

# The Standard Formula: A Guide to Solvency II

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## Chapter 1 Own Funds

### Introduction

Own funds is the Solvency II<sup>1</sup> term for the items that constitute a (re)insurer's regulatory capital. These are principally balance sheet items, with limited allowance for off-balance sheet items.

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

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

Since the UK's departure from the European Union on 31 December 2020, the UK's divergence from EU-derived rules has been a tale of its own. This divergence includes liberalisation of the EU Solvency II regime. These changes do not, for now, include own funds, and we expect the UK Prudential Regulation Authority (PRA) to continue to follow current Solvency II requirements in this regard for the foreseeable future. In this chapter, we summarise the Solvency II position, together with the UK approach (to the extent different or otherwise noteworthy). In the area of own funds, the UK has elected to remain aligned with Solvency II, and hence these instances are limited.

The key regulations for own funds are detailed in Articles 87 to 99 of Solvency II, the Own Funds Section of the PRA Rulebook, the Level 2 Delegated Regulation<sup>2</sup> (Delegated Regulation) and the European Insurance and Occupational Pensions Authority's (EIOPA's) Classification Guidelines<sup>3</sup> (EIOPA-BoS-14/168 EN) (Classification Guidelines). The regulations are supplemented by various PRA supervisory statements,<sup>4</sup> which clarify the same or provide the PRA's views where the regulations or subsidiary legislation are unclear.

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<sup>1</sup> Directive 2009/138/EC (Solvency II) as on-shored by the European Union (Withdrawal) Act 2018, implemented through the PRA Rulebook.

<sup>2</sup> Commission Delegated Regulation (EU) 2015/35 of 10 October 2014, supplementing Solvency II (Delegated Regulation) as on-shored by the European Union (Withdrawal) Act 2018, implemented by reference through the PRA Rulebook.

<sup>3</sup> European Insurance and Occupational Pensions Authority Guidelines on classification of own funds (EIOPA-BoS-14/168 EN) Classification Guidelines.

<sup>4</sup> PRA Supervisory Statement SS2/15; PRA Supervisory Statement SS3/15; PRA Supervisory Statement SS4/18; PRA Supervisory Statement SS19/16.

## 1. Categorisation

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

Own-fund items are further classified as either “basic own funds” or “ancillary own funds”.<sup>5</sup> The former are on-balance sheet items and qualify automatically and have a higher eligibility ranking. The latter are off-balance sheet items and require supervisory approval, discussed in Section 9 below.

## 2. Composition of Own Funds

(Re)insurers must observe prescribed limits in the composition of their own funds, as follows:<sup>6</sup>

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

Preference shares, subordinated debt and certain other items are limited to less than 20% of the total amount of Tier 1. See Section 5 below.<sup>7</sup>

## 3. General Characteristics of Own Funds

The PRA Rulebook states that “a firm may only include an own-fund item in its Tier 1 own funds if (a) it is an item of basic own funds, and (b) it substantially possesses the characteristics set out in 3.5(1) [permanent availability] and 3.5(2) [subordination], taking into consideration the features set out in 3.6 [Own Funds Characteristics]”.<sup>8</sup>

The two characteristics, which are fundamental to understanding own funds are “permanent availability” and “subordination”.

- “Permanent availability” relates to how readily such own funds can be mobilised to absorb losses.
- “Subordination” refers to whether and to what extent the item is accessible to absorb losses in a winding-up. This prioritises and protects policyholders and other similar beneficiaries.

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

In assessing capital instruments, (re)insurers (and regulators in certain contexts) will need to evaluate the following four characteristics of the relevant capital item:<sup>9</sup>

- The duration of the item, in particular whether the item is dated or not and, where an own-funds item is dated, the

relative duration of the item as compared to the duration of the insurance and reinsurance obligations of the firm (sufficient duration).

- Whether the item is free from requirements or incentives to redeem the nominal sum (absence of incentives to redeem).
- Whether the item is free from mandatory fixed charges (absence of mandatory servicing costs).
- Whether the item is clear of encumbrances (absence of encumbrances).

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

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

## 4. Criteria for All Basic Own-Fund Items

### Encumbrances and Connected Transactions

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

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

Encumbrances include the following, per the Classification Guidelines:

- Rights of set-off.
- Restrictions.
- Charges or guarantees.
- Holdings of own-fund items of the undertaking.
- The effect of a transaction or a group of connected transactions that have the same effect as any of the above, or which otherwise undermine an item’s ability to meet the features determining classification as an own fund item.

<sup>5</sup> Article 87 Solvency II.

<sup>6</sup> Article 82(1) and (2) Delegated Regulation.

<sup>7</sup> Article 82(3) Delegated Regulation.

<sup>8</sup> 3.1 and 3.2 Own Funds Part PRA Rulebook.

<sup>9</sup> 3.6 Own Funds Part PRA Rulebook.

## Suspension of Repayment or Redemption on Breach of SCR

All basic own funds instruments must provide for suspension of repayment or redemption in the case of noncompliance with the SCR (or where repayment or redemption would lead to such noncompliance).<sup>10</sup>

However, early redemption or repayment is permissible in some instances:

- The supervisory authority has exceptionally waived the suspension of repayment or redemption of that item.
- The item is exchanged for or converted into another own-fund item of at least the same tier.
- The MCR is complied with after the repayment or redemption.<sup>11</sup>

## Restrictions on Incentives To Redeem

Guideline 19 in the Classification Guidelines elaborates on factors considered as “incentives to redeem”. The factors are not confined to specific instances and, consequently, are prohibited across all tiers, as follows:

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

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

A basic own-fund item may be exchanged or converted into another basic own-fund item of at least the same tier out of the proceeds of a new basic own-fund item of at least the same tier. However, such conversion or exchange is subject to regulatory approval.<sup>12</sup>

## 5. Criteria for Tier 1 Own Funds

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

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

<sup>10</sup> Articles 71(1)(j), 73(1)(f) and 77(1)(f) to Delegated Regulation.

<sup>11</sup> Articles 71(1)(k), 73(1)(h) and 77(1)(h) to Delegated Regulation.

<sup>12</sup> Article 71(2), 73(2) and 77(2) Delegated Regulation.

to its holder until all other obligations, including insurance and reinsurance obligations to policyholders, have been met (ensuring subordination).<sup>13</sup>

Tier 1 capital includes:

- Paid-in-ordinary share capital (or equivalent).
- Surplus funds (effectively profit).
- A so-called reconciliation reserve (being a flexible category allowing a (re)insurer to take into account foreseeable dividends as well as expected profits in future premiums).<sup>14</sup>
- Paid-in preference share capital and subordinated debt (restricted Tier 1 or RT1).<sup>15</sup>

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

## Duration

- All Tier 1 instruments must be (a) undated<sup>16</sup> and (b) repayable or redeemable only at the option of the firm, subject to prior supervisory approval.<sup>17</sup>
- An RT1 instrument (a) must not be redeemable before five years after the date of issuance and (b) may only be redeemable between five and 10 years after the date of issuance where the SCR is exceeded by an appropriate margin, taking into account the (re)insurer’s solvency position and medium-term capital management plan.<sup>18</sup>

## Incentives To Redeem

Tier 1 capital instruments may not include any incentives to redeem.<sup>19</sup>

## Dividends, Distributions or Coupons – SCR Breach

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

- The supervisory authority has exceptionally waived the cancellation of distributions.
- The distribution does not further weaken the solvency position of the firm.
- The MCR is complied with after the distribution.<sup>20</sup>

<sup>13</sup> 3.5 Own Funds Part PRA Rulebook.

<sup>14</sup> See Article 260(2) Delegated Regulation.

<sup>15</sup> 3.1 Own Funds Part PRA Rulebook.

<sup>16</sup> Article 71(1)(f)(i) Delegated Regulation.

<sup>17</sup> Article 71(1)(h) Delegated Regulation.

<sup>18</sup> Article 71(1)(f)(ii) and 71(1)(g) Delegated Regulation.

<sup>19</sup> Articles 71(1)(i) Delegated Regulation.

<sup>20</sup> Article 71(1)(m) Delegated Regulation.

This requirement has proved challenging for UK (re)insurers as shareholder approval of a final dividend is, under English company law (absent any provision to the contrary in the company's constitution or approving resolution) a binding obligation giving rise to a debt. In response, the PRA has published guidance stating that if a company's articles of association do not explicitly forbid the cancellation of dividends — even post-declaration — such cancellations are implicitly permissible. This allows firms to declare dividends conditionally, retaining the right to withdraw the dividend before payout if specific conditions are not satisfied.<sup>21</sup>

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

### ‘Full Flexibility’

A Tier 1 capital instrument must also provide for “full flexibility” by the (re)insurer over any dividend or coupon, *i.e.* be fully discretionary.<sup>22</sup> Full flexibility is defined as follows:

- Distributions are solely paid from distributable items.
- Non-disbursement does not constitute an event of default.
- Cancellation of distributions does not restrict the firm's operations.<sup>23</sup>

For ordinary shares (and equivalent instruments), full flexibility includes:

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

For RT1 instruments, additional conditions include:

- Unrestricted authority for firms to indefinitely cancel distributions on a non-cumulative basis, utilising these funds to meet due obligations.
- No obligation to substitute the distribution by a payment in any other form.

<sup>21</sup> PRA Supervisory Statement SS2/15.

<sup>22</sup> Article 71(1)(n) Delegated Regulation.

<sup>23</sup> Article 71(3) Delegated Regulation.

- No obligation to make distributions linked to a distribution on another own-fund item.<sup>24</sup>

The provisions are developed in the Classification Guidelines. Notably “dividend stoppers” — *i.e.*, provisions in lower tier items that restrict Tier 1 distributions — should not be used, since this could discourage new investors in Tier 1 own funds.

### RT1 — Principal Loss Absorbance Mechanism

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

- A write-down of the principal amount of the item.
- An automatic conversion of the item into ordinary share capital (or equivalent).
- A mechanism with an equivalent outcome.<sup>25</sup>

This poses a challenge for (re)insurers in the UK given that the nominal value of shares cannot be redenominated under UK corporate law without a board resolution. In practice, certain firms achieve this through a temporary write-down, meaning values can decrease now and potentially increase later. The PRA emphasises the need for thorough deliberation around temporary write-down strategies, ensuring that the prospect of future write-ups does not impede potential recapitalisation via the issuance of new ordinary share capital. The prospect of future profits being applied toward preexisting investors after a write-down might deter prospective investors and future recapitalisation efforts.<sup>26</sup>

### RT1 — Trigger Events for Principal Loss Absorbance Mechanism

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

- The amount of own-fund items eligible to cover the SCR is equal to or less than the 75% of the SCR.
- The amount of own fund items eligible to cover the MCR is equal to or less than the MCR.
- Compliance with the SCR is not reestablished within a period of three months of the date when non-compliance with the SCR was first observed.<sup>27</sup>

Firms retain the discretion to incorporate extra trigger events within the terms and conditions of their instruments. This flexibility is particularly pertinent when multiple instruments are issued, each exhibiting unique trigger events for principal loss absorbency mechanisms. In such scenarios, the PRA anticipates that firms provide transparency concerning the interplay

<sup>24</sup> Article 71(4) Delegated Regulation.

<sup>25</sup> Article 71(1)(e) Delegated Regulation.

<sup>26</sup> PRA Supervisory Statement SS3/15.

<sup>27</sup> Article 71(8) Delegated Regulation.

among these instruments, ensuring they cohesively function within the broader framework of the firm's capital strategies.<sup>28</sup>

## 6. Criteria for Tier 2 Basic Own Funds

Tier 2 basic own funds are effectively those balance sheet items that are not eligible to constitute Tier 1 (other than Tier 3 — see below). Tier 2 funds are subject to slightly relaxed standards and must rank only after the claims of all policyholders/beneficiaries and non-subordinated creditors.<sup>29</sup>

### Duration

Tier 2 basic own-fund items must either be undated or have an original maturity of no less than 10 years.<sup>30</sup> Further, the first contractual possibility for repayment or redemption must be no earlier than five years from the issue date.

As with Tier 1, repayment or redemption must be at the sole discretion of the (re)insurer (and subject to PRA approval).<sup>31</sup>

### Limited Incentives To Redeem

Tier 2 basic own funds may, however, feature limited incentives to redeem (such as interest step-ups), which can only apply after 10 years of the date of issuance.<sup>32</sup> These may include an interest rate step-up associated with a call option, where the step-up takes the form of a single increase in the coupon rate no greater than the following:

- 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis.
- 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.<sup>33</sup>

### Dividends, Distribution or Coupons — SCR Breach

As with Tier 1, the instrument must also permit the (re)insurer to delay distributions, dividends and coupon payments for the duration of any breach of the SCR (or where such distribution, dividend or coupon payment would cause any breach of the SCR).<sup>34</sup>

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

<sup>28</sup>PRA Supervisory Statement SS3/15.

<sup>29</sup>Article 73(1)(a) Delegated Regulation.

<sup>30</sup>Article 73(1)(c) Delegated Regulation.

<sup>31</sup>Article 73(1)(d) Delegated Regulation.

<sup>32</sup>Article 73(1)(e) Delegated Regulation.

<sup>33</sup>Article 73(4) Delegated Regulation.

<sup>34</sup>Article 73(1)(g) Delegated Regulation.

## 7. Criteria for Tier 3 Basic Own Funds

Tier 3 basic own funds effectively represent the remainder of the balance sheet items subordinated after policyholder and beneficiaries' claims, and which are not eligible to constitute Tier 1 or 2.<sup>35</sup> They may also include a (re)insurer's deferred tax assets.<sup>36</sup>

### Duration

Tier 3 basic own fund instruments must be undated, or have a minimum maturity of five years.<sup>37</sup>

### Dividends, Distribution or Coupons — MCR Breach

Tier 3 basic own-fund instruments must also provide for the deferral of distributions in the case of non-compliance with the MCR (or where the payment would lead to such non-compliance).<sup>38</sup>

### Limited Incentives To Redeem

Tier 3 basic own-fund instruments may include limited incentives to redeem at any time, in the same manner as Tier 2 basic own funds.<sup>39</sup>

## 8. Ancillary Own Funds

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

### Tier 2 AOF

To qualify as Tier 2, AOF, must display the features of a Tier 1 instrument (in accordance with Section 5 above) once the item has been called up and paid in.<sup>40</sup> Tier 2 AOF include the following:

- Unpaid/uncalled ordinary or preference share capital (or equivalent).
- Unpaid subordinated debt.
- Letters of credit and guarantees.
- Other legally binding commitments provided that the item can be called up on demand and is clear of encumbrances.<sup>41</sup>

<sup>35</sup>Article 77(1)(a) Delegated Regulation.

<sup>36</sup>Article 76 Delegated Regulation.

<sup>37</sup>Article 77(1)(c) Delegated Regulation.

<sup>38</sup>Article 77(1)(g) Delegated Regulation.

<sup>39</sup>Article 77(1)(e) and Article 77(4) Delegated Regulation.

<sup>40</sup>Article 75 Delegated Regulation.

<sup>41</sup>2.3 Own Funds Part PRA Rulebook; Article 89(1) Solvency II and Article 74 Delegated Regulation.

Tier 2 AOF must be callable on demand.<sup>42</sup> This means that the call must not be:

- Contingent on the occurrence of an event or criteria being met.
- Subject to the agreement of the counterparty or any third party.
- Subject to any arrangement or incentive that means the firm is not permitted or is not likely to call up the item.
- Subject to any arrangement or combination of arrangements that has the same effect.<sup>43</sup>

### Tier 3 AOF

Tier 3 AOF are effectively AOF that do not meet all of the requirements for Tier 2 AOF.<sup>44</sup>

### PRA Approvals for AOF

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

The PRA will provide approval for a specified monetary amount or a method to determine the amount of AOF for a predefined period.<sup>45</sup> The PRA also requires that the quantitative amount attributed to AOF must be prudent, realistic and reflective of the item's ability to absorb losses.<sup>46</sup>

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

Specific supervisory approval procedures for AOF emphasise the need for firms to furnish comprehensive supporting evidence,<sup>47</sup> in particular a legal opinion affirming the enforceability of contracts and associated arrangements across pertinent jurisdictions, together with a detailed medium-term capital management plan. The latter should elucidate the intended contribution of AOF to the existing capital framework and their role in satisfying current or prospective capital mandates.<sup>48</sup>

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

<sup>42</sup>Article 74 Delegated Regulation.

<sup>43</sup>EIOPA Guidelines on ancillary own funds (EIOPA-BoS-14/167).

<sup>44</sup>Article 78 Delegated Regulation.

<sup>45</sup>2.5 Own Funds Part PRA Rulebook.

<sup>46</sup>2.7 Own Funds Part PRA Rulebook.

<sup>47</sup>Article 90 Solvency II; Article 62 Delegated Regulation.

<sup>48</sup>Commission Implementing Regulation (EU) 2015/499.

## 9. Pre-Issuance Notification

With the exception of ordinary shares (or any issuance of a class or type previously approved within the prior 12 months), the PRA expects a minimum of one month of notice for a Pre-Issuance Notification (PIN), prior to the inclusion of any instrument in basic own funds.<sup>49</sup> In respect of any issuance of own funds, a Solvency II firm must submit the following to the PRA, one month in advance of the intended issue date and via email:

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

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

## 10. Surplus Funds — With-Profits Funds

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

There is an exception, however, where those obligations constitute "surplus funds" under relevant national law and that satisfy the criteria for Tier 1 own funds (see Section 5 above).<sup>50</sup> The PRA's definition of surplus funds for these purposes is "in relation to a with-profits fund, accumulated profits which have not been made available for distribution to policyholders or other beneficiaries".<sup>51</sup>

To meet the exemption from inclusion in the technical provisions, the value of such funds must be calculated in accordance with a formula specified by the PRA for inclusion in a (re)insurer's own funds.<sup>52</sup>

## 11. Ring-Fenced Funds (RFFs)

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

Such funds cannot be accessed to cover losses more generally, which requires an adjustment in the calculation of own funds and the SCR. Solvency II requires "adjustments ... to reflect

<sup>49</sup>5.2 Own Funds Part PRA Rulebook; 6.2 Group Supervision Part PRA Rulebook.

<sup>50</sup>Article 91 Solvency II.

<sup>51</sup>1.2 Surplus Funds Part PRA Rulebook.

<sup>52</sup>3.1 Surplus Funds Part PRA Rulebook.

the lack of transferability of those own-fund items that can be used only to cover losses arising from a particular segment of liabilities or from particular risks (ring-fenced funds).<sup>53 54</sup>

The following products generally would not qualify as an RFF:

- Conventional unit-linked products.
- Conventional index-linked products.
- Conventional reinsurance business provided that individual contracts do not give rise to restrictions on the assets of the undertakings.
- Coverage assets and similar arrangements that are established for the protection of policyholders in the case of winding-up proceedings.<sup>55</sup>

The “adjustment” in question involves a modification of capital requirements or risk management measures that (re)insurers must undertake to ensure they maintain adequate financial resources and solvency capital, protecting policyholders against insolvency. This may involve adjustments to SCR calculations, technical provisions or other risk management systems to accurately reflect the firm’s risk profile and to comply with regulatory financial resilience standards.<sup>56</sup>

## 12. Own Funds Treatment of Participations

Solvency II requires participation by a (re)insurer in financial and credit institutions (essentially banks and investment firms) to be deducted from the (re)insurer’s own funds, save where an exception applies.<sup>57</sup> A participation is the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking.<sup>58</sup>

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

These own funds are to be reduced by the full value of participation in a financial and credit institution that exceeds 10% of

<sup>53</sup>Article 99 Solvency II.

<sup>54</sup>See also Article 80 Delegated Regulation and the EIOPA Guidelines on ring-fenced funds (EIOPA-BoS-14/169).

<sup>55</sup>EIOPA Guidelines on ring-fenced funds (EIOPA-BoS-14/169 EN).

<sup>56</sup>Article 81 Delegated Regulation.

<sup>57</sup>Article 68(1) Delegated Regulation.

<sup>58</sup>Article 13(20) Solvency II. Note different definition in the group context, being “the holding, directly or indirectly, of voting rights or capital in an undertaking over which, in the opinion of the supervisory authorities, a significant influence is effectively exercised”. Article 212(2) Solvency II.

the (re)insurer’s Tier 1 own funds (other than RT1).<sup>59</sup> In solo calculations, risk is addressed through the sub-module for equity risk, meaning that, in place of a deduction in own funds, a capital charge is applied.<sup>60</sup>

An exception applies such that (re)insurers shall not deduct “strategic participations” that are included in the calculation of group solvency on the basis of the ‘accounting consolidation’ method.<sup>61</sup> Strategic participations include equity investments for which the participating (re)insurer demonstrates:

- The value of the equity investment is likely to be materially less volatile for the following 12 months than the value of other equities over the same period as a result of both the nature of the investment and the influence exercised by the participating undertaking in the related undertaking.
- The nature of the investment is strategic, taking into account certain relevant factors listed thereafter, including the existence of a consistent, long-term, clear and decisive strategy to continue holding the participation.<sup>62</sup>

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

## 13. Application to Lloyd’s

The requirements outlined above apply equally to Lloyd’s overall in its capacity as a quasi-insurance entity that is subject to prudential supervision by the PRA.<sup>63</sup> Accordingly, the Society of Lloyd’s overall is required to hold own funds in the proportions set out above.

Although an individual Lloyd’s member, or syndicate, is not directly subject to the PRA’s own funds requirements, Lloyd’s has elected to treat them in certain respects as though they were, which in turn allows Lloyd’s to meet the requirements overall. As a result, the traditional reliance by Lloyd’s members on letters of credit (in some cases as to 100%) has been scaled back so that, from December 2020, letters of credit may not exceed 50% of a member’s individual Lloyd’s capital requirement (referred to as the Economic Capital Assessment, being the Lloyd’s equivalent of the SCR).<sup>64</sup>

<sup>59</sup>Article 68(1) Delegated Regulation.

<sup>60</sup>Articles 168 to 173 Delegated Regulation.

<sup>61</sup>Article 68(3) Delegated Regulation.

<sup>62</sup>Article 171 Delegated Regulation.

<sup>63</sup>3.1 Insurance General Application Part PRA Rulebook.

<sup>64</sup>Lloyd’s Market Bulletin Y5117.