Supervisory Statement | SS4/18

Financial management and planning by insurers

November 2024

(Updating May 2018)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Contents

1 Introduction

1.1 This supervisory statement (SS) is addressed to all UK Solvency II firms, including in the context of provisions relating to Solvency II groups, mutual, third-country branches, and to the Society of Lloyd's and its managing agents (collectively referred to as 'insurers'), 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;[1]
- the 'PRA's approach to insurance supervision';[2]
- SS41/15 'Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines';[3]
- SS5/16 'Corporate Governance: Board responsibilities';[4]
- SS19/16 'Solvency II: ORSA';[5]
- SS4/17 'Cyber insurance underwriting risk';[6] and
- SS5/17 'Dealing with a market turning event in the general insurance sector'.[7]

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 terms that are clearly understandable 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 reviewed and changed. Any revision to this statement is expected to be signed off by the board.

1 Conditions Governing Business Part: www.prarulebook.co.uk/rulebook/Content/Part/212969 & Investment Part: www.prarulebook.co.uk/rulebook/Content/Part/212926
2 www.bankofengland.co.uk/prudential-regulation/supervision.
3 November 2024: www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-applying-eiopa-set2-system-of-governance-and-orsa-guidelines-ss.
4 November 2024: www.bankofengland.co.uk/prudential-regulation/publication/2016/corporate-governance-board-responsibilities-ss.
5 November 2024: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-orsa.
6 November 2024: www.bankofengland.co.uk/prudential-regulation/publication/2017/cyber-insurance-underwriting-risk-ss.
7 November 2024: www.bankofengland.co.uk/prudential-regulation/publication/2017/dealing-with-a-market-turning-event-in-the-general-insurance-sector-ss.

2.3 The insurer's risk appetite statement is expected to include the risk appetite for the levels of capital that are to be maintained in reasonably foreseeable market conditions (eg as assessed through stress and scenario tests, or through some suitable alternative approach, to provide no more than a 1 in X probability that Solvency Capital Requirement (SCR) coverage might 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 risk appetite statement to include, in a proportionate manner, the insurer's appetite for the level and volatility of future dividend payments that it would be willing to make, in the context of, among other things: (a) its financial and business plans; (b) the levels of capital held by the insurer; and (c) the volatility of its earnings.

2.5 Syndicates at Lloyd's may have mixed capital, and will share in the Lloyd's Central Fund. In addition, they are structured as annual ventures. As a result, alternative considerations may be relevant, but the PRA expects such considerations to reflect the spirit of the above issues as appropriate.

2.6 The risk appetite statement should encompass all the material risks that are relevant to the insurer, including those listed in Conditions Governing Business 3.1(2)(c) that are considered to be material. 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.

2.7 The PRA expects any significant change to an insurer's risk appetite only to be made by the board following an overall discussion on the risks and capital requirements of the business. Most insurers review their strategy and business plans on an annual basis, in the context of the insurer's risk profile, a process which inherently includes reviewing the risk appetite, and a review may also be appropriate following some major external event. The PRA does not however expect the risk appetite to be changed solely to justify, or regularise, particular actions, such as the assumption of a new risk, a change in investment policy, or a dividend payment.

2.8 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.

2.9 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.

2.10 The PRA expects communications to external stakeholders, such as shareholders/capital providers, customers and their agents, rating agencies, and regulators, to be consistent with the risk appetite statement.

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 appropriately timed action to limit the insurer's exposures to the relevant risks, as well as revisions 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,[1] the PRA expects general insurance firms, along with insurance composites and groups undertaking general insurance business to consider in

1 See footnote 6, page 5.

advance, in a proportionate manner, the possible implications of a 'market turning event' 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[1] provide further detail on 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 identify and analyse potential management actions, in response to stress scenarios, that are realistic, credible, consistent with regulatory expectations, and achievable. The potential management actions and the analysis of them should be approved by the relevant board. Insurers should also consider whether any of the actions identified should be taken (or facilities established) 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 their identified management actions on third parties or external market conditions, and monitor those dependencies so that the effectiveness of those actions is not undermined.

3.9 Insurers should consider the circumstances under which their identified management actions might be applied. In particular, they should consider and establish suitable trigger points at which they would intend to implement any planned management actions that they take into account in the calculation of their technical provisions or the SCR.

3.10 Any planned reliance by an insurance firm on support from its group should be assessed carefully, after consultation with the group board, 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,[2] 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. In this context, insurers are also expected to consider how the dividend may be adjusted in the event of adverse financial performance by the insurer that

1 See footnote 4, page 5.
2 This would include here the assessment made for distributions to any capital providers, including for a return of premiums to the members of a mutual, or for a loan to a parent or holding company.

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 for example 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%. However, the PRA expects to be informed in advance where a firm is close to risk appetite, or where a proposed dividend would take a firm close to risk appetite. 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 of capital, the PRA may consider whether this indicates failings in the governance process by which the insurer sets its risk appetite.

Appendix: SS4/18 updates

This appendix details the changes that were made to this SS following its initial publication.

15 November 2024

This SS has been updated alongside the publication of Policy Statement (PS) 15/24 - Review of Solvency II: Restatement of assimilated law.[1] This includes updating all previous references to the Commission Delegated Regulation (EU) 2015/35 so as to now refer to the relevant rule(s) in the PRA Rulebook. In addition, the following changes were made:

- amendments to paragraph 1.1: updating cross-reference in the SS scope to terms, including defined the PRA Rulebook Glossary; and

- minor formatting and correcting broken links in footnotes.

1 www.bankofengland.co.uk/prudential-regulation/publication/2024/november/review-of-solvency-ii-restatement-of-assimilated-law-policy-statement.