Transposition of Solvency II

Part 1
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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.

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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

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ABI</td>
<td>Association of British Insurers</td>
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<tr>
<td>APR</td>
<td>Approved persons regime</td>
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<td>BTS</td>
<td>Binding Technical Standards</td>
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<td>CLD</td>
<td>Consolidated Life Directive</td>
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<td>CF</td>
<td>Controlled function</td>
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<td>COBS</td>
<td>Conduct of Business sourcebook</td>
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<tr>
<td>CP</td>
<td>Consultation Paper</td>
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<tr>
<td>CP1</td>
<td>This CP – our first consultation paper dealing with the transposition of Solvency II</td>
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<td>CP2</td>
<td>Our second planned consultation paper dealing with the transposition of Solvency II</td>
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<td>DA</td>
<td>Delegated Acts</td>
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<tr>
<td>EIOPA</td>
<td>European Insurance and Occupational Pensions Authority</td>
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<td>ESFS</td>
<td>European System of Financial Supervision</td>
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<td>EU</td>
<td>European Union</td>
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<td>FCA</td>
<td>Financial Conduct Authority</td>
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<td>FSMA</td>
<td>Financial Services and Markets Act 2000</td>
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<td>GENPRU</td>
<td>General Prudential sourcebook</td>
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<td>ICAS</td>
<td>Individual Capital Adequacy Standards</td>
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<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<td>ICOBS</td>
<td>Insurance: Conduct of Business sourcebook</td>
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<td>INSPRU</td>
<td>Prudential sourcebook for Insurers</td>
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<td>IPRU(FSOC)</td>
<td>Interim Prudential sourcebook for Friendly Societies</td>
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<td>Implementing Technical Standards</td>
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<td>MCR</td>
<td>Minimum Capital Requirement</td>
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<td>PS</td>
<td>Policy Statement</td>
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<td>QCP</td>
<td>Quarterly Consultation Paper</td>
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<tr>
<td>RAO</td>
<td>Regulated Activities Order</td>
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<td>RDR</td>
<td>Retail Distribution Review</td>
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<td>RTS</td>
<td>Regulatory Technical Standards</td>
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<td>SCR</td>
<td>Solvency Capital Requirement</td>
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<td>SFCR</td>
<td>Solvency and Financial Condition Report</td>
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<td>SOLPRU</td>
<td>Prudential sourcebook for Solvency II Insurers</td>
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<td>SPV</td>
<td>Special Purpose Vehicle</td>
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<tr>
<td>SUP</td>
<td>Supervision sourcebook</td>
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<tr>
<td>TS</td>
<td>Technical Standards</td>
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<tr>
<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
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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.

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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 II²

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

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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:

• 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.

Scope7

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
3. Approach to consultation
4. Alignment with regulatory reform
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 2009.²⁸ 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.²⁹

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

²⁹ 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\textsuperscript{10}

Where our consultation process sits in the current European timeline

\begin{figure}
\centering
\includegraphics[width=\textwidth]{timeline}
\caption{Timeline of the consultation process for Transposition of Solvency II.}
\end{figure}

\textsuperscript{10} This is the current position at the time of publication, and is subject to changes in the European timeline.
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 to 184 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

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...
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

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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.
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

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\(^{12}\) 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 to 131 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?
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?
12.1 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). 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

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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’. 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.

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

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16 SUP 10
17 The long-term fund
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.
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).

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?

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**

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.
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

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18. Introduction and key messages
19. Direct costs
20. Non-capital compliance costs
21. Capital compliance costs
22. Insurance market impacts
23. Financial market impacts
24. Benefits
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.
At the outset, EY agreed three workstreams with us:

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

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.

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.

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.

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

**Scope of the EY report**

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.

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.\textsuperscript{15}

18.14 To assess the capital impact, EY analysed the results of the Fifth Quantitative Impact Study (QIS5)\textsuperscript{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’).\textsuperscript{17} Its analysis took ‘UK Solvency I’ as the baseline for comparison.\textsuperscript{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.\textsuperscript{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.

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\textsuperscript{15} See Volume II of EY’s report – *Solvency II Cost Benefit Analysis*

\textsuperscript{16} FSA (2011) FSA UK Country Report: The Fifth Quantitative Impact Study (QIS 5) for Solvency II

\textsuperscript{17} See Volume I of EY’s report – *Solvency II Cost Benefit Analysis*

\textsuperscript{18} See page 10 of Volume I of EY’s report – *Solvency II Cost Benefit Analysis*

\textsuperscript{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.
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

<table>
<thead>
<tr>
<th>Type of insurer</th>
<th>Estimated cost £ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurance</td>
<td>150</td>
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<tr>
<td>Commercial London Market</td>
<td>213</td>
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<tr>
<td>General insurance</td>
<td>309</td>
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<tr>
<td>Life and pensions</td>
<td>825</td>
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<tr>
<td>Composites</td>
<td>366</td>
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<tr>
<td>Mutuals</td>
<td>27</td>
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<tr>
<td>Health</td>
<td>112</td>
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<tr>
<td>Run-offs</td>
<td>42</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2044</strong></td>
</tr>
<tr>
<td>Less FSA Special Project Fees</td>
<td>110</td>
</tr>
<tr>
<td><strong>Net total</strong></td>
<td><strong>1934</strong></td>
</tr>
</tbody>
</table>

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, 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’\textsuperscript{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>
<thead>
<tr>
<th>Subsector</th>
<th>Reduction of free surplus as % of Solvency I free surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life and pensions</td>
<td>41%</td>
</tr>
<tr>
<td>General insurers</td>
<td>25%</td>
</tr>
<tr>
<td>Pension management/investment firms</td>
<td>94%</td>
</tr>
<tr>
<td>Mutual firms</td>
<td>11%</td>
</tr>
<tr>
<td>Reinsurers</td>
<td>45%</td>
</tr>
<tr>
<td>Total</td>
<td>31%</td>
</tr>
</tbody>
</table>

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.

\textsuperscript{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 requirements.

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\(^{23}\) 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.


\(^{25}\) 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.

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.

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

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

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.


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/cgs44.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.

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\(^{30}\) £200m of non-capital compliance costs and £500m of capital compliance cost (assuming £12.5 billion of fresh capital is raised)

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

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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. 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

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.

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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 ISPVs, 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 ISPVs 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-absorbing capacity 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;

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

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

1) ‘SCR,’ and ‘SCR,’ 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) ‘ij’ means that the sum of the different terms should cover all possible combinations of ‘i’ and ‘j’;
(3) the factor ‘Corr$_{ij}$’ denotes the item set out in row ‘i’ and column ‘j’ of the correlation matrix in (4).

(4)

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[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:

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

[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 units.

[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.
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.
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.
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.

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).

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.

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.

[Note: article 128 of the Solvency II Directive]

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 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 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 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 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...
7.2.9 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 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 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 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 SOLPRU 8.5 applies to a UK Solvency II firm.

8.2 Pursuit of life and non-life activity

8.2.1 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
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;

(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
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.
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(1) 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(2) 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).
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.

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.

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.

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
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.
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]

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.

Risk concentration and intra-group transactions

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.

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]

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.

Where an intra-group transaction falling within (1) is very significant, it must be reported to the group supervisor as soon as practicable.

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.
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
(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

<table>
<thead>
<tr>
<th>Handbook reference</th>
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<th>Contents of record</th>
<th>When record must be made</th>
<th>Retention period</th>
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<tbody>
<tr>
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<td>Information provided by the financial markets and generally available data on underwriting risk used for the calculation of technical provisions</td>
<td>Not specified</td>
<td>Not specified</td>
</tr>
<tr>
<td>SOLPRU 2.4.3R(2)</td>
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<td>Not specified</td>
<td>Not specified</td>
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<tr>
<td>SOLPRU 2.4.9R(2)</td>
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<td>Not specified</td>
</tr>
<tr>
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<tr>
<td>SOLPRU 2.4.14R</td>
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<td>Not specified</td>
<td>Not specified</td>
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<tr>
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<td>Documented method used by a firm in determining the amount of the relevant item of ancillary own funds when determining its own funds</td>
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<td>Not specified</td>
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<tr>
<td>SOLPRU 3.3.6R(3)</td>
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<td>Not specified, but before the evidence is submitted to the FSA for consideration</td>
<td>Not specified</td>
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<tr>
<td>SOLPRU 4.3.3R(1)</td>
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<tr>
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<tr>
<td>4.4.5R</td>
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<tr>
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<tr>
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<tr>
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<td><strong>An estimate of the firm’s SCR determined in accordance with the standard formula</strong></td>
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<td><strong>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</strong></td>
<td>When required to do so by the FSA in respect of a firm seeking internal model approval</td>
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<tr>
<td><strong>4.16.3R</strong></td>
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<td><strong>4.18.1R</strong></td>
<td><strong>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</strong></td>
<td><strong>Not specified</strong></td>
<td>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</td>
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<tr>
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<td>Results of the firm’s MCR calculation</td>
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<tr>
<td>SOLPRU 5.4.2R</td>
<td>Sufficient information to enable the <em>FSA</em> to understand the reasons why either of the limits referred to in SOLPRU 5.3.4R determines a firm’s MCR</td>
<td>Sufficient information to enable the <em>FSA</em> to understand the reasons why either of the limits referred to in SOLPRU 5.3.4R determines a firm’s MCR</td>
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<td>Fact of deteriorating financial conditions</td>
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<tr>
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<td>Fact of non-compliance with SCR or risk of non-compliance within the next three <em>months</em></td>
<td><em>Firm’s observation</em> that SCR is no longer complied with or where there is a risk of non-compliance within the next three <em>months</em></td>
<td>Immediately</td>
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<td>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</td>
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<tr>
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<td>Firm’s observation that MCR is no longer complied with or where there is a risk of non-compliance within the next three months</td>
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<tr>
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<tr>
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<td>Outsourcing of critical or important functions or activities, as well as any subsequent material developments with respect to those functions or activities</td>
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<tr>
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<td><em>months</em></td>
<td>there is a risk of non-compliance within the next three <em>months</em></td>
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<td>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</td>
<td>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</td>
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<td>Group SCR</td>
<td>Requirement from group supervisor</td>
<td>Without delay</td>
</tr>
<tr>
<td>SOLPRU 11.7.4R(2) (a)</td>
<td>Non-compliance with the conditions referred to in SOLPRU 11.7.1R(2), (3)</td>
<td>Fact of non-compliance with the conditions referred to in SOLPRU 11.7.1R(2), (3) and (4)</td>
<td>The occurrence of non-compliance</td>
<td>Without delay</td>
</tr>
<tr>
<td><strong>SOLPRU 11.7.4R(2)(b)</strong></td>
<td>Plan to restore compliance with the conditions referred to in <strong>SOLPRU 11.7.1R(2), (3) and (4)</strong></td>
<td>Plan to restore compliance</td>
<td>The occurrence of non-compliance</td>
<td>Within an appropriate period of time</td>
</tr>
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<tr>
<td><strong>SOLPRU 11.8.1R</strong></td>
<td>Significant risk concentration at the level of the insurance group</td>
<td>Details of significant risk concentrations</td>
<td>Regular compliance monitoring</td>
<td>Regularly and at least annually</td>
</tr>
<tr>
<td><strong>SOLPRU 11.8.2R</strong></td>
<td>Significant intra-group transactions by <em>Solvency II undertakings</em> within an insurance group</td>
<td>Details of intra-group transactions</td>
<td>Regular compliance monitoring</td>
<td>Regularly and at least annually or as soon as practicable if the intra-group transaction is very significant</td>
</tr>
<tr>
<td><strong>SOLPRU 11.9.4R</strong></td>
<td><strong>SFCR</strong> for an insurance group</td>
<td>The matters required under <strong>SOLPRU 12.3 to 12.6</strong></td>
<td>Annual <strong>SFCR</strong></td>
<td>Annually</td>
</tr>
<tr>
<td><strong>SOLPRU 12.2.1R</strong></td>
<td>Information which is necessary for the purposes of the <em>FSA supervising the firm</em> in accordance with the requirements of the <em>Solvency II Directive</em>, including information which is necessary for the <em>FSA</em> to make any appropriate decisions resulting from the exercise of its supervisory</td>
<td>The matters required under <strong>SOLPRU 12.2.2R to SOLPRU 12.2.4R</strong></td>
<td>[As specified in the <em>Solvency II Regulation</em>]</td>
<td>[As specified in the <em>Solvency II Regulation</em>]</td>
</tr>
<tr>
<td>SOLPRU 12.2.6R</td>
<td>[UK-specific annual and quarterly quantitative reporting templates]</td>
<td>[As per template set out in [   ] ]</td>
<td>[Submission of annual/quarterly reporting templates as specified in the Solvency II Regulation]</td>
<td>[As specified in the Solvency II Regulation]</td>
</tr>
<tr>
<td>SOLPRU 12.3.1R</td>
<td>SFCR</td>
<td>The matters required under SOLPRU 12.3.2R to SOLPRU 12.3.8R</td>
<td>Annual disclosure of SFCR</td>
<td>As specified in the Solvency II Regulation</td>
</tr>
<tr>
<td>SOLPRU 12.4.2R</td>
<td>Disclosure of the granting of a waiver permitting non-disclosure of certain items in the SFCR (where applicable)</td>
<td>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</td>
<td>The grant of a waiver permitting non-disclosure in the firm’s SFCR</td>
<td>The disclosure of the waiver must be made in the firm’s SFCR</td>
</tr>
<tr>
<td>SOLPRU 12.5.1R</td>
<td>Any major development affecting significantly the relevance of the information disclosed in the firm’s SFCR</td>
<td>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</td>
<td>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</td>
<td>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)</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Chapter/ Appendix</th>
<th>Section/ Annex</th>
<th>Right of action under section 150</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>For private person</td>
</tr>
<tr>
<td>All rules in SOLPRU</td>
<td></td>
<td>No</td>
</tr>
</tbody>
</table>
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 issuers 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”.


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.

Solveny I firm  
a firm that immediately before the Solvency II implementation date was an insurer that fell within the scope of Solvency I Directive.

Solveny 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.

Solveny II implementation date  
[31 October 2012].

Solveny II EEA implementing measures  
a measure implementing the Solvency II Directive in an EEA State other than the United Kingdom.

Solveny 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
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 (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 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 and 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 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 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]

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.

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]

(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 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 14(2) 212(g) of the Insurance Groups Directive (Definitions)) a parent undertaking, other than an insurance undertaking, a Solvency II

Page 105 of 116
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 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; 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 II Directive**


(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 II Directive**


**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 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 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

Controlled functions

Type CF Description of controlled function

Required functions*

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<td>42B</td>
<td>Lloyd’s actuary function</td>
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Systems Group of systems and controls function

Systems and controls function
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 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 …
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 4.6.1R to perform the duties set out in SUP 4.6.7R. [deleted]
10.8 Systems and controls functions

Systems and controls functions (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.

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, 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.
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.

Who should make the application?

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.

### Outsourcing arrangements

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<tr>
<th>Outsourcing arrangements</th>
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<td>(i) A to B, where B is a non-authorised person not part of the</td>
<td>Responsibility for (as opposed to the performance of) and A ensures that an individual approved under one of the</td>
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<td>same group as A</td>
<td>activity outsourced to B will remain with A. See SYSC 3.2.4G and SYSC 8 or SOLPRU 9.7.1R</td>
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<td>(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</td>
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<tr>
<td>(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</td>
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