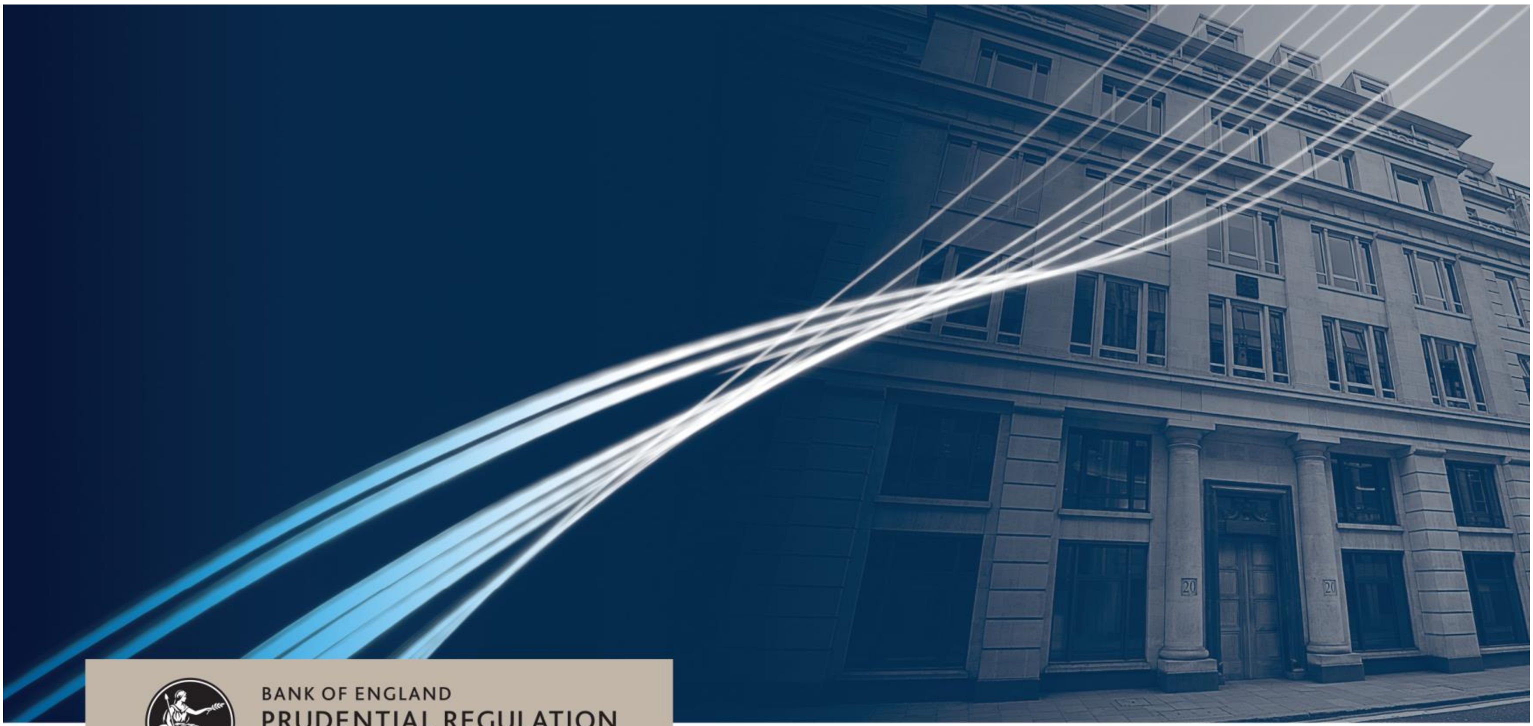

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP42/15

Capital extractions by run-off firms within the general insurance sector

November 2015

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Responses are requested by Wednesday 20 January 2016.

Please address any comments or enquiries to:
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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) proposes a supervisory statement that sets out the PRA's expectation of compliance with prudential provisions in the PRA Rulebook for run-off firms in the general insurance sector.

1.2 The PRA set out its expectations regarding the factors that senior management of general insurance firms in run-off should take into account when considering making a request to the PRA to extract capital from the firm during the course of a run-off in supervisory statement 4/14.[1] This statement also explained the approach the PRA takes when considering such requests.

1.3 The updates proposed to this statement (see Appendix) reflect the changes to the PRA Rulebook that will occur when the new Solvency II and non-Directive firm regimes come into force on 1 January 2016. The updates to this draft statement do not represent a change in PRA policy but do set expectations of how the Own Risk and Solvency Assessment (ORSA) should be used when making decisions about whether to apply for a capital extraction. In particular, the PRA expects that firms will not seek a capital extraction that would bring the level of capital below its overall solvency needs as set out in the firm's ORSA, even if this figure is above the solvency capital requirement. Paragraphs 1.6 to 1.13, 3.4 and 3.5 have been deleted and paragraphs 1.3, 2.2, 3.1 and 3.2 have been updated.

1.4 The proposals are compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA): to promote the safety and soundness of PRA-authorised firms;[2] and in the context of insurance, to contribute to policyholder protection.[3] In particular, the expectations set in the draft supervisory statement should prevent capital extractions that would weaken the level of protection available for remaining policyholders.

1.5 When discharging its general rule-making function, the PRA is legally required, so far as is reasonably possible, to facilitate effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.[4] The PRA does not anticipate that this proposed supervisory statement will have a material effect on competition.

1.6 This draft statement does not represent a change in PRA policy and reflects the changes to the PRA Rulebook that result from the new insurance regimes coming into force. Therefore, the PRA does not expect this statement to give rise to any substantial costs.

1.7 In making its rules and establishing its practices and procedures, the PRA must have regard to the Regulatory Principles as set out in the Financial Services and Markets Act 2000 (FSMA).[5] In particular, the draft statement sets out the PRA's expectations for run-off firms proposing capital extractions and provides information on the PRA review process, ensuring that this process is as transparent as possible. The PRA may not act in an unlawfully discriminatory manner. It is required, under the Equalities Act 2010, to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies,

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1 Capital extractions by run-off firms within the general insurance sector, April 2014, http://www.bankofengland.co.uk/pra/Pages/publications/capitalextractionss.aspx
2 See s.2B(1) and s.2B(2) FSMA.
3 See s.2C FSMA.
4 See s.2H FSMA.
5 See s.2H and s.3B FSMA.

services and functions.[1] The PRA does not consider that the proposed statement gives rise to any equality and diversity proposals.

1.8 FSMA requires that the PRA assesses whether, in its opinion, the impact of the proposed rules on mutuals will be significantly different from the impact on other firms.[2] The PRA does not believe that the proposed statement will have an impact on mutuals that significantly differs from other firms.

1.9 This consultation closes on Wednesday 20 January 2016. The PRA invites feedback on the proposals set out in this consultation and will consider this feedback before issuing a final supervisory statement. Firms should consider the proposals in this draft statement if they consider applying for a capital extraction between 1 January 2016 and the publication of the final statement. Firms should read this statement alongside another PRA supervisory statement — SS3/14: The Prudential Regulation Authority's (PRA's) approach to Schemes of arrangement proposed by PRA-authorised insurers under Part 26 of the Companies Act 2006.[3] Please address any comments or enquiries to CP42_15@bankofengland.co.uk.

1 Equalities Act 2010, section 149(1).
2 Section 138K of FSMA.
3 The Prudential Regulation Authority's (PRA's) approach to Schemes of arrangement proposed by PRA-authorised insurers under Part 26 of the Companies Act 2006, April 2014, http://www.bankofengland.co.uk/pra/Pages/publications/schemesss.aspx

Appendix: draft supervisory statement – Proposed updates to SS4/14 Capital extractions by run-off firms within the general insurance sector

In this appendix, changes to the supervisory statement text in SS4/14 Capital extractions by run-off firms within the general insurance sector are shown in tracked.

Introduction

1.1 The purpose of this statement is to set out the Prudential Regulation Authority's (PRA's) expectation of compliance with existing prudential provisions within the PRA ~~Handbook~~Rulebook for run-off firms in the general insurance sector. It does not represent a substantive change of policy.

1.2 This statement is aimed at general insurance firms in run-off and highlights some factors that the PRA expects the senior management of a run-off firm to take into account when considering making a request to the PRA to extract capital from the firm during the course of a run-off. This statement also explains the approach that the PRA intends to take when considering such requests.

1.3 Insurers must comply with relevant provisions in the PRA ~~Handbook (~~Rulebook including ~~GENPRU 1.2 and INSPRU 7.1),~~the Risk Management chapter of the Conditions Governing Business Part of the PRA Rulebook, which includes requirements to undertake an ~~Individual Capital Assessment (ICA) and to consider future capital needs including in times of stress~~ Own Risk and Solvency Assessment (ORSA). This supervisory statement complements another PRA supervisory statement — SS3/14: The Prudential Regulation Authority's (PRA's) approach to Schemes of arrangement proposed by PRA-authorised insurers under Part 26 of the Companies Act 2006 and the two should be read together for general insurers in run-off.

1.4 This supervisory statement provides additional clarification of the PRA's expectations of firms in respect of these existing requirements. Its purpose is to explain the PRA's expectations that:

- firms in run-off hold sufficient regulatory capital to continue to meet their obligations to policyholders as they fall due; and
- firms satisfy themselves and the PRA that this remains the case after a proposed capital extraction.

1.5 This statement expands on the PRA's general approach as set out in its Approach Document,[1] and is designed to help ensure the PRA meets its statutory objectives of ensuring safety and soundness of the firms it regulates and securing an appropriate degree of protection for policyholders.

Paragraphs 1.6 to 1.13 have been deleted.

~~Consultation feedback~~

1 The Prudential Regulation Authority's approach to insurance supervision is available at http://www.bankofengland.co.uk/pra/Pages/supervision/approach/default.aspx

~~1.6 The PRA has consulted on this statement.[1] Thirteen responses were received.~~

~~1.7 Some respondents expressed concern that the 200% cover of ICA/ICG quoted in the Consultation Paper (CP) was characterised as a relatively low level of cover. There was also a degree of confusion regarding the use of ICA/ICG in this context. The PRA accepts that whether a 200% ratio represents a 'relatively low' level of cover can only be assessed on a case-by-case basis and the statement now reflects this. Similarly to avoid confusion, and in the context of the above, cover is now expressed as a percentage of ICA.~~

~~1.8 Some respondents questioned whether the statement intended to set out an expectation that all general insurers in run-off should hold such a level of capital at all times. While the statement is intended for all firms within this sector, it is specifically concerned with the PRA's expectations of capital buffer for those general insurers in run-off that wish to extract capital. The level, as set out in this statement, is a key factor in determining the PRA's approach when dealing with requests for capital extractions by general insurers in run-off.~~

~~1.9 A number of respondents opined that the statement may have implications for the future of the run-off sector in that it may deter future investment or lead to the disappearance of the skills and experience required to service ongoing run-offs. It was also suggested that such developments could be detrimental to insurers still accepting new business (and to their policyholders) if there is no other option than to continue running the legacy book 'in-house'. The PRA acknowledges these views. The supervisory statement supports the PRA's statutory objectives by clarifying the existing policy positions. We do not anticipate that there would be a material effect on competition.~~

~~1.10 Several respondents asked whether the PRA will produce a generic scoping document for independent reviews; similarly there were a number who requested pre-defined timelines for the PRA to complete its reviews once a request for a capital extraction is submitted.~~

~~The PRA intends to treat each request on its own merit. If the PRA requires an independent review under s.166 of the Financial Services and Markets Act 2000 (FSMA), then the appropriate scope for the review will be provided at that time. Producing an ICA is the responsibility of the firm. The time taken for the PRA to review each submission depends on several factors, including the quality and content of the submission.~~

~~1.11 A number of respondents challenged the assertion that a lack of policy data makes it more difficult to estimate potential future claims with a high degree of accuracy. These opinions mare noted; however the statement does not specify that a lack of policy data is a feature of all firms within the sector. The individual circumstances of each firm will be taken into account when reviewing a request to extract capital.~~

~~1.12 A few respondents asked for the statement to clarify how the PRA expects firms to consider Solvency II capital requirements when carrying out a future capital projection for the next three to five years. The PRA acknowledges this request and reminds firms that they consider all capital requirements when preparing projections of likely capital resources.~~

~~Obligations on firms relating to the adequacy of financial resources~~

~~[1] www.bankofengland.co.uk/pra/Documents/publications/policy/2013/capitalextractions.pdf.~~

~~1.13 The PRA holds senior management of firms responsible for ensuring that their firms maintain overall financial resources which are adequate (in both quality and quantity) at all times. In meeting this requirement, insurers must comply with relevant provisions in the PRA Handbook (including GENPRU 1.2 and INSPRU 7.1), which include requirements to undertake an ICA and to consider future capital needs including in times of stress. This supervisory statement does not introduce any new policy requirements, but provides additional clarification on the PRA's expectations of firms in respect of existing requirements.~~

Background to capital extraction requests

1.14 General insurance firms in run-off occasionally approach the PRA with requests to extract capital. The PRA recognises that this may be a legitimate request in certain circumstances, for example where claims estimates have developed favourably over a long period, and where significant levels of surplus regulatory capital have been generated.

1.15 However, capital extractions during the life of a run-off inevitably weaken the level of protection available for remaining policyholders. This is of particular concern for the PRA in respect of firms in run-off, since these firms, compared to other insurers, may have more limited access to further capital, and often have fewer management actions available to them to restore capital levels if the need subsequently arises. For example, the financial position of run-off firms can be adversely affected by unexpected reserve deterioration as new risks emerge, or through changes in the expected frequency or severity of known risks. In addition, the historic policy data available to some run-off firms can be incomplete, making it more difficult to estimate potential future claims with a high degree of accuracy.

2 PRA expectations of run-off firms proposing capital extractions

2.1 The PRA expects senior management and boards of run-off firms to assess carefully the level of capital required on an ongoing basis to ensure that the firm can run-off their business in an orderly fashion, including under adverse conditions. If a firm in run-off wishes to extract capital during the course of a run-off, the PRA expects the firm's board and senior management to consider such proposals carefully and to be satisfied that ~~solvency levels~~ the financial position after the proposed extraction will still remain adequate for the duration of the run-off.

2.2 Where a run-off firm wishes to undertake a capital extraction, the PRA expects the firm first to take the following steps:

(a) The firm should undertake a thorough review of its capital position in order to assess the adequacy of its ~~solvency~~ financial position after the proposed extraction. ~~This~~For firms subject to the requirements of Solvency II (Solvency II firms), this analysis should include a review of the firm's Solvency ~~I Minimum~~ Capital Requirement (~~MCR~~SCR) and ~~an up-to-date ICA.~~ its overall solvency needs as required for inclusion in a firm's ORSA. In assessing its capital needs, a firm should take into account relevant factors such as:

(i) any restrictions on availability of capital; and

(ii) the quality of the policy records it holds and how this might impact its ability to estimate potential future claims, and make allowance for these factors as appropriate. The firm should also consider as far as reasonably practicable how its ~~solvency~~financial position might change in the future~~ following the implementation of Solvency II~~.

(b) As well as assessing its current ~~ICA~~capital needs, the firm should consider the expected future progress of the run-off of the business, including as a minimum over the next 3–5 years, based on realistic assumptions on relevant factors such as claims, reserve development and investment income, and taking into account any other expected changes in the business. These assumptions should reflect the firm's experience during the run-off to date, and be consistent with the firm's business plans. The firm should use this information to prepare a projection of its likely capital resources, ~~MCR~~ and ~~ICA~~capital requirement (ie SCR for Solvency II firms) over this future period. For Solvency II firms, the projection should also incorporate the forward looking computation of its overall solvency needs over a 3-5 year period. The firm should also consider plausible downside risks to these projections and show the possible effects of these scenarios on the future capital position.

(c) The firm should seek Board approval for the capital extraction proposal, having taken into account the results of the ~~ICA~~capital review, the future projections referred to above, and any other relevant information. The PRA expects a firm's Board to approve a capital extraction proposal only if the Board is satisfied that the firm will be able to maintain adequate financial resources after the proposed extraction — including that it would expect to continue to meet its ~~MCR~~capital needs, (including the SCR and ~~ICA~~overall solvency needs for Solvency II firms) at all times over a 3–5 year period, including in the event of a change in the stress scenario.

3 PRA review process

3.1 The PRA expects firms to request its views at an early stage and ensure that any concerns it may have in relation to a proposed capital extraction are properly addressed before the proposal is implemented~~ and to request its views at an early stage~~. Any request to the PRA should be made by ~~an approved person~~the CEO or CFO of the firm and confirm that the Board has approved the proposal having considered all the factors outlined in this statement.

3.2 Alongside its request, the firm should provide the PRA with a copy of ~~its latest ICA review and a copy of~~ the analysis submitted to its Board showing the projected evolution of the ~~MCR~~financial resources and capital needs and ~~ICA~~requirements, and the downside risks to this position. Solvency II firms should also provide a copy of the firm's most recent ORSA.

3.3 Where a firm has commissioned any independent actuarial review of its analysis, or other relevant factors such as an analysis of the adequacy of its policy records, it should make the PRA aware of this. The PRA may request copies of this analysis from the firm as part of its assessment of the capital extraction request. Where a firm has not already done so, the PRA may consider asking a firm to commission an independent review to provide assurance on the data underlying the request or the robustness of the analysis undertaken by the firm — for example, covering the actuarial assumptions used or the completeness and accuracy of the firm's policy records. The PRA may be more likely to request such an opinion where, for example~~, a capital extraction request is~~:

- a capital extraction request is significant in size;
- where the proposed extraction results in ~~a~~the projected ~~coverage over~~ financial resources in a ~~firm's ICA of~~stressed scenario being less than ~~200%;~~either its overall solvency needs or SCR; and
- where it has concerns about the ~~robustness~~accuracy of the firm's data or analysis.

Paragraph 3.4 has been deleted.

~~Once the PRA has reviewed this information, it may issue the firm with Individual Capital Guidance (ICG) specifying the amount of and quality of capital that it considers appropriate for the firm to hold in order for the firm to maintain adequate financial resources. If the PRA judges that the level of capital implied by the firm's ICA is not appropriate, or does not reflect some of the uncertainties faced by run-off firms, it may require a higher amount of capital to be held. For a run-off firm, the PRA would typically expect to express ICG as a fixed amount of capital to be held against the remaining risks faced by the firm.~~

~~The PRA expects firms to hold capital above the level of ICA/ICG at all times, or above the MCR if higher, in order for firms to be confident that they meet the requirement to hold adequate financial resources.~~

Paragraph 3.4A has been inserted.

3.4A The PRA expects Solvency II firms to seek to hold capital to manage and mitigate the risks identified in the ORSA and capital extractions should be considered accordingly. The PRA will not expect Solvency II firms to seek capital extractions which would bring the level of capital below its overall solvency needs as set out in the firm's ORSA, even if this figure is above the SCR.

Paragraph 3.5 has been deleted.

Paragraph 3.6 has been inserted.

3.6 In considering whether to give approval to a proposed capital extraction, the PRA will take into account: the firm's capital position immediately after the proposed extraction; the firm's projections of its financial position including over a 3–5 year period; the appropriateness of the assumptions underlying these projections; the possible downside risks to these projections; and any other information that the PRA deems to be relevant.