

**PRA RULEBOOK: SOLVENCY II FIRMS: CONDITIONS GOVERNING BUSINESS INSTRUMENT  
2015**

**Powers exercised**

- A. The Prudential Regulation Authority (“PRA”) 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 137G (the PRA’s general rules); and
  - (2) section 137T (general supplementary powers).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

**Pre-conditions to making**

- C. In accordance with section 138J of the Act (consultation with the Financial Conduct Authority), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

**PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015**

- D. The PRA makes the rules in the Annex to this instrument.

**Commencement**

- E. This instrument comes into force on 1 January 2016.

**Citation**

- F. This instrument may be cited as the PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015.

**By order of the Board of the Prudential Regulation Authority**

17 March 2015

## Annex

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

### Part

# CONDITIONS GOVERNING BUSINESS

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## Chapter content

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## 1 APPLICATION AND DEFINITIONS

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1.1 Unless otherwise stated, this Part applies to:

- (1) a *UK Solvency II firm*;
- (2) in accordance with Insurance General Application 3, the *Society*, as modified by 12; and
- (3) in accordance with Insurance General Application 3, *managing agents*, as modified by 12.

1.2 In this Part, the following definitions shall apply:

*closed year*

means a *syndicate year* closed by *reinsurance to close*, either into another *syndicate year* or into an *insurer* approved by the *Council* for that purpose.

*concentration risk*

means 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: Art. 13(35) of the *Solvency II Directive*]**

*corporate member*

means a *member* that is a *body corporate* or a Scottish Limited partnership.

*explicit maximum loss potential*

means the maximum economic risk transferred by the ceding undertaking to the *reinsurer* under a contract of *reinsurance*.

*external credit assessment institution*

means a credit rating agency that is registered or certified in accordance with Regulation (EC) No 1060/2009 or a central bank issuing credit ratings which are exempt from the application of Regulation (EC) No 1060/2009.

**[Note: Art. 13(40) of the *Solvency II Directive*]**

*finite reinsurance*

means *reinsurance*:

- (1) 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
- (2) which possesses at least one of the following characteristics:
  - (a) explicit and material consideration of the time value of money;

- (b) contractual provisions to moderate the balance of economic experience between the parties to the *reinsurance* over time to achieve the target risk transfer.

**[Note: Art. 210(3) of the Solvency II Directive]**

*former member*

means a *person* who has ceased to be a *member*, whether by resignation or otherwise, in accordance with the Lloyd's Act 1982 and any *byelaw* made under it.

*individual member*

means a *member*, or *former member*, who is a natural *person*.

*liquidity risk*

means the risk that a *firm* is unable to realise investments and other assets in order to settle its financial obligations when they fall due.

**[Note: Art. 13(34) of the Solvency II Directive]**

*reinsurer*

means an *insurance undertaking* whose business includes effecting or carrying out contracts of *reinsurance*; includes a retrocessionaire.

*technical provisions transitional measure*

means a *transitional deduction* from a *firm's technical provisions* applied in accordance with Transitional Measures 11.1.

## 2 GENERAL GOVERNANCE REQUIREMENTS

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- 2.1 A *firm* must ensure its *governing body* is ultimately responsible for the *firm's* compliance with the rules and all applicable laws, regulations and administrative provisions adopted in accordance with the *Solvency II Directive*.

**[Note: Art. 40 of the Solvency II Directive]**

- 2.2 (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 at least:
- (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) 2.5;
- (b) 3 to 7;
- (c) Insurance - Fitness and Propriety 2.1 to 2.3, 4.1, 4.3 and 4.4; and

(d) Insurance – Allocation of Responsibilities 4.

(4) The system of governance must be subject to regular internal review.

**[Note: Art. 41(1) of the Solvency II Directive]**

2.3 A *firm's* system of governance must be proportionate to the nature, scale and complexity of its operations.

**[Note: Art. 41(2) of the Solvency II Directive]**

2.4 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: Art. 41(3) of the Solvency II Directive]**

2.5 The written policy on risk management referred to in 2.4(1) must comprise:

- (1) policies relating to points (i) to (vi) in 3.1(2)(c); and
- (2) where the *volatility adjustment* is applied, a policy on the criteria for the application of the *volatility adjustment*.

**[Note: Art. 44(2) and (2a) of the Solvency II Directive]**

2.6 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: Art. 41(4) of the Solvency II Directive]**

### **3 RISK MANAGEMENT**

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- 3.1 (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 have *key functions*;

- (b) cover the risks to be included in the calculation of the *SCR* as set out in Solvency Capital Requirement - General Provisions 3.3(1), as well as the risks which are not, or not fully, included in the calculation thereof; and
- (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*.
- (3) Where a *firm* applies the *matching adjustment* or the *volatility adjustment* it must set up a liquidity plan projecting the incoming and outgoing cash-flows in relation to the assets and liabilities subject to those adjustments.

**[Note: Art. 44(1)–(2) of the Solvency II Directive]**

3.2 As regards asset-liability management, a *firm* must:

- (1) regularly assess the sensitivity of its *technical provisions* and *eligible own funds* to the assumptions underlying the extrapolation of the *relevant risk-free interest rate term structure* referred to in Technical Provisions 5;
- (2) where the *matching adjustment* is applied, regularly assess:
  - (a) the sensitivity of its *technical provisions* and *eligible own funds* to the assumptions underlying the calculation of the *matching adjustment*, including the calculation of the fundamental spread referred to in Technical Provisions 7.2(2), and the possible effect of a forced sale of assets on its *eligible own funds*;
  - (b) the sensitivity of its *technical provisions* and *eligible own funds* to changes in the composition of the assigned portfolio of assets;
  - (c) the impact of a reduction of the *matching adjustment* to zero;
- (3) where the *volatility adjustment* is applied, regularly assess:
  - (a) the sensitivity of its *technical provisions* and *eligible own funds* to the assumptions underlying the calculation of the *volatility adjustment* and the possible effect of a forced sale of assets on its *eligible own funds*;
  - (b) the impact of a reduction of the volatility to zero.

**[Note: Art. 44(2a) of the Solvency II Directive]**

3.3 A *firm* must submit the assessments referred to in 3.2 as part of the information reported annually in accordance with Reporting 2. Where the reduction of the *matching adjustment* or the *volatility adjustment* to zero would result in non-compliance with the *SCR*, the *firm* must

also submit an analysis of the measures it could apply in such a situation to re-establish the level of the *eligible own funds* covering the SCR or to reduce its risk profile to restore compliance with the SCR.

**[Note: Art. 44(2a) of the Solvency II Directive]**

- 3.4 As regards investment risk, a *firm* must demonstrate that it complies with the Investments Part of the PRA Rulebook.

**[Note: Art. 44(3) of the Solvency II Directive]**

- 3.5 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: Art. 44(4) of the Solvency II Directive]**

- 3.6 In order to avoid overreliance on *external credit assessment institutions* when it uses external credit rating assessments in the calculation of *technical provisions* and the SCR, a *firm* must assess the appropriateness of those external credit rating assessments as part of its risk management by using additional assessments wherever practicably possible in order to avoid any automatic dependence on external assessments.

**[Note: Art. 44(4a) of the Solvency II Directive]**

- 3.7 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: Art. 44(5) of the Solvency II Directive]**

- 3.8 (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 SCR and MCR; and
    - (ii) the requirements regarding *technical provisions*, as set out in Technical Provisions; and
  - (c) the significance with which the risk profile of the *firm* deviates from the assumptions underlying the SCR.

- (3) For the purposes of 3.8(2)(a), the *firm* must:
- (a) 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 and to which it is, or could be, exposed; and
  - (b) demonstrate the methods used in that assessment.
- (4) Where a *firm* applies the *matching adjustment*, the *volatility adjustment*, the *risk-free interest rate transitional measure* or the *technical provisions transitional measure*, it must perform the assessment of compliance with the capital requirements referred to in 3.8(2)(b) with and without taking into account those adjustments and transitional measures.
- (5) In the case referred to in 3.8(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: Arts. 45(1), (2), (2a), (3) of the Solvency II Directive]**

- 3.9 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: Art. 45(4) of the Solvency II Directive]**

- 3.10 A *firm* must perform the *ORSA* regularly and without delay following any significant change in its risk profile.

**[Note: Art. 45(5) of the Solvency II Directive]**

- 3.11 A *firm* must inform the *PRA* of the results of each *ORSA* as part of the information reported under Reporting 2.

**[Note: Art. 45(6) of the Solvency II Directive]**

## **4 INTERNAL CONTROL**

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- 4.1 (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: Art. 46(1) of the Solvency II Directive]**

- 4.2 The compliance *function* referred to in 4.1(2) must include:
- (1) advising the *governing body* on compliance with the rules and other laws, regulations and administrative provisions adopted in accordance with the *Solvency II Directive*; and
  - (2) 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: Art. 46(2) of the Solvency II Directive]**



- 4.3 A *firm* must have internal processes and procedures in place to ensure the appropriateness, completeness and accuracy of the data used in the calculation of its *technical provisions*.

**[Note: Art. 82 of the Solvency II Directive]**

- 4.4 A *firm* 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: Art. 83 of the Solvency II Directive]**

## 5 INTERNAL AUDIT

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- 5.1 (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; and
  - (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: Art. 47 of the Solvency II Directive]**

## 6 ACTUARIAL FUNCTION

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- 6.1 (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 the *best estimate* 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 Technical Provisions 12;
  - (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 referred to in 3, in particular with respect to the risk modelling underlying the calculation of the *SCR* and *MCR* 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: Art. 48 of the Solvency II Directive]**

## 7 OUTSOURCING

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7.1 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: Art. 49(1) of the Solvency II Directive]**

7.2 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: Art. 49(2) of the Solvency II Directive]**

7.3 A *firm* must, in a timely manner, notify the *PRA* 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: Art. 49(3) of the Solvency II Directive]**

7.4 Without prejudice to 7.1 to 7.3, 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 *PRA* and, where relevant, any other *supervisory authority* of the *firm* in connection with the *function* or activity that is the subject of the *outsourcing*;
- (2) the *firm*, its auditors, the *PRA* and, where relevant, any other *supervisory authority* of the *firm* must have effective access to data related to the *functions* or activities that are the subject of the *outsourcing*; and
- (3) the *PRA* 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: Art. 38(1) of the Solvency II Directive]**

## 8 FINITE REINSURANCE

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- 8.1 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: Art. 210 of the *Solvency II Directive*]**

## 9 RESTRICTION OF BUSINESS

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- 9.1 (1) A *firm*, other than a *pure reinsurer*, must not carry on any commercial business other than *insurance business* and activities directly arising from that business.
- (2) (1) does not prevent a *friendly society* that was on 15 March 1979 carrying on *long-term insurance business* and savings business from continuing to carry on savings business.

**[Note: Arts. 18(1)(a) and 305(3) of the *Solvency II Directive*]**

- 9.2 A *pure reinsurer* must not carry on any business other than the business of *reinsurance* and related operations.

**[Note: Art. 18(1)(b) of the *Solvency II Directive*]**

## 10 PREMIUMS FOR NEW BUSINESS

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- 10.1 A *firm* must not enter into a *contract of long-term insurance* unless it is satisfied, on reasonable actuarial assumptions, that the *premiums* receivable shall be sufficient:
- (1) to enable the *firm* to meet all of its commitments; and
- (2) in particular, to establish adequate *technical provisions* as required in the Technical Provisions Part of the *PRA Rulebook*.

**[Note: Art. 209 of the *Solvency II Directive*]**

- 10.2 For the purposes of 10.1, all aspects of the financial situation of the *firm* may be taken into account, provided that input from resources other than *premiums* and investment income expected to be earned from *premiums* is not systematic and permanent in a way that may jeopardise the long-term solvency of the *firm*.

**[Note: Art. 209 of the *Solvency II Directive*]**

## 11 STATISTICAL DATA

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- 11.1 A *leading insurer* and a *relevant insurer* must keep statistical data showing the extent of *Community co-insurance operations* in which they participate and the *EEA States* concerned.

**[Note: Art. 193 of the *Solvency II Directive*]**

## 12 LLOYD'S

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- 12.1 This Chapter applies to the *Society* and *managing agents*.
- 12.2 For the purpose of;

- (1) 3.1(2)(b), 3.8(2)(c) and 6.1(1)(i), as applied to *managing agents*, the reference to “SCR” is to be interpreted as a reference to the notional *syndicate SCR* calculated by *managing agents* as required by Solvency Capital Requirement - General Provisions 8.2.
  - (2) 3.7 and 3.8(5), as applied to *managing agents*, the reference to “internal model” is to be interpreted as a reference to any *internal model* used by a *managing agent* to calculate the notional *syndicate SCR* as required by Solvency Capital Requirement – General Provisions 8.2; and
  - (3) 3.10, as applied to *managing agents*, the reference to “risk profile” is to be interpreted as a reference to the risk profile of any *syndicate* managed by the *managing agent*.
- 12.3 For the purpose of 3.8 to 3.11, as applied to *managing agents*, *managing agents* must conduct an *ORSA* for each *syndicate* which they manage.
- 12.4 Where a provision of this Part requires that a *function* be established, the *Society* and *managing agents* must each separately establish that *function*.
- 12.5 The actuarial *function* of a *managing agent* must, in respect of each *syndicate* managed by the *managing agent*, carrying out *general insurance business*;
- (1) review the *technical provisions* of each *syndicate year* (other than a *closed year*); and
  - (2) provide an opinion to the *managing agent* and the *Society* confirming that the *technical provisions* (before addition of the *risk margin*) for each *syndicate year* are no less prudent than the *best estimate* of the amounts required to be held (before addition of the *risk margin*) in accordance with Technical Provisions 2 to 12.
- 12.6 The *PRA* must be informed by the *managing agent* promptly if the *managing agent* becomes aware that the actuarial *function* of the *managing agent* will or may be unable to produce an unqualified opinion under 12.5(2).
- 12.7 For the purpose of 9.1, the *Society* and *managing agents* must take all reasonable steps to ensure that:
- (1) a *corporate member* does not carry on any commercial business other than *insurance business* and activities arising directly from that business; and
  - (2) *individual members* do not, in their capacity as *underwriting members*, carry on any commercial business other than *insurance business* and activities arising directly from that business.