Bank of England PRA

Please note: This letter has been prepared for the website. Square brackets show where this letter may differ slightly, along with formatting from those versions sent directly to firms.

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11 January 2024

[Dear Chief Executive Officer]

Insurance supervision: 2024 priorities

We are writing to outline our priorities for the coming year. They are set against the backdrop of a challenging environment[1] which brings with it both risks and opportunities for the insurance sector. Our enduring supervisory aim is for the insurance sector to be able to provide financial protection and security to policyholders in both good and bad times. The insurance sector plays a vital role in supporting the real economy, covering critical sectors and facilitating important economic activity through the pooling of risk, provision of retirement income, and long-term investment.

As the sector moves to take the opportunities afforded by economic, regulatory, technological and other developments, it is vital for firms to assess their financial and operational capabilities and to adapt and grow in a sustainable way. This letter is intended to support firms as they make such assessments and manage their risks, by explaining our priorities for the sector and our plans at the sector level.

1 Financial Stability Report – December 2023; available at: **www.bankofengland.co.uk/financial-stability-report/2023/december-2023**.

Since our 2023 letter,[2] the insurance sector has continued to grow – in impact and complexity. For example, transfers of liabilities from defined benefit pension schemes to life insurers have already exceeded the 2022 total of £29.5 billion, and market projections anticipate a significant acceleration of transfers over coming years. In the general insurance sector, we see innovations in distribution and products, including continued rapid expansion of cyber risk underwriting. Moreover, the insurance regulatory landscape is being reshaped, as we implement Solvency UK[3] and advance our new secondary objective, in relation to international competitiveness of the UK as a vibrant, global centre for insurance, and the sector's contribution to medium-to-long term growth in the UK economy.

A summary of our cross-firm supervisory activities planned for each of our priority areas is also set out in the **Annex** to this letter. This is not an exhaustive list and forms part of our ongoing assurance work, alongside firm-specific actions that you will have received following the most recent Periodic Summary Meeting (PSM) for your firm.

Financial markets and the economic environment

In an economic environment presenting both business opportunities and threats, we are focussing on core areas requiring financial resilience:

- **Credit risk**
- **Liquidity risk**

Credit risk

Credit markets are exposed to a subdued outlook for economic growth, inflationary cost pressures, increased debt service and refinancing costs, property value uncertainty, and geopolitical tensions. It is essential that firms understand their risk exposures in these areas and can swiftly respond to novel risks, changes in risk correlations and any increase in distressed assets. To do this effectively, it is particularly important that firms' credit risk management and internal credit assessment framework and outcomes are appropriate. Assessing firms' approaches in these areas has been the focus of the Prudential Regulation Authority's (PRA) work to date with emphasis on firms' processes, controls, and internal ratings validation. Throughout 2024, we will continue to focus on the efficacy of firms' credit risk management capabilities as firms aim to continue to invest in a wider range of credit risky assets. We will also seek further assurance that firms' internal credit assessments appropriately reflect the risk profile of

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2 Letter from Charlotte Gerken and Shoib Khan 'Insurance Supervision: 2023 priorities'; available at: **www.bankofengland.co.uk/prudential-regulation/letter/2023/insurance-supervision-2023-priorities**.

3 Solvency UK refers to the reform package that will be delivered in response to the Government's Solvency II review.

their asset holdings and assess their current and forward-looking validation plans and approaches.

Liquidity risk

Events such as the Dash for Cash associated with the Covid-19 pandemic, in March 2020, and the Liability-Driven Investment shock in September 2022, led to derivative driven liquidity strains for some insurers as well as highlighting gaps in insurers' liquidity risk frameworks. During these events, the PRA sought to receive timely and accurate data on firms' positions and exposures and is looking to collect this information on a more consistent and systematic basis in advance of potential future market stresses. The PRA is also mindful of the impact of macroeconomic conditions on the incentives for policyholders to retain certain insurance products, leading to potential lapse risk. During 2024, the PRA will therefore work in collaboration with relevant stakeholders to develop liquidity reporting requirements that will provide information on liquidity risk exposures on a consistent and timely basis.

The Bank of England (the Bank) has also signalled its intention to develop a new lending tool for non-bank financial institutions,[4] including UK insurance companies, subject to their having in place appropriate liquidity risk management practices, including the ability to provide consistent management information.

In 2024, to further improve our understanding of both credit and liquidity risks to and from insurers in deteriorating economic conditions, we will prepare for both life and general insurance stress tests (as detailed later in this letter) and the Bank will run an exploratory system-wide exercise (SWES) in 2024. [5] The exercise will explore how the behaviours of insurance companies may interact with the behaviours of other financial institutions in stressed financial market conditions and amplify shocks in UK financial markets that are core to UK financial stability. We will continue to actively engage with participating insurers in both the design and execution of this exercise.

The business and operating environment

Fundamental to ensuring the safety and soundness of the insurance sector is building both operational and financial resilience. In this context, we will be focussing on:

- **Operational resilience**
- **Ease of exit**

4 A journey of 1000 miles begins with a single step: filling gaps in the central bank liquidity toolkit - speech by Andrew Hauser; available: **www.bankofengland.co.uk/speech/2023/september/andrew-hauser-speech-at-market-news-international-connect-event**.

5 System-wide exploratory scenario; available at: **www.bankofengland.co.uk/financial-stability/boe-system-wide-exploratory-scenario-exercise**.

- **Regulatory reform**

Operational resilience

We expect Boards and senior management to actively oversee the delivery of their firm's operational resilience programme.

Firms now have just over a year to complete the implementation of the PRA's operational resilience expectations.[6] By no later than March 2025, firms should be able to demonstrate that they can remain within impact tolerances for all their important business services (IBS). This includes identifying what resources are needed to support the delivery of each IBS, running tests using scenarios which are severe but plausible and learning lessons from any operational disruptions. We expect these scenarios to include cyber-related disruptions, which will help firms to identify what's needed to both withstand a cyber-related incident and to recover from one. Boards and senior management need to actively oversee the delivery of their firms' operational resilience programme.

Ease of exit

Our supervisory approach recognises the need to allow for a dynamic insurance market that fosters innovation and commercial opportunity, while ensuring we meet our core objective of policyholder protection. Consequently, we consider a safe exit process as an important corollary to a robust, well-functioning insurance market. A key objective for us is, therefore, to increase confidence that insurers can exit the market in an orderly way.[7]

We intend to consult shortly on requirements for insurers to prepare plans for an orderly solvent exit (to a level of detail proportionate with the size and impact of the insurer) as part of their business-as-usual activities; and if needed, to be able to execute one.

Regulatory reform

We are grateful to firms who devoted considerable time in 2023 to constructive engagement on the technical details of options for regulatory reform to create the Solvency UK regime. This engagement informed and improved proposals[8] on which we

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6 PRA supervisory statement 1/21 – Operational resilience: Impact tolerances for important business services; available at: **www.bankofengland.co.uk/prudential-regulation/publication/2021/march/operational-resilience-impact-tolerances-for-important-business-services-ss**, March 2021.

7 Prudential Regulation Authority Business Plan 2023/24; available at: **www.bankofengland.co.uk/prudential-regulation/publication/2023/may/pra-business-plan-2023-24**, May 2023.

8 Consultation paper 19/23 – Review of Solvency II: Reform of the Matching Adjustment; available at: **www.bankofengland.co.uk/prudential-regulation/publication/2023/september/review-of-solvency-ii-reform-of-the-matching-adjustment**, September 2023.

consulted[9] in the second half of the year. We are considering the feedback we have received, and in 2024 we will publish our final policy statements to ensure the changes to Solvency UK can be completed by the end of the year.

Alongside this, we are working on how to implement the changes in the most efficient and proportionate way and will seek to provide more clarity to relevant stakeholders throughout 2024 on matters such as our updated approach to the matching adjustment and internal model review processes. We will continue to seek to understand, in depth, firms' strategic investment plans so that we can prepare to handle new applications for matching adjustment eligibility in as effective and timely a way as possible.

Expansion of the life insurance sector

In aggregate, the insurance sector is increasing in size and impact as a part of the financial system and is entering and growing new lines of business and investment. In this context, we will be focussing on:

- **Risk management**
- **Funded reinsurance**
- **Stress testing**

Risk management

Life firms continue to invest in a wide range of credit risky assets, and we anticipate the range of investments held by firms will further expand in response to both the proposed Solvency UK reforms and the expected growth in the bulk purchase annuity (BPA) market.

The life insurance sector has committed to large, long term, productive investment in the UK.[10] Insurers have a responsibility, therefore, to adopt a strategic approach to investing. Investments must be assessed by firms with the long-term interests of policyholders in mind. The forthcoming changes under Solvency UK serve to increase the importance of, and reliance on, well-functioning risk management.

Firms must ensure their strategic choices and investment decisions are made within their own risk tolerance limits. As life firms look to substantially increase the scale and range of investments, their supporting risk management, asset origination, and

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9 Consultation paper 12/23 – Review of Solvency II: Adapting to the UK insurance market; available at: **www.bankofengland.co.uk/prudential-regulation/publication/2023/june/review-of-solvency-ii-adapting-to-the-uk-insurance-market**, June 2023.

10 Government's review of Solvency II; available at: **Solvency II Review: Consultation - GOV.UK (www.gov.uk)**.

operational capabilities must be developed in parallel, to be commensurate with the scale of the business and the increased breadth of investment.

Funded reinsurance

We continue to pay close attention to the role of 'funded reinsurance' in the UK life market. Per our letter in June to chief risk officers,[11] we see only a limited role for funded reinsurance as part of a diversified asset strategy. We consider systematic use of funded reinsurance has the potential to introduce significant risks to our objectives of safety and soundness and policyholder protection. These are complex transactions which give rise to contingent exposure via recapture risk, and it is essential firms limit the scale and structure of such transactions to retain high confidence in their ability to safely recapture the transferred risks under stressed conditions.

Our thematic work found risk management weaknesses across life insurers transacting funded reinsurance. In November 2023 we published a consultation paper[12] setting out how we expect firms to manage the risks associated with funded reinsurance at both an individual transaction and an aggregate level. This included the expectation that firms place limits on activity necessary to ensure sound risk management. Supervisors of firms who have undertaken, or plan to undertake funded reinsurance transactions, will engage closely on the prudent scale, structure, and risk management of funded reinsurance. Given the potential firm-specific and systemic risks, the Prudential Regulation and Financial Policy Committees[13] will keep funded reinsurance under review and we expect to develop further policy and supervisory measures in due course.

Life insurance stress test 2025 (LIST 2025)

Stress testing provides a valuable complement to risk assessment; highlighting vulnerabilities and risks that may not be easily visible in more stable times. Major life insurers participate in regular stress testing prescribed by the PRA and the next test will be in 2025. The PRA will publish individual firm results which will help inform the PRA as well as other stakeholders about the vulnerabilities to which firms are exposed in the scenarios we set out and about firms' resilience. The PRA will continue to engage with the industry on the technical, operational and communication aspects of the exercise, and in 2024 we will look to publish an approach document to LIST 2025.

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11 Feedback on the PRA's preliminary thematic review work on funded reinsurance arrangements; available at: **www.bankofengland.co.uk/prudential-regulation/letter/2023/june/thematic-review-work-on-funded-reinsurance-arrangements**, June 2023.

12 CP24/23 – Funded reinsurance; available at **www.bankofengland.co.uk/prudential-regulation/publication/2023/november/funded-reinsurance-consultation-paper**, November 2023.

13 Financial Stability Report – December 2023; available at: **www.bankofengland.co.uk/financial-stability-report/2023/december-2023**.

General insurance sector reserving risk and model drift

Our focus in 2024 for the general insurance sector will be:

- **Cyber underwriting risk**
- **Claims inflation**
- **Model drift**
- **General insurance stress test**

Cyber underwriting risk

Cyber insurance has continued to grow in significance to the UK insurance sector, while cyber threats have evolved and the technological surface area grown, at a time of increased geopolitical uncertainty. Building on prior work on cyber underwriting risk, including ongoing cyber and exposure management thematic exercises and the 2022 General Insurance Stress Test (GIST),[14] our work in 2024 will focus on ensuring that firms' capital and exposure management capabilities are commensurate to the growth in exposure, as well as the inherent volatility of this risk. We will also continue to monitor other relevant sources of uncertainty, including but not limited to, contract uncertainty risk.

Claims inflation

Claims inflation continues to be a significant risk for general insurers. Following a thematic review in 2023, we published a Dear Chief Actuary letter in June 2023 setting out our findings.[15] This work found that while reserves have increased, there remains material uncertainty and the potential for excessive optimism to impact reserving, pricing and reinsurance planning. It is expected that there will continue to be a lag in the emergence of claims inflation in the data, which insurers should be alert to. We shall continue to monitor the ongoing impact through the regulatory data we collect and in supervisory meetings into 2024 and beyond. Should our assessment of this risk change, further focused work may be considered.

Model drift

For firms using internal models to calculate capital requirements and aid risk management, it is crucial to ensure the models reflect the ever-changing risks to which the firms are exposed. We also expect model assumptions to reflect forward-looking

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14 Insurance Stress Test 2022 feedback; available at: **www.bankofengland.co.uk/prudential-regulation/letter/2023/ist-2022-report**, January 2023.

15 Follow up to the letter: Insights from PRA thematic review of general insurance reserving and capital modelling; available at: **www.bankofengland.co.uk/prudential-regulation/letter/2023/june/insights-from-thematic-review**, June 2023.

views of risks. In its 2023 model drift analysis,[16] the PRA identified a number of issues across internal model firms in the non-life sector, relating to limited allowance for inflation uncertainty, potential optimism in expected underwriting profits, potential optimism in the cost and benefit of reinsurance and limited allowance for economic and geopolitical uncertainties. We will follow up with firms identified as exhibiting model drift with targeted use of supervisory tools and actions where appropriate. Into 2024, the PRA will continue to monitor the ongoing appropriateness of internal models with an emphasis on improving the effectiveness of internal model validation.

General insurance stress test

To test the resilience of the general insurance sector and to identify shortcomings in the calculation and assessment of tail events, the PRA has previously conducted four General Insurance Stress Test exercises between 2015 and 2022. In 2025 we look to run the PRA's first dynamic stress test.[17] The dynamic nature of the 2025 exercise represents a significant change from previous exercises and will involve simulating a sequential set of adverse events over a short period of time. The PRA has begun engaging with the industry trade bodies and will provide more details of this exercise (including participation, design, and timelines) during the first half of 2024. Results of this exercise will be disclosed at an aggregate industry level.

Other areas of focus

Financial risks arising from climate change

While positive steps have been taken to embed our supervisory expectations,[18] further progress is required by all firms, particularly on scenario analysis and risk management.[19] Improvement in scenario analysis capabilities will support effective decision-making, and many firms are still in the process of embedding climate risk within their risk appetite statements, including both qualitative and quantitative

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16 Letter from Dan Curtis: 2023 Thematic review of expected underwriting profit allowed for in Internal Models for General Insurance firms; available at: **www.bankofengland.co.uk/prudential-regulation/letter/2023/underwriting-profit-allowed-for-in-internal-models-for-general-insurance**.

17 PRA statement on the dynamic general insurance stress test in 2025; available at: **www.bankofengland.co.uk/prudential-regulation/publication/2023/october/general-insurance-stress-test-in-2025**, October 2023.

18 SS3/19 – Enhancing banks' and insurers' approaches to managing the financial risks from climate change; available at: **www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss**, April 2019.

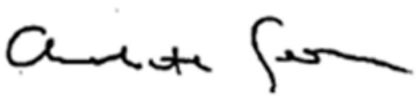
19 Letter from Sam Woods 'Thematic feedback on the PRA's supervision of climate-related financial risk and the Bank of England's Climate Biennial Exploratory Scenario exercise'; available at: **www.bankofengland.co.uk/prudential-regulation/letter/2022/october/managing-climate-related-financial-risks**, October 2022.

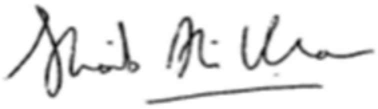
measures. As firms develop these capabilities, sources of climate risk should be considered across both sides of an insurer's balance sheet.

We expect all firms to be able to demonstrate how they are responding to our expectations and to set out the steps they are taking to address barriers to progress, recognising that each firm's approach should be proportionate to the nature, scale, and complexity of their business. In 2024, we will continue to assess firms' progress in managing climate-related financial risks and expect firms to increase their efforts now. We will also commence work to update supervisory statement 3/19 which will include, among other things, identified effective practice and developments in wider regulatory thinking.

We look forward to working with you over the coming year.

Yours sincerely,





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ANNEX: 2024 PRA-led cross-firm work

The Economic Environment	Impacted Sector
Credit risk • The PRA will focus on the efficacy of firms' credit risk management capabilities	• *Life insurers (predominantly annuity writers)*
Liquidity risk • The PRA will develop liquidity reporting requirements. • The PRA will actively engage with participating insurers in both the design and execution of the SWES exercise and publish findings from the SWES by the end of 2024.	• *All insurers, with an initial focus on annuity writers* • *Largest derivatives users*
Operational resilience • Firms must be able to demonstrably remain within Impact Tolerances for all Important Business Services by March 2025	• *All firms (applying proportionality in approach)*
Ease of exit • The PRA will consult in early 2024 on requirements for insurers to prepare plans for an orderly solvent exit	• *All firms (applying proportionality in approach)*
Expansion of the life insurance sector	**Impacted Sector**
Risk management capabilities • Firms must ensure that their strategic choices and investment decisions are made within their own risk tolerance limits	• *Life insurance firms*
Funded reinsurance • The PRA has consulted[20] on policy proposals forming part of the PRA's broader strategy to address the risks arising from firms' use of funded reinsurance. The PRA will continue to monitor how market practice evolves and will keep under review whether there is a need for further specific policy measures.	• *Life insurance firms entering into or holding funded reinsurance arrangements as cedants*
Stress testing • The PRA will continue to engage with the industry on the technical, operational and market communication aspects of the exercise, and in 2024 we will look to publish an approach document to LIST 2025.	• *We will notify life firms 12 months ahead of launch if they are in scope*

20 CP24/23 – Funded reinsurance; available at: **www.bankofengland.co.uk/prudential-regulation/publication/2023/november/funded-reinsurance-consultation-paper**, November 2023.

Regulatory reform • The PRA will publish policy statements in respect of CP12/23 and CP19/23 bringing into force new rules appropriate for the UK market. These new rules will take effect by 31 December 2024, giving firms time to make the necessary adjustments. However, we plan to have final policy in place on the MA to enable implementation of HMT's MA provisions by the end of June 2024. This will enable firms to take advantage of the new rules and broaden their investments in the matching adjustment in ways that support the wider UK economy.	• *All firms subject to Solvency II regulations*
General insurance sector, reserving risk	**Impacted Sector**
Cyber underwriting risk • The PRA will focus on ensuring that firms' capital and exposure management capabilities are commensurate to the growth in cyber risk exposure	• *General insurers underwriting cyber risk*
Claims inflation • The PRA will monitor claims inflation through regulatory data collection and in usual supervisory meetings into 2024. Further targeted will be considered, if necessary	• *All general insurance firms*
Model drift • We will follow up with firms identified as exhibiting model drift with targeted use of supervisory tools and actions where appropriate	• *All firms who make use of models, with an immediate focus on general insurers identified as exhibiting model drift*
GIST • The PRA has begun engaging with the industry trade bodies and will provide more details of GIST (including participation, design, and timelines) during the first half of 2024	• *We will notify relevant London Market, retail, and commercial insurers 12 months ahead of launch if they will be in scope*
Other areas of focus	**Impacted Sector**
Financial risks arising from climate risk • Firms must continue to address 'capability gaps', particularly around scenario analysis and risk management. • The PRA will assess firms' compliance with SS3/19 through supervisory engagement, firm-specific deep dives, and thematic work. And we will commence work to update SS3/19 to deepen the granularity of our expectations.	• *All firms*