



BANK OF ENGLAND



# The Bank of England, Prudential Regulation Authority

The PRA's approach to insurance supervision

October 2012



## Foreword



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Next year, the Prudential Regulation Authority (PRA) will take up its responsibilities as part of the new approach to financial regulation in the United Kingdom. The PRA, which will be responsible for the prudential regulation of deposit-takers, insurers and major investment firms, will be part of the Bank of England and will make an important contribution to the Bank's core purpose of maintaining financial stability in the United Kingdom.

This document sets out the PRA's intended approach towards regulating insurers. A companion document covers deposit-takers and investment firms. Our approach will be anchored in the objectives that I expect Parliament to give us when the new legislation comes into effect. For insurers, the PRA will have two complementary objectives. It will promote their safety and soundness, as with all firms it supervises, thereby reducing the threat they can pose to the stability of the financial system and thus to the continuity of provision of critical financial services. And, specific to insurers, it will contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.

The financial crisis has powerfully demonstrated the need for a new approach to financial regulation. Our job at the PRA will be to protect the public's access to critical financial services and thus to contribute to a healthy economy. But we recognise that the threats to safety and soundness of firms and thus to the continuity of financial services can be complex and fast-moving. Moreover, the PRA will come into existence during a period of profound change in the policies governing financial regulation around the world. Our goal at the PRA will be to focus on the things that matter most to achieving our statutory objectives and thus our responsibility to the public.

This document sets out how we intend to implement the PRA's approach in practice. It will be based on setting clear standards for insurers which are in line with the Threshold Conditions for authorisation set out in legislation. Our approach will be very clearly based on judgement rather than narrowly rules-based, and it will be forward looking to take into account a wide range of possible risks to our objectives.

The PRA will operate to high standards in pursuing its objectives, and we will expect firms likewise to support and conform to the public policy objectives set by Parliament. Our goal is to ensure that the public can put their trust in a stable and safe financial system.

This document is being issued ahead of the PRA assuming its responsibilities under statute. I very much welcome comments from all interested parties.

A handwritten signature in black ink that reads "Andrew Bailey". The signature is written in a cursive, slightly stylized font.

October 2012



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## Executive summary

The Prudential Regulation Authority (PRA), as part of the Bank of England, will become the United Kingdom's prudential regulator for deposit-takers, insurance companies and investment firms in 2013. This paper sets out how the PRA will carry out its role in respect of insurers. It is designed to help regulated firms and the market understand how the PRA will supervise these institutions, and to aid accountability to the public and Parliament.

### The PRA's objectives for insurers

Insurance companies enable policyholders to pool and transfer risk so that they are protected against the financial consequences of uncertain future events. Also, some policies enable the accumulation of long-term savings. Usually, policyholders pay premiums in advance in return for payments if and when the insured event happens. And, as with any service where payment is made in advance, policyholders are exposed to the risk that the insurer may fail, and to the fact that the incentives of management and policyholders may not be aligned, particularly in times of stress.

Insurers' liabilities are fundamentally different from those of banks. They are, in general, inherently uncertain, both to the individual policyholder and in aggregate. That is in contrast to the certain commitment that banks make to depositors to return their deposit on demand and in full. This fundamental uncertainty around insurers' liabilities, combined with imbalances in information, means it is difficult in practice for many policyholders to monitor the financial health of their insurer and to make reasonably informed judgements about the levels of risk to which they are exposed. Added to this, for many products (such as annuities), policyholders are constrained in their ability to switch insurer over the period during which the contract is being fulfilled. And for some types of insurance, including long-term savings products, it may be many years until policyholders receive payment.

The PRA will have two, complementary, statutory objectives in its supervision of insurers. It will **promote their safety and soundness as with all firms it supervises and, specific to insurers, it will contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.**

Policyholders will be protected both by the PRA as prudential regulator and by the Financial Conduct Authority (FCA) as conduct regulator. The FCA will seek to ensure that consumers are treated fairly in their dealings with insurers, whereas the **PRA's focus will be to ensure that policyholders**

**have an appropriate degree of continuity of cover for the risks they are insured against.** Ensuring continuity of cover requires insurers to be able to meet claims from, and material obligations to, policyholders as they fall due, which, in the case of some policies, may emerge after many years. More generally, the PRA's objectives require insurers to have resilience against failure and avoid disruption to the continuity of financial services. Thus both of the PRA's objectives serve to enhance continuity in critical financial services — a necessary condition for a healthy and successful economy.

The PRA will prioritise its approach to protecting policyholders reflecting both the potential for adverse effects on policyholders if continuity of policy provision were to be disrupted and the significance to policyholders of the risk insured. For example, the PRA's supervision of life insurers will recognise that they provide critical incomes to policyholders through annuities and for some general insurers that they provide mandatory cover without which economic activity cannot take place. Separately, the PRA will recognise that insurers' opportunities to be less safe and sound and deliver a lower standard of policyholder protection than is in the public interest will vary with the type of insurance. For example, insurers providing cover over long maturities, such as life insurance, or general insurance, where cover extends for many years, bring greater opportunities for failure and a lesser ability for policyholders to protect themselves. Reflecting these factors, the standards the PRA sets, including its approach to supervision and its approach to the arrangements for dealing with failing insurers, will differ.

In addition, the PRA will be required by statute to promote safety and soundness primarily by seeking to avoid adverse effects on financial stability. **The financial services that insurers provide are essential in supporting the pooling and transfer of risk and savings, and so wider economic activity. Traditional insurers do not, however, generally threaten the stability of the financial system in the same way as banks.** They do not typically undertake maturity transformation and so are less vulnerable to sudden losses of confidence, 'runs' and so contagion, than are banks. But their failure, nevertheless, has the potential adversely to disrupt the continuity of financial services and so financial stability, for example if critical insurance services are withdrawn on a scale sufficient to lead to a direct impact on economic activity, or through indirect effects via other financial institutions.

Contributing to an appropriate degree of policyholder protection and promoting resilience against failure does not mean protecting all policyholders in full in all circumstances, nor does it mean preventing all instances of failure. The statute is explicit that **it will not be the PRA's role to ensure**

**that no insurer fails.** Insurer failures will happen but the PRA will seek to ensure that they do not result in significant disruption to the supply of critical financial services, including by promoting an acceptable degree of continuity for policyholders' cover against insured risks (whether delivered through continuity of cover or the return of premiums paid).

The degree of disruption, and so the PRA's ability to advance its objectives, in the event of an insurer failing will of course depend on the efficacy of the statutory regime for dealing with failed insurers and the Financial Services Compensation Scheme's (FSCS) insurance compensation scheme, which protects some policyholders, up to certain limits, in the event of failure. Given the PRA's objectives, it will be important that there are mechanisms by which all types of insurer supervised by the PRA can exit the market in an orderly manner consistent with both of the PRA's objectives. The current range of such mechanisms set out in corporate and insurance company law vary in the extent to which they have been used in practice.

Assessing and planning to contain the impact of failure will be a core part of the PRA's work. This will of course depend on the statutory resolution arrangements, and so the PRA will consider whether its approach to supervision should change to the extent that the resolution arrangements change. In August 2012, HM Treasury launched a consultation<sup>(1)</sup> — supported by the Bank and the Financial Services Authority (FSA) — setting out proposals on possible enhancements to the mechanisms available for dealing with the failure of systemically important non-banks, including potentially insurers. In addition, the resolution arrangements for insurers may need to be adapted given international regulatory change. The PRA will therefore work with insurers, HM Treasury, FSCS and the rest of the Bank of England as appropriate to assess and enhance the resolution framework for insurers in order to support both its objectives of supporting the stability of the system and protecting policyholders appropriately.

### The PRA's requirements on firms — Threshold Conditions

The nature of insurers' business models exposes them to a different set of risks than banks. It means they fail for different reasons and with different impacts on the stability of the system. **Recognising the particular nature of insurance contracts and insurers' business models, the PRA's supervision of insurers will be framed in a different way to its supervision of banks.**

The requirements that insurers will need to meet in order to remain safe and sound and so to protect policyholders will be rooted in the PRA's statutory objectives, the statutory

Threshold Conditions for authorisation, and UK and EU law. The PRA's new statutory Threshold Conditions for insurers, which will set out the minimum requirements that insurers must meet in order to be permitted to perform insurance contracts are designed to promote safety and soundness, both to ensure insurers' ongoing ability to meet their obligations to policyholders and to support the stability of the financial system. The Threshold Conditions will be crucial to the operation of the new regime. In broad terms, they will require insurers to have appropriate financial resources, to have appropriate resources to measure, monitor and manage risk, to be fit and proper, to conduct their business prudently and to be capable of being effectively supervised by the PRA. **The PRA will expect insurers not merely to meet and continue to meet the letter of these requirements, but also to consider the overriding principles of safety and soundness and protection of policyholders.**

Maintaining safety and soundness will at times require insurers to act more prudently than they might otherwise choose. Their incentives can sometimes be to take more risk, and so to impose more risk on policyholders and the stability of the financial system, than is in the public interest. **It is the responsibility of each insurer's board of directors and senior management to manage their insurer prudently, with a view to maintaining its safety and soundness, thereby protecting policyholders and contributing to the continued stability of the financial system.** This will be in insurers' collective interest as well as in the public interest. It is vital that boards and senior management understand and uphold these objectives, and establish within their firms a culture that supports them.

### The PRA's approach to supervision

Within the statutory framework, **the PRA's approach will rely significantly on judgement. The PRA will supervise insurers to judge whether they are safe and sound, whether they protect policyholders appropriately, and thus whether they meet, and are likely to continue to meet, the Threshold Conditions.** Supervisors will reach judgements on the risks that an insurer poses to the PRA's objectives, and how to address any shortcomings.

**The PRA's approach will be forward-looking; it will assess insurers not just against current risks, but also against those that could plausibly arise in the future.** Where the PRA judges it necessary to intervene, it will generally aim to do so at an early stage. Insurers should be open and straightforward in their dealings with the PRA, taking the

(1) See [www.hm-treasury.gov.uk/d/condoc\\_financial\\_sector\\_resolution\\_broadening\\_regime.pdf](https://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf).



initiative to raise issues of possible prudential concern also at an early stage. The PRA, for its part, will respond proportionately. Trust can thus be fostered on both sides.

**The PRA will focus on those issues and those insurers that pose the greatest risk to the stability of the UK financial system and policyholders.** Focusing on key risks will inevitably involve the PRA tailoring its activities to an insurer's individual circumstances. And it will mean that the PRA's approach to supervision and the arrangements for dealing with failing insurers will differ across the life, general, wholesale and reinsurance sectors, recognising, for example, the different risks inherent in the business models of life and general insurers given the different maturities of their assets and liabilities, and the different risks to which policyholders are exposed. Consistent with its focus on key risks, the frequency and intensity of supervision applied to a particular firm will increase in line with the risk it poses to the PRA's objectives. The PRA will aim to concentrate on material issues when engaging with firms.

The PRA's supervisory judgements will be based on evidence and analysis. It is, however, inherent in a forward-looking system that, at times, the supervisor's judgement will be at variance with that of the insurer. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong. To minimise such outcomes, the PRA will need to be staffed by teams with strong, relevant skills and experience, and its major judgements and decisions will involve the PRA's most senior and experienced staff and directors.

The PRA will also engage with the boards and senior management of insurers in forming its decisions, using this dialogue both to ensure that it takes account of all relevant information in reaching its judgements, and to communicate clearly the rationale for them. Insurers should not, however, approach their relationship with the PRA as a negotiation.

**The PRA's regulatory decision-making will be rigorous and well documented, consistent with public law.** Its most significant supervisory judgements will be taken by its Board — comprising the Governor of the Bank of England, the Deputy Governor for Financial Stability, the Chief Executive Officer of the PRA, and the independent non-executive members of the Board. The PRA Board will be involved in the most important decisions on general policy and individual cases. The Board will, of course, be accountable to Parliament, in the same way as are the Monetary Policy Committee and

Financial Policy Committee, the Bank's other statutory decision-making bodies.

### The wider context

An effective regulatory framework for financial stability needs to **combine firm-specific supervision with work to protect and enhance the resilience of the financial system as a whole. The PRA will therefore work closely with the rest of the Bank of England**, including crucially the Financial Policy Committee, which will be able to make recommendations and potentially give directions to the PRA in respect of its supervision of insurers.

The PRA will also co-operate closely with the rest of the Bank on market intelligence and oversight of critical infrastructure. And it will work with the Bank's Special Resolution Unit and other relevant authorities to review and improve the ways in which failing insurers exit the market.

**The PRA will co-operate closely with the FCA**, which will be the conduct regulator for all PRA-authorised firms and the conduct and prudential regulator for many other UK firms. Policyholder protection will be an element of both the FCA and the PRA's objectives, and so they will co-ordinate to ensure that their separate mandates secure overall protection. In the case of with-profits policies, additional co-ordination arrangements will be needed: this is because the returns on with-profits policies are not well defined, and are at the discretion of the insurer.

Reflecting the international nature of the insurance industry, and in particular the United Kingdom's membership of the single market in EU financial services, **the PRA will play a full and active role with its counterparts globally and in the European Union** in developing and implementing prudential standards and in supervising insurers with international operations. The PRA will both reflect in its approach, and aim to influence, the work of the European Insurance and Occupational Pensions Authority (EIOPA) in setting prudential policy for insurers. More broadly, the PRA will support initiatives by the International Association of Insurance Supervisors (IAIS) to strengthen the supervisory framework for internationally active insurers which should provide the foundation needed for regulators to work together effectively in supervising complex cross-border insurance groups. It is the Bank and the FSA's view that for internationally active insurers, the group supervisor should be ready and able to conduct effective consolidated supervision of all activities (regulated and unregulated) within a group.

## Introduction

1. This paper is one of two being published jointly by the Bank of England and the FSA on the PRA's overall supervisory approach, prior to it assuming its responsibilities under the Financial Services and Markets Act 2000 (as amended by the Financial Services Bill) (FSMA)<sup>(1)</sup> and under the relevant EU Directives for which it will be a competent authority.<sup>(2)</sup>
2. This paper sets out how the PRA will carry out its role in respect of insurance companies; the second paper relates to supervision of deposit-takers (banks, building societies and credit unions) and investment firms.<sup>(3)</sup> Separate publications are necessary to capture the differences in the PRA's supervisory approach for these firms, the different risks they pose, and the additional statutory objective the PRA will have in respect of insurers. The papers provide further detail on the approach initially set out in *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision* issued in May 2011 and *The Bank of England, Prudential Regulation Authority: Our approach to insurance supervision* issued in June 2011.<sup>(4)</sup>
3. This paper serves three purposes. First, alongside its equivalent for deposit-takers and investment firms, it is intended to meet the statutory requirement on the PRA to issue guidance on how it intends to advance its objectives. Release of the paper now is designed to facilitate scrutiny of the PRA's proposed approach as the draft legislation establishing the PRA is debated in Parliament. Second, the paper will aid accountability by describing what the PRA will seek to achieve and how it will go about it. Third, the paper

communicates to regulated insurers what the PRA will expect of them, and what they can expect from the PRA in the course of supervision.

4. This paper is designed to provide the overall description of the PRA and its approach. A final version will be approved for publication by the PRA Board ahead of the PRA taking on its statutory responsibilities for prudential regulation in 2013. Thereafter, it is intended to be a standing reference, and will be revised and reissued in response to significant legislative and other developments which require changes to the PRA's approach.

5. The Act will require the PRA to investigate and report to HM Treasury on possible regulatory failures. More detail on how, and under what circumstances, the PRA will conduct such investigations will be published in due course.

### Structure of this paper

6. Section I describes the PRA's proposed statutory objectives under the Act, and its approach to advancing them. Section II outlines how the PRA will determine the focus of its supervision in identifying the key risks to its objectives. Section III examines the measures that the PRA will expect insurers to have in place to ensure their businesses are run in a safe and sound manner, both in guarding against failure and in reducing the adverse effects that failure could have on policyholders and financial stability. Section IV sets out more detail on the PRA's supervisory approach. Section V outlines its approach to setting and communicating expectations of insurers. Section VI concludes with next steps.

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(1) Henceforth 'the Act'.

(2) Specifically, the Consolidated Life Directives and the First, Second and Third Non-Life Co-ordination Directives.

(3) The PRA will regulate a small number of 'investment firms' that could present significant risks to the stability of the financial system. In May 2012, the Bank of England and FSA published an initial statement on the designation of investment firms, available at [www.bankofengland.co.uk/publications/Documents/other/financialstability/investmentfirms.pdf](http://www.bankofengland.co.uk/publications/Documents/other/financialstability/investmentfirms.pdf). A more detailed policy statement will be published in October 2012.

(4) Available at [www.bankofengland.co.uk/publications/Documents/other/financialstability/uk\\_reg\\_framework/pras\\_approach.pdf](http://www.bankofengland.co.uk/publications/Documents/other/financialstability/uk_reg_framework/pras_approach.pdf) and [www.bankofengland.co.uk/publications/Documents/other/financialstability/uk\\_reg\\_framework/pras\\_approach2.pdf](http://www.bankofengland.co.uk/publications/Documents/other/financialstability/uk_reg_framework/pras_approach2.pdf).

## I The PRA's objectives and its approach to advancing them

### Summary

7. The PRA will have two complementary objectives in respect of insurance supervision — **to promote insurers' safety and soundness thereby supporting the stability of the UK financial system** and **to contribute to securing an appropriate degree of protection for those who are or may become policyholders**. The financial services that insurers provide are essential in supporting the pooling and transfer of risk, savings and so wider economic activity. A stable financial system that is resilient in providing the critical financial services the economy needs is necessary to support a healthy and successful economy.

8. Consistent with the Act, **it will not be the PRA's role to ensure that no insurer fails**. Rather, the PRA will seek to ensure that any insurer that fails does so in a way that allows for an appropriate degree of protection for policyholders and avoids significant disruption to the supply of critical financial services. Nevertheless, failure is not costless. Consequently, the PRA will expect a given level of resilience to failure from all insurers.

9. To advance its statutory objectives, the PRA will set out policies that it expects insurers to meet both in letter and in spirit, and it will supervise insurers to judge whether they meet these policies, at the time of assessment and on a forward-looking basis, taking action if they do not.

### The PRA's objectives

10. The PRA's **general statutory objective is to promote the safety and soundness of the firms it regulates**. The general objective in turn requires the PRA to focus on seeking to avoid adverse effects on **the stability of the UK financial system**. In addition, the PRA will have a **statutory objective specific to its supervision of insurers: to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders**.

### Appropriate protection of policyholders

11. Policyholders will be protected both by the PRA as prudential regulator and by the FCA as conduct regulator. **The PRA's role in protecting policyholders will be to ensure there is a reasonably high probability that an insurer is able to meet claims from, and material obligations to, policyholders as they fall due; and to make sure that where an insurer is unable to meet such claims and obligations, the adverse consequences for policyholders are minimised**

**by ensuring that the insurer fails in an orderly manner**. The PRA will contribute to an appropriate degree of policyholder protection by setting standards for insurers and assessing how insurers meet these standards, and by the statutory resolution and compensation arrangements for dealing with failing insurers.

12. The PRA will take a forward-looking approach to assessing an insurer's ability to meet its obligations, being mindful in particular that an insurer's ability to deliver on obligations to existing policyholders can be affected by the terms on which it deals with new policyholders. In consequence, the PRA will expect insurers not to write new business where the terms on which it is written would expose either **existing or new** policyholders in aggregate to an unacceptable level of risk. The PRA will interpret the definition of 'policyholders' in a broader sense than simply the person who takes out the policy to include those who are the beneficiaries of insurance contracts (for example, third parties under motor policies and employers' liability policies).

13. **The PRA's priorities for protecting policyholders will vary according to the significance to the policyholder of the risk insured and the potential for significant adverse effects on policyholders if cover were to be withdrawn or obligations not paid**. Some classes of insurance allow individuals and companies protection against significant risks where the withdrawal of cover could have a very material impact on those policyholders and the economy more generally. For example, certain general insurance activities require, either contractually or as a matter of public policy, insurance cover to be maintained (for example employers' liability insurance or professional indemnity cover). Similarly, disruption to life insurance policyholders caused by any delay in the receipt of, or the absence of, annuity income could be significant in cases where, as is likely, such payments form a significant source of income. And some general insurance policies, for example health insurance, may not be easily replaceable, or in extreme cases at all, should they be terminated unexpectedly. Where the service provided by the insurer is important in any of these ways, the consequences for individual or corporate policyholders of a sudden loss of cover might be severe.

14. **The PRA's priorities will vary also in the light of the market failures for that type of insurance** (see Box 2). The PRA will recognise that insurers' opportunities to deliver a lower standard of policyholder protection than is in the public interest will vary with the type of insurance. For example, for products where policyholders hold a long-term and illiquid contract (for example whole of life policies or annuities), it may not be straightforward for policyholders to make

judgements about an insurer's financial soundness and to incentivise prudent behaviour over the course of the contract. Similarly, where there are barriers to exit (for example surrender penalties) or where policyholders may find it difficult or excessively costly to spread their risk among a number of insurers, policyholders will have a lower capacity to protect themselves from insurer failure.

### Stability of the system

15. In general, firms carrying out traditional insurance activities do not pose risk to the system in the same way as banks. They do not typically undertake maturity transformation and the nature of their liabilities means they are considerably less vulnerable to sudden losses of confidence. Nor, on the whole, do they become leveraged to the same extent as banks. And, in general, insurers are considerably less interconnected than banks.

16. **While insurers are not systemic in the same way as banks, their failure nevertheless has the potential to pose risk to the stability of the financial system.**<sup>(1)</sup> For example, the sudden withdrawal of general insurance in areas such as compulsory motor insurance, trade finance, or marine or aviation cover has the potential directly to affect the ability of individuals or companies to undertake real economic activity. And there could be a more general loss of confidence in financial services should critical services such as annuity payments be affected in the event of a life insurer failing.

17. When insurance is combined with banking in a single group — as is the case for some of the largest UK banks — the failure of the insurer might threaten the financial condition of the bank and so give rise to system-wide risk. In addition, where insurers provide reinsurance or financial guarantees, or are counterparties to many derivatives transactions, they may be highly interconnected with other financial firms and so their failure has the potential to affect the rest of the system, in a similar manner to the impact of the failure, for example, of an investment bank.

18. More broadly, insurance companies are significant providers of funds to the banking system both through outright holdings of debt and as effective providers of funds through financing operations such as securities lending. The ability and willingness of insurance companies to provide such financing is an important part of understanding banks' financial soundness, and this in turn is an important aspect of insurers' financial soundness. Indeed, the riskiness associated with this financing may increase as measures are taken to ensure that failing banks are able to do so an orderly way, without exposing public authorities to loss.

19. **An insurer can also adversely affect the stability of the financial system through the way in which it carries on its business in normal times**, including if its activities create the possibility of future stress. Insurers that offer savings products such as life insurance, with some element of guarantee, might be exposed to 'run risk' if policyholders are able to access their savings on more favourable terms than the insurer is able to liquidate the assets in which they have been invested. Similarly, the investment strategy of general or life insurance companies might have consequences for the rest of the system if the scale of their assets means that investment decisions accentuate movements in asset prices. And there is a particular risk arising from fire sales, when solvency is strained, which may lead to further downward price spirals with wider effects on the system as a whole.

20. In all of the above, the capacity of the financial system to carry out activities important to the functioning of the economy (in particular risk transfer, payment services or credit provision) may be impaired. Insurers may also have the potential to affect financial stability by encouraging the unsustainable expansion of credit through the provision of generous financial guarantee products, for example mortgage indemnity insurance or structured credit enhancement. And groups containing an insurer may undertake non-traditional activities including through non-insurance subsidiaries, such as the sale of credit default swaps and the investment of proceeds from securities lending, which bring risk to the system. **The PRA will aim to identify these and other examples of risks to financial stability that can be generated by insurers and, together with the Financial Policy Committee (FPC) as macroprudential authority, where appropriate, it will look to reduce such effects.**

### Safety and soundness

21. **The PRA will promote the safety and soundness of the insurers it supervises both to minimise any adverse effects they may have on the stability of the UK financial system and to ensure insurers' ongoing ability to meet their obligations to policyholders.** 'Safety and soundness' involves insurers having resilience against failure now and in the future, and avoiding harm resulting from disruption to the continuity of financial services — either in the course of business or in the event of failure.

22. **The Act will include 'Threshold Conditions', which will set out the minimum requirements that insurers must meet in order to be permitted to carry on the regulated activities**

(1) As set out in section 1 in the Act, 'the financial system' refers to 'the financial system operating in the United Kingdom and includes — (a) financial markets and exchanges, (b) regulated activities, and (c) other activities connected with financial markets and exchanges'.

in which they engage. The Threshold Conditions for which the PRA will be responsible are designed to promote safety and soundness and appropriate protection of policyholders. At a high level, the draft Threshold Conditions require (see Box 1):

- that an insurer's head office, and in particular its mind and management, to be in the United Kingdom if it is incorporated in the United Kingdom;
- an insurer's business to be conducted in a prudent manner — in particular that the insurer maintains appropriate financial and non-financial resources;
- the insurer to be fit and proper, and be appropriately staffed; and
- the insurer and its group to be capable of being effectively supervised.

23. Insurers must themselves ensure that they meet the Threshold Conditions at all times. The PRA will assess insurers against them on a continuous basis.

#### Firm failure

24. **As recognised in the Act, it will not be the PRA's role to ensure that no insurer fails. Nor will it be the PRA's role to ensure that all policyholders are protected in full in all circumstances.** Thus it will be a key principle underlying the PRA's approach that the PRA will not seek to operate a zero-failure regime.

25. In the event that an insurer's financial position comes under stress, policyholders will be protected through mechanisms by which insurers can exit the market; and the existence of the FSCS insurance compensation scheme, which protects some policyholders, up to certain limits. **The PRA will seek — as far as possible within the statutory arrangements in place for insurers to exit the market — to ensure that any insurers that fail do so in a way that avoids significant adverse effects on policyholders, and significant disruption to the supply of critical financial services.** Considering the impact of insurer failure, and acting promptly to ensure either recovery or orderly closure, will be core aspects of the PRA's approach. The PRA will work with HM Treasury, FSCS and the rest of the Bank of England as appropriate to assess and enhance the resolution arrangements for insurers to support both its objectives, to protect policyholders and to support the stability of the system.

26. Allowing insurers to fail, so long as failure is orderly — that is, so long as a failing firm's provision of critical financial services is preserved or wound-down in an orderly manner, including by transfer to another firm — reflects the view that insurers should be subject to the disciplines of the market. It

is important for insurers to be able to fail in an orderly way without public funds being put at risk since, apart from being an unwarranted subsidy, the public provision of solvency support to an insurer (or its creditors) can create an expectation of future assistance. This 'moral hazard' in turn increases the risk of future financial instability, as it provides incentives for excessive risk taking and reduces market discipline.

27. Although it will not be the PRA's role to ensure no firm fails, **a certain level of resilience to failure will be required of all insurers.** Failure is not costless. And, while failure of an individual insurer is a feature of a properly functioning market, it will be essential for the PRA to ensure confidence in general in the insurers that it supervises in order for it to deliver on its objectives.

#### The PRA's approach to advancing its objectives

28. The PRA will supervise a large number of very diverse insurers that make up the largest insurance industry in Europe and the third largest insurance industry in the world.

29. Around a thousand insurers operate in the United Kingdom. A majority of these provide general insurance services — typically commercial, public liability, motor and home insurance — while a smaller proportion are life insurance companies. A handful provide both.

30. Approximately one in ten insurers are involved in the largely wholesale London Market, providing a specialised subset of general insurance. These firms include underwriters operating under the franchise of Lloyd's (whose managing agents are authorised by the PRA) and wholesale insurers who will be regulated directly by the PRA. The PRA will also supervise the Society of Lloyd's in its own right as an authorised firm.

31. The PRA will supervise a handful of very large UK-headquartered firms that are significant to the insurance industry both domestically and internationally. And it will supervise more than one hundred small mutual insurers, including friendly societies, the majority of which operate in a particular locality or niche market.

32. The PRA will supervise UK-headquartered and international insurers operating in the United Kingdom. The majority will be incorporated and authorised in the United Kingdom, but several hundred European Economic Area (EEA) insurers provide services in the United Kingdom, and a further 75 operate as branches. Although the majority of these branches have small operations in the



## Box 1

### The PRA's Threshold Conditions

The Threshold Conditions are the minimum requirements that firms must meet at all times in order to be permitted to carry on the regulated activities in which they engage. Firms will need to meet both the PRA-specific and FCA-specific Threshold Conditions. This box sets out the draft PRA-specific Threshold Conditions that will apply for insurers.<sup>(1)</sup>

#### Introduction

- 4A.** (1) If the person concerned ('C') carries on, or is seeking to carry on, regulated activities which consist of or include a PRA-regulated activity relating to the effecting or carrying out of contracts of insurance, the threshold conditions which are relevant to the discharge by the PRA of its functions in relation to C are the conditions set out in paragraphs 4B to 4F.
- (2) If the person concerned ('C') carries on, or is seeking to carry on, regulated activities which consist of or include a PRA-regulated activity relating to managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's, the conditions which are relevant to the discharge by the PRA of its functions in relation to C are the conditions set out in paragraphs 4C to 4F except for sub-paragraphs (5)(d), (5)(e) and (6) of paragraph 4D which are not relevant for that purpose.
- (3) If the person concerned ('C') carries on, or is seeking to carry on, regulated activities which consist of or include a PRA-regulated activity relating to the arranging, by the Society, of deals in contracts of insurance written at Lloyd's, the conditions which are relevant to the discharge by the PRA of its functions in relation to C are the conditions set out in paragraphs 4C to 4F, subject to sub-paragraph (4).
- (4) Paragraph 4D has effect in relation to persons of the kind specified by sub-paragraph (3) as if —
- (a) for paragraph (d) and (e) of sub-paragraph (5) there were substituted — 'd) the effect that the carrying on of business by C might be expected to have on the stability of the UK financial system or on those who are or may become policyholders of members of C;
  - (e) the effect that the failure of C might be expected to have on the stability of the UK financial system or on those who are or may become policyholders of members of C;'; and
  - (b) sub-paragraph (6) did not apply.

#### Legal status

- 4B.** C must be —
- (a) a body corporate (other than a limited liability partnership);
  - (b) a registered friendly society; or
  - (c) a member of Lloyd's.

#### Location of offices

- 4C.** (1) If C is a body corporate constituted under the law of any part of the United Kingdom —
- (a) C's head office and,
  - (b) if C has a registered office, that office,
- must be in the United Kingdom.
- (2) If C is not a body corporate but C's head office is in the United Kingdom, C must carry on business in the United Kingdom.

#### Business to be conducted in a prudent manner

- 4D.** (1) The business of C must be conducted in a prudent manner.
- (2) To satisfy the condition in sub-paragraph (1), C must in particular have appropriate financial and non-financial resources.
- (3) To have appropriate financial resources C must satisfy the following conditions —
- (a) C's assets must be appropriate given C's liabilities;

- (b) the liquidity of C's resources must be appropriate given C's liabilities and when they fall due or may fall due; and
  - (c) C must be willing and able to value C's assets and liabilities appropriately.
- (4) To have appropriate non-financial resources C must satisfy the following conditions —
- (a) C must have resources to identify, monitor, measure and take action to remove or reduce risks to the safety and soundness of C;
  - (b) C must have resources to identify, monitor, measure and take action to remove or reduce risks to the accuracy of C's valuation of C's assets and liabilities;
  - (c) the business carried on by C must be, to a material extent, managed effectively; and
  - (d) C's non-financial resources must be sufficient to enable C to comply with —
    - (i) requirements imposed or likely to be imposed on C by the PRA in the course of the exercise of its functions; and
    - (ii) any other requirement in relation to which the PRA is required to maintain arrangements under section 2].
- (5) The matters which are relevant in determining whether C satisfies the condition in sub-paragraph (1) or (2) include —
- (a) the nature (including the complexity) of the regulated activities that C carries on or seeks to carry on;
  - (b) the nature and scale of the business carried on or to be carried on by C;
  - (c) the risks to the continuity of the services provided or to be provided by C;
  - (d) the effect that the carrying on of the business of effecting or carrying out contracts of insurance by C might be expected to have on the stability of the UK financial system or on those who are or may become C's policyholders;
  - (e) the effect that C's failure or C being closed to new business might be expected to have on the stability of the UK financial system or on those who are or may become C's policyholders; and
  - (f) whether C is a member of a group and any effect which that membership may have.
- (6) C is 'closed to new business' for the purposes of this paragraph if C has ceased to effect contracts of insurance or reinsurance or has substantially reduced the number of such contracts C effects.

#### Suitability

- 4E.** (1) C must be a fit and proper person, having regard to the PRA's objectives.
- (2) The matters which are relevant in determining whether C satisfies the condition in sub-paragraph (1) include —
- (a) whether those who manage C's affairs have adequate skills and experience and act with probity;
  - (b) whether C has complied and is complying with obligations imposed by the PRA in the course of the exercise of its functions, or requests made by the PRA relating to the provision of information to the PRA; and
  - (c) if C has so complied or is so complying, the manner of that compliance.

#### Effective supervision

- 4F.** (1) C must be capable of being effectively supervised by the PRA.
- (2) The matters which are relevant in determining whether C satisfies the condition in sub-paragraph (1) include —
- (a) the nature (including the complexity) of the regulated activities that C carries on or seeks to carry on;
  - (b) the complexity of any products that C provides or seeks to provide in carrying on those activities;
  - (c) the way in which C's business is organised;
  - (d) if C is a member of a group, whether membership of the group is likely to prevent the PRA's effective supervision of C;
  - (e) whether C is subject to consolidated supervision required under any of the relevant directives;
  - (f) if C has close links with another person ('CL') —
    - (i) the nature of the relationship between C and CL;
    - (ii) whether those links or that relationship are likely to prevent the PRA's effective supervision of C; and

- (iii) if CL is subject to the laws, regulations or administrative provisions of a territory which is not an EEA State ('the foreign provisions'), whether those foreign provisions, or any deficiency in their enforcement, would prevent the PRA's effective supervision of C.
  - (3) C has close links with CL if —
    - (a) CL is a parent undertaking of C;
    - (b) CL is a subsidiary undertaking of C;
    - (c) CL is a parent undertaking of a subsidiary undertaking of C;
    - (d) CL is a subsidiary undertaking of a parent undertaking of C;
    - (e) CL owns or controls 20% or more of the voting rights or capital of C; or
    - (f) C owns or controls 20% or more of the voting rights or capital of CL.
- 
- (1) HM Treasury will consult on an Order to introduce these Threshold Conditions in October 2012.

United Kingdom, some are significant, including in particular areas such as reinsurance.

33. Some issues will be common to the supervision of all insurers. Policyholders pay premiums in advance in return for payments should an insured event occur, leaving them vulnerable to insurer failure. That underlies the PRA's objectives to promote safety and soundness and to protect policyholders — so that insurers are financially sound, and run in a prudent manner — which the PRA will advance by setting out policies that insurers should meet in the spirit as well as to the letter.

34. The PRA will supervise insurers to judge whether they meet these policies, at the time of assessment and on a forward-looking basis, and will take action where needed in support of safety and soundness and appropriate policyholder protection. Recognising the wide diversity of insurers, the PRA will tailor its supervision to an insurer's particular business and circumstance, reflecting the fact that differing types of business can adversely affect policyholders, and an insurer's safety and soundness, in different ways.

35. The PRA's approach is necessarily determined in an international context. Insurance is an international industry, with insurers supervised on a co-operative international basis and the policy framework for supervision agreed internationally. Given the international nature of the UK insurance industry, effective international co-operation, on individual insurers and on general policy, will be essential to the PRA's success.

#### The PRA's expectations of insurers — policies

36. **Advancing the PRA's objectives will ultimately rely on insurers conducting their businesses in a manner consistent with safety and soundness and appropriate policyholder protection.** This will require insurers to act more prudently than they might otherwise choose, in the presence of incentives to take more risk, and thus to impose more risk on policyholders and the stability of the financial system than is in the public interest (see Box 2 on the underlying economic

justification for prudential regulation). Countering this tendency is the primary role of a prudential regulator.

37. The criteria against which insurers will be assessed will be rooted in the PRA's statutory objectives, the statutory Threshold Conditions for authorisation, and UK and EU law. The Threshold Conditions require insurers to: have adequate financial resources; have appropriate resources to measure, monitor and manage risk; be fit and proper; and conduct their business prudently.

38. **The PRA will set out clearly, including in this paper, the criteria against which it will judge whether insurers act in a manner consistent with safety and soundness and appropriate policyholder protection, so that insurers can understand what the PRA expects of them.** This document sets out high-level policies that elaborate on the Threshold Conditions and which will be supported in many cases by more detailed material published by the PRA and directly applicable rules set at EU level. Insurers should refer to these also for further detail on what is expected of them.

39. In general, the PRA will inherit the prudential aspects of the FSA's detailed policy framework. However, in the light of its objectives and the new Threshold Conditions, and as explained in this document, in assessing insurers the PRA will place greater emphasis on certain criteria than the FSA has in the past done. In addition, this paper sets out new expectations which have not been expressed previously to insurers, including in respect of an insurer taking action in normal times to minimise disruption in the event that it fails.

40. Rules will set out some of the requirements that an insurer must meet in order for its business to be conducted in a safe and sound manner, and for it to secure appropriate protection of policyholders. But the PRA will expect insurers not merely to meet the letter of the requirements nor indeed to game them by engaging in 'creative' compliance or regulatory arbitrage designed to mask the riskiness of activities or business models. **Rather, insurers should maintain sight of the overriding principles of safety and**

## Box 2

### Underlying economic justification for prudential regulation

It is likely that, in the absence of prudential regulation, insurers would be less safe and sound and deliver a lower standard of policyholder protection than would be in the public interest. This box explains the key factors which account for this and which prudential regulation aims to counter.

Core insurance activities are based on an 'inverted production cycle' where revenue is generated through writing policies and collecting premiums before the associated costs of paying claims and other obligations materialise. This fundamental uncertainty associated with insurers' liabilities — over the size and timing of future payments to policyholders — can mean that it is difficult for policyholders to assess the financial strength of their insurer. Policyholders may also have little scope to influence the behaviour of insurers once a policy has been taken out. For example, for some insurance products — such as fixed annuities — policyholders are constrained in their ability to switch insurer once they have taken out cover. And although for most general insurance products, cover relates to a one-year period, it may be many years thereafter before it is apparent to a policyholder that an insured event within the period of cover has occurred, leaving the policyholder exposed to the future financial soundness of an insurer even after the period of cover has expired.

Some policyholders — for example commercial or wholesale policyholders — along with wholesale debt investors, may be better equipped to monitor and exert discipline on insurers (including, by pushing for the owners to have a greater stake in the insurer). But they are hampered by the opacity of the value of insurers' assets and particularly their liabilities. And firms undertaking traditional insurance are typically less reliant on external funding than, for example, banks because revenues are generated before costs reducing the likelihood of wholesale debt investors exerting influence on an insurer. Furthermore in practice, the existence of guarantees for policyholders (from the FSCS) — while key to delivering an appropriate amount of protection to policyholders in the event their insurer fails — reduces policyholders' incentive to monitor and control. This may extend to other creditors, to

the extent that — as with many regulated industries — there is a perception of implicit support, for example for certain insurers or classes of policyholder.

These factors help to explain why an insurer may have the opportunity to take more risk than is in the interests of policyholders and other creditors. And as with other companies owned by private shareholders, a privately owned insurer will tend to have an incentive to take on additional risk because shareholders, although the first bearers of loss, typically have limited liability in the event of failure but enjoy the unlimited upside associated with successful risk-taking. So maximising the expected return on equity in the interests of shareholders will tend to mean taking on more risk than is in the interests of policyholders and creditors.

It can also be difficult for the owners of an insurer to control the firm effectively. This problem exists for all firms where ownership and control are separate, but it is particularly acute for insurers (and many other financial firms) because of the opacity of the value of their liabilities and assets. Compounding this, it is difficult for owners — who can be a diverse and numerous set of shareholders or members — to co-ordinate themselves to acquire the information that they would need to monitor management's activities effectively. Managers may have their own, different objectives to owners and this may result in them taking excessive risk, for example through pursuing growth in the interests of short-term reward. A further problem can in principle exist between senior management and individual risk-takers, with the latter having incentives to take excessive risk outside the formal control structures of the firm.

Finally, it is possible that individual insurers may adversely affect the stability of the financial system (see Section I), but they have no incentive to take this into account. Other things being equal, an insurer doing traditional insurance activities is less likely to pose risks to the stability of the financial system than is a bank. But there are ways in which insurers can adversely affect the stability of the system (with, for example, the scale of their assets such that their investment strategies could accentuate movements in asset prices). At an individual level, insurers have no incentive to take into account such effects, but collectively they share an interest in a stable financial system. They thus face a 'collective action' problem which prudential supervision can help to address.



**soundness and the protection of policyholders, and act accordingly.** Support for these objectives should be embedded in every insurer’s culture. So that there are no ambiguities about its intended outcomes, the PRA will set out in this document and elsewhere the purpose and principles of its approach.

### The PRA’s approach to supervision

41. The PRA will supervise insurers to judge whether they are acting in a manner consistent with safety and soundness and appropriate policyholder protection, and so whether they meet, and are likely to continue to meet, the Threshold Conditions.

42. **The PRA will weight its supervision towards those issues and those insurers that, in its judgement, pose the greatest risk to its objectives.** It will supervise a wide range of insurers from the life, general, wholesale and reinsurance sectors. And its supervisory approach will recognise the different risks inherent in the business models of these different insurers, with the frequency and intensity of supervision experienced by insurers increasing in line with the risks they pose. The PRA will aim always to focus on what it considers to be material issues when engaging with insurers.

43. **The PRA will be forward-looking, assessing its objectives not just against current risks, but also against those that could plausibly arise further ahead.** Where the PRA judges it necessary to intervene to mitigate the risks an insurer is creating, it will seek to do so at an early stage. To support this, insurers should be open and straightforward in their dealings with the PRA, taking the initiative to raise issues of possible concern also at an early stage. The PRA, for its part, will respond proportionately. Trust can thus be fostered on both sides.

44. **The PRA’s approach will rely significantly on judgement.** Supervisors will reach judgements on the risks that an insurer is running; the risks that it poses to the PRA’s objectives; whether it is likely to continue to meet the Threshold Conditions; and how to address any problems or

shortcomings identified. And, in particular, supervisors will need to decide which risks are the most material and must be pursued. A judgement-based approach is necessary in a forward-looking regime, where the future state of the world is inherently uncertain. Use of judgement is also necessary in the context of a complex financial system where compliance with detailed rules is, on its own, unlikely to secure acceptable outcomes.

45. The PRA’s supervisory judgements will be based on evidence and analysis. Nevertheless, it is inherent in a forward-looking system that, at times, the supervisor’s judgement will be at variance with that of the insurer. Furthermore, there will be occasions when events will show that the supervisor’s judgement, in hindsight, was wrong.

46. In order to minimise such outcomes, the PRA will need to be staffed by people with strong, relevant skills and experience (see Box 7). And its major judgements and decisions will involve the PRA’s most senior and experienced staff and directors. The PRA will engage with the boards and senior management of insurers in forming its decisions, using this dialogue both to ensure that it takes account of all relevant information in reaching its judgements and to communicate clearly the rationale for them. Insurers should not, however, approach their relationship with the PRA as a negotiation.

47. The PRA will ensure that it recognises promptly when its concerns appear subsequently to be unjustified, and so when its actions may need to be adjusted.

### The PRA’s risk framework

48. The PRA will take a structured approach when forming its judgements. The risk assessment framework for insurers will be the same as for banks, but will be used in a different way, reflecting the PRA’s additional objective to contribute to securing appropriate policyholder protection, the different risks to which insurers are exposed, and the different way in which insurers fail. The framework used, which is illustrated in **Figure 1**, will capture three key elements:

**Figure 1** The PRA’s risk framework

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation	Structural mitigation	
Potential impact	External context	Business risk	Management and governance	Risk management and controls	Capital	Liquidity	Resolvability

- the *potential impact* that an insurer could have on financial stability and policyholders, both by the way it carries on its business and in the event of failure;
  - how the external context in which an insurer operates and the business risks it faces (together, its *risk context*) might affect the viability of the firm; and
  - *mitigating factors*, including: an insurer's management and governance and its risk management and controls (operational mitigation); its financial strength, specifically capital and liquidity (financial mitigation); and its resolvability (structural mitigation).
- introduce a risk-sensitive regulatory framework;
  - introduce a new forward-looking Own Risk and Solvency Assessment (ORSA);
  - place greater emphasis on the importance of disclosure, with the aim of enhancing market discipline;
  - introduce a Ladder of Intervention designed to encourage early action by supervisors; and
  - strengthen co-operation arrangements between European regulators, particularly through colleges for insurance groups with cross-border operations within the European Union.

All these measures are consistent with the PRA's objectives and approach as described in this document.

49. The intensity of the PRA's supervisory activity will vary across insurers. The level of supervision will principally reflect the PRA's judgement of an insurer's potential impact on policyholders and on the stability of the financial system, its proximity to failure (as encapsulated in the Proactive Intervention Framework (PIF), which is described below) and its resolvability. Other factors that will play a part include the type of business done by the insurer and the complexity of the insurer's business and organisation.

50. Much of the PRA's proposed approach to the supervision of insurers will, in due course, deliver the supervisory activities which the United Kingdom will be required to carry out under Solvency II. Under current plans, Solvency II will:

51. The detail to support the Solvency II framework is still being finalised. The PRA will consider it important that the technical detail of Solvency II leaves scope for supervisors of individual insurers to make informed judgements about risks posed, and action to be taken, within a clear overall EU-wide policy framework.

52. The following sections: examine in more detail the individual elements of this risk framework; describe the work the PRA will do to support its judgements; and set out what the PRA will expect of insurers in these areas. Box 3 sets out how the PRA will interact with other authorities both domestically and internationally, in support of its approach.

### Box 3

## Working with other authorities

Co-ordination with other authorities will be essential to the PRA's success. This box outlines the PRA's approach to interaction with these other bodies.

### Bank of England and FPC

The PRA will be a part of the Bank of England, and will therefore be connected to its other functions — including its work on market intelligence, oversight of financial market infrastructure, prudential policy, financial sector resilience and resolution. This will facilitate the flow of information between these functions.

The PRA's objectives of promoting the safety and soundness of insurers and contributing to appropriate policyholder protection will complement the Bank's wider objective to 'contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'.

An effective regulatory framework for financial stability also needs to combine insurer-specific supervision with work to protect and enhance the resilience of the financial system as a whole. The PRA will therefore work closely with the FPC, which will have statutory responsibility for reducing risks to the financial system as a whole.

The FPC will be able to make recommendations and potentially give directions to the PRA on specific actions that should be taken in order to achieve the FPC's objectives. The PRA will be responsible for implementing FPC recommendations on a 'comply or explain' basis, and for complying with the FPC's directions in relation to the use of macroprudential tools, specified by HM Treasury in secondary legislation.<sup>(1)</sup> The PRA will report to the FPC on its delivery of these recommendations and directions.

There will be a frequent two-way flow of information and exchange of views between the PRA and the FPC. The PRA will provide insurer-specific information to the FPC, to assist its macroprudential supervision. And the FPC's assessment of systemic risks will influence the PRA's judgements in pursuit of its objectives.

Co-ordination between the PRA and the FPC will be assisted by the common membership of the Governor of the Bank of England, the Deputy Governor for Financial Stability and the

Chief Executive Officer (CEO) of the PRA on both the PRA Board and the FPC.

### FCA

While the PRA will regulate insurers for prudential purposes, the FCA will act as insurers' conduct regulator. Both will contribute to the securing of an appropriate degree of policyholder protection through their separate objectives.

The PRA will have a statutory duty to co-ordinate with the FCA in the exercise of its public functions, including policymaking and supervision. A Memorandum of Understanding (MoU) between the FCA and the PRA will describe how the two regulators will fulfil this duty to co-ordinate in a way that supports each regulator's ability to advance its own objectives.<sup>(2)</sup>

A key principle for this co-operation, given the regulators' separate mandates for prudential and conduct regulation, will be that each authority should focus on the key risks to its own objectives, while being aware of the potential for concerns of the other.

In some cases, the two authorities will have a direct interest in the same issue but from different perspectives or at different levels of detail. For example, the PRA will want to understand risks to an insurer's capital and profitability if sums are due as redress for a conduct matter but it will not need to be as close to the details of the remedial action as will the FCA.

In other cases, there will need to be closer co-operation. For example, the FCA and the PRA will share their respective views on key conduct and prudential issues facing a firm. Public actions such as enforcement cases will be carefully co-ordinated to assess the potential for more significant prudential implications. And from an operational perspective, structured data routinely collected by one regulator will be readily accessible to the other.

Co-ordination between the PRA and the FCA will also be assisted by the membership of their CEOs on each other's board. This cross-board role will focus on areas of overlap and discussions of material relevance to each CEO's own organisation. Co-ordination between the organisations will also be assisted by common membership of their CEOs on the FPC.

The FCA and the PRA will also be party to other MoUs with the Bank as a whole and HM Treasury on international

engagement, and the rest of the Bank on the oversight of financial market infrastructure.

The FCA and the PRA will co-ordinate in their supervision of insurers generally under the framework set out in the Memorandum of Understanding described above. However, in the case of 'with-profits' policies, special arrangements are needed. A separate Memorandum of Understanding will set out how the PRA and the FCA will work together in order appropriately to protect the interests of 'with-profits' policyholders.

### Other UK bodies

The PRA will often need to work with other UK regulators, either to pursue its own objectives or to assist them in theirs; this may also include other enforcement agencies.

The PRA will have agreements to support the sharing of information and judgements, and the co-ordination of actions. The PRA's general approach to these arrangements and the relationships they underpin will be focused on:

- enabling all parties to focus on their own objectives;
- the substantive issues of the potential co-ordination;
- avoiding where possible a detailed, prescriptive approach, to ensure that judgement and flexibility are not lost; and
- provisions for regular review, ensuring that MoUs remain current and embedded within the organisations.

### International co-operation

Insurance is an international industry. The PRA will perform two important functions within the international regulatory environment. First, it will play a full and active role with its counterparts in Europe and beyond in supervising cross-border insurers. And second, it will attach great importance to being an influential and persuasive participant in international policy debates, seeking to achieve agreement at the global and European level to the reforms necessary for a strong, balanced and coherent prudential framework.

The PRA will actively participate in the work of the Financial Stability Board (FSB), the IAIS and other global fora. It will support in particular IAIS initiatives to strengthen the supervisory framework for internationally active insurers, reflecting the view that for these insurers, the group supervisor should be ready and able to conduct effective consolidated supervision of all activities (regulated and unregulated) within a group. The PRA will also support IAIS work to identify potential global systemically important insurers.

The PRA will be an active participant in the European System of Financial Supervision established at the start of 2011. Its approach will both reflect and aim to influence the EU-wide standards and guidance set out by the European Supervisory Authorities (ESAs), specifically EIOPA, in addition to supporting day-to-day supervision.

(1) See HM Treasury consultation on the FPC's macroprudential tools, published September 2012, available at [www.hm-treasury.gov.uk/press\\_83\\_12.htm](http://www.hm-treasury.gov.uk/press_83_12.htm).

(2) See the draft Memorandum of Understanding: [www.bankofengland.co.uk/financialstability/Documents/overseeing\\_fs/fca\\_pra\\_draft\\_mou.pdf](http://www.bankofengland.co.uk/financialstability/Documents/overseeing_fs/fca_pra_draft_mou.pdf).

## II Identifying risks to the PRA's objectives

53. The PRA's approach relies on supervisors understanding the significance of individual insurers to the PRA's objectives, the nature of an insurer's business and the wider economic environment, and the potential risks to the PRA's objectives that, together, these entail. This section describes how the PRA will assess this.

### Potential impact

54. As a core part of its work, **the PRA will assess the significance of an insurer to its objectives.** This 'potential impact' will reflect an insurer's potential to affect adversely the PRA's objectives by failing, coming under stress, or by the way it carries on its business.

55. 'Potential impact' will have a wider meaning for insurers than it does for banks because of the different objectives the PRA will have in supervising insurers. It requires consideration of the channels **for a firm's potential impact on policyholders and the stability of the UK financial system, including in times of wider stress.** The PRA's assessment of potential impact will:

- help to **determine the intensity of supervision for an insurer;** and
- **help focus the supervisory strategy,** for example, by identifying particular areas where an insurer provides critical economic functions, and so highlighting likely sources of significant risk to the PRA's objectives.

56. The **potential impact of a firm on policyholders** will take account of its size (the number of policyholders) and the nature of the business it conducts. This will capture the disruption to policyholders were they no longer to be covered by existing policies and were there to be no substitute policies available (or where there may be delays or significant additional costs involved in obtaining replacement cover). It will also cover policyholders' ability to assess, incentivise and manage their insurer's financial soundness over the course of the contract. In consequence, the assessment of impact on policyholders will differ, potentially significantly, across the different types of insurers and insurance contracts (life, general, wholesale, reinsurance) regulated by the PRA. The PRA will seek to contribute to the same appropriate degree of policyholder protection across all insurers.

57. The potential for an insurer adversely to affect the stability of the financial system will depend on both the

functions it provides and its significance within the system. The assessment of **potential impact on the stability of the system** will capture the potential impairment to the capacity of the financial system as a whole to provide services important to the functioning of the economy, for example, compulsory insurance products. In addition, it will cover impairment arising from activities related to insurance business (such as stock lending or funding of banks) or other interconnections, for example, via derivatives, reinsurance or financial guarantees, or non-traditional insurance activities that pose particular risk to the PRA's objectives. The scale of an insurer's potential impact will depend on its size, complexity, business type and interconnectedness with the rest of the system.

58. The PRA will divide all deposit-takers, investment firms and insurers it supervises into the five 'categories' of impact below:

#### Category 1

- The most significant deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.
- Insurers whose size (including number of policyholders) and type of business mean that there is very significant capacity to cause disruption to the interests of a substantial number of policyholders.

#### Category 2

- Significant deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause some disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.
- Insurers whose size (including number of policyholders) and type of business mean that there is significant capacity to cause disruption to the interests of a substantial number of policyholders.

#### Category 3

- Deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause minor disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across

a whole sector or subsector have the potential to generate disruption.

- Insurers whose size (including number of policyholders) and type of business mean that there is minor capacity to cause disruption to the interests of a substantial number of policyholders.

#### Category 4

- Deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them very little capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.
- Insurers whose size (including number of policyholders) and type of business mean that there is very little capacity to cause disruption to the interests of a substantial number of policyholders.

#### Category 5

- Deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them almost no capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector may have the potential to generate some disruption.
- Insurers whose size (including number of policyholders) and type of business mean that there is no capacity to cause disruption to the interests of a substantial number of policyholders.

59. The PRA will also consider the substitutability of the services that the insurer provides, and the extent to which this could mitigate the impact of failure. It will be mindful of the extent to which this is possible in benign and stressed circumstances.

60. The PRA will use quantitative and qualitative analysis to allocate insurers to categories. Numerical scoring based on insurers' regulatory reporting will provide a 'suggested' categorisation which supervisors will review in light of qualitative analysis, to confirm that it presents a full picture of an insurer's potential impact.

61. Insurers will be told to which category they have been assigned, providing a broad indication of what level of supervisory interaction to expect. The PRA will intend to

publish aggregate statistics on the number of firms in each category in its *Annual Report*.

### External context

62. **Any assessment of the risks facing insurers requires an appreciation of the external context in which they operate.** The PRA's assessment will therefore include consideration of system-wide risks, for example, from low interest rates or rising credit spreads, and sectoral risks, for example, medical improvements affecting longevity risk.

63. The PRA will draw on work by other parts of the Bank, including the views of the FPC on the macroprudential environment. Sectoral analysis to understand key market developments over the medium term will draw upon both market intelligence and, where appropriate, standardised information from insurers.<sup>(1)</sup> The PRA will also consider actions by other regulators, including the FCA, which might materially affect the prudential soundness of PRA-regulated insurers.

### Business risk

64. **Business model analysis will form an important part of the PRA's supervisory approach.** The PRA will examine the threats to the viability of an insurer's business model, and the ways in which an insurer could create adverse effects on other participants in the system by the way it carries on its business. The analysis will include an assessment of where and how an insurer makes money and the risks it takes in so doing. Insurers will be assessed at the level of the insurer or the sector, as appropriate.

65. The PRA will aim to understand a business model's sustainability and vulnerabilities. Vulnerabilities might include: unsustainable expectations of growth of market share without due regard to changing underwriting market dynamics and the adequacy of reserves; the risk of a low interest rate environment affecting the valuation of options or guarantees or the level of future investment returns; or specific vulnerabilities such as catastrophe risk or longevity risk. The PRA will use this work to focus its supervisory activity.

66. For those insurers posing greater risk to policyholders or the stability of the system, the analysis will be more detailed. It will include a review of the drivers of profitability, risk appetite, performance targets and underlying assumptions, and an insurer's own forecasts and their plausibility. The PRA

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(1) Data reported in a pre-agreed format by a defined set of insurers, using common definitions.



will use this analysis to form a projection of the insurer's ability to generate returns and associated risks over the medium term. This projection, and the general picture that supervisors form of the nature of the business, will guide the PRA's work in assessing the adequacy of the measures the insurer has in place to mitigate risk. For example the PRA's forward-looking view of an insurer's prospects will inform its judgement on the level of capital the insurer requires; and the complexity of an insurer's business will inform judgements about its risk management procedures. If the PRA believes that mitigating measures alone cannot adequately reduce material risks to safety and soundness and policyholder protection, it will require the insurer to change its business model.

**67. Peer analysis will form an important part of this assessment**, providing a diagnostic tool to highlight where individual institutions may be outliers relative to their sector and so in need of further analysis. Such analysis will also support an understanding of common sectoral risks that have

the potential to affect the stability of the system, on which the PRA will involve the FPC.

**68. The PRA's assessment of business risk will also include an assessment of whether the PRA can effectively supervise the activities that an insurer carries out** — whether it is possible, with a reasonable amount of effort, for the PRA to form a clear view of the risks posed to safety and soundness and policyholder protection by the insurer. Where an insurer's business is particularly complex, the PRA will consider whether it is possible to evaluate effectively the prudential risks to the insurer arising from it.<sup>(1)</sup> Where the PRA identifies material barriers to effective supervision, it will require remedial action.

69. Other key attributes that will determine whether an insurer is capable of being effectively supervised are the organisational structure of its group and its ability to provide sufficient information to the PRA. Further key attributes are considered in Section III.

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(1) The PRA will take this into account in its assessment of a firm against the 'effective supervision' Threshold Condition, that a firm must be capable of being effectively supervised by the PRA.

### III Safeguarding safety and soundness and policyholder protection

70. The PRA will assess whether an insurer has in place adequate measures to safeguard its safety and soundness and appropriate policyholder protection in light of the risks the insurer poses to the PRA's objectives. These mitigating measures include: management and governance, risk management and controls, financial resources and resolvability. This section sets out some of the key criteria against which the PRA will assess the adequacy of these measures. It also outlines some specific supervisory activities that the PRA will undertake to assess them. More general supervisory activities are outlined in the next section.

71. The PRA will expect higher standards of risk mitigation from insurers posing greater risks to its objectives. For example, an insurer offering long-term or long-tail cover may be required to have more sophisticated risk management, consistent with the principle that an insurer's approach to risk management should be appropriate to the nature and degree of risk in its business.

72. Where possible, the PRA will take an integrated view of the elements of mitigation that an insurer has in place. This might mean that supervisors may want an insurer temporarily to hold additional capital to make up for perceived shortcomings in risk management. Nevertheless, **insurers must meet a minimum level of capital adequacy across all areas** in the long term: high levels of capital cannot act as a long-term substitute for sub-standard management, for example.

73. The PRA will expect insurers to meet its requirements on both a consolidated basis for groups headquartered in the United Kingdom, for UK sub-groups of wider global groups, and at the level of regulated legal entities. A regulated insurer's relationships with other entities in the group may affect its prudential soundness, for example through access to capital, intra-group exposures or contagion.

74. As well as setting expectations of insurers, the PRA will advance its objectives by taking action to improve the wider environment within which insurers operate. In particular:

- The PRA will work with the FCA and the Financial Reporting Council (FRC) where appropriate to ensure the quality and usefulness of information disclosed by insurers. This includes key information on financial risk and accounting

and actuarial judgements, on a consistent basis across insurers. Disclosure of such information assists creditors in judging the risk they take in lending to the insurer. This in turn improves insurers' own incentives to mitigate those risks. The PRA believes that where it is feasible for the authorities to allow insurers to fail, market discipline will become a more powerful force.

- Making rules for the FSCS in respect of the provision of insurance. The existence of an insurance compensation scheme can be key in reducing risks to policyholders and financial stability. The PRA will be responsible for the design of the scheme, including for example its funding arrangements, its capacity to support insurer resolution and the arrangements for publicising the extent of cover under the scheme.

75. Upon implementation, the requirements of Solvency II will form a key part of how the PRA delivers its objectives. The PRA's approach to Solvency II is considered in more detail in Box 4.

#### Management and governance Overall approach

76. **It is the responsibility of each insurer's board and management to manage the insurer prudently, consistent with its safety and soundness and the appropriate protection of policyholders, and thereby contributing to the stability of the financial system.** This goes beyond complying with the letter of the PRA's detailed requirements, for example on adequate capital and risk management and controls, and it will often mean insurers acting more prudently than they would otherwise choose. It also goes beyond core responsibilities for all boards and management; such as ensuring that individuals appointed to senior management positions are competent to fill such roles, setting the firm's strategy and policies clearly, and ensuring that these are applied throughout the organisation, with responsibilities clearly apportioned.

77. The boards and management of regulated insurers **must understand the kind of behaviour that will deliver an acceptable level of safety and soundness from the point of view of policyholders and the financial system, and act accordingly.** This includes following the PRA's policies in line with their spirit and intended outcome — not managing the business only to the letter, or gaming the rules. And it includes embedding the principle of safety and soundness in the culture of the whole organisation. Without such effective, prudent management and governance, it is not possible for insurers to ensure their own safety and soundness.



## Box 4 Solvency II

Solvency II will be the new European-wide system for insurance regulation. Its main objective is the adequate protection of policyholders and beneficiaries and it sets out a new, risk-based and harmonised EU-wide approach to the assessment of capital adequacy and to risk management and reporting for insurers.

In a number of areas, the PRA's objectives and the requirements of Solvency II will be closely aligned. For example, the Prudent Person Principle within Solvency II will be a tool to implement the Threshold Condition that business must be conducted in a prudent manner and assets must be appropriate; the ORSA will support the Threshold Condition that insurers must have appropriate non-financial resources and robust risk and capital management systems; and the Actuarial Function, Internal Audit and Risk Management Function requirements will help ensure that insurers satisfy the Threshold Conditions that business must be conducted in a prudent manner and that the insurer and its management are fit and proper.

The Solvency II Pillar 1 framework will, when implemented, become the PRA's principal means of implementing the condition that the insurer must have appropriate financial resources. This framework will set out detailed requirements around the nature and quality of capital resources, the appropriate valuation of assets and liabilities, and the appropriate minimum standards for capital adequacy.

Solvency II will set out a framework for the initial approval and ongoing review of the appropriateness of internal models used to calculate capital requirements. As set out in Section 3, the PRA will only approve an internal model if it is satisfied that the systems for identifying, measuring, monitoring, managing and reporting risks are adequate. Following approval, the PRA will require assurance that insurers have put in place systems which ensure that the internal model and associated controls operate effectively at all times.

All insurers in the scope of Solvency II will need to meet its requirements. To ensure that insurers meet the required standards the PRA will, if necessary and appropriate, impose capital add-ons as provided for in the framework Directive.

There is a central and underlying principle in Solvency II that all actions taken by supervisors should be proportionate to the nature, scale and complexity of the risks inherent in the insurers' business including insurers and activities which are more complex or more important for financial stability. This will be consistent with the PRA approach of categorising insurers as described in Section II.

The final requirements of Solvency II are not yet fully agreed. The PRA, in concert with HM Treasury, will continue to take a positive approach to helping to shape the developing policy within EIOPA and beyond.

78. For an insurer to be permitted to carry out regulated activities, the insurer as a whole must be fit and proper. At initial authorisation the PRA will take into consideration the record of the firm itself, where appropriate, and of those who manage its affairs including the existence of any record of past misconduct.<sup>(1)</sup>

79. This requirement for the insurer to be 'fit and proper' is in addition to the obvious need for an insurer's board and senior management, and in particular its Chair, to have regard to the need for the insurer to comply with all applicable laws and regulations. These obligations are extensive and not limited to the laws and regulations enforced by the PRA. This is because other laws and regulations — for instance, conformity with tax laws — could affect an insurer's fitness and properness, and the probity and reputation of its management.

80. This section elaborates on these broad expectations. In many cases these expectations will be directly reflected in PRA rules. More generally they elaborate on the 'prudent conduct', 'effective supervision' and 'suitability' Threshold Conditions. They are broken down into: culture and behaviour, competence and structures.

### Culture and behaviour

81. The PRA will expect insurers to have a **culture that supports their prudent management**. The PRA will not have any 'right culture' in mind when making its assessment; rather it will focus on whether boards and management clearly understand the circumstances in which the insurer's solvency and viability would be under question, whether accepted orthodoxies are challenged, and whether action is taken to address risks on a timely basis. The PRA will want to be satisfied in particular that designated risk management and control functions carry real weight within insurers.

82. **Individuals, whatever their position in the insurer, will have to take responsibility for acting in a manner consistent with its safety and soundness and the appropriate protection of policyholders.**

83. The PRA will expect insurers to have in place sufficient controls to **minimise incentives for excessive risk-taking** by management and risk-taking staff. Remuneration and incentive structures should reward careful and prudent management.

84. The PRA will expect insurers and individuals within them to **deal with the PRA (and other regulators as appropriate) in an open and co-operative manner**. That includes taking the initiative to disclose anything relating to the insurer, and

the protection of policyholders and financial stability more generally, of which the PRA would reasonably expect notice, and providing the PRA with the information it requests on a timely basis. Boards and senior management will be expected to ensure that all staff comply with this requirement.

85. The PRA will expect an insurer's **board to take responsibility for establishing, embedding and maintaining the type of culture described above**.

86. More generally, an insurer's **board should hold management to account for conducting the insurer's business in line with the board's expectations**. That should include the board (and its committees) engaging with management to test the robustness and prudence of the assumptions in the business plan and strategic initiatives, the adequacy and integrity of controls, and the consistency of implementation of the board's decisions. To do this, the board needs to be provided with high-quality management information, both quantitative and qualitative.

87. The PRA considers the **responsibility of board members to be individual, as well as collective**. This means that, should any director have concerns about the insurer or its management and governance, the PRA will expect them to press for action to remedy the matter and, if those concerns are not addressed, to alert the PRA. An insurer's culture should be encouraging of this.

### Competence

88. Insurers must be **run by people who are competent to fill their roles**. That means ensuring that individuals have appropriate expertise and experience and in the case of non-executive directors, give sufficient time to fulfil their obligations to a high standard.

89. It is the **responsibility of an insurer's board to ensure that individuals appointed to senior management positions are competent to fill them**. As an insurer grows and changes, and as the challenges it faces change, it may need different board members and management. The Chair and independent directors should stand ready to have an open exchange of views with the PRA on the performance of senior management, as should the Senior Independent Director on the performance of the Chair.

90. The **board should have a mix and balance of skills so that collectively it can understand the breadth of the business**. The PRA will expect many on an insurer's board to

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(1) This includes the existence of any spent and unspent convictions, regulatory investigations and enquiries, prior refusals of authorisations and/or connections with unsuitable persons.

have expertise in financial services, though this will not be a pre-requisite for all members. The PRA will expect all board members, either at the outset or after a set period of time, to develop an understanding of the different areas of the business and the main prudential risks and controls and so to be able to engage in an informed conversation with the PRA. The PRA will expect more than one independent director to understand major lines of business and risk controls, in order to avoid undue reliance on individuals by the board as a whole.

## Structures

91. The PRA will expect insurers to have in place **clear structures of accountability and delegation of responsibilities** for individuals and committees, including checks and balances to prevent dominance by an individual. Senior individuals should remain accountable for the actions of those to whom they delegate responsibilities, including where insurers use third parties in respect of outsourced functions.

92. Within a financial group, **boards and senior management of all authorised entities, including those subject to consolidated supervision, should take responsibility for ensuring that the business is conducted in a prudent manner.** Boards cannot delegate this responsibility.

93. Not all legal entities within a group will necessarily be directly authorised by the PRA. Nonetheless, unregulated group entities can be important to the functioning of the group as a whole (for instance, by providing important support services), or can undertake activities which have the potential to create risks for the group as a whole and so for authorised insurers. The PRA will expect all boards of legal entities within groups, as a result of the responsibilities of their holding companies and its regulated affiliates, to have regard to the PRA's objectives. **In cases where the most senior legal entity within a group is a holding company, and so not itself authorised under the United Kingdom's statutory regulatory regime, the PRA will expect to have extensive contact with its board and senior management, and will consider whether it is suitable to exercise control over a regulated firm.** The PRA will expect the holding company to take responsibility for the group as a whole having due regard to the PRA's objectives. And the PRA will consider whether the insurers' membership of a group affects whether the insurer satisfies the Threshold Conditions, including if the ownership structure compromises the ability of the insurer to be supervised effectively by the PRA. Further, if the actions of the holding company have, or may have, a material adverse effect on the authorised insurer or the effectiveness of consolidated supervision, the PRA will exercise

the power conferred by the Act to direct the holding company.<sup>(1)</sup>

94. **These requirements on the boards and management of legal entities within groups apply equally to overseas insurers** which establish separately incorporated entities within the United Kingdom. In particular, the PRA will expect boards and senior management of these insurers to have proper regard to the PRA's objectives, both for the group as a whole and for individual insurers (and sub-groups) in the United Kingdom, since issues at the parent or group level could have an effect on the PRA-regulated entity and the PRA's objectives more generally.

95. Insurers are able to operate in the United Kingdom as branches of overseas legal entities, meaning that there is no separate legal entity in the United Kingdom. Such branches can take one of two forms: those where the legal entity overseas is located within the EEA; and those located outside the EEA. Regardless of the corporate structure and location of the parent, the PRA will expect all UK branches, like UK subsidiaries, to act responsibly in a manner that is consistent with safety and soundness and the appropriate protection of policyholders. The PRA will expect the branch to appoint a senior individual with authority to act as a primary contact with the PRA in relation to the branch's affairs. This individual should also act as a channel for communication with the parent. Box 6 sets out how the PRA will aim to ensure that its objectives are met in respect of overseas insurers.

## Supervision — Approved Persons

96. The PRA will have the power under the Act to require individuals in identified roles with a significant influence on the affairs of an insurer (Significant Influence Function roles) — and who are critical to the advancement of the PRA's objectives — to seek PRA approval before taking up their position. Such individuals are known as 'Approved Persons'.

97. Those roles which the PRA will deem to be significant will include the: Chair, CEO, Finance Director, Chief Risk Officer, Head of Internal Audit, Actuarial Function Holder<sup>(2)</sup> and the key non-executive directors, namely the Senior Independent Director and the Chairs of the Audit, Risk and Remuneration Committees.<sup>(3)</sup> In addition, the PRA will wish to be able to consider any other role with responsibility for managing

(1) The Bank and the FSA will soon issue a consultation paper on the PRA's proposed policy regarding the power of direction over holding companies.

(2) Including, where relevant, the 'With-Profits' actuary.

(3) To the extent that they exist as separate roles — where only some of these roles exist within an organisation, for example in a very small firm which has only a Chief Executive Officer and a Chair of the board, the PRA will assess only these individuals.

significant parts of the business, where that role is considered significant in the context of the supervision of that individual insurer. Approval will only be granted if the PRA as prudential regulator and the FCA as conduct regulator are both satisfied that an individual is fit and proper.<sup>(1)</sup>

98. All individuals applying for the above roles will be subject to a basic review of probity, reputation and financial soundness, including criminal record and credit checks. The PRA will also perform an assessment of an individual's competence and capability to carry out the role. Assessing probity and integrity will reduce the risk of behaviour intentionally misaligned with the PRA's objectives; assessing competence is necessary given the prime role of these individuals in ensuring an insurer's safety and soundness and the protection of policyholders. The nature and intensity of the PRA's assessment will depend on the potential impact of the insurer.

99. The PRA may interview individuals applying for the above roles. Interviews will include an assessment of the technical experience of the applicant and his or her understanding of the risks posed to the viability of the insurer and the risks posed by the insurer to the wider financial system. The PRA will assess whether the insurer has conducted an appropriately rigorous recruitment process and will take into account the due diligence done by the insurer on the applicant.

100. The PRA will review the fitness and properness of individuals on an ongoing basis, including as part, of its supervisory assessment of an insurer against the 'suitability' Threshold Condition.

101. While the PRA's Approved Persons regime applies only to individuals holding certain senior roles, the PRA will, as noted previously, expect all individuals within an insurer to act in a manner consistent with its objectives.

### Disciplinary action against individuals

102. While the PRA's preference will be to use its statutory powers to secure *ex ante*, remedial action, it will also have a set of disciplinary powers which it will use *ex post* if necessary.

103. The PRA will have disciplinary powers over individuals approved to perform a Significant Influence Function by the PRA or FCA and will be empowered to use these where an individual acts in a manner inconsistent with the *Statement of principles and code of practice for Approved Persons*.<sup>(2)</sup> The powers enable the PRA to impose penalties, to censure an individual publicly, to withdraw approval from individuals holding Significant Influence Functions, and to prohibit

individuals from holding Significant Influence Functions in the future.

104. In considering whether to take disciplinary action against Approved Persons, the PRA will consider a variety of factors, including:

- the impact the individual's behaviour has had or is having on the PRA advancing its objectives — including the behaviour of others in the insurer over which the individual should exercise control — and thus whether that behaviour calls into question the person's fitness and properness as an Approved Person (be it an isolated incident or a course of conduct); and
- the individual's behaviour towards the regulator, including the level of co-operation and openness with which the individual deals with the PRA and the appropriateness of the individual's actions in response to concerns raised.

## Risk management and controls

### Overall approach

105. The PRA will attach particular importance to insurers managing risk effectively because it is the crystallisation of risk, or concerns about risks crystallising in the future, which causes problems for insurers' safety and soundness and so policyholders and the stability of the financial system. Insurers should have robust frameworks for risk management and financial and operational control, commensurate with the nature, scale and complexity of their business. Competent and, where appropriate, independent control functions should oversee these frameworks.

106. This section sets out the PRA's expectations for an insurer's approach to risk management, its control framework, and its risk management and control functions. In many cases these expectations will be directly reflected in PRA rules. More generally they elaborate on the 'prudent conduct' and 'effective supervision' Threshold Conditions.

### Risk management approach

107. **The PRA will expect insurers to articulate for themselves the amount of risk they are willing to take across different business lines to achieve their strategic objectives.** This risk appetite should be consistent with the PRA's objectives, and the insurer should pay appropriate attention to identifying, measuring and controlling risks, including those arising in unlikely but very severe scenarios.

(1) A consultation paper detailing which functions will be designated by the PRA and the FCA was published on 3 October 2012.

(2) Currently within the *FSA Handbook*: <http://fsahandbook.info/FSA/html/handbook/APER>.

108. The PRA will recognise that it is always possible to identify a stress scenario in which an insurer fails, and it will not expect insurers to be able to withstand all such events. The PRA will consider it important, however, for insurers' senior management and boards to have an explicit understanding of the circumstances in which their firm might fail.

109. The PRA will expect an insurer's risk appetite to be integral to its strategy and the foundation of its risk management framework, so that the whole insurer operates within this appetite. This requires a **robust risk management framework and its effective and consistent implementation throughout the organisation**. Members of staff in both business and control functions should manage risks as a central part of their role: responsibility for risk should not be delegated to risk management and control functions. This is a key aspect of a culture which supports the prudent management of the insurer.

110. The PRA will expect key decisions, both on assuming new risks and managing existing ones, to be taken at the appropriate level, including, where they are sufficiently important, at the level of the board. Risks should be reported to the board and senior management on a timely basis, with risks outside the agreed risk appetite and key sensitivities highlighted.

### Control framework

111. An insurer's control framework encompasses the processes, delegated authorities and limits that put into effect an insurer's approach to risk management and control. The PRA will expect an insurer's control framework to be comprehensive in its coverage of the whole firm and all classes of risk, to be commensurate with the nature, scale and complexity of the insurer's business, and to deliver a properly controlled operating environment (including, for example, through segregation of duties and reconciliations or through the processes to report and act on any breaches of limits).

112. **The PRA will expect insurers to observe high standards in the management of operational as well as financial risks.** For example, **insurers should have procedures in place to ensure continuity of critical services**, such as the payment of claims to policyholders. Insurers will be expected to comply with standards for resilience set in this area, including where they outsource material operational functions to third parties.

113. The PRA will expect **insurers to have available the information needed to support their control frameworks**. This information should be of an appropriate quality, integrity

and completeness, to provide a reliable basis for making decisions and so to control the business within agreed tolerances. It should be produced in a sufficiently timely manner. And it should be able to be accessed and analysed both in aggregate for the business as a whole, across the group, and for each business line and legal entity within it, to facilitate understanding and swift management of the risks to which the insurer is exposed. This is relevant also to the Threshold Condition that insurers must be capable of being supervised effectively by the PRA. Senior management of a firm and the PRA need to be able, with a reasonable amount of effort, to form a clear view of the safety and soundness of the insurer and how policyholders are protected. This includes forming a view of the financial position of the rest of the insurer's group and the risks posed by other individual entities within it.

114. One key element of having robust information will be sight of the likely path and risks around future earnings. Another will be processes intended explicitly to assess uncertainties in the valuation of assets and liabilities and to ensure that material uncertainty is reported to the board and senior management.

115. Models have been used in understanding and managing insurance risks for many years. But, while recognising that quantitative models can play an important role in supporting insurers' risk management and helping to determine the regulatory capital an insurer holds, the PRA will expect **insurers to be prudent in their use of such models given the inherent difficulties with risk measurement**. Senior management and the board should therefore understand the extent of reliance on models for managing risk, as well as the limitations from the structure and complexity of models, the data used as inputs and key underpinning assumptions. Models, and their output, should be subject to effective, ongoing and independent validation to ensure that they are performing as anticipated. The PRA will expect senior management to have a clear understanding of key assumptions supporting the models, the risks that are not adequately captured by them, and the alternative risk management processes in place to ensure that such risks are adequately measured and incorporated into the firm's overall risk management framework.

### Risk management and control functions

116. Insurers should have in place separate risk management and control functions — notably risk management, actuarial, finance and internal audit functions — to the extent warranted by the nature, scale and complexity of their business. The PRA will expect these functions to support and challenge the management of risks across the business as a



whole, by expressing views on the appropriateness of the level of risk being run and the adequacy and integrity of the associated governance, risk management and financial and other control arrangements.

117. To the extent warranted by the nature, scale and complexity of the business, the PRA will expect these functions to be **independent of an insurer's revenue-generating functions**, and to possess sufficient authority to offer robust challenge to the business. This will require these functions to be adequately resourced, to have a good understanding of the business, and to be headed by individuals at senior level who are willing and able to voice concerns effectively. For example for general insurers, it is important that there are separate pricing and reserving teams, subject to different governance, so that there is clearly defined, separate responsibility for each of them.

118. An effective **risk management function will ensure that material risk issues receive sufficient attention from the insurer's senior management and board.**

119. The PRA will expect insurers to have in place an operationally independent actuarial function commensurate with the nature, scale and complexity of the risks inherent in the firm's business. The PRA will consider the actuarial function integral to the effective implementation of the firm's risk management framework and therefore expects the actuarial function to be engaged with all aspects of risk management.

120. An insurer's finance function should deliver an accurate understanding of the firm's financial position, including through the effective challenge of valuations.

121. Internal audit should provide **independent assurance over insurers' internal controls, risk management and governance.** In the absence of an internal audit function, there should be a review performed by an independent third party. The PRA will work closely with professional bodies for internal auditors to develop a code that sets out expectations for the internal audit function of insurers.

122. Senior management and the board should hear and heed the views of these functions. This will mean that they require access to the board and (where an insurer has one or both) the board's Risk and Audit Committees, which should oversee the functions to ensure their independence and effectiveness.

## Financial resources

### Overall approach

123. Unlike banks, insurers operate a liabilities-led business. For some types of insurance (such as most life insurance), liabilities are long term and losses emerge slowly. For other types of insurance (such as much, but not all, general insurance) liabilities are shorter term and losses emerge relatively quickly. But, in both cases, assets must be chosen to match these liabilities so that the liabilities incurred in writing insurance policies are matched with assets of an appropriate nature and term. Long-term life insurance will typically be matched with assets providing cash flows with appropriate matching nature and term, often taking on some investment risk within these constraints (for example by investing in corporate debt). As the term of insurance gets shorter, or the liabilities more volatile, business may well be matched with more liquid assets. **Capital is required to allow for uncertainty over the valuation of both liabilities and assets. And an insurer must be able to meet its liabilities as they fall due**, holding liquidity assets when appropriate, for example cash or government securities.

124. **The PRA's assessment of insurers' financial strength will be designed to judge its solvency, ie whether it is able to meet its obligations to policyholders and others creditors, including in times of stress.** This will include assessing: the level of capital held by an insurer and the firm's ability to raise more; reserving of general insurers and the adequacy of technical provisions for all insurers; the profitability of underwriting (for example by scrutinising the claims and other performance ratios of general insurance firms); whether the insurer is exposed to particular concentrations of risk (including to particular loss events or large or clustered exposures); whether the insurer is significantly exposed to non-traditional, non-insurance activities; the approach to liquidity management (including contingency planning); and the adequacy of key assumptions (for example, discount rates being applied to technical provisions and life insurers' longevity assumptions).

125. **The PRA will analyse the adequacy of a firm's solvency position on a forward-looking basis, including in times of stress when asset valuations may become strained and capital positions are impaired as a consequence.** Supervisors will assess whether insurers are properly funded and whether they are able to meet their obligations as they fall due. The PRA will also seek to consider whether the firm has plausible recovery actions that it could take, including in times of general market stress.

126. **Insurers should maintain adequate capital resources, both in terms of quantity and quality, taking into account**

the risks to which they are exposed and consistent with their safety and soundness and the protection of policyholders. Having enough capital of sufficiently high quality reduces the risk that an insurer becomes unable to meet the claims of policyholders and its creditors, and is therefore crucial for maintaining their confidence. In addition, where an insurer is owned by private shareholders, having more shareholder equity — the highest form of capital — gives owners a greater interest in the firm being run prudently, because it increases the amount that they will lose in the event of failure.

127. As with all elements of its approach, the PRA will expect insurers in the first instance to take responsibility for ensuring their solvency. But, reflecting the incentives insurers have to run their business in a less prudent manner than the public interest would indicate, there is also a clear role for the PRA as prudential regulator to specify a minimum solvency requirement for insurers to meet. This does not, however, diminish the need for insurers themselves to judge solvency in an appropriately prudent manner, since that is necessary to maintain the confidence of policyholders and creditors. Insurers should engage honestly and prudently in such solvency assessments, not least because the PRA's limited resources mean that it cannot be expected to identify and account for all the risks that insurers may face.

128. The rest of this section sets out what, at a high level, the PRA will expect around the quality and quantity of insurers' capital, including the main elements of the regulatory framework that will inform the levels of regulatory capital that insurers should maintain. It also sets out the PRA's expectations of insurers' funding positions. In many cases these will be directly reflected in PRA rules, and more generally elaborate on the 'prudent conduct' Threshold Condition. In due course much of the PRA's expectations in this area will be achieved through the implementation of Solvency II requirements.

### Quality of capital

129. The PRA will expect a significant part of an insurer's capital to be ordinary shares and reserves. These are the highest-quality form of capital as they allow insurers to absorb losses on a going concern basis — that is, without prompting the winding up or legal reorganisation of the insurer and consequent disruption and loss of value. Going forward, permissible capital instruments for insurers will be those included in Solvency II, which will set out the type and quality of capital allowed.

130. The PRA will expect all capital to be capable of absorbing losses in the manner indicated by its place in the

capital structure. Upon implementation, Solvency II will set out the types and quality of capital which can be recognised as permissible capital instruments for insurers. The PRA will expect all capital instruments to meet these Solvency II criteria regarding the definition of capital, and it will object to insurers issuing regulatory capital instruments that are deliberately structured to meet the letter but not the spirit of these criteria, notably where their incentive is to minimise issuance cost and promote the attractiveness to investors at the expense of genuine loss-absorbing capacity. Until Solvency II criteria are fully implemented, the PRA expects insurers to anticipate the enhanced quality of capital that will be needed, when issuing or amending capital instruments.

131. While less valuable in terms of the PRA's objectives, lower-quality capital (for example, subordinated loan capital) can play a role if an insurer has failed. Since an insurer's capital — including subordinated loan capital — protects the FSCS, and since costs incurred by the FSCS are mutualised among other insurers, so subordinated loan capital helps reduce the impact of failure on other insurers. Such capital can also be valuable in the event of an insurance business being transferred from an insurer that has entered, or is about to enter, an insolvency proceeding. The PRA will seek to support the principle that in the event of insolvency, policyholders' claims are preferred above those of other creditors.

### Location of capital

132. The PRA will be mindful that capital resources are not always freely transferable around a group when it matters most. Therefore, **the PRA will expect capital to be located in the regulated entities where it is needed.** Policyholders', creditors' and counterparties' claims are on specific legal entities, not on groups, and should an insurer fail, its orderly resolution will be facilitated if individual legal entities, and UK sub-groups, hold capital commensurate with their risks. For example, amounts held in a 'with-profits' fund, or some other segregated fund for a particular group of policyholders or other creditors, may be available to absorb losses arising in that fund but may not be readily available for transfer elsewhere within the firm or group. In order to support the integrity of individual regulated entities, the PRA will limit their intra-group exposures.

### Level of capital

133. **The PRA will expect insurers to take responsibility for maintaining at all times an adequate level of capital, taking into account the risks to which they are exposed; and consistent with their safety and soundness and the protection of policyholders.** Capital should be sufficient to absorb unexpected losses, including those arising from

uncertainties about provisions and valuations, in a wide range of severe but plausible stresses, both market-wide and firm-specific. Such an approach is designed to maintain the confidence of an insurer's creditors even in stressed circumstances.

134. The PRA will itself form a judgement about how much capital an individual insurer will need to maintain, given the risks to which it is exposed and uncertainties about the values of assets and liabilities. The PRA will assess the extent to which the insurer has considered life and non-life underwriting risks and credit, market and operational risks adequately in its assessment of capital adequacy, and will also assess the scale of other risks which the insurer faces. The PRA's judgements will inform insurers' own assessments. **But the PRA will expect insurers in the first instance to take responsibility for determining the appropriate level of capital they should maintain.** Insurers should engage honestly and prudently in the process of assessing capital adequacy, and not rely on regulatory minima. And they should not rely on aggressive interpretations of actuarial or accounting standards; especially in calculating technical provisions.

135. **The PRA will expect all insurers to develop a framework for stress testing and solvency assessment that enables them to monitor the assumptions underlying their assessments, and the significance of any volatility in their earnings or in their capital and reserves including in a range of plausible yet severe scenarios.** In assessing risk, the PRA will expect insurers to employ a range of stress-testing techniques proportionate to the nature, scale and complexity of their business. In support of this, the PRA will expect all insurers to ensure that assets and liabilities are appropriately valued and that reserves and provisions are adequate. For its part, the PRA will ensure the stresses applied are appropriately prudent.

136. **Insurers are expected to develop, as a matter of routine, planned management actions in response to stress scenarios.** Such plans — designed to return insurers to a stable, sustainable position following firm-specific or market-wide stress — should include options to address capital shortfalls through generating capital internally and externally. Plans to generate capital internally should include restricting dividends and variable remuneration. The PRA will assess the appropriateness of an insurer's plan, in terms of the adequacy of the recovery options it identifies and the triggers and governance to activate them.

### **The framework for determining regulatory capital**

137. **The PRA will assess a firm's financial strength to analyse the adequacy of its solvency position on a**

**forward-looking basis, including in times of stress when asset valuations may become strained and the adequacy of reserves may, in consequence, come under stress.** Particular emphasis will be placed on reviewing a firm's approach to reserving. The PRA will ensure that insurers have a robust approach to the setting of reserves and that there is appropriate and adequate oversight of reserving processes. Underwriting concentrations and performance will also be considered, including reviewing sensitivities to longevity and discount rate assumptions.

138. The PRA will come to a view, currently through the use of Individual Capital Adequacy Standards (ICAS), on whether any adjustments are necessary to the overall required level of capital the firm should hold to reflect adequately the particular risks it takes. The PRA's view will be informed by an insurer's own assessments, but it will also reflect its views of the risks to its objectives. It will have particular regard to the idiosyncratic risks facing the insurer, in the context of the business model of the insurer, the wider circumstances or external context, and the effectiveness of the insurer's governance and of its management of the risks it faces. Following the implementation of Solvency II, it will carry out this assessment in a manner consistent with the provisions of the Directive.

### **Internal capital models**

139. The PRA's overarching principle will be that it **expects insurers to maintain at all times an amount of capital that adequately reflects the risks to which they are exposed.** In consequence, if an insurer is to use an internal model in calculating its regulatory capital requirements, the PRA will expect the model to be appropriately prudent.

140. The use by an insurer of quantitative techniques or 'models' is an inherent part of judging its liabilities and understanding its risks. Indeed, the modelling of non-economic risks in the insurance sector is long-standing.<sup>(1)</sup> For example, in life insurance, longevity and mortality tables are used to understand an insurer's liabilities, while non-life insurance models are used to assess the probability and severity of possible future seismic, meteorological, epidemiological and industrial events.

141. The use of quantitative techniques that seek to describe the risks around individual liabilities, such as weather patterns or longevity, is unlikely to change the nature of the risk being modelled. This contrasts with many financial risk models used

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(1) The use of modelling to estimate some technical provisions was introduced by The Insurance Companies Act 1909. Historically, modelling by insurers has mainly been on the liabilities side of the balance sheet, with the use of models to estimate capital requirements being relatively new.



to manage financial assets, including in banking, where the assessment of risk can drive investment decisions and hence asset returns, giving rise to potentially destabilising feedback loops. Such models also contrast with those where underlying risk parameters, for example default probabilities or correlations, are unobservable.

142. Within this context, the PRA will recognise that **internal models introduce additional risks that should be understood and managed appropriately by an insurer and its senior management**, for example:

- the extension of modelling techniques to assets potentially exposes insurance models to the same vulnerabilities as seen in risk models in banks;
- although not necessarily complex, internal models can in practice obscure the key underlying assumptions and biases from management and supervisors, and thereby make meaningful challenge and oversight difficult; and
- implementation of internal models, including across the balance sheet as a whole, can rest on a great number of firm-specific judgements and assumptions, for example about correlations across risks, both explicit and implicit. Where insurers use an internal model to determine required capital, additional supervisory scrutiny is therefore needed to ensure that the model and its governance are appropriate.

143. Internal models should be supported by **adequate testing and justification of the model on an ongoing basis**. Insurers will be expected to explain any significant changes in capital requirements arising from modelled approaches. Insurers should not select between internal model-based and non model-based 'standardised' approaches to calculating capital adequacy on the basis of lower capital requirements.

144. To complement the use of models, management should **assess the financial impact of a range of scenarios, including stressed scenarios calibrated to be equivalent to, or more severe than, the model calibration, and including reverse stress tests**. They should also assess the effect, and the appropriateness, of the management actions that they would propose to take in these scenarios. The financial impact of these scenarios and reverse stress tests, as well as their appropriateness, should be assessed independently from the development of the internal models. Management should consider the reliability of the output of the internal model compared with the results of these tests.

145. To monitor the ongoing appropriateness of internal models, the PRA will use early warning indicators based on metrics that are independent of the model calculations. In cases where the PRA has reason to doubt the prudence and appropriateness of models, it will require a firm to hold a capital add-on in respect of risks inadequately captured. Importantly, the PRA will expect that where internal models are used for regulatory capital purposes, they should contribute to prudent risk management and measurement. And they should be updated regularly in order to reflect the insurer's risk profile and not just to ensure compliance with the letter of the PRA's requirements.

### Liquidity and funding

146. **Insurers have to be able to meet their liabilities on an ongoing basis with sufficient confidence, including in stressed circumstances, consistent with their safety and soundness and the protection of their policyholders.**

147. As with all elements of its approach, **the PRA will expect insurers in the first instance to take responsibility for ensuring they are able to meet their liabilities with sufficient confidence**. Reflecting the incentives insurers have to run their business in a less prudent manner than the public interest would indicate, however, there is a clear role for the PRA as prudential regulator in ensuring that insurers have an appropriate degree of resilience to liquidity stresses.

148. The PRA recognises that insurers generally do not suffer from the same liquidity risks as banks. Indeed, in the case of life companies, insurers may, through their ability to match cash flows from assets and liabilities, be able to be providers of liquidity to other parts of the financial system. However, the PRA will expect that at all times an insurer will maintain sufficient liquid assets to enable it to meet its liabilities as they fall due, including under a range of severe but plausible stress scenarios. Such scenarios should consider potential liquidity stresses affecting both assets (for example stressed financial market conditions) and, where relevant, liabilities (such as increases in policy surrenders or simultaneous claims). An insurer's approach to managing its liquidity should reflect also its use of asset-liability matching and its management of liabilities, for example by ensuring a spread of maturities or lengthening the liability term structure.

149. Liquidity swaps and collateral upgrade transactions have the potential to transfer liquidity risk from the banking to the insurance sectors. The PRA will expect to be notified by insurers prior to significant transactions. More broadly, the PRA will expect insurers that engage in such non-traditional, non-insurance activities to manage the greater liquidity risks potentially associated with this business appropriately.

150. Insurers have failed in other jurisdictions in recent years because of liquidity concerns — for example as access to wholesale funding has dried up. The PRA will take the view that this is potentially a serious risk for the sector, and one that may rise in future if insurers become more closely engaged in providing liquidity for other parts of the financial sector.

151. The PRA will be mindful that liquidity resources will not always be freely transferable around a group when it matters most, and also that they may be transferred away from one area which needs them to support other areas. The PRA will therefore **expect liquidity to be available without impediment, including in stressed times, in the regulated entities where it is needed**. For life insurers, the PRA will expect liquidity to be adequate in the portfolio as a whole and in its component funds. This includes not only the shareholders' funds, non-profits funds and with-profits funds but also unit-linked funds. Insurers should ensure that the liquidity in these funds is adequate in stressed conditions as well as normal business conditions.

## Resolvability

### Overall approach

152. One of the key channels through which insurers can adversely affect the PRA's objectives is through disorderly failure that disrupts the continuity of critical financial services to policyholders, causes dislocation in financial markets and results in spillovers to the wider economy.

153. To mitigate this risk, it is important for there to be mechanisms by which **all types of insurer supervised by the PRA can exit the market in an orderly manner: that is, with minimal disruption to the supply of critical financial services, including the degree of continuity for policyholders' cover against insured risks** (delivered either through continuity of cover or compensation for premiums paid). An insurer's resolvability reflects the extent to which it can exit the market in such an orderly manner, preserving critical financial services and minimising adverse effects on financial stability and the wider economy, consistent with the PRA's objectives, and without exposing taxpayers to loss.

154. Insurers typically do not fail in the same way as banks. At least in their traditional activities, insurers do not undertake significant maturity transformation, and so they are less susceptible to 'fast-burn' failure than are banks. In consequence, insurers are likely to have more time in which to attempt to restore their solvency and viability (such as by raising additional capital). And where insurers exit the market, they can typically do so over a longer time period than is usually the case for banks.

155. At present, the United Kingdom does not have a special resolution regime for insurers. When insurers fail, they exit the market via:

- *Run-off*: the firm is closed to new business and the liabilities 'run off' over time. Insurers may use a scheme of arrangement approved by a court under the Companies Act to agree a compromise with their creditors and to accelerate the process.
- *Statutory reorganisation/winding-up*: an insurer that is insolvent may enter a modified administration or liquidation procedure. A new administration order came into effect in 2011 which requires the administrator of a failed insurer to continue to administer existing long-term insurance policies. Such continuity might be achieved by reducing the value of policies, by transferring policies elsewhere, or by finding replacement cover. The FSCS provides compensation to policyholders for claims against insurers that are declared to be in default, or seeks to ensure continuation of cover.

156. These arrangements vary in the extent to which they have been put into practice. To date, for example, no life insurance firm of a significant size has required compensation from the FSCS to be paid to its policyholders. Nor has an insurer with a large derivatives portfolio been put into insolvency in the United Kingdom. But that does not mean such events could not happen.

157. To be more confident that all insurers are resolvable, a strengthening of these arrangements may be needed. In August 2012, a consultation by HM Treasury<sup>(1)</sup> sought views on whether improvements are required to the current insolvency framework for insurers and whether a comprehensive resolution regime with stabilisation powers, as is currently available for banks, is required also for systemically important insurers. The Bank and the FSA support HM Treasury's work in this area. In particular, the United Kingdom, along with other G20 members, has signed up to the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*.<sup>(2)</sup> So where firms are systemically important, the applicable resolution arrangements should meet these standards.

158. The PRA will be able to make rules to ensure that the FSCS compensation regime advances its objectives. The FSCS is required to seek continuity of cover for life business, and has

(1) See [www.hm-treasury.gov.uk/d/condoc\\_financial\\_sector\\_resolution\\_broadening\\_regime.pdf](https://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf).

(2) See [www.financialstabilityboard.org/publications/r\\_111104cc.pdf](https://www.financialstabilityboard.org/publications/r_111104cc.pdf).

the discretion to do so for general insurance business. If continuity is not appropriate, the FSCS can instead return premiums. Considering further policy developments in this area and any associated operational constraints will be an important early task for the PRA.

159. Assessing and planning to contain the impact of failure will be a core part of the PRA's work. The PRA will therefore work with insurers to assess, and improve where possible, their resolvability in the context of the current statutory arrangements. The PRA will also work with HM Treasury, FSCS and the rest of the Bank to assess and enhance the resolution arrangements for insurers to support its objectives to protect policyholders appropriately and promote safety and soundness.

160. The remainder of this section outlines the PRA's expectations of insurers' resolvability in the context of existing arrangements, elaborating on the 'prudent conduct' Threshold Condition and in some cases reflecting PRA rules.

#### Expectations of insurers

161. **Insurers should provide to the PRA all information needed to perform an assessment of their resolvability.** This will include: relevant information on group structure, including intra-group risk management and reinsurance arrangements; information on derivatives exposures and use of financial market infrastructures; analysis of the critical financial services provided by the insurer and the potential consequences if these were disrupted; and information on the extent to which the firm undertakes non-traditional insurance activities (such as collateral upgrade transactions or liquidity swaps) which may lead to contagion elsewhere in the financial system. This will also include ensuring **the FSCS and insolvency practitioners have sufficient understanding of insurers' systems that they can undertake their functions effectively including maintaining payments to, and cover for, policyholders in the event of an insolvency, should that be needed.**

162. **Where significant barriers to resolvability are identified, the PRA will expect insurers to propose and**

**implement adequate changes to reduce these where possible.** This may involve changes to business practices, legal and financial structure or organisation.

163. Failure of an insurer will not, however, be costless. **Insurers will therefore be expected to set out credible steps to maintain or restore their business to a stable and sustainable condition in the event of stress.** And the less resolvable an insurer, the greater the degree of supervisory focus that will be applied to such a plan and the actions implied by the firm's proximity to failure (as set out in the Proactive Intervention Framework).

164. The PRA will consider whether and how to introduce rules requiring insurers to have Recovery and Resolution Plans.

#### Supervision — what the PRA will do to assess and enhance resolvability

165. The PRA will assess the extent to which an insurer is resolvable, taking into account the structure of the group to which the firm belongs, the different critical economic functions it carries out (for example life versus general insurance) and the ability of the FSCS to provide appropriate continuity of cover in the event of failure.

166. The PRA will recognise that — since they do not write new business — insurers in 'run-off' are subject to different incentives and pressures to other insurers. The PRA will therefore require insurers entering run-off to provide and maintain a scheme of operations, specifically to address how they intend to deal with their liabilities. Any proposed transaction (such as a scheme of arrangement or 'Part VII' transfer) that has the potential materially to change an insurer's risk profile, and so its ability to meet obligations to policyholders, must be agreed with the PRA.

167. The PRA will supervise any insurer under administration or liquidation proceedings, until its permission to carry out existing contracts is withdrawn, working with insolvency practitioners and the courts as appropriate, and with the FSCS.

## IV Supervisory activity

168. This section describes how in practice the PRA will supervise insurers including the PRA's approach to authorising new insurers (see Box 5). As part of this, it describes the Proactive Intervention Framework and the PRA's high-level approach to using its legal powers. For UK insurers, the PRA's assessment will cover all entities within the consolidated group.

169. The PRA's supervision will involve engagement with insurers at all levels of seniority. At a senior level, boards as a whole, and the independent directors in the absence of executive management, should expect regular dialogue with the PRA, either in groups or on an individual basis. The PRA will always focus on material issues in its engagement with insurers.

### Assessing risk

170. The PRA will aim to develop a rounded, robust and comprehensive view of an insurer, in order to judge whether it is being run in a safe and sound manner. **The PRA will conduct its assessment work on a continuous cycle**, regularly updating its overall view of an insurer, the risks it faces and the risks it poses.

171. The PRA will undertake a set of 'core' supervisory activities to inform its overall assessment. Reflecting the PRA's focus on the biggest risks to its objectives, the work making up this core will increase in frequency and intensity in line with an insurer's potential impact (ie its Category). The PRA's supervisory approach will recognise the different risks inherent in the business models of insurers from the life, general, wholesale and reinsurance sectors. Activity will also vary with other factors including whether or not the insurer is incorporated in the United Kingdom. The PRA will contribute to securing the same appropriate degree of policyholder protection across all insurers. But through its risk-based approach, the PRA will focus on those insurers and types of insurance which will have the greatest potential impact on the PRA's objectives. For example, supervision of life insurers will recognise that they provide critical incomes to policyholders through annuities and for some general insurers that they provide mandatory cover. And insurers providing products with long maturities and illiquid contacts, such as life insurance or long-tail general insurance, bring greater opportunity for failure and a lower ability for policyholders to protect themselves.

172. Additional work beyond this core will be performed where necessary to provide information on particular areas of

concern. This will be informed by the issues identified in this core work, an insurer's viability and resolvability, the prevailing market and economic conditions and the business model of the insurer.

173. Supervisory concerns will influence the PRA's future supervisory approach to an insurer. For example, concerns about management or systems and controls will influence the PRA's attitude to the growth of a business (including via acquisition), or to new appointments to Significant Influence Functions

174. **The PRA will not be formulaic about the supervisory activity it will perform, since the focus on key risks means that this will depend inevitably on an insurer's particular circumstances.** Nonetheless, the supervisory programme will comprise a selection of possible activities described below.

### Supervisory activities and tools

175. In forming supervisory judgements, the PRA will draw on a broad set of information and data. **Supervisors will require insurers to submit sufficient data, of appropriate quality, to support their judgements about key risks.** Given the importance of this, the PRA will periodically validate insurers' data, either through on-site inspection by its own supervisory and specialist risk and actuarial staff or by third parties. Pending the introduction of Solvency II, insurers' annual returns will remain subject to external audit.

176. The PRA will gather and analyse some information on a regular basis, including relevant information in the public domain, for example insurers' annual reports and disclosures. In addition, it may request additional, firm-specific data from insurers (for example management information or forecasts). It is essential, however, that supervisors are not overwhelmed by the amount of information that they have to analyse. Further detail on the PRA's approach to regulatory data will be set out in a discussion paper to be published in November 2012.

177. To support its broad information-gathering and analysis, the PRA will require insurers to participate in meetings with supervisors at a senior and working level. Some discussions will be strategic in nature, while other interactions will focus on information-gathering and analytical work.

178. The PRA will also, as appropriate, conduct detailed on-site testing or inspections of a particular area. In-depth, focused reviews, for example of material aspects of an insurer's governance or risk management arrangements (for example reinsurance programme, asset/liability management or board effectiveness) will involve discussions with staff,

## Box 5

### Authorising new insurers

Firms wishing to effect or carry out contracts of insurance must apply to the PRA for authorisation (permission) to do so. The PRA will assess applicant insurers from a prudential perspective, using the same framework that is employed for supervision of existing insurers. Thus, the PRA will determine whether, if authorised, an applicant insurer would meet the Threshold Conditions, at the point of authorisation and on an ongoing basis. This includes an assessment of whether it could exit the market in an orderly way.

At the same time, the FCA will assess applicants from a conduct perspective. An insurer will be granted authorisation only where both the FCA and the PRA are satisfied that an insurer meets the relevant requirements. As provided for in the MoU, the PRA will lead and manage a single administrative process. This will include co-ordinating the process and transmitting all formal notices and decisions to the applicant insurer.

The PRA will set out the information that it requires insurers to supply in order to complete its assessment. It will stand ready to answer questions where necessary, though this will not extend to providing consultancy on completing applications.

The PRA will take a proportionate approach to the assessment of authorisation applications based upon the risk the applicant poses to the PRA's objectives. All applicants will be subject to a minimum level of assessment.

The PRA will ensure that, at the point of authorisation, and consistent with EU requirements, new insurers hold capital sufficient to cover the risks that they run.

The PRA's aim through this proportionate approach will be for barriers to entry to be kept to the minimum consistent with its objectives, so enabling the PRA to contribute to a competitive insurance market.

reviews of internal documents and some testing. In addition, the PRA may review an insurer's approach to stress testing, or undertake bespoke stress testing of its own. The PRA will involve its risk-specialist, actuarial and other technical staff in on-site work, stress testing and other assessments as appropriate. And the PRA may use insurers' risk, compliance, internal audit and actuarial functions to identify and measure risks, where it feels it can rely on their effectiveness.

179. **Insurers' external auditors can and should play a role in supporting prudential supervision, given their ability to identify and flag to the PRA current and potential risks in an insurer.** The PRA will expect to work with insurers' external auditors in an open, co-operative and constructive manner and it will abide by and continue to develop the *Code of Practice*, which aims to promote such a relationship.<sup>(1)</sup> The PRA will share relevant information with auditors, for example where it considers an insurer's valuations of less liquid assets or its approach to reserving as significantly out of line with peers. And, consistent with the *Code*, it will expect auditors to disclose to the PRA emerging concerns within insurers, where this would assist the PRA in carrying out its functions.

180. Given their role in assessing the risks to which an insurer is exposed, actuaries can play an important part in supporting prudential supervision. Full, regular and timely dialogue

between actuaries and supervisors should form a key part of supervision, so the PRA will seek also to maintain a constructive relationship with actuaries, as a profession and individually, so enabling the PRA to understand and critically challenge actuarial judgements within insurers. Engagement with the FRC Board and its advisory Actuarial Council and the Institute and Faculty of Actuaries will be an important part of this dialogue.

181. To assist with its risk assessment, the PRA will at times use its statutory powers — in particular its information-gathering power and its powers to commission reports by Skilled Persons on specific areas of interest (under sections 165 and 166 of the Act respectively). The PRA will be able to enter into contracts with Skilled Persons directly, and will follow a transparent and consistent approach to selecting and appointing them. The PRA's will continue to make increased use of section 166 reports as a supervisory tool.

182. The PRA will also make use of the FCA's findings on insurers' key conduct risks and any material prudential risks in relation to FCA-authorised subsidiaries of dual-regulated groups, where they are materially relevant to the PRA's objectives.

(1) See current FSA code [www.fsa.gov.uk/pubs/guidance/fg11\\_09.pdf](http://www.fsa.gov.uk/pubs/guidance/fg11_09.pdf).



183. The PRA will not be a ‘fraud’ regulator; this role is filled by other authorities. The PRA’s on-site inspections will not therefore be designed to uncover all instances of malpractice. Rather, the PRA will aim to assess the adequacy of an insurer’s control framework in preventing serious fraud that could threaten its safety and soundness and the protection of policyholders. And it will draw to the attention of the relevant authorities any suspicion or information that may be of material interest to them.

## Proactive Intervention Framework

184. Supervisors will consider an insurer’s proximity to failure when drawing up its supervisory plan. **The PRA’s judgement about proximity to failure will be captured in an insurer’s position within the Proactive Intervention Framework (PIF).**

185. Judgements about an insurer’s proximity to failure will be derived from those elements of the supervisory assessment framework that reflect the risks faced by an insurer and its ability to manage them — namely, external context, business risk, management and governance, risk management and controls, capital, and liquidity. The PIF will not be sensitive to an insurer’s potential impact or resolvability.

186. **The PIF is designed to ensure that the PRA puts into effect its aim to identify and respond to emerging risks at an early stage.** There will be five clearly demarcated PIF stages, each denoting a different proximity to failure, and every insurer will sit in a particular stage at each point in time (see **Table A**). As an insurer moves to a higher PIF stage — that is, as the PRA determines the insurer’s viability has deteriorated — supervisors will review their supervisory actions accordingly. Senior management of insurers will be expected to ensure they take appropriate remedial action to reduce the likelihood of failure. And the authorities will ensure appropriate preparedness for resolution.

187. An insurer’s PIF stage will be reviewed at least annually, and in response to relevant, material developments. In addition, supervisors will revisit their assessment in response to significant new information which could have a bearing on an insurer’s PIF stage. Challenge and control mechanisms will exist to ensure that supervisors’ assessment of an insurer’s PIF stage is subject to an appropriate degree of scrutiny.

188. The PRA will consider it important for markets and counterparties to make their own judgements on the viability of an insurer. The PRA will not therefore routinely disclose to the market its own judgement on an insurer’s proximity to failure, not least given the possible risk that such disclosures could act to destabilise in times of stress. The PRA would

prefer to disclose PIF stages to insurers as a means of summarising the PRA’s overall judgement on safety and soundness. In view of the current disclosure obligations in European legislation, however, the Bank and the FSA have decided not to do so, given the risk that in some cases the insurer may be under a legal obligation to disclose its PIF stage publicly. The PRA will engage with HM Treasury to discuss whether it would be appropriate to pursue changes to relevant European legislation to support disclosure of such supervisory judgements to insurers but not to the market generally.

189. The PRA will intend to publish aggregate statistics on PIF stages in its *Annual Report*.

## Mitigating risk

190. The PRA will continually review its judgement of the risks that insurers pose to its objectives, on the basis of the supervisory activities undertaken. It will communicate these judgements to insurers, and require them to take action as a result.

191. There will be annual internal stock-take meetings for all insurers to discuss the major risks they face, the supervisory strategy and proposed remedial actions, including guidance about the adequacy of an insurer’s capital (as described in Section III). There will be strong senior-level involvement in these assessments, such that major judgements are made by the PRA’s most senior and experienced individuals. These formal assessments will also be subject to rigorous review by those not directly involved in day-to-day supervision — including risk specialists, independent advisers and relevant participants from the rest of the Bank.

192. **There will be a clear and direct link between the risks that the PRA identifies and the actions it will expect from insurers in consequence.** For example, if the PRA has identified deficiencies in an insurer’s forecasts of earnings, or an excessive level of proposed employee remuneration or dividends to shareholders, leading to risks to its financial health, the PRA will require the insurer to take steps to tackle this. This may involve direct restrictions on payments, or requirements on the insurer to improve its forecasting, systems or governance as appropriate. Or the assessment may have revealed that senior management has an inadequate view of the insurer’s aggregate exposures, compromising the effectiveness of the insurer’s governance and, in consequence, the firm’s soundness. The PRA may then expect the insurer to enhance internal systems for monitoring aggregate exposures or to review the design and effectiveness of its governance and reporting lines.

**Table A** Stages in the Proactive Intervention Framework

Stage	Presumed actions
Stage 1 – Low risk to viability of insurer	<ul style="list-style-type: none"> <li>— Insurer subject to the normal supervisory assessment process and required to plan for stressed conditions and identify appropriate recovery actions or exit strategies.</li> <li>— The PRA to assess insurer resolvability.</li> </ul>
Stage 2 – Moderate risk to viability of insurer Supervisors have identified vulnerabilities in an insurer’s financial position or deficiencies in its risk management and/or governance practices.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> <li>— The intensity of supervision will increase and the insurer will be required to reassess the appropriateness of recovery actions and exit strategies.</li> <li>— The PRA may set additional reporting requirements, and make use of information gathering and investigatory powers.</li> <li>— The PRA will review the insurer’s risk profile and the regulatory capital requirements and consider realigning the latter, as well as setting restrictions on the insurer’s activities until remedial actions have been completed.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>— The PRA will identify and instigate any initial contingency planning needed, potentially including information gathering and liaison with the FSCS.</li> </ul>
Stage 3 – Risk to viability absent action by the insurer Significant threats to an insurer’s safety and soundness or policyholder protection have been identified.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> <li>— The insurer will be required to submit a recovery plan designed to address specific current problems and to initiate recovery actions in a timely manner to address the vulnerabilities identified. Actions may include: capital raising; asset disposal; and business transfer or sale of the insurer.</li> <li>— Other actions the PRA may require include: changes to management and/or the composition of the board; limits on asset disposal/acquisition or capital distribution; restrictions on existing or planned activities; a limit on balance sheet growth; and an assessment of the effectiveness of risk transfer arrangements such as reinsurance.</li> <li>— At insurer or PRA initiative, an insurer’s authorisation to carry out new business may be removed.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>— The PRA will intensify contingency planning for resolution.</li> <li>— The PRA will co-ordinate with FSCS to ensure it has obtained the information necessary to evaluate continuity of cover or payout options (this will include an assessment of the potential exposure of the FSCS).</li> </ul>
Stage 4 – Imminent risk to viability of insurer The position of an insurer has deteriorated such that the PRA assesses that there is a real risk that the insurer will fail to meet the Threshold Conditions, but some possibility of corrective action remains.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> <li>— In most cases, the PRA will remove the insurer’s authorisation to write new business.</li> <li>— Insurer to accelerate and complete recovery actions, demonstrating to the PRA that these have mitigated the imminent risk to the viability of the insurer.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>— The PRA, working with the FSCS, will complete all necessary actions for resolution of the insurer including planning for commencement of orderly liquidation or administration and with the assistance of the insolvency practitioner in waiting.</li> </ul>
Stage 5 – Insurer in resolution or being actively wound up	<p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>— As necessary, the PRA will trigger the appropriate insolvency process and the insolvency practitioner will work with the FSCS and PRA to effect continuity of cover and/or compensation to eligible claimants.</li> <li>— As appropriate, the PRA will monitor insurers exiting the system.</li> </ul>

### Conveying supervisory messages

193. The PRA will focus on outcomes. **The PRA will highlight issues of concern and the outcomes it wishes to see, but as it is the responsibility of an insurer to manage itself, in general the way in which insurers achieve these outcomes will be a matter for them.** In some cases the PRA may choose to be directive in terms of the action required, if it considers it necessary in order to reduce risks to its objectives.

194. The PRA will send an annual letter to each insurer’s board, clearly outlining the small number of key risks that are of greatest concern, and on which it requires action. **The test of materiality for points raised with insurers will be high, with a focus on root cause analysis rather than symptoms, and with supervisory interventions clearly and directly linked to reducing risks to the PRA’s objectives.** The PRA will expect to verify itself that action is taken on these key risks, and will communicate to the board when and how it intends

to do this. The PRA will send individually tailored letters to all insurers, except those with the lowest potential impact where a standard letter will outline issues relevant to all insurers in that group except where specific issues have been identified with a particular insurer. The PRA will actively engage with an insurer's Audit Committee and its non-executive directors on progress made in dealing with the most significant risks identified.

195. Insurers will sometimes disagree with the PRA's decisions. This is inherent in a forward-looking system. The PRA will in general actively discuss issues with insurers in reaching its decision, and will carefully consider representations made, not least to ensure that its decisions are made on the basis of all the relevant evidence. But **insurers should not approach their relationship with the PRA as a negotiation.**

196. Any less significant issues that have arisen — and of which the PRA feels the insurer should be aware — will be conveyed to the insurer, but with the onus on the insurer itself to address these. The PRA will expect self-certification by the most appropriate senior individual within the insurer, for example the CEO, Chief Actuary, Finance Director or chair of the Audit Committee, that issues have been closed. The link between the issues raised and the PRA's objectives will remain clear and direct.

## Tailored application of the Supervisory Assessment Framework

197. The PRA will be responsible for the supervision of a diverse range of insurance companies. This will include life, general, wholesale and reinsurance. Even within these broad categories there is substantial diversity in firm structures and sizes as well as products. This will shape the business models and risks to which these insurers are exposed. The PRA will tailor its application of the supervisory assessment framework to take account of this diversity.

### Lloyd's

198. The PRA will be the prudential supervisor of the Society of Lloyd's and the managing agents that operate within the Lloyd's market. The unique legal framework of Lloyd's means that the PRA will, where appropriate, need to tailor its approach in order to reflect the Lloyd's structure.

199. In supervising the Lloyd's market, the PRA will have regard to two principles.

200. First, that the Lloyd's market should be supervised to the same standards as the insurance market outside of Lloyd's.

This means that Lloyd's policyholders should benefit from the same level of protection as other policyholders. In practice, this requires the PRA to promote the safety and soundness of the Society of Lloyd's and the members of the Society taken together.

201. Second, supervision of the various entities that make up the Lloyd's market will take place primarily at the level in the market where risk is managed. The PRA will therefore apply supervision at two levels — to the Society of Lloyd's itself (which provides central functions, including the maintenance of the New Central Fund),<sup>(1)</sup> and to each of the managing agents (which carry out the underwriting and risk management functions for Lloyd's members).

202. The power will be reserved to the PRA to intervene directly with individual members of Lloyd's (or with all of them together) and/or to direct the Council or the Society (acting through the Council) if it determines that such action is necessary for the purpose of advancing its objectives.

203. The MoU between the FCA and the PRA will set out how they will co-ordinate in respect of the supervision of the Lloyd's market. In general the FCA and the PRA will consult with the other before using a power of direction over members and, in particular, will obtain consent from the other when exercising its powers to require members of Lloyd's to become authorised. The PRA will, where appropriate, enter into new arrangements with the Society of Lloyd's that reflect the PRA's objectives and focus as the market's prudential supervisor.

### With-profits insurers

204. The FCA and the PRA will co-ordinate in their supervision of insurers generally under the framework set out in the Memorandum of Understanding described above. In the case of with-profits policies, however, special arrangements are needed because the returns on with-profits policies are not well defined, and are at the discretion of the insurer. A separate Memorandum of Understanding will set out how the FCA and the PRA will work together in order appropriately to protect the interests of with-profits policyholders.

205. As part of its on-going assessment of the insurer's financial resources, the PRA will seek to ensure that any discretionary benefit allocations or other changes with financial implications that the insurer has proposed are compatible with its continued safety and soundness. The FCA

(1) As provided for in the Lloyd's New Central Fund Byelaw (Number 23 of 1996).



will have responsibility for monitoring whether the proposed changes are consistent with the insurer's previous communications to policyholders, the FCA's conduct rules and the insurer's overriding obligation to treat customers fairly.

206. There may be circumstances where the proposed discretionary benefit allocations call into question the safety and soundness of the firm as a whole and so its ability to meet its obligations to policyholders generally. In such circumstances, the PRA will work with the insurer and the FCA to explore alternative ways those allocations could be made without materially impairing the insurer's safety and soundness. If no reasonable alternative exists, and given the risk to the insurer's overall safety and soundness and its ability to meet obligations to policyholders, the statute gives the PRA the power to take action to prevent such allocations being made. Where the PRA is satisfied that the insurer's decisions, or the FCA's requirements, do not materially affect the overall safety and soundness of the firm, the PRA will not take action.

### Smaller insurers

207. This section summarises the PRA's approach to supervising insurers with the lowest potential impact on the PRA's objectives. It is likely that there will be a large number of insurers within this category, made up in practice primarily of small overseas insurers (branches or subsidiaries) and mutual insurers.

208. Although at an individual level, small insurers have almost no capacity to cause significant harm to the stability of the system, the PRA's statutory objective to contribute to securing an appropriate degree of protection for all policyholders motivates a baseline level of supervisory monitoring for all insurers. Further, there is a risk that several insurers may fail together through a common exposure, with possible wider impact on financial stability.

209. Given that these insurers are likely to pose low risks to the PRA's objectives, it will supervise them on a portfolio basis. Automated tools, analysing insurers' regulatory returns, will issue alerts highlighting outliers and trends, and insurers will in general be examined individually only when their regulatory returns trigger such an alert.

210. The PRA will also examine individual insurers when a risk crystallises (as discovered through, for example, a visit to the insurer, or an approach from the insurer itself), or in response to authorisation requests from the insurer (for example a request to change its permissions to undertake regulated activities, or to extend the nature or scale of its business).

211. The PRA will conduct peer group analysis across sectors as a whole, to develop a clear understanding of the risks posed by both small insurers in aggregate and by a typical insurer. The PRA will conduct annual assessments of these insurers, but in large peer groups.

212. In contrast to the higher-impact insurers, those insurers in the lowest category will contact the PRA through a centralised enquiries function and will not have an individual-named supervisor.

213. Small insurers will not be visited by the PRA on a fixed, regular schedule. Notwithstanding this approach, all insurers, regardless of category, will be subject to on-site work by the PRA — with some period of notice — at any time.

### Mutual insurers

214. The PRA's approach to the supervision of mutual insurers will be consistent with the approach adopted for other insurers. It will reflect variety in the sector — for example different constitutions, different governance frameworks, and different policyholders. It will also recognise that there are issues that are specific to the mutual sector, for example constraints on raising external capital.

### Reinsurers

215. The PRA's approach to supervising reinsurers will be based on the same principles as its supervision of primary insurers. However, reinsurance may give rise to a greater degree of connectivity with other parts of the financial system than is usually seen with primary insurance business. Undertaking an appropriate degree of supervision of the reinsurance business transacted in the United Kingdom will therefore be an important element in meeting the PRA's objectives.

216. Reinsurance is transacted through UK-regulated vehicles (both inside and outside the Lloyd's market) and through incoming EEA branches (Box 6). The PRA will seek to understand to the greatest extent feasible the activities of reinsurers operating in the United Kingdom and their potential impact on its objectives.

### Using powers in the course of supervision

217. The PRA will have a variety of formal powers available to it under statute, which it can use in the course of supervision, if deemed necessary to reduce risks. For example, it may vary an insurer's permission or impose a requirement under Part 4A of the Act to prevent or curtail an insurer from undertaking certain regulated activities, which may require a change to an insurer's business model or future strategy. It may also, as

## Box 6

### International approach

Insurance is an international industry. Supervision of overseas insurers operating in the United Kingdom, and consolidated supervision of international groups operating in the United Kingdom via supervisory colleges, will therefore be an important part of the PRA's work.

The PRA's legal powers and responsibilities will vary depending on the location of the parent and the legal form of its operations in the United Kingdom. Regardless of this, the PRA's supervisory approach will be to assess all insurers to the same prudential standards. Where the PRA does not have direct powers against such insurers, it will raise any concerns that it has with the insurer's home state supervisor or at the appropriate international forum.

### Overseas insurers operating in the United Kingdom

Many overseas insurers, including some reinsurers, operate in the United Kingdom and are significant providers of financial services to the UK economy. As with UK insurers, the PRA's supervision of overseas insurers operating in the United Kingdom will reflect an assessment of the potential impact of the UK entity on the PRA's objectives, including via risk from overseas, its legal status (branch or subsidiary) and the nature of the home country regulatory regime (if the insurer originates from a non-EEA country).

**For subsidiaries of overseas insurers**, the PRA will have full powers and responsibilities and so its approach will be to treat such insurers equivalently to UK-owned insurers, applying its full prudential requirements, including for example stress testing for the most significant insurers. Consistent with its objectives, the PRA will assess and limit as necessary the (potentially complex) interlinkages with the rest of the group.

**For UK branches of EEA insurers**, the PRA will have very limited powers and responsibilities will be limited under European law. In order to ensure itself that risks to its objectives from such branches are adequately managed, the PRA will look to engage with the home state supervisors (in particular through supervisory colleges) where the failure of one of these insurers would have a material effect on policyholders or financial stability in the United Kingdom. The PRA will focus on receiving assurances about the safety and soundness of the parent insurer.

The PRA will expect UK branches of EEA insurers to appoint a senior individual with authority to act as a primary contact with the PRA in relation to the branch's affairs. This individual should also act as a channel for communication with the parent.

Where the PRA is not able to assess the risk of an insurer satisfactorily, the PRA will work with the home authority, and promote public understanding of the limits of its powers, including by using whatever tools it can to reduce the impact of these limitations.

In some cases the PRA may judge that an EEA insurer applying to passport into the United Kingdom poses risks to its objectives, but does meet the requirements set out by the relevant EU Directives, and thus as a legal matter has a right to conduct business in the United Kingdom. In such cases, the PRA will carefully consider the tools available to it as a host regulator, acting in co-operation with the home regulator, to mitigate the resulting risks.

**For UK branches of non-EEA insurers** the PRA's authorisation applies to the whole insurer. At the point at which a non-EEA branch seeks initial authorisation in the United Kingdom, the PRA will, as a first step, form a judgement on the adequacy of the home regulator including its ability and willingness to share confidential information. Where it considers the home supervisor not to have a regime 'broadly equivalent' to that of the United Kingdom, the PRA will refuse authorisation of the branch. It may instead decide to authorise a stand-alone subsidiary, in which case it may limit the interlinkages with the rest of the group or ring-fence the subsidiary (for example where it considers the home supervisor does not deliver effective consolidated supervision). In assessing a non-EEA firm against the threshold conditions, the PRA may also have regard to the opinion of an overseas regulator in any country or territory in which the non-EEA firm carries on regulated activities. In considering how much weight to attach to that opinion, the PRA must have regard to the nature and scope of the supervision exercised by the overseas regulator.

For existing UK branches of non-EEA insurers where the home regime is not considered to be equivalent, the PRA's supervisory work will be aimed at mitigating the risks of non-equivalence in the relevant areas. Its supervision will focus on issues such as the financial strength of the whole insurer, including the adequacy of its capital and its resolvability (collaborating with the home authorities in

colleges as applicable), taking into account the importance of the insurer to the PRA's objectives.

For UK branches of non-EEA insurers where the PRA is satisfied that the home regulatory regime is equivalent and where the PRA has assured itself over the home regulator's supervisory approach, the PRA will rely where possible on the home supervisor's prudential supervision. In these cases, the PRA will focus on collaboration with home regulators (including via supervisory colleges). In addition, the PRA will take a close interest in what would happen in the event of failure and will ensure that there are senior individuals in the United Kingdom who are clearly responsible for management of both the UK operations and business booked in the United Kingdom. The PRA will discuss and agree with the home regulator the areas in which it will seek to rely on the home regulator's supervision.

### Supervisory colleges

The PRA will be an active participant in international co-ordination of supervision for major insurers. Where invited to do so, it will participate in supervisory colleges for all insurers with significant operations in the United Kingdom,

whether a legal entity or a branch. The PRA will publish on its website a list of those colleges in which it participates and note any cases where, in respect of insurers with major UK operations, the lead authority in another country has not invited the PRA to participate.

For UK insurers, the PRA will organise and chair the supervisory college. To be fully effective, colleges must operate in a manner which enables supervisors to be open and transparent with each other, and to address the difficult issues. The PRA will seek to adopt this approach when it runs colleges and will expect other authorities to participate on the same basis. As the lead authority and college chair for UK insurers, the PRA will be prepared to tackle instances where it believes that other authorities are not acting in a manner consistent with the PRA's objectives. And the PRA will encourage other authorities to challenge it if they have concerns.

A fuller statement on the PRA's approach to the supervision of overseas firms operating in the United Kingdom will be published in due course.

noted above, use its powers to require information from insurers.

218. **While the PRA will look to insurers to co-operate with it in resolving supervisory issues, it will not hesitate to use formal powers where it considers them to be an appropriate means of achieving its desired supervisory outcomes.** This means that, in certain cases, the PRA will choose to deploy formal powers at an early stage and not merely as a last resort.

219. The PRA will consider when and how to use its formal powers on a case-by-case basis and will assess the particular facts and circumstances of each case. In all cases, the PRA will be likely to consider a number of factors in connection with the possible deployment of such powers, including:

- the confidence supervisors have that insurers will respond appropriately to the PRA's requests without the use of powers;
- the PRA's view of the insurer's proximity to failure, as reflected in its PIF stage; and
- the impact — on policyholders and the stability of the system — and proximity of the risk the PRA is aiming to mitigate.

220. In addition, the PRA will be able to use its powers to approve or allow certain changes requested by insurers (for example, a change in an insurer's controller or in its permissions to perform regulated activities or outward passporting of a UK insurer). Where those changes could

adversely affect the PRA's objectives, the PRA may use its powers to refuse such requests.

## Enforcement powers

221. The PRA's preference will be to use its powers to secure *ex ante*, remedial action, given its approach of intervening early to address emerging risks. If successful, application of this approach should mean that enforcement actions are rare.

222. **The PRA will, however, have a set of disciplinary powers, including the power to impose financial penalties and publish public censures, for cases where such sanction is an appropriate response to the insurer failing to meet the PRA's policies. It can also use such powers where directions or restrictions imposed by the PRA are ignored by the firm.**

223. The intention in deploying disciplinary powers might include: reinforcing the PRA's objectives and priorities; changing and promoting high standards of regulatory behaviour; the need to send a clear signal to the insurer, and to the regulated community more widely, about the circumstances in which the PRA considers an insurer's behaviour to be unacceptable; and deterring future misconduct.

224. These powers are additional to those that the PRA will hold in relation to Approved Persons (as detailed in Section III). The Bank and the FSA will consult prior to the PRA's establishment as prudential regulator on its policy and procedures regarding the exercise of disciplinary powers.

## V Making policy to support the PRA's general approach

225. Prudential supervision is based on policies which ensure that judgements about risks to the PRA's objectives are made within a clear and coherent framework.

226. This section sets out the PRA's approach to setting and communicating these policies, common across all the insurers that it regulates and both of its statutory objectives.

### The PRA's approach to published policy material

227. **The PRA will aim to establish and maintain published policy material which is consistent with its objectives, clear in intent, straightforward in its presentation and as concise as possible, so that it is usable by the senior management of firms.** Taken as a whole, the set of published policy material will set out clearly and concisely what the PRA expects of firms in terms of intended outcomes, so that they can meet these expectations through their own actions. When the PRA judges that it is necessary to take action against a firm to mitigate risks to the PRA's objectives, the basis for its judgement will be clear from its published policies.

228. As noted in Box 3, the policy framework for the PRA's supervision is to a large extent agreed internationally, both at a global level, for example through the IAIS, and within the European Union. In terms of published policy material, the policy framework is increasingly being codified at EU level. Relevant EU Directives will be implemented in the United Kingdom through legally binding PRA rules. Any relevant EU Regulations that apply directly to UK insurers will not be reproduced in the PRA rules but will be part of the PRA's requirements of insurers.

229. Where the PRA issues material in areas not covered by EU policy, it will articulate the policy in a manner which is clear in intent and straightforward to understand, whether in the form of rules or otherwise.

230. The PRA will not plan to issue significant amounts of additional, detailed guidance to clarify its policy, whether in the form of general guidance issued publicly or advice given by supervisors to individual insurers.

231. When it assumes its responsibilities, the PRA will adopt parts of the pre-existing *FSA Handbook*. It will review the

*FSA Handbook* after this point, and will replace it with a rulebook, containing only PRA rules. Other relevant types of material currently in the *FSA Handbook*, for example procedures manuals, and information on how the PRA itself will act, will be published separately.

### What the PRA will do in delivering and maintaining its policy

232. **The PRA will attach great importance to being an influential and persuasive participant in international policy debates and negotiations.** It will seek agreement at both global and EU levels to the policy reforms which will deliver and maintain a strong, coherent and clear prudential framework that allows the PRA effectively to advance its objectives.

233. **The PRA will perform careful analysis to determine whether and what revisions to its set of policies may be appropriate, whether negotiating policy internationally or acting autonomously.** The PRA will only propose or support a policy reform where it is justified by the presence of current or potential market failures relating to its objectives; and where it believes that the net effect will be beneficial and that the particular proposal is on balance the most efficient way of dealing with the identified problem. Quantitative estimates of costs and benefits will be included in its published documents only where they can reasonably or practicably be estimated.

234. The PRA will actively review the continued effectiveness of its policies and their coherence, with the aim of ensuring that as the financial system develops, the prudential regime remains effective and proportionate.

235. **The PRA will solicit comment on policy proposals, for example on the likely effect of proposed reforms and on different ways of achieving its intended policy outcome.** The PRA will have a statutory duty to consult in introducing new rules and a public law duty to consult on any other measures that will significantly affect firms. It will communicate policy proposals (including an analysis of their effect and an explanation of their purpose) to all parties likely to be affected by them. This will usually be done through publication on the PRA's website, in addition to other channels as appropriate. The PRA will carefully consider the representations made to it. The consultation period will normally be twelve weeks, consistent with Government guidelines, unless a different approach is warranted.

## Box 7 Staffing the PRA

The PRA’s approach to resourcing will be to employ staff with the necessary skills to carry out the forward-looking, judgement-based approach to supervision necessary to advance its objectives.

The PRA’s approach will be advanced primarily by its front-line supervisors. These will have the right capabilities to make judgements about current and future risks to an institution’s safety and soundness, and to make interventions early before risks crystallise. Their judgements will be grounded in analysis, supervisory experience, and a strong understanding of the sectors they supervise gained through direct exposure to the industry. On this basis they will have credibility with the senior management of firms, and be able to deliver robust messages.

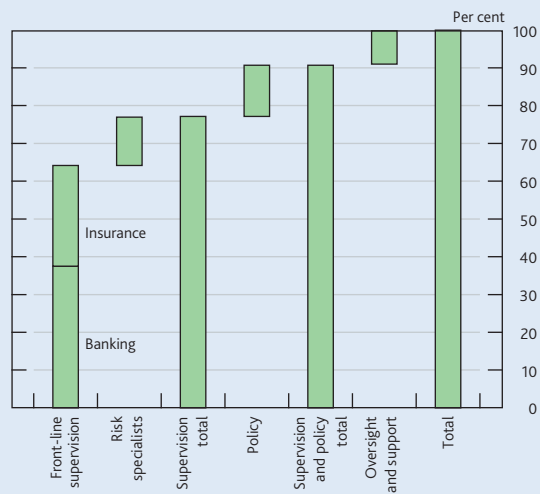
The PRA’s front-line supervisors will be supported by risk specialists. These will provide important knowledge and technical expertise to support analysis and supervisory judgements. Within the insurance area, these will include actuaries and other specialists in insurance risk, who will provide important knowledge and technical expertise to support analysis and supervisory judgements.

In addition, the PRA will employ policy experts to develop the policies that underpin its supervisory framework. Since, as noted above, the policy framework is to a large extent agreed internationally, the PRA’s policy experts will have the necessary skills and experience to influence the policy debates — at both global and EU levels — to ensure that the PRA’s views are properly represented.

In delivering its objectives, the PRA will ensure that there is an efficient allocation of resources. As illustrated in **Chart A**, over 90% of staff will be directly involved in supervision and policy. Over 60% of staff will be involved in front-line supervision with a further 27% performing policy, actuarial and risk specialist roles.

The allocation of resources, illustrated in **Table 1**, shows that around one third of supervisory staff will be focused on the 20 or so firms with the highest potential impact (Category 1); a further third will be focused on the next 70 most significant firms (Category 2) while the remaining third will focus on 1,500 lower-impact firms (in Category 3 and below).

**Chart A** PRA split by function



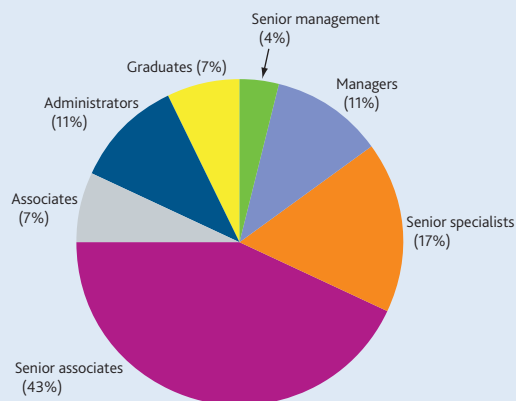
**Table 1** PRA resource allocation

- Category 1:** c. 20 firms (1% of total), 200 supervisors, average ratio of 10:1.
- Category 2:** 70–80 firms (4% of total), 200 supervisors, average ratio of 3:1.
- Category 3–5:** >1,500 firms (95% of total), 200 supervisors, average ratio of 0.14:1.

The PRA’s rank mix will reflect its approach to advancing its objectives, with the highest proportion of senior and experienced supervisors responsible for supervising those firms that present the greatest risk to its objectives (see **Chart B**).

The PRA will have a larger proportion of more experienced and senior supervisors compared with the past. The process for delivering this has already started and implementation will continue. This will involve development of the PRA’s own

**Chart B** PRA rank mix





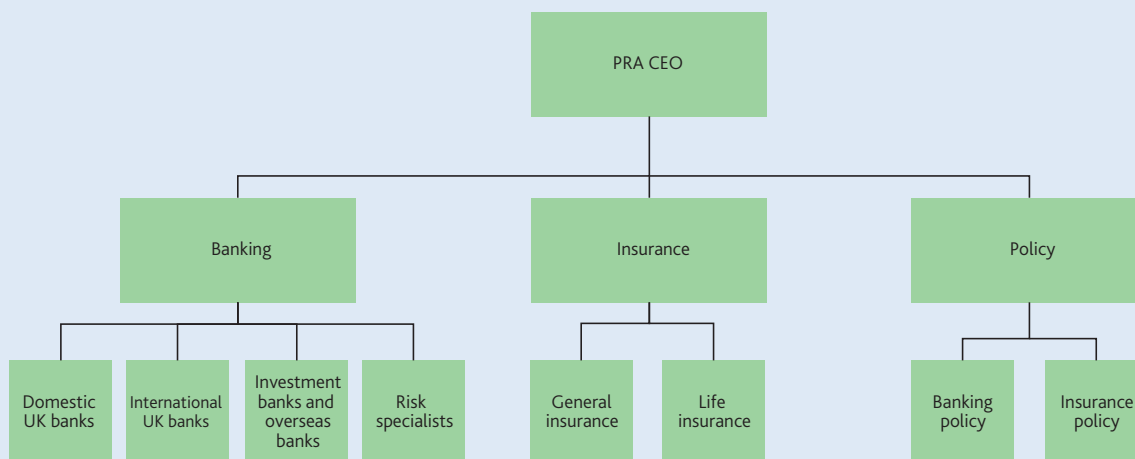
supervisors as well as external recruitment. Internal career development will be an important aspect of building the PRA's capability in the long term.

The Bank's recruitment, talent management and career development programmes will be extended across the PRA. The objective will be to ensure that staff have the opportunity to develop to their full potential, and that there is a strong pipeline of talented senior supervisors.

The PRA's focus on prudential supervision will develop supervisors with in-depth experience of the key issues that pose a risk to the safety and soundness of firms and to advancing the PRA's objectives. It will be important to ensure

that this experience is retained for the PRA to benefit fully from their regulatory knowledge and expertise. Retaining staff will require the PRA to offer compelling careers centred around intellectual challenge and excellence, and a commitment to public service through its public policy objectives. Graduates will undertake a three-year development programme. And staff at all levels will be coached by their managers on the exercise of supervisory judgement. Secondment opportunities to and from the industry and to overseas regulators will be made available to staff. Additionally, staff will have the opportunity to work in other parts of the Bank of England as a way of broadening their knowledge and management experience, and similarly the PRA will be open to staff moving from other parts of the Bank.

Figure A PRA organisation structure



## VI Next steps

236. This paper has been published prior to the PRA assuming its responsibilities in order to facilitate scrutiny of the PRA's proposed approach, as the draft legislation is debated in Parliament. It is complemented by other publications on specific aspects of the PRA's regime including transitional arrangements.<sup>(1)</sup>

237. Interested parties can submit comments on the PRA's proposed approach via email to [praapproachdoc@bankofengland.co.uk](mailto:praapproachdoc@bankofengland.co.uk) and [praapproachdoc@fsa.gov.uk](mailto:praapproachdoc@fsa.gov.uk).

238. Interested parties are also encouraged to attend the public event scheduled for 22 October 2012.<sup>(2)</sup> The intention will be to discuss the details set out in this document, and address the key questions insurers wish to raise, including those submitted in advance.

239. Supervisors will be happy to discuss the contents of this publication with insurers.

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(1) See letter to firms from Andrew Bailey on 12 September 2012, [www.fsa.gov.uk/static/pubs/other/pras-transition-letter.pdf](http://www.fsa.gov.uk/static/pubs/other/pras-transition-letter.pdf).

(2) The booking site for this event is available at: <http://fsa.cvent.com/PRAinsurance>.



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