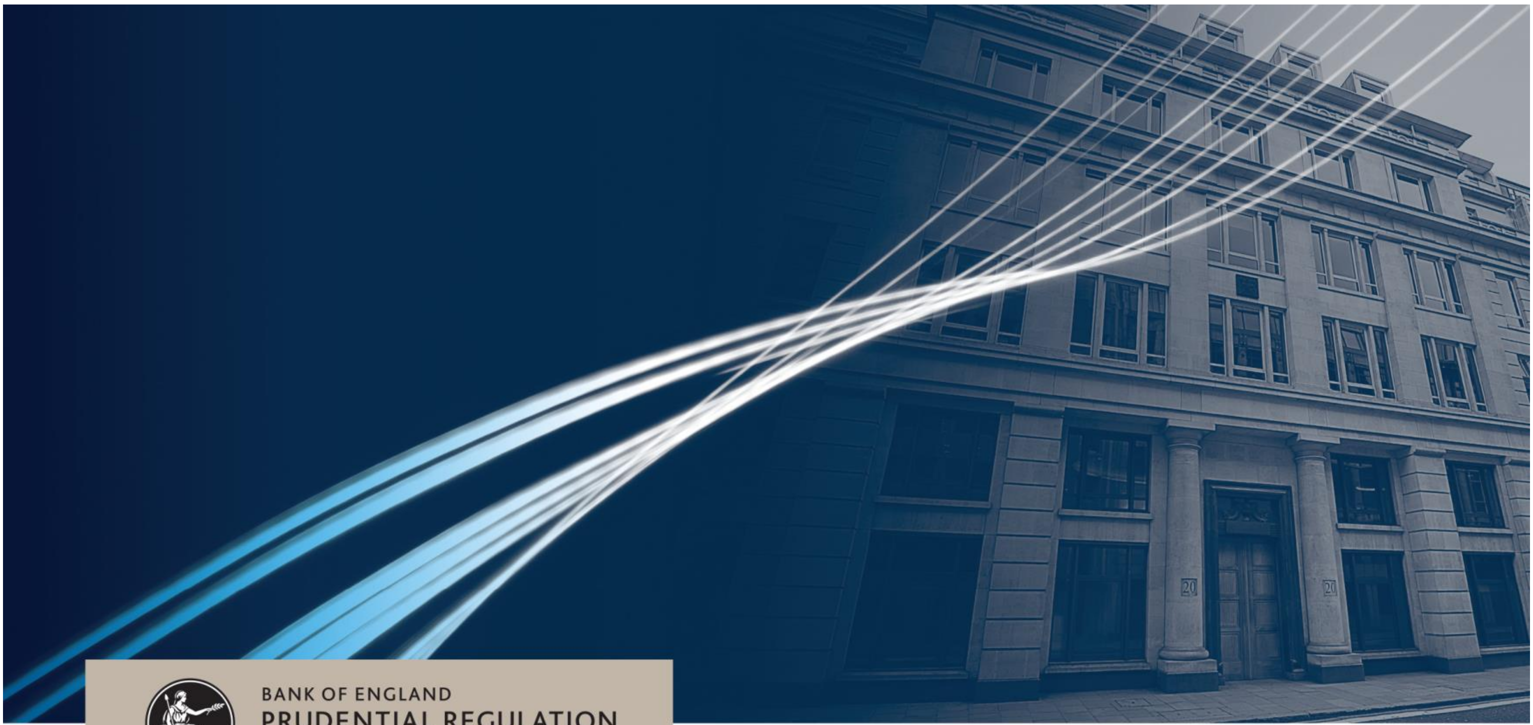

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP23/17

Financial management and planning by insurers

November 2017

Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

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Responses are requested by Friday 9 February 2018.

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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) seeks views on a draft supervisory statement (SS) (see Appendix) on effective financial management and planning by insurance firms and groups.

1.2 This CP is relevant to all UK insurance firms, and groups, in scope of the Solvency II Directive, and to the Society of Lloyd's and managing agents ('insurers').

1.3 The purpose of these proposals is to set out how the application of effective risk management and governance may be linked together with the need for insurers to maintain a sound financial condition going forward, by issuing an SS setting out the PRA's expectations on financial management and planning by insurers.

1.4 The PRA considers that effective financial management and planning is especially important for those insurers with a high risk appetite, and for those insurers with capital levels that may fluctuate significantly.

1.5 As explained in 'The PRA's approach to insurance supervision'[1] the PRA expects to see proper board scrutiny and challenge at an insurer of the ongoing financial management of the insurer, including the sustainability of its capital management and dividend policies, in the context of its risk appetite.

1.6 The draft SS is drafted in the context of the Conditions Governing Business and Investments Parts of the PRA Rulebook, and Articles 258 – 267 of the Commission Delegated Regulation (EU) 2015/35. It would sit alongside 'The PRA's approach to insurance supervision'; SS41/15 'Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines';[2] SS5/16 'Corporate Governance: Board responsibilities';[3] SS19/16 'Solvency II: ORSA';[4] and SS5/17 'Dealing with a market turning event in the general insurance sector'.[5]

1.7 This draft SS is intended to complement existing policy material, rather than to set any new expectations on governance or risk management for insurers. The PRA considers that most insurers will already be meeting the expectations set out in this draft SS.

1.8 The PRA considers that setting out its expectations around financial management and planning by insurers, will enable firms to interpret the PRA's rules and meet its expectations. It will also help to support and reinforce the approach that has been taken by insurance supervisors to their review of financial management and planning by insurers.

1.9 The draft SS confirms that the PRA no longer normally expects insurers (other than those insurers in run-off) to ask for the PRA's non-objection to dividends, provided the insurer is within risk appetite; the proposed dividend leaves its capital position within risk appetite, and likely to remain so; and the insurer's Solvency Capital Requirement (SCR) coverage ratio is above 100%.

1 March 2016: www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
2 October 2015: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss4115.aspx.
3 March 2016: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss516.aspx.
4 November 2016: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1916.aspx.
5 July 2017: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss517.aspx.

Responses and next steps

1.10 This consultation closes on Friday 9 February 2018. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP23_17@bankofengland.co.uk.

2 Proposals

2.1 The draft SS in the Appendix to this CP sets out the PRA's expectations for financial management and planning by insurers. These include the framework for the development and maintenance of a risk appetite statement by an insurer, the application of this risk appetite to an insurer's business and financial plans, and the assessment of the suitability and sustainability of capital distribution plans in the context of this risk appetite.

Risk appetite statement

2.2 The PRA proposes in paragraph 2.2 of the draft SS that as part of their governance and risk management arrangements, insurers should have a risk appetite that is approved by the board, and documented in clearly understandable terms in a risk appetite statement.

2.3 Further, the PRA proposes that the risk appetite statement should include the:

- risk tolerance limits (ie the limits on the amount of risk) that have been set for the various types of risk that the insurer is willing to bear (paragraph 2.5 of the draft SS); and

- levels of capital that are expected to be maintained in reasonably foreseeable market conditions, taking into account a number of relevant specific factors (eg sensitivity of the balance sheet to changes in the key risk drivers) (paragraph 2.3 of the draft SS). The PRA also proposes that the risk appetite statement includes the insurer's appetite for the level and volatility of future dividend payments that it would be willing to make (paragraph 2.4 of the SS).

2.4 Any significant change to an insurer's risk appetite should only be made by the board following an overall discussion on the risks and capital requirements of the business. The PRA proposes that the risk appetite is not changed solely to justify the assumption of a new risk, a change in investment policy, or a dividend payment (paragraph 2.6 of the draft SS).

2.5 The level of detail to be included in the risk appetite statement should be commensurate with the nature, scale and complexity of the risks borne by the insurer (paragraph 2.7 in the SS).

2.6 The PRA proposes that the risk appetite statement is communicated appropriately within the insurer, so as to set a framework for the management and reporting of relevant risks that can be clearly understood by individuals performing key functions at the insurer (paragraph 2.8 of the draft SS).

Business and financial plans

2.7 In the draft SS, the PRA proposes, as part of effective financial management and planning, that insurers should have business plans that are consistent with their risk appetite and risk tolerance limits. The PRA proposes that insurers should:

- identify and understand the drivers of the insurer's profitability, and potential balance sheet volatility, together with the significant risks relating to its business plans. They should have plans for the maintenance of capital resources in line with their risk appetite (paragraph 3.1 of the draft SS);

- maintain regular management information (MI), and provide this to both relevant senior managers and the board, to show how the insurer is performing against its plans (paragraphs 3.2 and 3.3 of the draft SS); and

- consider how they will address the risks and vulnerabilities to their business plans consistently with their risk appetite (paragraphs 3.4 and 3.5 of the draft SS).

2.8 The PRA proposes that insurers address risks to their business strategy and plans through their Own Risk and Solvency Assessment (ORSA), and through the development of appropriate plans and management actions for managing the ongoing levels of capital resources within the business, in line with the insurer's risk appetite (paragraph 3.6 of the draft SS).

2.9 The PRA also proposes that insurers develop planned management actions in response to stress scenarios that are realistic, credible, consistent with regulatory expectations, and achievable; and consider suitable trigger points for these planned management actions (paragraphs 3.7 to 3.9 of the draft SS).

Dividend suitability and sustainability

2.10 In the draft SS, the PRA proposes, as part of effective financial management and planning, that insurers should be able to demonstrate that any planned dividend payments are appropriate in relation to actual and projected business performance, as well as the current and future capital position of the insurer, taking account of its documented risk appetite (paragraphs 4.1-4.3 of the SS).

2.11 PRA supervisors may review the sustainability of insurers' capital management and dividend policies as part of regular supervision, and may take a particular interest in this sustainability for insurers which operate with capital levels that are close to the SCR or which fluctuate unexpectedly (paragraph 4.4 of the SS).

2.12 If an insurer's capital management policies are calibrated such that frequent or foreseeable breaches of SCR occur or are likely to occur, the PRA may consider whether the insurer is meeting the requirements in Conditions Governing Business 2.1. Similarly, if the level of capital of an insurer regularly or persistently falls outside of its risk appetite, or an insurer makes frequent changes to its risk appetite for its planned levels of capital, the PRA may consider whether this indicates failings in the governance process by which the insurer sets its risk appetite (paragraph 4.5 of the SS).

3 The PRA's statutory obligations

3.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA)[1] to consult when setting its general policies and practices. In doing so, it is required to comply with several statutory and public law obligations. The PRA meets these obligations by providing the following in its consultations:

- a cost benefit analysis;

1 Section 2L of FSMA.

- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective,[1] insurance objective[2] (if applicable), and secondary competition objective;[3]
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles;[4] and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[5]

3.3 The PRA is also required by the Equality Act 2010[6] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.4 The PRA does not expect the proposals to add to the compliance costs already identified in relation to the rules to which the guidance relates. The guidance is intended not to add to the benefits associated with the rules (identified in the corresponding Financial Services Authority (FSA) CP for the rules)[7] but to increase the likelihood of their being realised. The benefit of these proposals is that firms will be better able to interpret the PRA's rules and meet its expectations.

Compatibility with the PRA's objectives

3.5 The final SS would set out clearly the PRA's expectations around financial management and planning by insurers. In particular, it would set out the PRA's expectations around the assessment of the affordability and sustainability of dividends by insurers.

3.6 This would then enable the PRA to further its objectives to promote the safety and soundness of insurers, and contribute to the protection of current and future policyholders, through ensuring that insurers are managing their ongoing financial position with properly developed and tested financial plans.

3.7 The final SS would also be compatible with the PRA's secondary objective of facilitating effective competition, as it would help to ensure that insurers operate under comparable standards of financial and risk management, which have regard to the need to maintain an adequate financial position, and would not materially increase barriers to entry or exit from responsible insurers.

Regulatory principles

3.8 The PRA considers that the proposals have regard to the regulatory principle that a firm's senior management is responsible for the firm's activities and for ensuring that its business

1 Section 2B of FSMA.
2 Section 2C of FSMA.
3 Section 2H(1) of FSMA.
4 Sections 2H(2) and 3B of FSMA.
5 Section 30B of the Bank of England Act 1998.
6 Section 149.
7 FSA CP11/22 'Transposition of Solvency II', November 2011; www.fsa.gov.uk/pubs/cp/cp11_22.pdf.

complies with regulatory requirements, though setting out some general expectations around financial management and planning by firms themselves. In addition, the principle that the PRA should use its own resource in the most economic and efficient way is met through setting out publicly the PRA's clear expectations for all insurers with which their senior management can then engage.

Impact on mutuals

3.9 In the PRA's opinion, the impact of the proposed policy changes on mutuals is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

3.10 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.[1]

3.11 The PRA considers that three of these aspects are of particular relevance to these proposals, namely:

- The PRA believes that the proposals setting out its expectations on proper financial management and planning by insurers will help to ensure the robustness of these insurers and the resilience of the financial system in the United Kingdom, which could help to sustain the reputation of London as a leading international financial centre.

- The PRA considers that the proposals are consistent with delivering better outcomes for consumers, through ensuring that insurers are fully cognisant of the PRA's expectations on their financial planning, and against which the PRA can take actions to address any weaknesses identified in insurers' risk management and governance.

- The PRA considers that the proposals will not hamper innovation in the financial services sector, as insurers will be able to develop their own business models within a clearly articulated framework to manage their ongoing financial soundness, taking account of their own risk appetite and risk profile.

Equality and diversity

3.12 The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

1 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at www.bankofengland.co.uk/about/Pages/people/prapeople.aspx.

Appendix – Draft supervisory statement 'Financial management and planning by insurers'

1 Overview

1.1 This supervisory statement (SS) is addressed to all UK firms and groups that fall within the scope of the Solvency II Directive ('the Directive'), and to the Society of Lloyd's and its managing agents (collectively called 'insurers' in this SS), and sets out the PRA's expectations concerning:

(a) the development and maintenance of a risk appetite statement by insurers;

(b) how insurers apply their risk appetite when developing and monitoring their medium term business and financial plans; and

(c) the assessment of the suitability and sustainability of capital distribution plans in the context of this risk appetite.

1.2 This SS should be read in conjunction with:

- the Conditions Governing Business and Investments Parts of the PRA Rulebook;
- Articles 258 – 267 of the Commission Delegated Regulation (EU) 2015/35;
- the 'PRA's approach to insurance supervision';[1]
- SS41/15 'Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines';[2]
- SS5/16 'Corporate Governance: Board responsibilities';[3]
- SS19/16 'Solvency II: ORSA';[4] and
- SS5/17 'Dealing with a market turning event in the general insurance sector'.[5]

2 Risk appetite statement

2.1 For the purpose of this SS, the 'risk appetite' is intended to mean the amount and type of risk that an insurer is willing to take in order to meet its strategic objectives.

2.2 The PRA expects an insurer's risk appetite to be approved by the board, and to be documented in clearly understandable terms by insurers in a risk appetite statement, along with the rationale for the terms in which the risk appetite is expressed, and for how this appetite has been determined. The PRA expects the insurer's risk appetite statement to identify the reasonably foreseeable circumstances under which the statement might be

1 March 2016: www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
2 October 2015: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss4115.aspx.
3 March 2016: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss516.aspx.
4 November 2016: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1916.aspx.
5 July 2017: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss517.aspx.

reviewed and changed. Any revision to this statement is expected to be signed off by the board.

2.3 This statement is expected to include the risk appetite for the levels of capital that are to be maintained in reasonably foreseeable market conditions (eg a 1 in x probability that Solvency Capital Requirement (SCR) coverage will fall below 100%). This appetite is expected to take into account factors such as the following, where relevant:

- sensitivity of the balance sheet to changes in the key risk drivers, including changes in market and underwriting conditions, and the emergence of large claims;
- non-linearities and discontinuities that may arise in the balance sheet due to combinations of adverse events and the potential loss of matching adjustment (MA)or volatility adjustment (VA) approval in stress scenarios;
- quality of capital resources;
- inherent uncertainty in the technical provisions (including in the application of the MA or transitional measure on technical provisions (TMTP)), risk margin, the value of any illiquid assets, and the SCR, due to limitations and approximations in the insurer's regular solvency monitoring;
- levels of uncertainty in forecast earnings;
- the results of stress and scenario testing (including reverse stress testing);
- capital levels that are considered to be required to maintain credit ratings and market reputation;
- potential impact of firm failure on policyholders (including substitutability of insurance cover); and
- recovery options that may be available to the insurer, including consideration of when each option may not be available.

2.4 The PRA also expects the statement to include the insurer's appetite for the level and volatility of future dividend payments that it would be willing to make, in the context of: (a) its financial and business plans; (b) the levels of capital held by the insurer; and (c) the volatility of its earnings.

2.5 The statement should encompass all the material risks that are relevant to the insurer, including those listed in Conditions Governing Business 3.1(2)(c). It should include the risk tolerance limits (ie the limits on the amount of risk) that have been set for the various types of risk (including market risk, underwriting risk, operational risk and liquidity management risk) that the insurer is willing to bear. Many of these limits are likely to be expressed in quantitative terms, but the appetite for some types of risk (eg reputational risk) may be expressed qualitatively.

2.6 Any significant change to an insurer's risk appetite should only be made by the board following an overall discussion on the risks and capital requirements of the business. The PRA does not expect the risk appetite to be changed solely to justify the assumption of a new risk, a change in investment policy, or a dividend payment.

2.7 The level of detail to be included in the risk appetite statement should be commensurate with the nature, scale and complexity of the risks borne by the insurer.

2.8 The PRA expects this risk appetite statement to be communicated appropriately within the insurer, so as to set a framework for the management and reporting of relevant risks that can be clearly understood by individuals performing key functions at the insurer, and to be expressed in sufficient detail to be clearly relevant to them.

3 Business and financial plans

3.1 The PRA expects insurers to have business plans that are consistent with their risk appetite and risk tolerance limits, and which show how they intend to generate revenue and earnings each year. Such plans should reflect achievable capital generation and a capacity for dividend payouts in accordance with their risk appetite. Insurers should identify and understand the drivers of their profitability, and potential balance sheet volatility, together with the significant risks relating to their business plans, and consider reasonably foreseeable adverse scenarios. Insurers should have plans for the maintenance of capital resources in line with their risk appetite, that take account of each of these factors, as well as the insurer's intended levels and mix of business growth.

3.2 The PRA expects regular management information (MI) to be maintained, and provided to both relevant senior managers and the board, to show how the insurer is performing against its plans. Frequency of MI generation should reflect the volatility of drivers of capital surplus and calculations should, if approximate, reflect the main drivers well enough to provide useful information to management.

3.3 The PRA expects this MI to include information about whether any deviation from these plans is, and is likely to continue to be, over the planning timescale, within its risk appetite and/or risk tolerance limits. Any material deviations that are not within appetite should result in timely action to limit the insurer's exposures to the relevant risks, as well as revision to the business and financial plans to bring these in line with its risk appetite.

3.4 The PRA expects insurers to consider how they will address the risks and vulnerabilities to their business plans consistently with their risk appetite, including through an appropriate allocation of capital and through their risk management framework and controls.

3.5 As explained in more detail in SS5/17, the PRA expects general insurance firms, along with insurance composites and groups undertaking general insurance business to consider in advance, in a proportionate manner, the possible implications of a MTE on their business, including what steps might reasonably be taken in advance to enable them to respond appropriately and to meet their regulatory obligations.

3.6 The insurer's Own Risk and Solvency Assessment (ORSA) should help to ensure there are effective links between an insurer's business plan, risk appetite, and capital management plans. Chapters 5 and 6 in SS19/16 provide further detail around how insurers are expected to address risks to their business strategy and plans through their ORSA, and through the development of appropriate plans and management actions for managing the ongoing levels of capital resources within the business.

3.7 The PRA expects insurers and groups to develop planned management actions in response to stress scenarios that are realistic, credible, consistent with regulatory expectations, and achievable. These should be approved by their boards. They should also consider whether any of the actions identified should be taken in advance as precautionary measures, or whether they would be relevant or desirable only in the stress scenario.

3.8 The PRA expects insurers to understand any dependencies for the implementation of the planned management actions on third parties or external market conditions, and actively monitor those dependencies so that the effectiveness of those actions is not undermined. Insurers should consider suitable trigger points for their planned management actions.

3.9 Any planned reliance by an insurance firm on support from its group should be assessed carefully to consider whether such support would be readily available, taking account of: (a) the potential effect of any stressed conditions on the group as a whole, as well as on other individual members of the group; (b) the group's likely appetite to provide such support; and (c) any other potential barriers to the provision of such support (eg legal or regulatory requirements, or practical difficulties in transferring funds between currencies or countries).

4 Dividend suitability and sustainability

4.1 When assessing potential dividend payments,[1] the PRA expects insurers to be able to demonstrate that any planned dividend payments are appropriate in relation to actual and projected business performance, as well as the current and future capital position of the insurer, taking account of its documented risk appetite.

4.2 For this purpose, the PRA expects insurers to consider whether the level of their capital resources held following payment of a planned dividend would be in line with the insurer's risk appetite; and to have a dividend policy that takes account of the sources of the insurer's earnings and their sustainability, as well as how the dividend is likely to be adjusted in the event of adverse financial performance by the insurer that could result either from adverse market (or other external) conditions, or from insurer-specific issues.

4.3 Accordingly, it will be important for insurers to consider the level, timing, and source of capital generation, including whether it comes from new business, the back book or one-off management actions, and hence to consider the longer term implications of their dividend policies, including whether future dividends could be supported by future capital generation. Insurers are expected to have suitable MI to inform this analysis.

4.4 The PRA would not normally expect insurers (other than insurers in run-off) to seek the PRA's pre-approval of dividends provided: the insurer is within risk appetite; the dividend payment leaves the insurer's capital position within risk appetite and it is likely to remain so; and the insurer's SCR coverage is above 100%. PRA supervisors may wish to review the sustainability of insurers' capital management and dividend policies as part of regular supervision, and may take a particular interest for insurers that operate with capital levels that are close to the SCR or which fluctuate unexpectedly.

4.5 If an insurer's capital management policies are calibrated such that frequent or foreseeable breaches of SCR occur or are likely to occur, the PRA may consider whether the insurer is meeting the requirement in Conditions Governing Business 2.1 to have in place an 'effective system of governance which provides for sound and prudent management of its business'. Similarly, if the level of capital of an insurer regularly or persistently falls outside of its risk appetite, or an insurer makes frequent changes to its risk appetite for its planned levels

1 This would include here the assessment made for distributions to any capital providers, or for a loan to a parent or holding company.

of capital, the PRA may consider whether this indicates failings in the governance process by which the insurer sets its risk appetite.