Supervisory Statement | SS3/15

Solvency II: The quality of capital instruments

March 2020

(Updating September 2019)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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1 Introduction

1.1 This supervisory statement is of interest to all UK insurance firms within the scope of Solvency II, the Society of Lloyd's, and firms that are part of a Solvency II group that will determine and classify capital instruments under the Solvency II own funds regime, together with their advisors. This statement should be read alongside all relevant European legislation and relevant parts of the Prudential Regulation Authority (PRA) Rulebook.

1.2 This supervisory statement covers the following topics:

- liability management and capital reduction;
- principal loss-absorbency mechanism for Tier 1 instruments subject to limitation ('restricted Tier 1' or rT1);
- external rT1 instruments which write down on trigger; and
- additional considerations for instruments intended to contribute to group own funds.

2 Prohibition on redemption prior to five years from date of issue [deleted]

[This chapter has been deleted in its entirety]

3 Liability management and capital reduction

3.1 In recent years some firms have conducted 'liability management' exercises in which they have bought back some of their outstanding capital instruments. Firms have generally engaged with their supervisors prior to carrying out such exercises. In accordance with the relevant Solvency II provisions[1] the PRA expects that any means by which capital instruments are reduced, repaid or bought back (including share repurchases), will be subject to prior supervisory approval. The PRA also expects firms to ensure that any relevant terms and conditions in their capital instruments include the requirement for such prior supervisory approval.

3.2 Since the economic substance of a substitution of issuer is equivalent to a redemption by the original issuer and issuance by the substituted firm, the PRA regards issuer substitution as falling within the scope of redemption and thus subject to prior supervisory approval.

4 Principal loss-absorbency mechanism

4.1 The PRA recognises that firms issuing restricted Tier 1 instruments (rT1) will need to achieve clarity as to the manner in which a principal loss-absorbency mechanism (PLAM) would operate[2] and expects the instrument's terms and conditions to be sufficiently clear, for the PRA to be confident that the mechanism works as expected and meets the requirements of the Solvency II Regulations. The Solvency II Regulations contain a number of high-level requirements which instruments with a PLAM will have to meet. The European Insurance and Occupational Pensions Authority (EIOPA) guidelines also clarified some aspects of how these requirements might apply in practice.

[1] Articles 71(1)(h), 73(1)(d) and 77(1)(d) of Regulation 2015/35.
[2] Article 71(1)(e) of Regulation 2015/35.

4.2 The PRA considers that the minimum trigger point for an instrument with a PLAM will be that specified in the Solvency II Regulations[3] and recognises that firms may choose a higher point or points for the mechanism to operate should they so wish.

4.3 If a trigger higher than the minimum is specified, the PRA expects this to be sufficiently clearly defined so that the firm could identify at any point in time whether or not that trigger is met.

4.4 Once the trigger point is reached, the PRA expects the instrument with a PLAM to achieve the write-down or conversion required by the Solvency II Regulations so that the nominal or principal amount absorbs loss.

4.5 Similarly if firms issue several instruments with a PLAM with differing trigger points, the PRA expects them to be mindful of the need for clarity and transparency regarding how they interact with each other, and the firm's overall capital arrangements.

4.6 The PRA considers that any temporary write-down mechanism needs to be considered carefully in order to ensure that the potential for any subsequent write-up does not act to hinder future recapitalisation through the raising of new ordinary share capital. The PRA considers that the potential for eligible future profits to be used to restore the position of holders of the written-down instrument could be viewed by future potential shareholders as limiting the extent to which they might receive dividends and thus could act as a disincentive to their providing investment to recapitalise.

4.7 In addition, the Solvency II provisions require firms to demonstrate that any write-up mechanism has a basis for apportioning eligible future profits that does not undermine the loss absorbency of the instrument,[4] eg if appropriate, by adopting a similar basis as between all Tier 1 instruments, including ordinary share capital and the reconciliation reserve.

5 External rT1 instruments which write down on trigger or which convert on trigger and contain a conversion share offer

5.1 For any external rT1 instrument which writes down on trigger, issued on or after Thursday 21 February 2019, the PRA expects the issuing firm to deduct an amount to reflect the maximum tax charge generated on write-down when calculating its own funds. Firms are expected to do this both when calculating solo own funds and, where relevant, group own funds of a SII group to which the issuer belongs.

5.1A The PRA expects external rT1 instruments which convert on trigger and have a conversion share offer (CSO) issued on or after 16/03/20 to deduct an amount to reflect the maximum tax charge, before the set off of any prior year losses generated in the same manner, unless either condition A or condition B applies:

- condition A is that the issuing firm has provided the PRA with a properly reasoned, independent tax opinion from an appropriately qualified person, taking into account HMRC precedent, statements and guidance, confirming that before the set off of any prior year losses, the exercise of the CSO would not create a tax charge (a 'tax opinion'). Where a firm that has issued an rT1 instrument containing a CSO arrangement (the 'original instrument') and has provided the PRA with a corresponding tax opinion (the 'original tax opinion') proposes to issue a new rT1

3 Article 71(8) of Regulation 2015/35.
4 EIOPA Guidelines on classification of own funds, Guideline 5 para 1.33 (d).

instrument with a CSO arrangement on terms identical to those of the original instrument, instead of providing a new tax opinion, the firm may choose to obtain a confirmation from the original provider of the tax opinion that, taking into account any HMRC precedent, statements and guidance from time to time, the original tax opinion applies equally to the terms of the new rT1 instrument. The provider of the original tax opinion must continue to be independent of the firm for this condition to be fulfilled. The PRA would generally expect either a tax opinion or a subsequent confirmation to be provided at least 10 days before issuance of any rT1 instrument; and

- condition B is that the terms of the external rT1 instrument expressly forbid the issuer from exercising the CSO unless it has provided the PRA with a tax opinion (no later than 10 days before it intends to exercise the CSO). The PRA expects such tax opinion to be current, and in any event issued not earlier than three months from the date of exercise of the CSO.

5.1B HMRC has informed us that they will calculate the tax charge before the set off of any prior year losses based on the face value of the rT1 instrument less the value of cash transferred to the rT1 noteholders by the ordinary shareholders through the CSO mechanism. However, the CSO price will not be known until after the instrument has been triggered and a CSO offer made.

5.1C Since the trigger event only occurs on significant breach of solvency capital requirement (SCR), it is realistic to assume that the market price of shares are impacted and therefore that the CSO price will be very low and potentially near the face value of the ordinary shares. For the purposes of the calculation of the maximum tax charge generated, the PRA therefore expects firms to calculate the tax adjustment on the assumption that the CSO price is set at the face value of the ordinary shares unless, at the point of issuance, the terms and conditions of the instrument state a higher minimum price, on or above which any CSO will be offered.

5.1D Where such a minimum CSO price is included in the terms and conditions, the PRA will expect the deduction to be calculated based on the difference between the face value of the rT1 instrument and the minimum CSO price.

5.2 That deduction should be calculated using the corporation tax rate applicable at the date the own funds is calculated. That being the case, the PRA expects that the deduction may change over the life of the instrument, if the relevant tax rate changes.

5.3 Firms that calculate their SCR using an approved internal model should not capture this loss of own funds in their modelling, as otherwise it would be double counted.

Instruments that convert on trigger unless the issuer has been taken over, in which case they write down

5.4 Certain rT1 instruments have been issued with features requiring that an instrument converts on trigger, but with provisions that if a takeover occurred then the instrument would revert to write-down instead. The PRA does not expect firms that have issued (or that issue in future) such instruments to adjust the amount of rT1 recognised as basic own funds (so long as if the instrument has a CSO they have observed the PRA's expectation set out in paragraph 5.1A above) unless and until the principal loss absorbency mechanism has changed. At that point, the PRA does not expect the firm to restate its regulatory returns pertaining to periods before the change in rT1 instrument's principal loss absorbency mechanism.

6 Instruments intended to count towards group own funds

6.1 The PRA recognises that many of the Solvency II provisions at solo level apply with the necessary modifications for the purposes of group solvency calculations. In respect of own funds requirements, the Solvency II Regulations require specific additional features that will be necessary if a capital instrument is to count towards group own funds. The detail of the additional features required by the Solvency II Regulations differs depending on which type of company in the group has issued the instrument. The PRA will consider the inclusion, or not, of these specific features as well as assessing the availability of own group funds.

6.2 Where a UK Solvency II firm has issued the instrument, the PRA expects that instrument to meet the features determining classification for the relevant tier at a solo level. If that same item is to count towards group own funds, then the PRA expects that actions required in relation to the firm's SCR and minimum capital requirement (MCR) at solo level will also need to be triggered by reference to the group SCR, and the minimum group SCR as proxy (since there is no group MCR) where method 1[5] applies in whole or part to the group solvency calculation.[6] The PRA considers that compliance with relevant group features for such an instrument does not obviate the need for the item's availability to be assessed.[7] In the absence of evidence regarding availability, the PRA expects to apply the rebuttable assumption that the item is not effectively available to cover the group SCR.[8]

6.3 In the case of an instrument issued by a third country insurer, the PRA expects groups to classify the item by reference to the solo features determining classification as set out in the Solvency II Regulations. Where method 1 applies in whole or part to the group solvency calculation, the PRA also expects appropriate references to the group SCR, the local capital requirement laid down by the third country supervisor and the minimum group SCR.[9]

6.4 The PRA recognises that many groups choose to issue capital instruments from the ultimate holding company, or sometimes from a subsidiary set up for the purpose of issuing capital. In such circumstances, the PRA expects firms to consider the extent to which the instrument satisfies the solo requirements, as if the issuer were an insurance undertaking subject to Solvency II.[10] This includes making suitable adjustments to the references to SCR to group SCR, and for MCR to the minimum group SCR in relation to method 1, and to the insolvency of the issuer.

6.5 The PRA expects all instruments classified at the group level to be free from any encumbrances and any connected arrangements which would undermine the quality of the instrument at group level. The PRA draws firms' attention to the fact that an instrument issued by an insurance holding company or a mixed financial holding company should be deemed to be encumbered, unless the claims relating to the instrument rank after the claims of policyholders and beneficiaries of all group companies.[11] This is consistent with the detailed requirements for group capital. For example, pursuant to the PRA's rules on Own Funds 3.5(2)[12] the PRA expects groups to consider the development of terms providing that, in the case of winding up proceedings of any firm in the group, repayment of amounts due under that instrument are refused until all obligations by that member of the group to its policyholders and beneficiaries have been met.

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5 Article 331 of Regulation 2015/35.
6 The PRA's rules at Group Supervision 11 and 12 lay down two methods by which group solvency can be calculated. It refers to these as 'Method 1' and 'Method 2'. Method 1 (the default method) is an accounting consolidation-based method. The alternative Method 2 is a deduction and aggregation method.
7 Article 331(2)(b) of Regulation 2015/35.
8 Article 330 of Regulation 2015/35.
9 Article 332 of Regulation 2015/35.
10 Article 333 of Regulation 2015/35.
11 Recital 127 of Regulation 2015/35.
12 See 3.5(2) of the Own Funds Part of the PRA Rulebook.

6.6 Holding company issues must therefore satisfactorily address the position of all group policyholders and beneficiaries. Instruments will not qualify for classification as own funds at the group level if this consideration is omitted.

6.7 In assessing the availability of own funds at group level where group solvency has been calculated on the basis of method 2, the PRA will apply similar consideration as to whether own-fund items of related undertakings meet the solo requirements and have suitable references to the undertaking's SCR and the group's SCR.

Annex – updates to SS3/15

This annex details changes made to SS3/15 following its initial publication in March 2015 following PRA Policy Statement 2/15 'Solvency II: A new regime for insurers'.[13]

2020

March 2020

Following publication of Policy Statement (PS) 7/20 'Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on conversion',[14] this SS was updated to:

- rename Chapter 5 as 'External rT1 instruments which write down on trigger or which convert on trigger and contain a conversion share offer';
- insert paragraphs 5.1A to 5.1D into that chapter; and
- amend paragraph 5.4 to point back to the expectations in paragraph 5.1A for instruments that have a CSO.

The new policy will come into effect for all instruments issued on or after Monday 16 March 2020.

This SS was also updated to simplify formatting and aid readability.

2019

September 2019

Following publication of PS21/19 'Responses to CP13/19 Occasional Consultation Paper',[15] this SS was updated to:

- reflect changes in the Solvency 2 Regulations published on 5 August 2019 by deleting:
  - Chapter 2 in its entirety and related reference to buyback exercises in Chapter 3; and
  - The expectation that conversion or write-down would need to be done in its entirety from Chapter 4.
- delete extraneous and historical material from the SS to bring the SS up to date with current PRA formatting and style guidelines.

The new policy will come into effect for all instruments issued on or after Monday 30 September 2019.

February 2019

Following publication of PS4/19 'Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on write down',[16] this SS was updated to:

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13 https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-a-new-regime-for-insurers.
14 March 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/sii-adjusting-for-reduction-of-loss-absorbency-where-own-fund-instruments-are-taxed-on-conversion.
15 https://www.bankofengland.co.uk/prudential-regulation/publication/2019/occasional-consultation-paper.
16 https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-adjusting-for-reduction-loss-absorbency-where-own-fund-instruments-taxed-on-write-down.

- insert a new Chapter 5 ‘External rT1 instruments which write down on trigger’;
- renumber the original Chapter 5 to Chapter 6; and
- delete the original Chapter 6 ‘Cost benefit analysis’.

The new policy will come into effect for all instruments issued on or after Thursday 21 February 2019.

This SS was also updated to simplify the formatting and aid readability, including sequential numbering of footnotes, the updating of hyperlinks to reflect the location of materials on the Bank of England’s website, and to make hyperlinks more easily identifiable.