidence is submitted to the *FSA* for consideration	Not specified
SOLPRU 4.26.1R	Documentation of the design and operational details of a *firm's internal model*	As required by *SOLPRU* 4.26.2R	Upon seeking *internal model approval* and for duration of that *internal model approval*	Not specified
SOLPRU 9.3.4R(3)	To document a *firm's internal model* and any subsequent changes made to it	As required by *SOLPRU* 4.26.2R	Upon seeking *internal model approval* and for duration of that *internal model approval* (and in respect of subsequent changes made to the *internal*	Not specified

			model)	
SOLPRU 9.9.1R	Risks arising from a contract of *finite reinsurance*, or the pursuit of *finite reinsurance* activities	Documentation of how a *firm* is properly identifying, measuring, monitoring, managing, controlling and reporting the risks arising from contracts or activities of *finite reinsurance*	Not specified	Not specified

Sch 2 Notification and reporting requirement

Sch 2.1 G The aim of the *guidance* in the following table is to give the reader a quick overall view of the relevant notification requirements.

Sch 2.2 G It is not a complete statement of those requirements and should not be relied on as if it were.

Sch 2.3 G

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
SOLPRU 2.4.16R	Appropriateness of the level of *technical provisions*	Evidence supporting the appropriateness of the level of a *firm's technical provisions*, the applicability and relevance of the methods applied, and/or the adequacy of the underlying statistical data used	When requested by the *FSA*	Not specified, but within such reasonable period as may be requested by the *FSA*
SOLPRU 4.4.1R	Results of the *firm's SCR* calculation	Results of the *firm's SCR* calculation	Annual calculation of the *firm's SCR*	Not specified.
SOLPRU 4.4.4R	Recalculation of the *firm's SCR*	Results of the *firm's SCR* recalculation	*Firm's* risk profile deviates significantly from the assumptions underlying its last reported *SCR*	Not specified.
SOLPRU 4.13.1R	*Internal model approval application*	Information to demonstrate that the requirements of *SOLPRU* 4.21 to	Submission of *internal model approval application*	As determined by the *firm*

		SOLPRU 4.26 have been met		
SOLPRU 4.13.3R	*Internal model change policy*	*Internal model change policy*	Submission of *internal model approval application*	Simultaneously with submission of *internal model approval application*
SOLPRU 4.13.4R	An estimate of the *firm's SCR* determined in accordance with the *standard formula*	An estimate of the *firm's SCR* determined in accordance with the *standard formula*	When required to do so by the *FSA* in respect of a firm seeking *internal model approval*	Not specified
SOLPRU 4.15.1R	Realistic transitional plan to extent the scope of a proposed partial *internal model*	Realistic transitional plan setting out the manner in which the *firm* plans to extend the scope of the proposed partial *internal model* as required by *SOLPRU* 4.15.2R	When required to do so by the *FSA* in respect of a firm seeking *internal model approval*	Not specified
SOLPRU 4.16.3R	A major change to an *internal model* for which *internal model approval* has been received or any change to a firm's *internal model change policy*	Request for approval must meet the requirements of *SOLPRU* 4.13 to *SOLPRU* 4.15	Proposed major change to an *internal model* for which *internal model approval* has been received or a proposed change to a firm's *internal model change policy*	Not specified
SOLPRU 4.18.1R	For a *firm* with *internal model approval*, the proposed reversion to calculating the whole or any part of the *SCR* in accordance with the *standard formula*	Not specified	For a *firm* with *internal model approval*, the proposed reversion to calculating the whole or any part of the *SCR* in accordance with the *standard formula*	Not specified
SOLRPRU	For a *firm* with *internal model*	Plan to restore compliance within a	*Firm* ceasing to comply with the	Without delay

4.19.1R	*approval*, ceasing to apply with the requirements of *SOLPRU* 4.21 to *SOLPRU* 4.26	reasonable period of time or demonstration that the effect of non-compliance is immaterial	requirements of *SOLPRU* 4.21 to *SOLPRU* 4.26	
SOLPRU 4.23.3G	Proposal by a *firm* to use approximations to calculate the *SCR*	Demonstration that *policyholders* are provided with a level of protection equivalent to that set out in *SOLPRU* 4.3.2R to *SOLPRU* 4.3.5R and *SOLPRU* 4.12.1R(2)	Proposal by a *firm* to use approximations to calculate the *SCR*	Not specified
SOLPRU 5.4.1R	Results of the *firm's MCR* calculation	Results of the *firm's MCR* calculation	Quarterly calculation of the *MCR*	Not specified
SOLPRU 5.4.2R	Sufficient information to enable the *FSA* to understand the reasons why either of the limits referred to in *SOLPRU* 5.3.4R determines a *firm's MCR*	Sufficient information to enable the *FSA* to understand the reasons why either of the limits referred to in *SOLPRU* 5.3.4R determines a *firm's MCR*	Where either of the limits referred to in *SOLPRU* 5.3.4R determines a *firm's MCR*	Not specified
SOLPRU 6.2.1R	Deteriorating financial conditions	Fact of deteriorating financial conditions	When financial conditions deteriorate	Immediately
SOLPRU 6.3.1R(1)	Non-compliance with *SCR* or risk of non-compliance within the next three *months*	Fact of non-compliance with *SCR* or risk of non-compliance within the next three *months*	*Firm's* observation that *SCR* is no longer complied with or where there is a risk of non-compliance within the next three *months*	Immediately
SOLPRU 6.3.1R(2)	Realistic *recovery plan* to ensure compliance	*Recovery plan* which includes at least the particulars or evidence required by	The observation of non-compliance with	Within two *months* from the observation of non-compliance

	with *SCR*	*SOLPRU* 6.5.1R	the *SCR*	with the *SCR*
SOLPRU 6.3.4R	Progress report on measures taken and progress made to re-establish the level of *eligible own funds* covering the *SCR* or to reduce its risk profile to ensure compliance with the *SCR*	Measures taken and progress made to re-establish the level of *eligible own funds* covering the *SCR*, or to reduce its risk profile to ensure compliance with the *SCR*	If the *FSA* has determined a longer period in relation to *SOLPRU* 6.3.1R(3) by reason of an exceptional fall in financial markets and notified the *firm* that such longer period applies	Every three *months*
SOLPRU 6.4.1R(1)	Non-compliance with *MCR* or where there is a risk of non-compliance within the next three *months*	Fact of non-compliance with *MCR* or risk of non-compliance within the next three *months*	*Firm's* observation that *MCR* is no longer complied with or where there is a risk of non-compliance within the next three *months*	Immediately
SOLPRU 6.4.1R(2)	*Finance scheme* to restore compliance with *MCR*	*Finance scheme* which includes at least the particulars or evidence required by *SOLPRU* 6.5.1R	*Firm's* observation of non-compliance with the *MCR*	Within one *month* from the observation of non-compliance with the *MCR*
SOLPRU 6.6.2R(1)	Non-compliance with *pre-Solvency II MCR* or where there is a risk of non-compliance within the next three *months*	Fact of non-compliance with *pre-Solvency II MCR* or where there is a risk of non-compliance within the next three *months*	Where *firm* complies with *pre-Solvency II MCR* but does not hold sufficient *eligible own funds* to cover the *MCR* observation that *pre-Solvency II MCR* is no longer complied with or where there is a risk of non-compliance within the next three *months*	Immediately
SOLPRU 6.6.2R(2)	*Finance scheme* to restore	*Finance scheme* which includes at	*Firm's* observation of	Within one *month* from the

	compliance with the *pre-Solvency II MCR*	least the particulars or evidence required by *SOLPRU* 6.6.2R(2)	non-compliance with the *pre-Solvency II MCR*	observation of non-compliance with the *pre-Solvency II MCR*
SOLPRU 9.3.8R	Results of each *ORSA*	Results of each *ORSA*	Carrying out of *ORSA*	As required by reporting requirements specified in respect of reporting obligations set out in *SOLPRU* 12.2.1R
SOLPRU 9.7.3R	Proposed *outsourcing* of critical or important *functions* or activities, as well as any subsequent material developments with respect to those *functions* or activities	*Outsourcing* of critical or important *functions* or activities, as well as any subsequent material developments with respect to those *functions* or activities	Proposed *outsourcing* of critical or important *functions* or activities. Any subsequent material developments with respect to those *functions* or activities	In a timely manner
SOLPRU 11.1.4R	Information in relation to *UK Solvency II firms* excluded under article 214(b) or (c) of the *Solvency II Directive*	Information specified by the *FSA*	When required to do so by the *FSA*	Not specified
SOLPRU 11.3.3R	Deteriorating financial conditions within *insurance groups*	Details of the deterioration	The occurrence of deterioration	Immediately
SOLPRU 11.3.5R(1)	Non-compliance with *group SCR* or risk of non-compliance	Fact of non-compliance with *group SCR* or risk of non-compliance within the next three	*Firm's* observation that *group SCR* is no longer complied with or where	Immediately

	within the next three *months*	*months*	there is a risk of non-compliance within the next three *months*	
SOLPRU 11.3.5R(2)	Realistic *recovery plan* to ensure compliance with *group SCR*	*Recovery plan* which includes at least the particulars or evidence required by *SOLPRU* 6.5.1R	The observation of non-compliance with the *group SCR*	Within two *months* from the observation of non-compliance with the *group SCR*
SOLPRU 11.3.5R(4)	Progress report on measures taken and progress made to re-establish the level of *own funds* covering the *group SCR* or to reduce its risk profile to ensure compliance with the *group SCR*	Measures taken and progress made to re-establish the level of *own funds* covering the *group SCR* or to reduce its risk profile to ensure compliance with the *group SCR*	If the *FSA* has determined a longer period in relation to *SOLPRU* 11.3.5R(3) by reason of an exceptional fall in financial markets and notified the *firm* that such longer period applies	Every three *months*
SOLPRU 11.3.10R (2)	Recalculation of the *group SCR* following a significant deviation from assumptions	*Group SCR*	Occurrence of significant deviation from assumptions	Without delay
SOLPRU 11.3.10R (3)	Recalculation of the *group SCR* as required by the *group supervisor* in accordance with article 219(2) of the *Solvency II Directive*	*Group SCR*	Requirement from *group supervisor*	Without delay
SOLPRU 11.7.4R(2) (a)	Non-compliance with the conditions referred to in *SOLPRU* 11.7.1R(2), (3)	Fact of non-compliance with the conditions referred to in *SOLPRU* 11.7.1R(2), (3) and (4)	The occurrence of non-compliance	Without delay

	and (4)			
SOLPRU 11.7.4R(2)(b)	Plan to restore compliance with the conditions referred to in *SOLPRU* 11.7.1R(2), (3) and (4)	Plan to restore compliance	The occurrence of non-compliance	Within an appropriate period of time
SOLPRU 11.8.1R	Significant risk concentration at the level of the *insurance group*	Details of significant risk concentrations	Regular compliance monitoring	Regularly and at least annually
SOLPRU 11.8.2R	Significant intra-group transactions by *Solvency II undertakings* within an *insurance group*	Details of intra-group transactions	Regular compliance monitoring	Regularly and at least annually or as soon as practicable if the intra-group transaction is very significant
SOLPRU 11.9.4R	*SFCR* for an *insurance group*	The matters required under *SOLPRU* 12.3 to 12.6	Annual *SFCR*	Annually
SOLPRU 12.2.1R	Information which is necessary for the purposes of the *FSA* supervising the *firm* in accordance with the requirements of the *Solvency II Directive*, including information which is necessary for the *FSA* to make any appropriate decisions resulting from the exercise of its supervisory	The matters required under *SOLPRU* 12.2.2R to *SOLPRU* 12.2.4R	[As specified in the *Solvency II Regulation*]	[As specified in the *Solvency II Regulation*]

	powers			
SOLPRU 12.2.6R	[UK-specific annual and quarterly quantitative reporting templates]	[As per template set out in [ ]]	[Submission of annual/quarterly reporting templates as specified in the *Solvency II Regulation*]	[As specified in the *Solvency II Regulation*]
SOLPRU 12.3.1R	*SFCR*	The matters required under *SOLPRU* 12.3.2R to *SOLPRU* 12.3.8R	Annual disclosure of *SFCR*	As specified in the *Solvency II Regulation*
SOLPRU 12.4.2R	Disclosure of the granting of a *waiver* permitting non-disclosure of certain items in the *SFCR* (where applicable)	The fact of the granting of the *waiver* and the basis for the granting of the *waiver* as set out in *SOLPRU* 12.4.1G	The grant of a *waiver* permitting non-disclosure in the *firm's SFCR*	The disclosure of the *waiver* must be made in the *firm's SFCR*
SOLPRU 12.5.1R	Any major development affecting significantly the relevance of the information disclosed in the *firm's SFCR*	Information on the nature and effects of the major development. Where the major development concerns non-compliance with a *firm's MCR* or significant non-compliance with the *SCR* in the circumstances set out in *SOLPRU* 12.5.3R, the additional disclosure required by *SOLPRU* 12.5.4R to *SOLPRU* 12.5.6R, as applicable, must also be made	Any major development affecting significantly the relevance of the information disclosed in the firm's *SFCR*, including the matters set out in *SOLPRU* 12.5.3R	As specified in the *Solvency II Regulation* (except where immediate disclosure is required by *SOLPRU* 12.5.3R and as otherwise required by *SOLPRU* 12.5.5R and *SOLPRU* 12.5.6R)

Sch 3 Fees and other requirement payments

G There are no requirements for fees or other payments in *SOLPRU*.

Sch 4 Powers exercised

Sch 4.1 G The following powers and related provisions in the *Act* have been exercised by the *FSA* to make rules in *SOLPRU*:

section 138 (General rule-making power)

section 141 (Insurance business rules)

section 149 (Evidential provisions)

section 150(2) (Action for damages)

section 156 (General supplementary powers).

Sch 4.2 G The following power in the *Act* has been exercised by the *FSA* to give the *guidance* in *SOLPRU*:

section 157(1) (Guidance)

Sch 5 Right of action for damages

Sch 5.1 G The table below sets out the *rules* in *SOLPRU* contravention of which by an *authorised person* may be actionable under section 150 of the *Act* (Actions for damages) by a *person* who suffers loss as a result of the contravention.

Sch 5.2 G If a "Yes" appears in the column headed "For *private person*", the *rule* may be actionable by a *private person* under section 150 (or, in certain circumstances, his fiduciary or representative; see article 6(2) and (3)(c) of the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001/2256)). A "Yes" in the column headed "Removed" indicates that the *FSA* has removed the right of action under section 150(2) of the *Act*. If so, a reference to the *rule* in which it is removed is also given.

Sch 5.3 G The column headed "For other *person*" indicates whether the *rule* may be actionable by a *person* other than a *private person* (or his fiduciary or representative) under article 6(2) and (3) of those Regulations. If so, an indication of the type of *person* by whom the *rule* may be actionable is given.

Chapter/ Appendix	Section/ Annex	Right of action under section 150		
		For private person	Removed	For other person
All *rules* in *SOLPRU*		No	Yes – *SOLPRU* 13.1.1R	No

Sch 6 Rules which can be waived

G The rules in *SOLPRU* can be waived by the *FSA* under section 148 of the *Act* (Modification or waiver of rules) but, if the *rules* incorporate requirements laid down in European directives, it will not be possible for the *FSA* to grant a *waiver* that would be incompatible with the *United Kingdom's* responsibilities under those directives. Therefore, it follows that if a *rule* in *SOLPRU* contains provisions which derive partly from a directive, and partly not, the *FSA* will be able to consider a *waiver* of the latter requirements only, unless the directive provisions are optional rather than mandatory.

Annex B

Amendments to the Glossary of Definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

Insert the following new definitions in the appropriate alphabetical position. This text is not underlined.

ancillary own funds	(1) (in relation to a *UK Solvency II firm*) the *own funds* determined in accordance with *SOLPRU* 3.2.4R to 3.2.10G; or (2) (in relation to a *Solvency II undertaking* other than a *UK Solvency II firm*), an *own funds* item referred to in article 89 of the *Solvency II Directive*, determined in accordance with the applicable *Solvency II EEA implementing measures*; or (3) (in relation to an *insurance holding company*) an *own funds* item referred to in article 89 of the *Solvency II Directive*, determined in accordance with (1) as if it were a *UK Solvency II firm*. [**Note**: article 89 of the *Solvency II Directive*]
[*approved surplus funds*]	accumulated profits of a *UK Solvency II firm* which: (a) have not been made available for distribution to *policyholders*; and (b) satisfy the conditions for classification as *Tier 1 own funds* under *SOLPRU* 3.3.2R; and (c) in respect of which a *waiver* of *SOLPRU* 2.4.7R(3) has been obtained, in accordance with section 148 of the *Act.* [**Note**: article 91 of the *Solvency II Directive*]
basic own funds	(1) (in relation to a *UK Solvency II firm*) the *own funds* determined in accordance with *SOLPRU* 3.2.2R; or (2) (in relation to a *Solvency II undertaking* other than a *UK Solvency II firm*) an *own funds* item referred to in article 88 of the *Solvency II Directive*, determined in accordance with the applicable *Solvency II EEA implementing measures*; or (3) (in relation to an *insurance holding company* an *own funds* item referred to in article 88 of the *Solvency II Directive* determined in accordance with (1) as if it were a *UK*

Solvency II firm.

[**Note**: article 88 of the *Solvency II Directive*]

basic SCR the capital requirement referred to in *SOLPRU* 4.6.1R.

[**Note**: articles 103(a) and 104–106 of the *Solvency II Directive*]

beneficiary any *person* who is entitled to a right under a *contract of insurance.*

[**Note**: recital 16 of the *Solvency II Directive*]

best estimate the best estimate of future cash-flows, calculated in accordance with *SOLPRU* 2.4.3R to *SOLPRU* 2.4.4R.

capital add-on the amount by which the *SCR* of a *UK Solvency II firm*, or the *group SCR* of an *insurance group* (as appropriate), is increased by the *FSA* as a result of a *standard formula significant risk profile deviation*, *internal model significant risk profile deviation*, *significant system of governance deviation* or (if appropriate) a specific risk existing at group level.

captive insurer a *Solvency II undertaking* owned by:

(a) a financial *undertaking* other than a *Solvency II undertaking*; or

(b) an *insurance group*; or

(c) a non-financial *undertaking*;

the purpose of which is to provide insurance cover exclusively for the risks of the *undertaking* or *undertakings* to which it belongs, or of an *undertaking*, or *undertakings*, of the *group* of which that *Solvency II undertaking* is a member.

[**Note**: article 13(2) of the *Solvency II Directive*]

concentration risk all risk exposures with a loss potential which is large enough to threaten the solvency or the financial position of a *Solvency II undertaking*.

[**Note**: article 13(35) of the *Solvency II Directive*]

cost-of-capital rate the rate that must be used in the determination of the cost that a *Solvency II undertaking* would incur in order to hold an amount of *eligible own funds* equal to the *SCR* necessary to support the insurance and *reinsurance* obligations over their lifetime, as set out in article [ ] of the *Solvency II Regulation.*

credit risk the risk of loss, or of adverse change, in the financial situation, resulting from fluctuations in the credit standing of *issuer*s of

securities, *counterparties* and any debtors to which a *Solvency II undertaking* is exposed, in the form of *counterparty* default risk, or *spread risk*, or *market risk* concentrations.

[**Note**: article 13(32) of the *Solvency II Directive*]

dominant influence the relationship between two *undertakings* that exists in the circumstances described in paragraphs (a)(iii), (iv) and (v) of the definition of a "*parent undertaking*".

EIOPA the European Insurance and Occupational Pensions Authority established in accordance with Regulation (EU) No. 1094/2010 of the European Parliament and of the Council of 24 November 2010.

eligible own funds

(1) as far as compliance with a *UK Solvency II firm's SCR*, the aggregate of the *firm's*:

(a) *Tier 1 own funds*; and

(b) *eligible Tier 2 own funds*; and

(c) *eligible Tier 3 own funds*; and

(2) as far as compliance with a *UK Solvency II firm's MCR*, the aggregate of the *firm's*:

(a) *Tier 1 own funds*; and

(b) *eligible Tier 2 own funds*; and

(3) as far as compliance by a *composite firm* with the *notional life MCR*, the aggregate of the *firm's*:

(a) *Tier 1 own funds*; and

(b) the *firm's Tier 2 basic own funds* that satisfy the limits in *SOLPRU* 3.3.12R and the *Solvency II Regulation*, as if references to the "*MCR*" and "Minimum Capital Requirement" in those provisions were references to the *notional life MCR*; and

(4) as far as compliance by a *composite firm with the notional non-life MCR*, the aggregate of the *firm's*:

(a) *Tier 1 own funds*; and

(b) the *firm's Tier 2 basic own funds* that satisfy the limits in *SOLPRU* 3.3.12R and the *Solvency II Regulation*, as if references to the "*MCR*" and "Minimum Capital Requirement" in those provisions were references to the *notional non-life MCR*.

eligible Tier 2 own funds	(1) as far as compliance with a *UK Solvency II firm's SCR*, the *UK Solvency II firm's Tier 2 own funds* that satisfy the limits set out in *SOLPRU* 3.3.11R and the *Solvency II Regulation*; and (2) as far as compliance with a *UK Solvency II firm's MCR*, the *firm's Tier 2 basic own funds* that satisfy the limits in *SOLPRU* 3.3.12 and the *Solvency II Regulation*.
eligible Tier 3 own funds	as far as compliance with a *UK Solvency II firm's SCR*, the *firm's Tier 3 own funds* that satisfy the limits set out in *SOLPRU* 3.3.11R(2).
explicit maximum loss potential	the maximum economic risk transferred by the ceding undertaking to the *reinsurer* under a contract of *reinsurance*.
finance scheme	the finance scheme required to be provided by a *UK Solvency II firm* to the *FSA* under *SOLPRU* 6.4.1R(2) (Non-compliance with the MCR) or *SOLPRU* 6.6.2R(2) (transitional arrangements regarding compliance with the MCR).
finite reinsurance	*reinsurance*: (a) under which the *explicit maximum loss potential* arising from a significant transfer of both *underwriting risk* and timing risk exceeds the *premium* payable by the ceding undertaking over the duration of the contract by a limited but significant amount; and (b) which possesses at least one of the following characteristics: (i) explicit and material consideration of the time value of money; and (ii) contractual provisions to moderate the balance of economic experience between the parties to the *reinsurance* over time to achieve the target risk transfer. [**Note**: article 210(3) of the *Solvency II Directive*]
function	within a system of governance, an internal capacity to undertake practical tasks. [**Note**: article 13(29) of the *Solvency II Directive*]
general insurer	an *insurer* with *permission* to *effect* or *carry out contracts of insurance* that are *general insurance contracts*.
group of systems and controls functions	any of the *controlled functions* CF 28, 14 and 15 in the *table of controlled functions*, and described more fully in *SUP* 10.8.

group SCR	the Solvency Capital Requirement calculated at the level of the *insurance group,* in accordance with *SOLPRU* 11.3.
group supervisor	in relation to an *insurance group*, means the authority designated as group supervisor in relation to that *insurance group,* in accordance with article 247 of the *Solvency II Directive*.
internal audit function	*controlled function* CF15 in the *table of controlled functions*, described more fully in *SUP* 10.8.4R.
internal model	the methodology used by a *firm* to calculate its *SCR,* or by an *insurance group* to calculate its *group SCR*, in place of some or all of the *standard formula*.
internal model approval	(1) (in accordance with [HMT statutory instrument]) a permission for use of an *internal model* granted to a *firm*; (2) (in accordance with [HMT statutory instrument] and in relation to a *UK Solvency II firm* that is a member of an *insurance group*) a permission for use of an *internal model* granted to an *insurance group*.
internal model approval application	in respect of an *internal model*, an application by a *firm* for *internal model approval.*
internal model change policy	a *firm's* policy for making minor and major changes to its *internal model*.
internal model significant risk profile deviation	the determination by the *FSA* of a significant deviation in the risk profile of a *UK Solvency II firm*, or an *insurance group* (as appropriate), from the assumptions underlying the *SCR* (or *group SCR*, as appropriate) in circumstances where the *firm's SCR* (or the *insurance group's group SCR*, as appropriate) is calculated using an *internal model*.
linked long-term liabilities	the insurance obligations in respect of *linked benefits* under a *linked long-term contract of insurance.*
major business unit	a defined segment of an *undertaking* that operates independently from other parts of the *undertaking*, has dedicated governance resources and procedures within the *undertaking* and contains risks which are material in relation to the whole business of the *firm*. [**Note**: article [ ] of the *Solvency II Regulation*]
method 1	the method for calculating a *group SCR* described in *SOLPRU* 11.5.1R.
method 2	the method for calculating a *group SCR* described in *SOLPRU* 11.5.5R.

mutual-type group	a group of *undertakings* based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those *undertakings*, and that may include mutual or mutual-type associations, provided that: (a) one of those *undertakings* effectively exercises, through centralised coordination, a *dominant influence* over the decisions, including financial decisions, of the other *undertakings* that are part of the group of *undertakings*; and (b) the establishment and dissolution of such relationships for the purposes of Title III of the *Solvency II Directive* are subject to prior approval by the *group supervisor*, where the *undertaking* exercising the centralised coordination shall be considered as the *parent undertaking*, and the other *undertakings* shall be considered as *subsidiary undertakings.* [**Note**: article 212(1)(c)(ii) of the *Solvency II Directive*]
non-Solvency I firm	a *firm* that immediately before the *Solvency II implementation date* was a *non-directive firm.*
notional life MCR	the notional Minimum Capital Requirement calculated under *SOLPRU* 8.4.6R(1).
notional life SCR	the notional Solvency Capital Requirement for *long-term insurance business*, calculated in accordance with article [ ] of the *Solvency II Regulation.*
notional non-life MCR	the notional Minimum Capital Requirement calculated under *SOLPRU* 8.4.6R(2).
notional non-life SCR	the notional Solvency Capital Requirement for *general insurance business*, calculated in accordance with article [ ] of the *Solvency II Regulation.*
notional SCR	the notional Solvency Capital Requirement referred to in article [ ] of the *Solvency II Regulation.*
ORSA	own risk and solvency assessment from time to time, as detailed in *SOLPRU* 9.3.5R to *SOLPRU* 9.3.8R.
own funds eligible for the SCR	the aggregate of the *firm's own funds* referred to in paragraph (1) of the definition of *eligible own funds.*
own funds eligible for the group SCR	(1) in relation to *method 1*, the *own funds eligible for the group SCR* in accordance with *SOLPRU* 11.5.1R(3); and (2) in relation to *method 2*, the aggregate *eligible own funds* of the *insurance group* referred to in *SOLPRU* 11.5.6R.

participating Solvency II undertaking	a *Solvency II undertaking* that holds a *participation* in another *undertaking*.
participating undertaking	an *undertaking* that holds a *participation* in another *undertaking*
pre-Solvency II MCR	the *minimum capital requirement* that applied to the *UK Solvency II firm* under *FSA rules* as at [31 December 2012].
probability distribution forecast	a mathematical function that assigns a probability of realisation to an exhaustive set of mutually exclusive future events. [**Note**: article 13(38) of the *Solvency II Directive*]
prudent person principle	the investment principles in *SOLPRU* 7.2. [**Note**: article 132 of the *Solvency II Directive*]
recovery plan	(1) in *SOLPRU* (except in *SOLPRU* 11 (Group supervision)), the recovery plan required to be provided by a *firm* to the *FSA* under *SOLPRU* 6.3.1R(2) (Non-compliance with the SCR); (2) in *SOLPRU* 11 (Group supervision), the recovery plan required to be provided by a *relevant participating undertaking* to the *FSA* under *SOLPRU* 11.3.5R(2) (non-compliance with the *group SCR*).
related Solvency II undertaking	a *Solvency II undertaking* that is a *related undertaking* of another *undertaking*.
relevant insurance group undertakings	in relation to an *insurance group* falling within SOLPRU 11.1.3R(1) or (2), each *UK Solvency II undertaking* within that *insurance group*.
relevant risk-free interest rate term structure	the relevant risk-free interest rate term structure, in accordance with article [ ] of the *Solvency II Regulation*.
ring-fenced fund	a fund structure, maintained by an *insurer*, which gives one class of *policyholder* greater rights to the assets within that fund, as a result of which the assets in the fund cannot be made available to meet the insurance risks or liabilities outside the fund. [**Note**: recital 49 of the *Solvency II Directive*]
risk function	*controlled function* CF14 in the *table of controlled functions*, described more fully in *SUP* 10.8.3R.
risk margin	the portion of *technical provisions* calculated in accordance with *SOLPRU* 2.4.5R and *SOLPRU* 2.4.6R.

risk measure	a mathematical function which assigns a monetary amount to a given *probability distribution forecast* and increases monotonically with the level of risk exposure underlying that *probability distribution forecast*. [**Note**: article 13(39) of the *Solvency II Directive*]
risk-mitigation techniques	all techniques which enable a *Solvency II undertaking* to transfer part or all of their risks to another party. [**Note**: article 13(36) of the *Solvency II Directive*]
SCR	the Solvency Capital Requirement calculated in accordance with *SOLPRU* 4. [**Note**: article 100 of the *Solvency II Directive*]
significant system of governance deviation	the determination by the *FSA* of a significant deviation by a *UK Solvency II firm*, or an *insurance group* (as appropriate), from the system of governance requirements set out in *SOLPRU* 9.2.3R to *SOLPRU* 9.8 (including pursuant to *SOLPRU* 11.9.1R, where appropriate).
SFCR	solvency and financial condition report, as detailed in *SOLPRU* 12.3 to *SOLPRU* 12.6.
Solvency I firm	a *firm* that immediately before the *Solvency II implementation date* was an *insurer* that fell within the scope of *Solvency I Directive*.
Solvency II undertaking	an undertaking authorised in accordance with *Solvency II implementing measures* transposing article 14 of the *Solvency II Directive* and a *UK Solvency II firm*.
Solvency II implementation date	[31 October 2012].
Solvency II EEA implementing measures	a measure implementing the *Solvency II Directive* in an *EEA State* other than the *United Kingdom.*
Solvency II Regulation	the Regulation of the European [Commission] of […] 201[2] on […] (no ….).
standard formula	a methodology used by a *firm* to calculate its *SCR* according to the *rules* in *SOLPRU* 4.5 to *SOLPRU* 4.11.
standard formula significant risk profile deviation	the determination by the *FSA* of a significant deviation in the risk profile of a *UK Solvency II firm*, or an *insurance group* (as appropriate), from the assumptions underlying the *SCR* (or *group SCR*, as appropriate) in circumstances where the *firm's SCR* (or the *insurance group's group SCR*, as appropriate) is calculated using the *standard formula*.

supervisory authority	a national authority or the national authorities empowered by law or regulation of an *EEA State* to supervise *Solvency II undertakings* for the purposes of the *Solvency II Directive*, including the *FSA*.
third country insurance undertaking	an undertaking that would require authorisation as an insurance undertaking in accordance with article 14 of the *Solvency II Directive* if its head office was situated in the EEA. [**Note:** article 13(3) of the *Solvency II Directive*]
third country reinsurance undertaking	an undertaking that would require authorisation as a reinsurance undertaking in accordance with article 14 of the *Solvency II Directive* if its head office were situated in the *EEA*. [**Note**: article 13(6) of the *Solvency II Directive*]
Tier 1 own funds	an item of *basic own funds* that satisfies the conditions in *SOLPRU* 3.3.2R.
Tier 2 ancillary own funds	an item of *Tier 2 own funds* that is an item of *ancillary own funds*.
Tier 2 basic own funds	an item of *Tier 2 own funds* that is an item of *basic own funds*.
Tier 2 own funds	an item of *own funds* that satisfies the conditions in *SOLPRU* 3.3.3R.
Tier 3 ancillary own funds	an item of *Tier 3 own funds* that is an item of *ancillary own funds*.
Tier 3 own funds	an item of *own funds* referred to in *SOLPRU* 3.3.4R.
UK Solvency II firm	a *firm* that satisfies the following conditions: (1) it is an *insurer*; (2) its head office is in the *United Kingdom*; (3) if it is a *Solvency I firm*, it is not excluded pursuant to [rules transposing article 4(4) of the *Solvency II Directive*]; (4) if it is a *non-Solvency I firm*, either: (a) it is excluded pursuant to [rules transposing article 4(1)–(3) of the *Solvency II Directive*] but it has opted to be a *Solvency II undertaking* pursuant to [rules/mechanics to opt-in]; or (b) it is not excluded pursuant to [rules transposing article 4(1)–(3) of the *Solvency II Directive*]; and

(5) if it is neither a *Solvency I firm* nor a *non-Solvency I firm*, either:

(a) it is excluded pursuant to [rules transposing article 4(1)–(3) of the *Solvency II Directive*] but it has opted to be a *Solvency II undertaking* pursuant to [rules/mechanics to opt-in]; or

(b) it is not excluded pursuant to [rules transposing article 4(1)–(3) of the *Solvency II Directive*].

ultimate UK Solvency II insurance parent undertaking means an *insurance parent undertaking* that meets all of the following conditions:

(1) it has its head office in the *United Kingdom*;

(2) it is within an *insurance group*; and

(3) it is not itself the *subsidiary undertaking* of another *insurance parent undertaking* that meets the first two conditions.

undertaking specific parameters for the purposes of determining the *SCR* using the *standard formula*, the replacement of a subset of parameters used in the life *underwriting risk* module, non-life *underwriting risk* module or health *underwriting risk* module with parameters specific to a *firm*.

underwriting risk the risk of loss or of adverse change in the value of insurance liabilities, due to inadequate pricing and provisioning assumptions.

[**Note**: article 13(30) of the *Solvency II Directive*]

Amend the following definitions as shown:

captive reinsurer (1) (except in *SOLPRU*) a *pure reinsurer* owned by:

(a) a financial *undertaking* other than an *insurance undertaking* or a *reinsurance undertaking*; or

(b) an *insurance group* ~~of *insurance undertakings* or *reinsurance undertakings*~~ to which the ~~*Insurance Groups Directive*~~ *Solvency II Directive* applies; or

(c) a non-financial *undertaking*,

the purpose of which is to provide *reinsurance* cover exclusively for the risks of the *undertaking* or *undertakings* to which it belongs or of an *undertaking* or

undertakings of the *group* of which that *pure reinsurer* is a member.

(2) (in *SOLPRU)* a *Solvency II undertaking* that is a *pure reinsurer* owned by:

(a) a financial *undertaking* other than a *Solvency II undertaking*; or

(b) an *insurance group*; or

(c) a non-financial *undertaking*;

the purpose of which is to provide *reinsurance* cover exclusively for the risks of the *undertaking* or *undertakings* to which it belongs or of an *undertaking* or *undertakings* of the *group* of which that *pure reinsurer* is a member.

[**Note**: article 13(5) of the *Solvency II Directive*]

claim (1) (in *COMP*) a valid claim made in respect of a civil liability owned by a *relevant person* to the claimant.

(2) (in *INSPRU*, *SOLPRU* and *SUP*) a claim under a *contract of insurance*.

class (1) (in *GENPRU, INSPRU*, *SOLPRU* and *SUP*) (in relation to a *contract of insurance*) any class of *contract of insurance* listed in Schedule 1 to the *Regulated Activities Order* (Contracts of insurance) and references to:

(a) *general insurance business class* 1, 2, 3, etc. are references to *contracts of insurance* of the kind mentioned in the corresponding numbered paragraph in Part I of Schedule 1 to that Order or, as the context may require, to the *effecting* or *carrying out* of *contracts of insurance* of that kind; and

(b) *long-term insurance business class* I, II, III, etc. are references to *contracts of insurance* of the kind mentioned in the corresponding numbered paragraph in Part II of Schedule 1 to that Order or, as the context may require, to the *effecting* or *carrying out* of *contracts of insurance* of that kind.

…

contract of insurance (1) (in relation to a *specified investment*) the *investment*, specified in article 75 of the *Regulated Activities Order* (Contracts of insurance), which is rights under a contract of insurance in (2).

(2) (in relation to a contract) (in accordance with article 3(1) of the *Regulated Activities Order* (Interpretation)) any contract of insurance which is a *long-term insurance contract* or a *general insurance contract*, including:

…

(e) contracts of a kind referred to in article ~~2(2)(e) of the *Consolidated Life Directive*~~[8] 2(3)(b)(v) of the *Solvency II Directive* (Collective insurance etc); and

(f) contracts of a kind referred to in article 2(3)(c) of the ~~the *Consolidated Life Directive*~~ *Solvency II Directive* (Social insurance);

but not including a *funeral plan contract* (or a contract which would be a *funeral plan contract* but for the exclusion in article 60 of the *Regulated Activities Order* (Plans covered by insurance or trust arrangements)); in this definition, "annuities on human life" does not include superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of *persons* engaged, or who have been engaged, in any particular profession, trade or employment, or of the dependants of such *persons*.

EEA firm (in accordance with paragraph 5 of Schedule 3 to the *Act* (EEA Passport Rights)) any of the following, if it does not have its relevant office in the *United Kingdom*:

…

(d) an undertaking ~~pursuing the activity of direct insurance (within the meaning of article 2 of the *Consolidated Life Directive* (No. 2002/83/EC) or of Article 1 of the *First Non-Life Directive* (No. 73/239/EEC))~~ which has received authorisation under ~~of the Consolidated Life Directive or Article 6 of the First Non-Life Directive~~ article 14 of the *Solvency II Directive* from its *Home State regulator*;

…

~~(g) an *undertaking* pursuing the activity of *reinsurance* (within the meaning of article 1 of the *Reinsurance Directive*) which has received authorisation under article 3 of the *Reinsurance Directive* from its *Home State Regulator*.~~

in this definition, relevant office means:

(i) in relation to a *firm* falling within sub-paragraph (e), which has a registered office, its registered office;

(ii) in relation to any other *firm* falling within any other paragraph, its head office.

EEA insurer an *insurer*, other than a ~~pure reinsurer or a~~ *non-directive insurer*, whose head office is in any *EEA State* except the *United Kingdom* and which has received *authorisation* under article 6 of the *First Life Directive* or article 4 of the *Consolidated Life Directive* or article 6 of the *First Non-Life Directive* or article 14 of the *Solvency II Directive* from its *Home State* ~~*R*~~*regulator*.

general insurance business the business of *effecting* or *carrying out* *contracts of insurance* that are *general insurance contracts.*

group (1) (except in relation to an *ICVC* and except for the purposes of *SYSC* 12 (Group risk systems and controls requirement), *SOLPRU* and *LR)* as defined in section 421 of the *Act* (Group) (in relation to a *person* ("A")) A and any *person* who is:

(a) a *parent undertaking* of A;

(b) a *subsidiary undertaking* of A;

(c) a *subsidiary undertaking* of a *parent undertaking* of A;

(d) a *parent undertaking* of a *subsidiary undertaking* of A;

(e) an *undertaking* in which A or an *undertaking* in (a) to (d) has a participating interest;

(f) if A or an *undertaking* in (a) or (d) is a *building society*, an associated undertaking of that *building society*;

(g) if A or an *undertaking* in (a) or (d) is an *incorporated friendly society*, a *body corporate* of which that *friendly society* has joint control (as defined in section 13(9)(c) or (cc) of the Friendly Societies Act 1992); in this definition:

(i) "participating interest" has the same meaning as in

(A) Part VII of the Companies Act 1985 or Part VIII of the Companies (Northern Ireland) Order 1986, where these

provisions are applicable; or

(B) paragraph 11(1) of Schedule 10 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) where applicable; or

(C) paragraph 8 of Schedule 7 to the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) where applicable; or

(D) paragraph 8 of Schedule 4 to the Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1913) where applicable; or

(E) paragraph 8 of Schedule 5 to the Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912) where applicable;

In (A) to (E), the meaning also includes an interest held by an individual which would be a participating interest for the purposes of those provisions if he were an *undertaking*.

(ii) "associated undertaking" has the meaning given in section 119(1) of the Building Societies Act 1986.

…

(6) (in *SOLPRU*) a group of *undertakings* that:

(a) consists of a *participating undertaking*, its *subsidiary undertakings* and the *undertakings* in which it holds a *participation*, as well as *undertakings* linked to each other by a *consolidation Article 12(1) relationship*; or

(b) consists of a *mutual-type group*.

[**Note**: article 2(5) of the *MiFID implementing Directive*]

[**Note**: article 212(1)(c) of the *Solvency II Directive*]

insurance group (1) ~~an *insurance parent undertaking* and its *related undertakings*; or~~ a *group* that exists under *SOLPRU* 11.1.2R and includes the entities referred to in *SOLPRU*

11.1.3R.

(2) ~~a *participating insurance undertaking* (not within (1)) and its *related undertakings*.~~ [deleted]

insurance parent undertaking

a *parent undertaking* which is:

(a) a *participating* ~~*insurance undertaking*~~ *Solvency II undertaking* which has a *subsidiary undertaking* that is ~~an *insurance undertaking*~~ *a Solvency II undertaking*; or

(b) an *insurance holding company* which has a *subsidiary undertaking* which is ~~an *insurer*~~ *a Solvency II undertaking*.

~~(c) an *insurance undertaking* (not within (a)) which has a *subsidiary undertaking* which is an *insurer*.~~

~~*insurance special purpose vehicle*~~

ISPV

an *undertaking*, whether incorporated or not, other than ~~an *insurance undertaking or reinsurance undertaking*~~ a *Solvency II undertaking*, which has received ~~an official~~ authorisation in accordance with ~~article 6 of the *First Non-Life Directive*, article 4 of the *Consolidated Life Directive* or article 3 of the *Reinsurance Directive*~~ article 211(1) or (3) of the *Solvency II Directive* and:

(a) which assumes risks from ~~such *insurance undertakings* or *reinsurance undertakings*~~ *Solvency II undertakings*; and

(b) which fully funds its exposures to such risks through the proceeds of a debt issuance or some other financing mechanism where the repayment rights of the providers of such debt or other financing mechanism are subordinated to the *undertaking's* ~~*reinsurance*~~ obligations to the *Solvency II undertaking* in respect of the risks referred to in (a).

[Note: article 13(26) of the *Solvency II Directive*]

linked benefit

(1) (in *COBS* 21 (Permitted Links)) *property-linked benefits* or *index-linked benefits*.

(2) (other than in *COBS* 21) a benefit payable under a ~~*life policy*~~ *linked long-term contract of insurance* or a *regulated collective investment scheme* the amount of which is determined by reference to:

(a) the value of the property of any description (whether specified or not); or

(b) fluctuations in the value of any such property; or

(c) income from such property; or

(d) fluctuations in an index of the value of such property.

liquidity risk

(1) (in *COLL* and in accordance with article 3(8) of the *UCITS implementing Directive*) the risk that a position in a *UCITS* portfolio cannot be sold, liquidated or closed out at limited cost in an adequately short timeframe and that the ability of the *scheme* to comply at any time with *COLL* 6.2.16R (Sale and redemption) or, in the case of an *EEA UCITS scheme*, article 84(1) of the *UCITS Directive.*

(2) (in *SOLPRU* and in accordance with article 13(34) of the *Solvency II Directive*) the risk that a *UK Solvency II firm* is unable to realise investments and other assets in order to settle its financial obligations when they fall due.

(3) (except in *COLL* and *SOLPRU*) the risk that a *firm*, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure such resources only at excessive cost.

long-term insurance business

the business of *effecting* or *carrying out* *contracts of insurance* that are *long-term insurance contracts.*

market risk

(1) (in *COLL* and in accordance with article 3(9) of the *UCITS implementing Directive*) the risk of loss for a *UCITS* resulting from fluctuations in the market value of positions in the *scheme's* portfolio attributable to changes in market variables, such as interest rates, foreign exchange rates, equity and commodity prices or an ~~issuer's~~ *issuer's* credit worthiness;

(2) (in *SOLPRU* and in accordance with article 13(31) of the *Solvency II Directive*) the risk of loss or of adverse change in the financial situation resulting, directly or indirectly, from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments;

(3) (except in *COLL* and *SOLPRU)* (in relation to a *firm*) the risks that arise from fluctuations in values of, or income from, assets or in interest or exchange rates.

MCR

(1) (except in *SOLPRU*), the *minimum capital requirement*

(2) (in *SOLPRU*), the Minimum Capital Requirement calculated in accordance with *SOLPRU* 5.

mixed activity insurance holding company

(in accordance with article ~~1(j)~~ 212(g) of the ~~*Insurance Groups Directive* (Definitions))~~ *Solvency II Directive* a *parent undertaking*, other than ~~an *insurance undertaking*,~~ a *Solvency II*

	undertaking, an *insurance holding company* or a *mixed financial holding company*, the *subsidiary undertakings* of which include at least one ~~*insurance undertaking*~~ *Solvency II undertaking*.
mutual	an *insurer* or a *UK Solvency II firm* which: (a) if it is a *body corporate* has no *share* capital (except a wholly owned *subsidiary* with no *share* capital but limited by guarantee); or (b) is a *registered friendly society* or *incorporated friendly society*; or (c) is a society registered or deemed to be registered under the Industrial and Provident Societies Act 1965 or the Industrial and Provident Societies (Northern Ireland) Act 1969.
operational risk	(1) (in *COLL* and in accordance with article 3(10) of the *UCITS implementing Directive*) the risk of loss for a *UCITS* resulting from inadequate internal processes and failures in relation to the people and systems of the *management company* or from external events, and it includes legal and documentation risk and risk resulting from the trading, settlement and valuation procedures operated on behalf of the *scheme*. (2) (in *SOLPRU* and in accordance with article 13(33) and article 101(4) of the *Solvency II Directive*) the risk of loss arising from inadequate or failed internal processes, personnel or systems, or from external events, including legal risks but, for the purposes of *SOLPRU* 4.3.3R(1) it excludes risks arising from strategic decisions and reputational risks. (3) (except in *COLL* and *SOLPRU*) (in accordance with Article 4(22) of the *Banking Consolidation Directive*) the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.
outsourcing	(1) (except in *SYSC* 8 , *COBS* 11.7, *SOLPRU* and the definition of *relevant person*) the use of a *person* to provide customised services to a *firm* other than: (a) a member of the *firm's* governing body acting in his capacity as such; or (b) an individual employed by a *firm* under a contract of service.

(2) (in *SYSC* 8, *COBS* 11.7, *SOLPRU* and the definition of *relevant person*) an arrangement of any form between a *firm* and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the *firm* itself.

[**Note**: article 2(6) of the *MiFID implementing Directive*]

own funds

(1) (in *BIPRU and GENPRU*) own funds as described in articles 56 to 67 of the *Banking Consolidation Directive*.

(2) [deleted]

(3) (in *IPRU(INV)* 8) capital, as defined in *CRED* 8.2.1R.

(3A) (in *IPRU(INV)* 13) the own funds of a *firm* calculated in accordance with *IPRU(INV)* 13.1A.14R.

(4) (in *UPRU*) funds calculated in accordance with *UPRU* Table 2.2.1R (Method of calculation of financial resources) composed of the specified items set out in that Table.

(5) (in *SOLPRU*):

(i) in relation to a *UK Solvency II firm*, the *firm's* aggregate *basic own funds* and *ancillary own funds* as determined in accordance with *SOLPRU* 3; or

(ii) in relation to a *Solvency II undertaking* other than a *UK Solvency II firm*, own funds determined in accordance with *Solvency II EEA implementing measures*; or

(iii) in relation to an *insurance holding company*, own funds determined in accordance with (1) as if it were a *UK Solvency II firm*

[**Note**: article 87 of the *Solvency II Directive*]

permission

permission to carry on *regulated activities*; that is, any of the following:

…

(f) the permission that the *Society* ~~Society of Lloyd's~~ has, under section 315(2) of the *Act* (The Society: authorisation and permission), which is to be treated as a *Part IV permission* for the purposes of Part IV of the *Act* (Permission to carry on regulated activities) in accordance with section 315(3) of the *Act*.

policyholder

(1) (except in respect of *contracts of insurance* where the *insurance undertaking* is a *Solvency II undertaking*) (as defined in article 3 of the Financial Services and Markets Act 2000 (Meaning of "Policy" and "Policyholder") Order 2001 (SI 2001/2361)) the *person* who for the time being is the legal holder of the *policy*, including any *person* to whom, under the *policy*, a sum is due, a periodic payment is payable or any other benefit is to be provided or to whom such a sum, payment or benefit is contingently due, payable or to be provided; and

(2) (in respect of a *contract of insurance* where the *insurance undertaking* is a *Solvency II undertaking*), a policyholder, which includes a *beneficiary*.

regulated market

(1) a multilateral system operated and/or managed by a *market operator*, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in *financial instruments* – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the *financial instruments* admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III of *MiFID*.

[Note: article 4(1)(14) of *MiFID*]

(2) (in addition, in *INSPRU*, ~~and~~ *IPRU(INS)* and *SOLPRU* only) a market situated outside the *EEA States* which is characterised by the fact that:

(a) it meets comparable requirements to those set out in (1); and

(b) the *financial instruments* dealt in are of a quality comparable to those in a regulated market in the United Kingdom.

reinsurance contract

(in *COBS* 21, *ICOBS*, *CASS* 5, ~~and~~ *COMP* and *SOLPRU*) a *contract of insurance* covering all or part of a risk to which a *person* is exposed under a *contract of insurance*.

related undertaking

in relation to an *undertaking* ("U"):

(a) any *subsidiary undertaking* of U; or

(b) any *undertaking* in which U or any of U's *subsidiary undertakings* holds a ~~participation~~ *participation*; or

(c) any *undertaking* linked to U by a *consolidation Article 12(1) relationship*; or

	(d)	any *undertaking* linked by a *consolidation Article 12(1) relationship* to an *undertaking* in (a), (b) or (c).
solvency deficit	(a)	(in *GENPRU* 3 Annex 1R (Capital adequacy calculations with respect to financial conglomerates) and in respect of a member of the *overall financial sector*) the amount (if any) by which its *solo capital resources* fall short of its *solo capital resources requirement*; or
	(b)	(in *SOLPRU* 11.4.4R (proportional shares in certain *related undertakings*)) the amount (if any) by which the *related undertaking's eligible own funds* fall short of its *SCR*.
Solvency ~~1~~ I Directive	(1)	(except in *SOLPRU*) the Directive of the European Parliament and of the Council of 5 March 2002 amending Council Directive 79/267/EEC as regards the solvency margin requirements for life assurance undertakings (No. 2002/12/EC); and
	(2)	(in SOLPRU) each of:
		(a) the *Consolidated Life Directive*;
		(b) the *First Non-Life Directive*;
		(c) the *Second Non-Life Directive;*
		(d) the *Third Non-Life Directive*; and
		(e) the *Reinsurance Directive*.
Solvency ~~2~~ II Directive		the Directive 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) (No 2009/138/EC).
technical provision	(1)	(except in *SOLPRU*) a technical provision established:
		(a) for *general insurance business*, in accordance with *INSPRU* 1.1.12R; and
		(b) for *long-term insurance business*, in accordance with *INSPRU* 1.1.16R.
	(2)	(in *SOLPRU*) a technical provision established in accordance with *SOLPRU* 2.3.1R to *SOLPRU* 2.4.17G.
UK ISPV		an *ISPV* with a *Part IV permission* to *effect* or *carry out contracts of insurance*

Annex C

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text.

10 Approved Persons

10.1 Application

…

Incoming EEA firms etc with top-up permission activities from a UK branch

10.1.15 R …

10.1.15A G If an *incoming EEA firm* or a *firm* which has a *top-up permission* is a *Solvency II undertaking* then *SUP* 10.1.13R(4) and *SUP* 10.1.14R(2) will not apply if the fitness and propriety of the *person* performing that *controlled function* has been considered by the *Home State regulator* in accordance with article 42 of the *Solvency II Directive*.

…

ISPVs

10.1.27 R Only the following *controlled functions* apply to an *ISPV*:

(1) the *governing functions*; and

(2) the *significant management function* in so far as it relates to effectively running the *ISPV* under *SUP* 10.9.10R(1B).

…

10.4 Specification of functions

…

10.4.5 R **Controlled functions**

Type	CF	Description of controlled function
…		
*Required functions**	…	
	~~12B~~	~~*Lloyd's actuary function*~~ [deleted]
~~*Systems*~~ *Group of systems and controls* ~~*function*~~ *functions**	…	
	28	*Systems and controls function*

14		*Risk function*
15		*Internal audit function*
		[deleted]

…

10.5 Significant influence functions

What are the significant influence functions?

10.5.1 G The *significant influence functions*, which are specified in *SUP* 10.4.1R, comprise the *governing functions* (see *SUP* 10.6), the *required functions* (see *SUP* 10.7), the *group of systems and controls ~~function~~ functions* (see *SUP* 10.8) and the *significant management functions* (see *SUP* 10.9). *SUP* 10.5 applies to each of the *significant influence functions*.

…

10.6 Governing functions

…

What the governing functions include

10.6.2 R Each of the *governing functions* (other than the *non-executive director function* and the function described in *SUP* 10.6.4R(2)) includes where apportioned under *SOLPRU* 9.2.3R(2)(a) or *SYSC* 2.1.1R or *SYSC* 4.3.1R and *SYSC* 4.4.3R:

(1) the *systems and controls function*; and

(2) the *significant management function*.

10.6.3 G The effect of *SUP* 10.6.2R is that a *person* who is *approved* to perform a *governing function* (other than the *non-executive function* and the function described in *SUP* 10.6.4R(2)) will not have to be specifically approved to perform the *systems and controls function* or the *significant management function*. A *person* who is *approved* to perform a *governing function* will have to be additionally approved before he can perform any of the *required functions*, the *risk function*, the *internal audit function* or the *customer function*.

…

10.7 Required functions

Apportionment and oversight function (CF8)

10.7.1 R …

10.7.1A G A *UK Solvency II firm* is not required to appoint a *director* or *senior manager* to carry out the *apportionment and oversight function*. However, if:

(1) a *UK Solvency II firm* chooses to appoint an *employee* to carry out some or all of the *apportionment and oversight function*; and

(2) by carrying out the *apportionment and oversight function*, that *employee* will be effectively running the *firm* or will be responsible for some other key *function*;

the obligations on the *firm* to assess fitness and propriety in accordance with *SOLPRU* 9.8 (Fit and proper requirements) will apply and such *employee* is likely to be performing at least one other *controlled function* that is applicable to a *UK Solvency II firm*.

…

Compliance oversight function (CF10)

10.7.8 R The *compliance oversight function* is the function of:

(1) for a *firm* that is not a *UK Solvency II firm,* acting in the capacity of a *director* or *senior manager* who is allocated the function set out in *SYSC* 3.2.8R or *SYSC* 6.1.4R(2)~~.~~;

(2) for a *UK Solvency II firm*, acting in the capacity of an *employee* who is responsible for the compliance *function* set out in *SOLPRU* 9.4.1R(2).

…

Actuarial function (CF12) and *with-profits actuary function* (CF12A)

10.7.17 R The actuarial function is the function of:

(1) for a *firm* that is not a *UK Solvency II firm,* acting in the capacity of an *actuary* appointed by a *firm* under *SUP* 4.3.1R to perform the duties set out in *SUP* 4.3.13R~~.~~;

(2) for a *UK Solvency II firm*, acting in the capacity of an *employee* who is responsible for the actuarial *function* set out in *SOLPRU* 9.6.1R.

…

~~Lloyd's actuary function (CF12B)~~

10.7.22 R ~~The *Lloyd's actuary function* is the function of acting in the capacity of the *actuary* appointed under *SUP 4.6.1 R* to perform the duties set out in *SUP 4.6.7 R*.~~ [deleted]

…

10.8 ~~Systems~~ Group of systems and controls functions

Systems and controls function~~s~~ (CF28)

10.8.1 R The *systems and controls function* is the function of acting in the capacity of an *employee* of the *firm* that is not a *UK Solvency II firm* with responsibility for reporting to the *governing body* of a *firm*, or the audit committee (or its equivalent) in relation to:

(1) its financial affairs;

(2) setting and controlling its risk exposure (see *SYSC* 3.2.10G and *SYSC* 7.1.6R);

(3) adherence to internal systems and controls, procedures and policies (see *SYSC* 3.2.16G and *SYSC* 6.2).

…

10.8.2A G …

10.8.2B G If:

(1) a *UK Solvency II firm* chooses to appoint an *employee* with responsibility for reporting to the *governing body* of the *firm* in relation to its financial affairs; and

(2) by carrying out that part of the *systems and controls function*, that *employee* will be effectively running the *firm* or will be responsible for some other key *function*;

the obligations on the *firm* to assess fitness and propriety in accordance with *SOLPRU* 9.8 (Fit and proper requirements) will apply and such *employee* is likely to be performing at least one other *controlled function* that is applicable to a *UK Solvency II firm*.

…

The risk function (CF14)

10.8.3 R ~~[deleted]~~ The *risk function* is the function of acting in the capacity of an *employee* who is responsible for the risk management *function* set out in *SOLPRU* 9.3.3R.

The internal audit function (CF15)

10.8.4 ~~G~~ ~~[deleted]~~ The *internal audit function* is the function of acting in the capacity
R of an *employee* who is responsible for the internal audit *function* set out in *SOLPRU* 9.5.1R.

…

10.9 Significant management functions

Application

10.9.1 R *SUP* 10.9 applies only to a *firm* which:

(1) under *SOLPRU* 9.2.3R(2)(a), *SYSC* 2.1.1R or *SYSC* 4.1.1R, apportions a significant responsibility, within the description of the *significant management function*, to a *senior manager* of a significant business unit; or

(2) undertakes *proprietary trading*; or

(3) (in the case of an *EEA firm*) undertakes the activity of *accepting deposits* from *banking customers* and activities connected with this; or

(4) is a *UK Solvency II firm or UK ISPV* that has individuals who are effectively running the *firm* or are responsible for other key *functions* that do not fall entirely within the scope of one or more of the other *controlled functions*.

10.9.2 G The *FSA* anticipates that there will be only a few *firms* needing to seek approval for an individual to perform the *significant management function* set out in *SUP* 10.9.1R(1). In most *firms*, those approved for the *governing functions*, *required functions* and, where appropriate, the *group of systems and controls ~~function~~ functions*, are likely to exercise all the significant influence at senior management level.

…

10.9.3 G The scale, nature and complexity of the *firm*'s business may be such that a *firm* apportions under *SUP* 10.9.1R(1) a significant responsibility to an individual who is not approved to perform the *governing functions*, *required functions* or, where appropriate, the *group of systems and controls ~~function~~ functions*. If so, ~~v~~ the *firm* should consider whether the functions of that individual fall within the *significant management function*. For the purposes of the description of the *significant management functions*, the following additional factors about the *firm* should be considered:

…

Significant management function (CF29)

10.9.10 R

…

(1A) …

(1B) In the case of a *UK Solvency II firm* or *UK ISPV*, the *significant management function* also includes acting in the capacity of an individual who is effectively running the *firm* or has responsibility for a key *function*.

…

…

10.9.10C G For the purposes of *SUP* 10.9.10R(1B), it will be specific to the *person*, role and *firm* whether a *person* is effectively running a *UK Solvency II firm* or *UK ISPV* or has responsibility for some other key *function*. It may depend (for example) on how much influence or control a particular *person* has over the particular *firm,* or a key *function* within it. Therefore, each *firm* will need to form its own view about each relevant *person* and their role before deciding whether he is carrying out the *significant management function*. A *firm* should keep a careful record of each decision and the reasons for it. A *firm* should also review each decision if a material fact or circumstance changes.

…

10.12 Application for approval and withdrawing an application for approval

…

Who should make the application?

10.12.3 G …

(2) Usually this will be the *firm* that is employing the *candidate* to perform the *controlled function*. Where a *firm* has outsourced the performance of a *controlled function*, the details of the outsourcing determine where responsibility lies and whom the *FSA* anticipates will submit *approved persons* application forms. *SUP* 10.12.4G describes some common situations. The *firm* which is outsourcing is referred to as "A" and the person to whom the performance of the *controlled function* has been outsourced, or which makes the arrangement for the *controlled function* to be performed, is referred to as "B". In each situation, A must take reasonable care to ensure that, in accordance with section 59(2) of the *Act*, no *person* performs a *controlled function* under an *arrangement* entered into by its contractor in relation to the carrying on by A of a *regulated activity*, without approval from the *FSA*. See also *SYSC* 3.2.4G and *SYSC* 8.1.1R; ~~and~~ for *insurers* other than *UK Solvency II firms* see *SYSC* 13.9 and see *SOLPRU* 9.7 for *UK Solvency II firms*.

10.12.4 G **Outsourcing arrangements**

…

Outsourcing arrangements		*Submitting form*
…		
(i) A to B, where B is a non-*authorised person* **not part of the**	**Responsibility for (as opposed to the performance of) and**	**A ensures that an individual approved under one of the**

same *group* **as A** **(ii) A to B, where A is a** *branch* **of an** *overseas firm* **in the** *United Kingdom*, **and B is an** *overseas undertaking* **of the same** *group* **(iii) A to B, where A is a** *UK authorised subsidiary* **of an** *overseas firm,* **and B is an** *overseas undertaking* **of the same** *group*	**activity** *outsourced* **to B will remain with A. See** *SYSC* **3.2.4G and** *SYSC* **8 or** *SOLPRU* **9.7.1R**	*significant influence functions* **has responsibility for the** *outsourced arrangement* **and A submits a form in relation to that individual**

PUB REF: 002686

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk