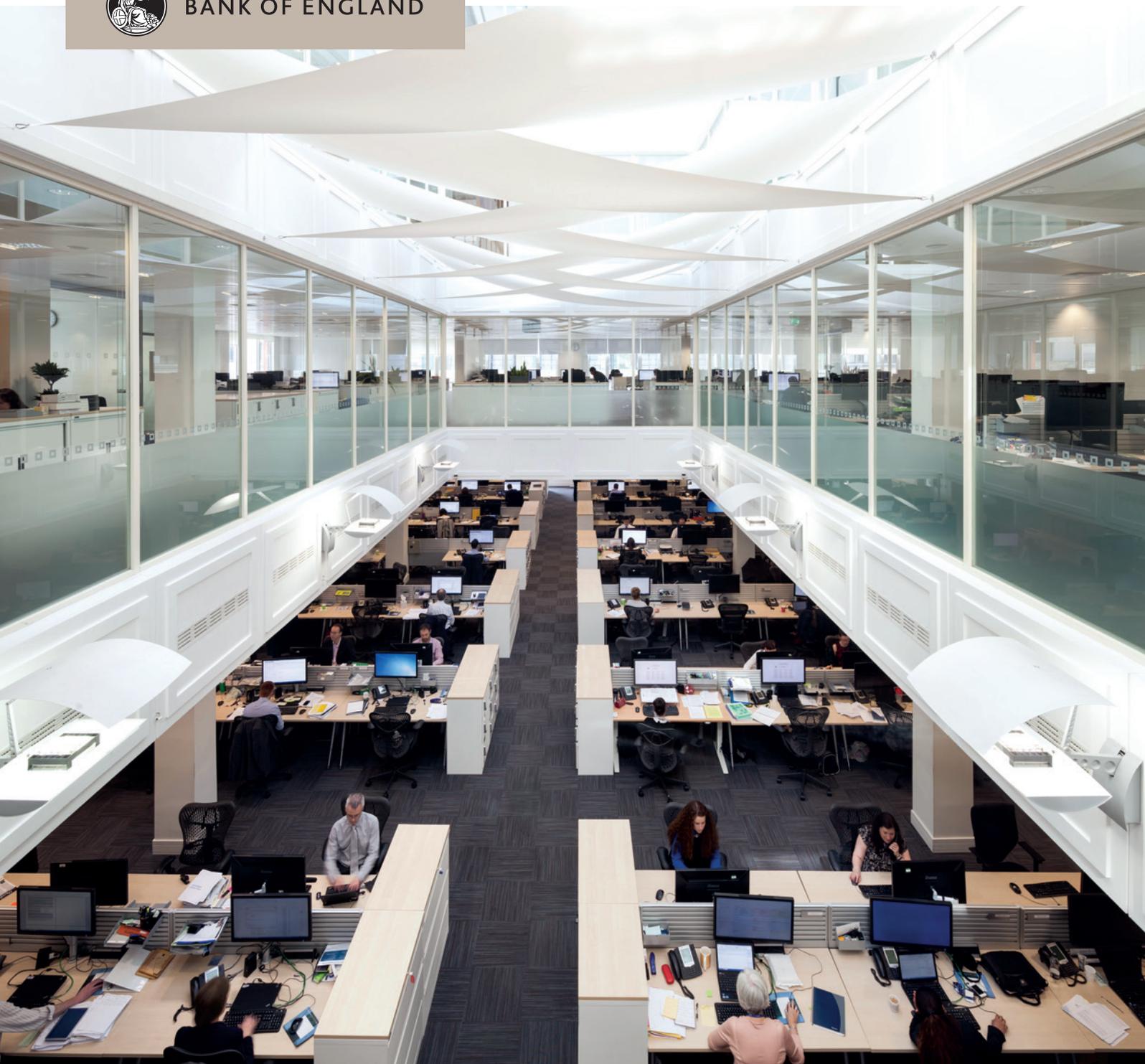


Evaluation of the Prudential Regulation Authority's approach to its Insurance Objective

March 2017



BANK OF ENGLAND





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Independent Evaluation Office, Bank of England

Foreword from the Chairman of Court

The Prudential Regulation Authority (PRA), part of the Bank of England, was given new duties in 2013 in respect of insurers. Specifically, the PRA was given responsibility for the prudential supervision of all authorised insurers in the United Kingdom — the first time in the Bank's 320-year history that it had been responsible for insurance oversight. The PRA's statutory insurance responsibilities include the need to contribute to the securing of an appropriate degree of protection for policyholders. This is a new requirement for the Bank, and one that, when combined with the PRA's broader responsibilities, has few direct parallels among regulators elsewhere.

The Court of the Bank of England (the Bank's Board) has wide-ranging oversight responsibilities with respect to the Bank, including the PRA. And Court wants to ensure that the PRA is taking an appropriate approach to what Court Directors consider to be an important part of its remit. In April 2016, Court therefore commissioned its Independent Evaluation Office (IEO) to assess the PRA's approach to its policyholder protection duties.

The IEO's findings and recommendations are contained in this report. And, as the report shows, the PRA's articulation of its policyholder protection responsibilities appears to be unfinished business. A large body of work was undertaken by the PRA in respect of its insurance responsibilities in the period running up to, and immediately following, the regulator's inception. But subsequent consideration of the PRA's approach to policyholder protection seems to have been somewhat crowded out by live supervisory issues, as well as by the considerable work involved in the implementation of the European Union's Solvency II Directive.

The statute affords the Prudential Regulation Committee (PRC) considerable discretion when discharging its policyholder protection responsibilities. This scope for discretion underscores the need for the PRC to articulate its preferred approach fully. The current, incomplete, articulation raises a number of considerations. These include questions of consistency, of ensuring that supervisory practices are aligned with the preferences of the PRC, of allocating resource efficiently, and of mitigating any risk of overreach. It is important to note, however, that the IEO found no evidence of PRA supervisors falling short of their policyholder protection duties, nor of formal overreach (that is, the PRA exercising powers without legal basis).

The recommendations contained in this report fall into four categories: articulating the PRA's approach to its policyholder protection responsibilities fully; communicating this approach clearly; implementing it effectively; and ensuring an appropriate framework for co-ordination with the Financial Conduct Authority. The PRC has committed to taking the IEO's recommendations forward. And Court will be monitoring their implementation as part of its wider follow-up framework for IEO reports.

Anthony Habgood, Chairman of Court
March 2017

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Executive summary

In April 2016, the Bank of England's Court of Directors (the Bank's Board) commissioned its Independent Evaluation Office (IEO) to assess the Prudential Regulation Authority's (PRA's) approach to its Insurance Objective.⁽¹⁾ This was a new statutory objective conferred on the Bank following the enactment of the 2012 Financial Services Act. The Act, *inter alia*, gave the PRA responsibility for supervising all UK-licensed insurers — some 600 firms in total.

The IEO project was aimed at ensuring that Court was fully sighted on — and content with — the PRA's approach to its Insurance Objective. This report sets out our findings and recommendations. As with previous IEO evaluations, the project team drew on a variety of independent expertise to support the work. This included selected external members of what is now the Prudential Regulation Committee (PRC), PRA Senior Advisors and figures within the insurance industry.⁽²⁾ The evaluation covers the period from early 2014 to early 2016, and was largely conducted in the second half of 2016.

The statutory framework for the PRA's supervision of insurers differs from that of banks in a number of respects. In particular, the PRA has two primary objectives with respect to insurance. These objectives are: (i) to promote the safety and soundness of firms (the 'General Objective'), which also applies to banks; and (ii) to contribute to the securing of an appropriate degree of protection for policyholders (the 'Insurance Objective'), which applies to insurers only and is the focus of this report. The PRA additionally has a Secondary Competition Objective, which has previously been evaluated by the IEO (Independent Evaluation Office (2016)).

In many instances, the PRA's General and Insurance Objectives are synonymous. In other words, steps taken by supervisors to promote the safety and soundness of insurers will generally also contribute towards policyholder protection. There are, however, a number of circumstances where the PRA's Insurance Objective is likely to have particular relevance. These include where insurers cease to write new business, where insurance firms or funds undergo structural change and the issue of discretionary 'with profit' allocations (Section 2). The Insurance Objective is also relevant to the PRA's approach to its responsibilities with respect to the Financial Services Compensation Scheme, which compensates policyholders in the event of firm failure.

As set out in Section 3, there are limits to the scope of the PRA's ability to take action with respect to policyholder protection. Specifically, our understanding is that the PRA's focus should be on prudential policyholder protection, rather than, say, conduct issues, where the Financial Conduct Authority (FCA) would typically be expected to lead. The statute also affords the PRA considerable discretion in aspects of its approach. For example, it is for the PRA to determine (subject to the requirements of UK and EU law) what constitutes an appropriate degree of policyholder protection, including whether different degrees of protection should be provided for different policyholders. In our view, the scope for discretion puts a high premium on a clear and comprehensive articulation by the PRA of its approach, as well as on ensuring that this approach is consistently understood throughout the organisation.

The overarching theme of this report is that there is more to do to articulate the PRA's approach to its Insurance Objective. But it is important to note that we have found no evidence to suggest that the PRA is falling short of — or stepping beyond — its policyholder protection responsibilities. Indeed, we have found clear evidence, from multiple sources and in a wide range of settings, of supervisors taking meaningful and appropriate actions to

(1) The evaluation was conducted by an IEO team of Lea Paterson (IEO Director), Sarah Ashley and Ed Dew, with further support from Amber Evans, George Holbrow-Wilshaw, Rachel Savage and Kate Stratford.

(2) Including: PRC External Members David Belsham, Norval Bryson; PRA Senior Advisors Nick Dexter, Ron Baxter, Ian Marshall; Nick Prettejohn, previously Non-Executive Director of the PRA Board, and currently Non-Executive Chairman of Scottish Widows; John Stewart, former Non-Executive Chairman of Legal & General and a former Non-Executive Director of the Bank's Court; and Mark Zelmer, who was previously Deputy Superintendent of Financial Institutions at the Office of the Superintendent of Financial Institutions (OSFI), Canada's main insurance regulator, and in October became a PRA Senior Advisor. Input was provided on an advisory basis only. The analysis contained in this report, together with any errors herein, is the sole responsibility of the IEO, and not the wider Bank nor the IEO's external advisors.

advance policyholder protection. Rather, the question is one of consistency, of ensuring that supervisory practices are aligned with the PRC's preferred approach, of allocating resource efficiently and of mitigating any risk of overreach.

Our recommendations fall into four categories — articulating more fully the PRA's approach to its Insurance Objective, communicating this articulation clearly, implementing the preferred approach effectively and enhancing the PRA's framework for co-ordination with the FCA. The table on page 7 sets out our recommendations in more detail.

On articulation (Section 3), there are a number of issues that would, in our view, benefit from fuller consideration by the PRC. These include the interaction of the General and Insurance Objectives as well as the boundaries of the PRA's policyholder protection responsibilities (including their interaction with the responsibilities of the FCA). Another important aspect of articulation is, in our view, clarity about the level and nature of policyholder protection that the PRA is seeking to achieve. Solvency II — the EU directive for insurance supervision — currently prescribes elements of this. But, in our view, there is further to go, including on reaching a settled view on the degree to which the PRA seeks to provide differential policyholder protection for different types of policyholders (to the extent that such differentiation is permissible under Solvency II).

Once the PRC has agreed a fuller articulation of the Insurance Objective, this should be communicated both internally and externally in order to ensure a clear and consistent understanding among both supervisory staff and regulated firms (Section 4). Internally, we recommend that the supervisory framework and guidance be updated, and that an appropriate training programme be put in place for all relevant staff. Externally, a key communication vehicle is the PRA's published *Approach to insurance supervision* (Prudential Regulation Authority (2016c)), and this could usefully be updated following the recommended PRC discussions set out above.

On implementation (Section 5), our view is that the core processes that together constitute the PRA's forward-looking judgement-based approach to supervision are effective at supporting delivery of its Insurance Objective. We also note the value of specialist teams within the PRA that provide support in areas where the Insurance Objective has particular relevance (for example, teams that specialise in insurer run-off). We would note, however, that the articulation issues outlined above may have potentially important implications for resourcing and internal organisation. We recommend that the PRA revisits aspects of its resourcing strategy once the PRC has articulated its approach more fully.

On FCA co-ordination (Section 6), our evaluation found evidence of positive and effective collaboration between the regulators. We did, however, observe a lack of consistency in how PRA supervisors dealt with 'boundary' issues that potentially impacted the FCA's objectives at least as much as those of the PRA. We also noted an apparent reluctance among PRA supervisors to use the relatively formal mechanisms for co-ordination embedded in the relevant Memoranda of Understanding between the two organisations.

We should emphasise that we have found no evidence of formal overreach — that is, of the PRA exercising supervisory powers without legal basis. Indeed, we think the probability of this is very low, given the checks and balances that exist within the PRA's framework. Our view is, however, that there is scope to mitigate further against the risk that PRA supervisors are inadvertently drawn into areas that are ultimately the responsibility of the FCA (such as conduct regulation). A fuller articulation by the PRC of the boundaries of the PRA's policyholder protection responsibilities would be an important step in this regard, as would consideration of whether the current escalation framework needs review.

This report was approved for publication by the Chairman of Court in March 2017. By releasing this report into the public domain, we hope to increase understanding and facilitate discussion of the work both of the IEO and of the Bank more broadly. We welcome feedback.⁽¹⁾

(1) The Bank's Independent Evaluation Office can be contacted at independentevaluation@bankofengland.co.uk.

Summary of recommendations

High-level recommendation	Detailed recommendations
<p>1. Articulate more fully the PRA's strategy and approach with respect to its policyholder protection responsibilities</p>	<p>(A) The PRC to articulate more fully the PRA's policyholder protection responsibilities, taking account of:</p> <ul style="list-style-type: none"> (i) The interaction of the General and Insurance Objectives (ii) The relationship between the PRA's policyholder protection objective and the FCA's complementary responsibilities <p>(B) The PRC to articulate more fully the level and nature of policyholder protection that it is seeking to achieve, taking account of:</p> <ul style="list-style-type: none"> (i) The degree to which 'appropriate' levels of protection differ between different types of policyholders (ii) The meaning of non-zero failure within the context of insurance, and the PRA's appetite for failure (iii) The extent to which PRA supervisors should explicitly take into account the existence of the Financial Services Compensation Scheme (FSCS)
<p>2. Communicate the PRA's preferred strategy and approach, both internally and externally</p>	<p>(A) The PRA Executive to communicate the fuller articulation under Recommendation 1:</p> <ul style="list-style-type: none"> (i) Internally, through an update to guidance for supervisors, reinforced by training for new and existing staff (ii) Externally, including through an update of the PRA's published Approach document for insurance supervision, and other vehicles for external communication (eg speech, <i>Quarterly Bulletin</i> article)
<p>3. Implement the PRA's preferred strategy and approach effectively, including via a clear and consistent approach to firm categorisation</p>	<p>(A) Building on Recommendation 1, the PRA Executive to ensure that the PRA's wider resourcing strategy is aligned with the preferred approach to policyholder protection, including considering any wider implications for the supervisory strategy and operating model</p> <p>(B) The PRC to consider the extent to which it prioritises protection for some policyholders via the firm categorisation framework, and the PRA Executive to implement this as appropriate through clear guidance for supervisors</p>
<p>4. Enhance the PRA's framework for co-ordination with the FCA in respect of policyholder protection</p>	<p>(A) The PRC to consider — in conjunction with the FCA as appropriate — how best to mitigate the risk of PRA supervisors being drawn into areas beyond the scope of responsibility of the prudential regulator. This should include consideration of whether:</p> <ul style="list-style-type: none"> (i) There should be some formalisation of existing working practices (ii) An update of the relevant Memoranda of Understanding with the FCA is needed

1 Context for the PRA's Insurance Objective

The UK insurance industry is the largest in Europe and the fourth largest in the world. All UK-authorised insurers — around 600 institutions in total,⁽¹⁾ with combined investment holdings of around £2 trillion and gross premiums of £250 billion — are regulated by the PRA, part of the Bank of England.

Among the population of PRA-regulated firms are two Global Systemically Important Insurers. PRA-supervised insurance entities also include firms operating in the London Market, a wholesale market providing a subset of general insurance whose firms include commercial insurance and reinsurance companies, and underwriters operating under the franchise of the Society of Lloyd's. In 2015, Lloyd's gross written premium was £27 billion, and a further £15 billion of premium income was written by other insurance and reinsurance companies operating in the London Market.

Insurers provide a diverse range of products. General insurance products, including motor and home policies for individuals, and general liability and property insurance for companies, provide payments in the event of loss from a particular event. Life insurance policies provide benefits in the event of death, retirement, or long-term sickness as well as savings mechanisms for individuals. Reinsurance policies enable a primary insurer to transfer a portion of its risk to a reinsurer.

The PRA has two primary objectives, set out in statute, with respect to insurance supervision. First, the 'General Objective' empowers it to 'promote the safety and soundness' of the firms it regulates, an objective which also applies to the PRA's supervision of deposit-takers and major investment firms. Second, it has an 'Insurance Objective' that applies only in the context of insurance and which is the focus of this report — specifically, the PRA is empowered to 'contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders' (see Section 3).

The PRA also has a Secondary Competition Objective (SCO). The SCO requires that, when exercising its general functions in pursuit of its primary objectives, the PRA does so in a way that facilitates effective competition, as far as reasonably possible. The PRA's approach to the SCO has previously been evaluated by the IEO (IEO (2016)). The PRA is not responsible for promoting the competitiveness of the UK insurance industry.⁽²⁾

This section provides further relevant context on the UK insurance market, and the PRA's approach to supervision. It first recaps briefly on the rationale for prudential regulation of insurers (Section 1.1), before describing the statutory framework for UK insurance regulation (Section 1.2). Section 1.3 compares the UK supervisory set-up to those of other insurance supervision regimes.

1.1 Rationale for prudential regulation of insurance

Insurance is a critical financial service (Debbage and Dickinson (2013)). Insurance products are designed to pool and transfer risk, allowing businesses and individuals to exchange the risk of an uncertain and potentially very costly financial outcome for a fixed cost, or premium. While the business model of insurers is such that they are less exposed to liquidity risk (or a 'run' on liabilities) than banks, insurance firms can pose systemic risk through their interconnectedness with banks, or because they have expanded into non-insurance activities. The potential links between insurance and financial stability are likely to be more marked for a large and mature insurance industry such as that in the United Kingdom.

(1) This covers insurers of all types, including general insurers, life insurers, friendly societies, mutuals and the London Market (see PRA (2016a)).

(2) Competitiveness is usually taken to mean a firm's, or a group of firms', or a nation's ability to compete internationally on cost or quality grounds. It is a distinct concept from that of competition.

Insurers may also face incentives for excessive risk-taking. This reflects two factors. First, insurers have inverted production cycles — revenue is generated through writing policies and collecting premia before any associated costs (paying claims or obligations) materialise. In the absence of regulation, these incentives could lead an insurer to make poor underwriting or reserving decisions, or to hold excessively risky assets.

Second, policyholders may not always have the incentives or capacity to enforce payment of their claims, or more generally to exert discipline over insurers. This may result from, *inter alia*: information asymmetries facing policyholders; impediments to switching between firms; the difficulty of diversifying insurance exposures across firms; and the fact that for some types of insurance (for example, third party motor insurance), the recipient of any payment is not the person who took out the policy.

Setting minimum capital requirements — a key aspect of prudential regulation — can help to reduce the incentive for excessive risk-taking. More generally, ensuring that insurance companies are well-capitalised and prudently managed strengthens their capability to withstand economic and financial shocks. This can help protect not only the interests of individual policyholders, but also the financial system as a whole.

1.2 The statutory framework for insurance supervision in the United Kingdom

It was only in 2001, following the creation of the Financial Services Authority (FSA), that responsibility for both prudential and conduct insurance regulation was formally handed to a stand-alone regulatory agency. Prior to that, UK insurance supervision was led by former incarnations of the Department for Business, Energy and Industrial Strategy, supported by the Government Actuary's Department. The FSA's regulatory objectives under the Financial Services and Markets Act 2000 (FSMA) were wide-ranging, and included market confidence, public awareness, the protection of consumers and the reduction of financial crime.

The post-crisis reforms to the UK regulatory regime led to the abolition of the FSA in 2013. Supervision of insurers was split between conduct supervision — the responsibility of the newly created FCA — and prudential supervision — the responsibility of the PRA. This was the first time in the United Kingdom that statutory-based prudential and conduct supervision of insurance companies had been separated, and the first time that the Bank of England had been granted statutory responsibility for insurance supervision. The new statutory framework required, among other things, close co-operation between the FCA and PRA (Section 6).

The PRA's objectives were introduced by the Financial Services Act 2012, which amended FSMA to create the PRA and the FCA⁽¹⁾. In the initial stages of drafting the Financial Services Act 2012, the PRA was to have only one primary objective, namely to promote financial stability through the supervision of individual firms. Eventually, it was decided that the PRA should have two primary objectives: one to promote the safety and soundness of firms with a focus on financial stability (the 'General Objective') and the other, for insurance companies, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders (the 'Insurance Objective'). The Insurance Objective is considered more fully in Section 3.

The motivation for the PRA's Insurance Objective appears to have been two-fold. First, there were concerns that — as insurers could be perceived as posing less of a risk to the financial system than banks — a single financial stability objective might not ensure that insurance firms received adequate levels of supervision. And second, the European Union was then in the process of agreeing the Solvency II Directive — the maximum-harmonising EU directive that sets the framework for insurance supervision across the European Union. Solvency II makes explicit that financial stability must not have precedence over policyholder protection in the prudential supervision of insurance firms. Box 1 provides further detail on the Solvency II framework.

On its creation in 2013, the PRA's Insurance Directorate reported to a statutory PRA Board. The PRA Board was replaced by the Prudential Regulation Committee (PRC) on 1 March 2017 following the enactment of the relevant sections of the Bank of England and Financial Services Act 2016.

(1) Hereafter, this report refers to the PRA's objectives as written in FSMA, rather than as written in FSMA as amended by the Financial Services Act 2012.

Box 1

Solvency II

Solvency II is a European directive which sets out prudential standards for insurance firms and their supervision. It has three pillars, covering capital adequacy, governance and risk management, and disclosure. The aim of Solvency II was to standardise insurance regulation across Europe and to provide an enhanced and more consistent level of protection for policyholders. Solvency II also introduced features to improve firms' understanding, and management, of risk (Swain and Swallow (2015)). The Directive came into effect on 1 January 2016, but planning for its implementation was a significant exercise which took a number of years.

Solvency II represented a significant change for both the PRA and regulated firms. The Directive requires firms to report new types of data and for firms' internal capital models to be approved against the Directive's requirements. Solvency II introduced forward-looking, risk-based capital requirements. In particular, the Solvency Capital Requirement is the quantity of capital that firms must hold to provide protection against unexpected losses over the following year, up to the statistical level of a '1 in 200-year event'.

Solvency II promotes policyholder protection through measures that should also improve safety and soundness. Not all provisions in Solvency II cover matters relevant to the PRA (some are for the FCA, for example provision of information to policyholders) and not all of the PRA's responsibilities under FSMA are covered by Solvency II (policyholder compensation following firm failure being one example). Solvency II is a largely maximum harmonising directive, notably in its capital adequacy provisions. The effect of this is that, in areas within scope of these maximum harmonised provisions, the PRA cannot impose different requirements on firms.

1.3 International peer comparisons

Very few countries are set up like the United Kingdom for insurance supervision; none appear to be exactly the same. Although the PRA is fully compliant with, and bound by, Solvency II, the institutional responsibilities and statutory objectives relating to UK insurance supervision do not perfectly match those of EU peers. More generally, none of the 40 insurance regimes reviewed as part of this evaluation had the exact combination of institutional responsibilities and statutory objectives seen in the United Kingdom, that is: the central bank as insurance supervisor; a 'twin peaks' approach to supervision, with prudential and conduct regulation being undertaken by separate authorities; and two separate statutory objectives for insurance supervision, one covering safety and soundness, and a second policyholder protection.

Table 1.A provides further details on the characteristics of selected insurance supervision regimes, where some similarities with the UK framework are evident.

Despite institutional differences, there remain many similarities between UK insurance supervisory practices and those of other jurisdictions. Discussions with international insurance supervisors conducted as part of our evaluation pointed to a strong sense of professional responsibility to protect policyholders, as is also the case for the United Kingdom.

More generally, the tools that other supervisors use to protect policyholders are broadly the same as those at the disposal of the PRA. The majority of the time, policyholder protection is delivered by ensuring safety and soundness of firms, particularly by ensuring that regulated firms are holding appropriate capital, and by ensuring as far as possible that there is a robust management and governance framework in place. When the financial viability of an insurer is called into question, supervisors put a premium on acting early before capital is unduly eroded, as well as ensuring that remaining capital is used appropriately and with regard for all groups of policyholders. This is the same conceptual framework that underpins much of the PRA's work to ensure it is delivering on its policyholder protection responsibilities, as discussed further in the body of this report.

Table 1.A Selected countries' insurance supervision and insurance industry characteristics

Country	Prudential regulator	Central bank?	Only prudential remit?	'Policyholder protection' in objective?	Policyholder protection fund?	Formal resolution regime for insurance?	Able to put firms into 'run-off'?	Significant with-profits industry?
United Kingdom	Prudential Regulation Authority	Yes	Yes	Yes	Yes	No	Yes	Yes
Australia	Australian Prudential Regulation Authority	No	Yes	Yes	Yes	No	Yes	No
New Zealand	Reserve Bank of New Zealand	Yes	Yes	No	No	No	Yes	No
Canada	The Office of the Superintendent of Financial Institutions	No	Yes	Yes	Yes	No	Yes	Yes
Ireland	The Central Bank of Ireland	Yes	No	Yes	Yes	No	Yes	No
Hong Kong	Office of the Commissioner of Insurance	No	No	Yes	Yes	Yes	Yes	Yes

The United Kingdom's regime for authorising insurance companies explicitly allows the PRA to withdraw permission for a firm to write new insurance business while maintaining its authorisation to service ongoing insurance contracts — a dual-aspect authorisation. This was common to all of the countries where we looked at the insurance supervision regime in more depth — although in most it is not formalised as a dual-aspect authorisation process. In the United Kingdom, removing permission to write new business is described as putting a firm in to 'run-off', and is an important part of the PRA's toolkit for policyholder protection. This is discussed further in the next section.

2 Methodology

The IEO's evaluation of the PRA's approach to its Insurance Objective follows established evaluation principles drawn from the wider public policy field (as set out more fully in Ashley and Paterson (2016)).

This section briefly describes our remit and scope (Section 2.1), before turning to the conceptual framework used in the evaluation (2.2). Further supporting detail is provided in Annex 1. The evaluation itself is detailed in Sections 3 to 6.

2.1 Remit and scope of the evaluation

At its April 2016 meeting, the Bank's Court of Directors (the Bank's Board) commissioned the IEO to evaluate the PRA's approach to its Insurance Objective.⁽¹⁾ The IEO commenced its evaluation in May 2016 and focussed primarily on the period from early 2014 to mid-2016.

The Insurance Objective evaluation satisfied the prioritisation criteria agreed by Court for in-depth evaluations conducted by the IEO in that it was a relatively new statutory duty.⁽²⁾ As noted in Section 1, prior to 2013, the Bank had not previously had responsibility for insurance supervision, and consequently the concept of policyholder protection was a relatively new one for the Bank (as compared with the more familiar concept of safety and soundness). More generally, the overlapping nature of the PRA's policyholder and the FCA's consumer protection responsibilities meant that the Insurance Objective potentially provided an interesting insight into the practical experience of operating the relatively new 'twin peaks' structure of UK financial regulation.

Two topics were considered beyond the remit of the project. First, the IEO evaluation took as given the lack of an insurance resolution regime. While a resolution regime might be thought of as a tool to support policyholder protection, any decision to introduce such a regime would not be the responsibility of the PRA, and therefore we considered the issue to be beyond the scope of our evaluation. Second, Solvency II was not evaluated in and of itself. But, given the importance of the Solvency II framework to insurance supervision, as noted in Section 1, it formed an important part of the context for much of the IEO's analysis.

A founding principle of the IEO is its independence: it operates at arm's length from local business areas of the Bank, and reports directly to the Chairman of Court. To support this independence, as well as to help assure the quality of its work, the IEO regularly draws on third-party expertise. For this evaluation, we benefited from the support of a small number of external experts from industry and public policy.⁽³⁾ In addition, a senior-level advisory group, including two external members of the Bank's PRC and PRA Senior Advisors, as well as members of the Bank's Executive, met regularly with the IEO team to provide feedback on the work (for further details, see Annex 1). And the IEO team also benefited from discussion with the PRA Practitioner Panel.⁽⁴⁾ All analysis and judgements contained in this report are the sole responsibility of the IEO, however.

(1) See the Minutes of the April 2016 Court: www.bankofengland.co.uk/publications/minutes/Documents/court/court1604.pdf.

(2) See the minutes of the December 2015 Court: www.bankofengland.co.uk/publications/minutes/Documents/court/court1512.pdf. In-depth projects conducted by the IEO are one way in which Court carries out its statutory duties, as set out in the Bank of England 1998 Act (as amended by the Bank of England and Financial Services Act 2016), to keep the performance of the Bank under review.

(3) Namely: Nick Prettejohn, previously a Non-Executive Director of the PRA Board and currently Non-Executive Chairman of Scottish Widows; John Stewart, former Non-Executive Chairman of Legal & General and a former Non-Executive Director of the Bank's Court; and Mark Zelmer, previously Deputy Superintendent of Financial Institutions at the Office of the Superintendent of Financial Institutions (OSFI) and Head of Financial Stability at the Bank of Canada, and, since October 2016, PRA Senior Advisor.

(4) The PRA Practitioner Panel is an independent statutory panel required under FSMA to represent the interests of practitioners.

(i) Evaluation criteria

In line with the approach taken in previous reports, the IEO developed a set of four *ex ante* criteria, describing what 'good' should comprise and against which the effectiveness of the PRA's approach to its Insurance Objective could be judged. Specifically, these were that:

- The PRA's Insurance Objective, including its interaction with the General Objective, should be clearly articulated and commonly understood across all levels and functions of the PRA.
- The PRA's strategy, tools, supervisory framework, and approach should support the delivery of the Insurance Objective in a way that is consistent with the statutory framework.
- Insurance supervision should benefit from appropriately allocated resources, and should organise itself effectively, to support the fulfilment of the Insurance Objective.
- The PRA should work effectively with other relevant regulatory bodies — particularly the FCA — in pursuit of policyholder protection.

Figure 2.1 builds on to those evaluation criteria some of the questions that formed the starting point of the IEO evaluation.

Figure 2.1 Evaluation criteria

Evaluation criteria			
Clearly articulated and well understood	Reflected in strategy, tools, supervisory framework and approach	Resourced and organised effectively to deliver	Effective interface with other relevant bodies
Questions underlying the evaluation criteria			
Examining what was drafted in statute, how does the PRA's understanding of and approach to its Insurance Objective accord with the legislative framework?	To what extent is policyholder protection as an objective viewed in practice as distinct from safety and soundness?	Is there a resource allocation strategy for the Insurance Objective?	Is there a consistent understanding and approach within the PRA to interaction with the FCA on policyholder protection?
How does this interpretation interact with the objectives of Solvency II?	Reflecting that, is there a consistent approach to the objective shared across all levels and functions, eg policy and supervision, of the organisation?	Is the PRA's operating model consistent with its broader approach to policyholder protection?	How does the PRA see its remit in respect of policyholder protection relative to the cover provided to policyholders by the FSCS?
	Do all of the approach, framework and governance arrangements fully reflect the PRA's interpretation of its Insurance Objective?		How does interaction with other relevant bodies work in practice, both in terms of supervisory approach and when formulating insurance policy?

(ii) Methodology and data sources

In line with good practice in the broader evaluation field, we used a number of different approaches and techniques within our evaluation. These are described in more detail in Annex 1 and outlined briefly below. Specifically, the bulk of our work comprised three complementary workstreams, and we drew on common themes arising from these when formulating findings and recommendations. The workstreams were:

- (1) A consideration of **how the PRA interprets its Insurance Objective**, what is required in statute, and where there is scope for discretion.
- (2) A desk-based review of **how the PRA's interpretation of its Insurance Objective had been transposed** into its supervisory framework and approach. This comprised reviews of internal and external documents, structured discussions with staff and a staff survey.

- (3) Six in-depth **case studies aimed at building an understanding of how the Insurance Objective had been applied in practice**, influenced policy decisions, and any challenges that had arisen in pursuit of it. These were chosen to allow us to examine how the PRA had approached its policyholder protection responsibilities in areas where the Insurance Objective could be seen in particularly sharp relief (see Section 2.2).

The review team received full and unrestricted access to all papers and minutes for relevant supervisory committees, including the PRA Board. The IEO was also able to interview without restriction members of the PRA Senior Leadership Team and the supervisory committees, in addition to staff at all levels within the Insurance, Prudential Policy and other relevant directorates, and received their full co-operation in relation to its broader evaluation activities.

2.2 Conceptual framework for the evaluation

The PRA pursues its statutory objective for policyholder protection through both firm-level supervision and policy formulation. In this report we have had a particular focus on how the PRA's Insurance Objective informs its approach to firm-level supervision. But we have also considered aspects of the policy approach (including the role of the Financial Services Compensation Scheme (FSCS)⁽¹⁾ within policyholder protection, and the PRA's approach to determining policyholder compensation limits within the FSCS, see Section 3).

The PRA's two objectives for insurance supervision — safety and soundness (the General Objective) and policyholder protection (the Insurance Objective) — are not easily separated. Most supervisory actions pursue safety and soundness and policyholder protection simultaneously. The IEO's evaluation has been grounded in the fact that if a supervised firm is safe, sound and judged to be financially viable over the longer term, with robust management and governance frameworks in place, then it is reasonable to assume that supervisors are also contributing to the protection of policyholders. As explained in Section 1, this is in line with the approach taken by other insurance regulators. It is also consistent with Solvency II, which promotes policyholder protection (its stated primary objective) largely through measures that will also improve safety and soundness (see Box 1, Section 1.2).

There are a number of circumstances, however, where the PRA's Insurance Objective is of particular relevance. In other words, there are circumstances where policyholder protection considerations may lead the PRA to adopt an approach to supervision or to resourcing that differs from that required by considerations of safety and soundness alone. Our work therefore had a focus on these areas of the PRA's work where the insurance policyholder protection objective could be seen in particularly sharp relief.

These situations, which are described below, typically arise when ensuring safety and soundness may not be sufficient to deliver protection for all policyholders: discretionary profit allocations to policyholders in a with-profits fund; firms or funds in 'run-off' or at the point of closure; and firms or funds going through structural change (typically dealt with through a 'Part VII' transfer).

(i) Discretionary profit allocations to policyholders in a with-profits fund

As explained in Box 2, with-profits policies are contracts that allow policyholders to invest in a fund provided by an insurance company. Returns to with-profit policyholders, at the point that their policies mature, typically consist of a contractually guaranteed minimum amount and a discretionary payment (a proportion of the profits generated by the fund).

When a with-profits fund is making a discretionary payment, it must decide on the appropriate allocation of profits between payments to policyholders and retained reserves. Safety and soundness of the firm could be enhanced (by retaining more reserves), but possibly at the expense of policyholders who may suffer in terms of the reduced distributions they receive. For example, by building up a relatively large reserve, a fund may be very safe and sound. But withholding more profit in the short term could also result in a disproportionately generous allocation to those with policies maturing at a relatively later point.

(1) The FSCS provides the final safety net for insurance policyholders. See Box 6, Section 3, for more detail.

Box 2

With-profits insurance

With-profits policies are contracts that allow policyholders to invest in a fund provided by an insurance company. These funds are designed so that the profits (and losses) are shared primarily among the participants in that fund. The policies can take many different forms, such as annuities, life insurance and mortgage endowments and therefore combine both insurance and investment in a single policy.

Conventional with-profits policies consist of a contractually guaranteed minimum amount (the basic sum assured) and a discretionary payment. The discretionary payment is a distribution of a portion of the profits that the fund has generated (often called a bonus); these bonuses, which are added both annually and, in some cases at termination, will usually be guaranteed from the point that they are issued. Benefits accrued over the life of a policy are paid, as a lump sum, at the point the policy matures.

With-profits policies have become less popular in the United Kingdom: the value of with-profits funds managed by insurers has declined in recent years from around £280 billion in 2005 to just under £170 billion in 2015. This declining popularity reflects a number of factors, including poor fund performance (resulting from, for example, lower rates of return on safe assets and the cost of guarantees), and concerns about contractual obligations following problems with Equitable Life in the late 1990s and early 2000s.

New with-profits policies continue to be written, however. There is also a significant back book of historic with-profits policies due to the long-term nature of these policies.

Since the 1990s, insurers have increasingly offered unit-linked products instead of with-profits policies. Similar to with-profits policies, unit-linked products can take many forms such as annuities, life insurance and endowments. However, they transfer the majority of investment risk from the insurance firm to the saver: there is no guaranteed level of pay-out and the value of the units is fully reflective of the value of the underlying investments. Typically, the insurance company will charge the policyholder a percentage of the value of the fund to cover their investment expenses, the cost of providing any insurance cover and other administrative expenses.

The PRA has responsibility for ensuring that a firm includes in its Solvency II reserves future payments (both guaranteed minimum and discretionary) that the firm expects to make to policyholders. The amount that the firm expects to pay is influenced by FCA requirements to treat customers fairly. At the point that a distribution of profits to a cohort of policyholders looks so generous that it would leave a fund unable to meet future obligations, the PRA may require that the fund make the allocation to that cohort of policyholders less generous. Such an intervention reflects the PRA's role in protecting future generations of policyholders — as well as a judgement on the safety and soundness of the fund. As noted in Section 6, a Memorandum of Understanding (MoU) between the PRA and FCA outlines the framework for co-ordination on with-profits policies.

(ii) Firms in 'run-off' or at the point of closure

There are a number of circumstances in which an insurance firm may cease to write new business. For example, a business line may be stopped voluntarily because of a change in the firm's strategy — reflecting falling demand, reduced profitability or regulatory changes. Equally, a firm may be required by the PRA to cease writing new business where supervisors have concerns about its safety and soundness, and longer-term viability.

When a firm ceases to write new business, but continues to service existing contracts, it is said to be in 'run-off' (see Box 3). In this situation the PRA's policyholder protection responsibilities can come into sharper relief:

- First, at the point that run-off is being considered, supervisors will assess if the firm has sufficient capital and infrastructure to be able to maintain solvency and discharge its remaining insurance liabilities as they fall due. Starting run-off while a firm is able to maintain solvency over the duration of its remaining liabilities is particularly important for long-term insurance products, such as life insurance, since the cost of replacing the existing contract with a new one may have changed significantly since the policy was first taken out. It can also

Box 3

Run-off

'Run-off' refers to a firm that no longer has permission to accept new business and write new insurance policies, but retains permission to service existing insurance policies.

Run-off can be on a solvent or insolvent basis. A solvent firm manages its assets such that it is able to meet claims as they fall due. In this case the service received by the policyholder is unchanged as a result of the firm being in run-off.

A firm in run-off can, however, be insolvent, with assets insufficient to meet claims as they fall due. Where a firm in run-off is insolvent, policyholders might receive only a proportion of any claim based on the assets that remain.

be true of some general insurance policies where there is the potential for claims to manifest many years after the policy was written — such as claims for the effects of asbestosis.

- Second, firms that have ceased writing new business and are in run-off remain authorised and supervised. Supervisors will be aware that management may seek to extract capital for shareholders in the short run, and will seek to prevent the removal of capital that would jeopardise the solvent run-off — and make it more likely that the firm would enter insolvency and possibly cease servicing existing contracts.
- Third, at the point a firm in run-off can demonstrate it has discharged all of its insurance liabilities, it can approach the PRA with plans to cancel its permission to continue servicing existing contracts and be de-authorised. At this point supervisors must consider whether the firm has identified all possible claimants, and should be permitted to close.⁽¹⁾
- Fourth, there are circumstances when a firm may still be servicing insurance contracts, but be insolvent or on a path to insolvency, ie it is unable to meet all future claims as they fall due. In this case, supervisors will balance the merits of (i) the firm closing, but only after encouraging further claims to materialise in the short term; and (ii) enabling more claims to manifest over the longer term by allowing the firm to continue, aware that some may arrive only after the remaining funds have been exhausted.

(iii) Firms going through structural change

Insurance firms and funds routinely go through structural change. They may merge, for example, or one firm may acquire a portfolio of insurance business from another. PRA supervisors assess whether such transactions will have an impact on the safety and soundness of the firms as well as the position of relevant policyholders.

Transactions are often driven by changes in firms' business models. Some firms, for example, may choose to dispose of portfolios that are no longer core to their business model or capital efficient; while other firms will specialise in acquiring and managing run-off portfolios. When two or more firms' portfolios of insurance business combine they will typically do so using a statutory mechanism called a 'Part VII transfer' (Box 4). This court process creates a framework and makes it easier for firms to carry out the transfer — it also facilitates policyholders' opportunity to object.

During the Part VII process PRA supervisors consider whether, in the context of the PRA's objectives, there is any reduction in the financial strength of a firm (either the transferring firm or the transferee) sufficient to leave policyholders materially worse off. In the event that PRA supervisors do consider that any transfer would leave policyholders materially worse off, this is communicated to the court.

⁽¹⁾ Firms in solvent run-off that have not discharged all of their insurance liabilities, but that wish to accelerate the conclusion of run-off, might seek to transfer remaining business (see Box 4), or enter into an arrangement to bring forward any remaining claims.

Box 4

Part VII transfers

A 'Part VII transfer' is a statutory mechanism outlined in Part VII of FSMA that allows insurers and reinsurers to transfer portfolios of insurance business from one entity to another, subject to court approval, without obtaining individual policyholder consent to the transfer.

Using the 'Part VII' process allows firms to sell or consolidate business or maximise efficiency from a capital or tax perspective.

The PRA must (*inter alia*) approve the appointment of an independent expert to report to the court. That expert will consider whether any group of policyholders in either the transferring firm or the receiving firm will be made materially worse off as a result of the transfer.

PRA supervisors will also consider the impact of the transfer on the PRA's General and Insurance Objectives.

3 Evaluation — articulation

Central to the effective discharge of the PRA's statutory responsibilities is a sound understanding of what is required in statute, together with a clear articulation of what this understanding implies for the supervisory strategy and approach. A clear and comprehensive articulation is particularly important in areas where the PRA is afforded discretion, in order to ensure a consistent approach that is fully aligned with the preferences of the PRC.

This section considers the extent to which such clarity currently exists in relation to the PRA's interpretation and articulation of its responsibilities for policyholder protection. It first summarises the statutory framework, within which the PRA's Insurance Objective applies, and considers the degree to which the PRA has discussed and agreed its approach within this framework (Section 3.1). It then assesses the degree to which the PRA has considered the level of policyholder protection that it is seeking to achieve, an important aspect of articulation (Section 3.2). Section 3.3 concludes.

This section of the report speaks to our first and second evaluation criteria (Section 2), specifically the degree to which the Insurance Objective (including its interaction with the General Objective) has been fully articulated and transposed into an effective supervisory framework for the PRA. It draws particularly on evidence from our workstream interpreting the Insurance Objective and from the desk-based review of the PRA's framework for delivery on its policyholder protection responsibilities.

3.1 Interpreting the Insurance Objective

The PRA's Insurance Objective, set out in FSMA, requires the PRA to: 'contribute to the securing of an appropriate degree of protection for those who are or may become policyholders'. It is one of two primary objectives that apply to insurance supervision, the other being the requirement to promote the safety and soundness of PRA-regulated firms (the General Objective).

Box 5 sets out more fully our understanding of the nature of the PRA's Insurance Objective, and highlights key aspects. In particular:

- The PRA's focus should be on prudential policyholder protection. The General and Insurance Objectives are explicitly linked: if an issue has no direct capacity to affect safety and soundness one way or the other, then the PRA may find it difficult when exercising its general functions (such as rule-making and policy determination) to justify taking action solely on the basis that it advances policyholder protection.⁽¹⁾ Doing so would potentially involve overreach into another institution's responsibilities, most obviously the FCA (as policyholders are a subset of consumers and the FCA has by far the greater role in the consumer sphere).
- When the PRA acts to make rules and determine policy, it is obliged, in so far as reasonably possible, to do so in a way compatible with both its General and Insurance Objectives. As such, the circumstances in which the PRA might contemplate taking an action that is clearly incompatible with one of its objectives (ie when the two Objectives pull in different directions) are likely to be exceptional. Were this to happen, the PRA would have to weigh up the impacts carefully, to seek an outcome that reconciles them if possible, and to justify its position clearly.
- The PRA has considerable discretion when discharging its statutory responsibilities for policyholder protection. For example, it is for the PRA to determine (subject to the requirements of EU and UK law) what an

(1) This is not the same as a situation in which policy proposed by the PRA has the capacity to affect firms' safety and soundness but the effects are judged to be broadly neutral overall — in this situation, the PRA could clearly justify taking action on the basis of its policyholder protection objective.

Box 5

The Insurance Objective explained

The PRA's Insurance Objective is:

Contributing to the securing of an appropriate degree of protection for those who are or may become policyholders.

The Insurance Objective is one of two primary objectives for the PRA. (The other is to promote the safety and soundness of PRA-authorized firms, known as the General Objective.) FSMA gives the PRA a specific direction that it should consider financial stability in advancing the General Objective but there is no similar direction for the Insurance Objective. Therefore, in relation to the Insurance Objective, the PRA has wide discretion to act in the way it considers most appropriate to advance the objective.

Contributing to the securing...

- The word 'contributing' recognises that other bodies (eg the FCA, HM Treasury) also have a role in policyholder protection. The FCA's consumer protection objective ('securing an appropriate degree of protection for consumers' rather than 'contributing to...') demonstrates how wide its role is in protecting policyholders and consumers more generally.
- When the PRA acts in the exercise of its general functions (such as rule-making and policy determination), it must do so, to the extent possible, in a way compatible with both primary objectives. This explicit link between the two objectives helps set limits for PRA action. This means:
 - it would be difficult for the PRA to justify adopting a position where this had no capacity to impact on the safety and soundness of firms. In such a case, it is likely to be more appropriate for another body (typically the FCA) to act; and
 - the circumstances in which the PRA might contemplate taking policy positions that are incompatible with one of its objectives (ie when they pull in different directions) are likely to be exceptional; in such circumstances the PRA would have to weigh up the impacts carefully, to seek an outcome that reconciles them, and to justify its position clearly.

...of an appropriate degree of...

- It is for the PRA to decide what degree of protection is 'appropriate' (subject to the requirements of EU and UK law). The appropriate degree can vary according to the type of product, type of policyholder, their current or future interests, or other factors the PRA considers relevant.

...protection...

- The form of protection is a matter of discretion for the PRA. The PRA can decide to provide different types of protection in different circumstances. FSCS protection is also a form of policyholder protection, and the PRA has discretion to decide what is sufficient for different policyholders.

...for those who are or may become...

- The PRA may take a forward-looking approach and consider the position of those who may become policyholders in the future. It is for the PRA to determine what course of action is appropriate after considering the interests of current and future policyholders and the interests of different generations of policyholders.

...policyholders.

- 'Policyholders' can have a broad interpretation, including beneficiaries (or potential beneficiaries) of insurance policies as well as those who actually purchase policies. It does not include any explicit geographic limitation.

The Insurance Objective applies when the PRA is carrying out its general functions, including rule-making and determining policy; FSMA does not formally apply it to supervision of individual firms (except as a basis for the use of certain FSMA formal powers of intervention). However, as the Insurance Objective informs the PRA's general approach (as laid out eg in the PRA's *Approach to insurance supervision* document, Policy Statements and the PRA Rulebook), it will be indirectly relevant to firm-specific decisions.

'appropriate' degree of protection constitutes, and whether the PRA provides different types and degrees of protection in different circumstances.

In addition to the requirements under FSMA, the PRA must always act in accordance with the general decision-making principles of UK public law and the requirements of EU law (such as the Solvency II Directive on insurance supervision: see Box 1 in Section 1). But while both Solvency II and FSMA have policyholder protection as an objective of insurance supervision, neither piece of legislation defines the concept precisely, which increases the premium on the PRA articulating its approach clearly.

As the prudential supervisor of the Society of Lloyd's and managing agents that operate within the Lloyd's market, and in view of the unique legal framework of Lloyd's, the PRA also needs, where appropriate, to tailor its approach to reflect the Lloyd's structure. As outlined in the *Approach* document (PRA (2016c)), in supervising the Lloyd's market and in the pursuit of its Insurance Objective, the PRA has regard to the principle 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.

Consideration and articulation of statutory responsibilities within the PRA

A considerable body of work to articulate the institution's responsibilities was carried out in the period leading up to the transfer of responsibility for insurance supervision to the PRA. And in late 2013 and early 2014, shortly after the inception of the PRA, policyholder protection was discussed by the PRA's Supervision, Risk and Policy Committee (SRPC), the most senior supervisory committee below the PRC. The intent of these discussions was to provide the basis for further articulation of the PRA's Insurance Objective, together with a consideration of how this articulation should impact upon insurance supervision.

The focus of the SRPC discussions was primarily on a relatively narrow, albeit important, aspect of the PRA's approach to its Insurance Objective — the firm categorisation process (discussed further in Section 5). Nonetheless, the actions agreed by the SRPC would have — if implemented in full — gone some way towards fleshing out the PRA's interpretation of its policyholder protection responsibilities more broadly. These agreed actions included that there be a discussion of the policyholder protection issues raised at SRPC at the PRA Board (now the PRC). Partly owing to senior staff departures, and the focus on Solvency II implementation, this action was not taken forward. As such, there was a missed opportunity for the PRA Board to discuss and agree its preferred approach.

Our view is that it is important that the PRC considers the policyholder protection issues initially discussed by the SRPC in 2013 and 2014, as well as the nature of its responsibilities relating to the Insurance Objective more broadly, and spells out its articulation of them fully. This includes the need for a comprehensive articulation of the PRC's preferred approach in those areas where it has discretion, together with its view of the nature of the interaction between the General and Insurance Objectives (especially in areas where the Insurance Objective may have particular relevance).

Another important aspect of articulation is, in our view, the interface of the PRA's responsibilities with those of the FCA. As set out in Section 6, the statutory framework, by design, contains no 'hard' delineation of responsibility for policyholder protection issues between the two organisations, increasing the premium on clarity about the PRC's views on the PRA's responsibilities.

3.2 Level of policyholder protection that the PRA is seeking to achieve

An important aspect of the PRA's articulation of its Insurance Objective is clarity about the level and nature of policyholder protection that it is seeking to achieve. The level of protection that the PRA delivers to policyholders appears to have increased in recent years — through, for example, the introduction of Solvency II, the Senior Insurance Managers Regime (which replaced the Approved Persons Regime),⁽¹⁾ and changes to the compensation limits available to insurance policyholders through the Financial Services Compensation Scheme. And while Solvency II goes some way towards clarifying the level of policyholder protection that the PRA should be seeking to achieve (in setting capital requirements such that firms should be able to withstand a 1-in-200 year adverse event, see Box 1), there remains in our view a number of open questions that will ultimately help to determine the level and nature of policyholder protection delivered by the PRA.

Among these questions are the issue of differential treatment for different policyholders (where we note that Solvency II does not distinguish between types of policyholders in the '1-in-200' calibration of capital requirements), as well as the question of firm failure within the context of insurance. These are considered in turn below.

(i) Are all policyholders equal?

This fundamental question has been considered, both directly and indirectly, at various points in the period leading up to, and following, the PRA's inception. For example:

- Work done in the period leading up to the inception of the PRA, and reflected in the PRA's *Approach to insurance supervision* (PRA (2016c)), points to a differential approach. Specifically, the Approach document states that through its risk-based approach, the PRA focuses on those insurers and types of insurance which have the greatest potential impact on the PRA's objectives. Annuities, mandatory cover without which economic activity cannot take place, and policies that cover a long period of time are mentioned explicitly.
- Work undertaken since the PRA's inception highlights that the 'appropriate degree' of protection is a matter for the PRA's discretion, and that it can vary according to the type of product, type of policyholder, their current or future interests, or other factors the PRA considers relevant.
- Work undertaken in 2014 in support of the SRPC discussion noted in Section 3.1 sought to embed the differential approach signalled in the *Approach* document through the firm categorisation framework (a process by which the PRA prioritises resource allocation across firms, discussed in more detail in Section 5 and Annex 2). Annuities, compulsory insurances (eg employers' liability and third-party motor), term assurance and professional indemnity insurance were highlighted as meriting greater protection under this framework.
- In 2015, the PRA determined that different classes of insurance business should receive differential levels of compensation under the rules of the FSCS. While some types of insurance continued to be covered up to 90%, it was decided to extend full cover (up to 100%) to a number of types of insurance (see Box 6 for more details). As part of its case study workstream, the IEO considered the PRA's approach to determining the limit structure of FSCS protection for policyholders between 2013 and 2015. The PRA's Insurance Objective, and in particular the PRA's statutory responsibility to contribute to the securing of an 'appropriate degree' of protection for policyholders, was one of the factors which was observed to carry force in the PRA's deliberations.

The PRC has not, however, had an in-depth discussion of the extent to which all policyholders are equal, and as a result these decisions do not collectively represent a top-down, explicit PRA view. In our view, there is considerable merit in an in-depth discussion of this matter. The implications of such a determination could be far-reaching, potentially covering for example, resourcing and firm categorisation (see Section 5), FSCS compensation and regulatory policy more generally (although we note that the maximum harmonising nature of Solvency II requirements may constrain aspects of this discussion).

(1) The Senior Insurance Managers Regime was introduced, alongside the Senior Managers Regime, as part of the implementation of the recommendations of the Parliamentary Commission on Banking Standards. For more detail, see www.bankofengland.co.uk/pr/Pages/authorisations/smsimr/default.aspx.

In relation to the FSCS, a clearer articulation by the PRA of its Insurance Objective, and of the extent to which all policyholders are equal, has the potential to impact not only on the PRA's role in setting priorities for the FSCS (where, as noted above, there is precedent for differentiation among policyholders). It could also prompt wider consideration of the role of the FSCS within policyholder protection. This also depends, however, on the PRA's approach to firm failure. As outlined below, the definition of failure, as well as the PRA's tolerance of it, are important considerations in this context.

(ii) To what extent is firm failure consistent with policyholder protection?

Firm failure is not necessarily inconsistent with policyholder protection. As set out, for example, in the PRA's *Approach* document (PRA (2016c)), an expectation that a prudential regulator will necessarily come to the assistance of a failing firm risks a range of unwelcome consequences, such as incentivising excessive risk-taking. And these unwelcome consequences may lead to substantial policyholder detriment over the longer term, as well as adversely affecting financial stability. In part reflecting these concerns, the PRA has, in the period leading up to and following its inception, consistently communicated that its approach to supervision (both banking and insurance) is 'non-zero failure'.

Failure within insurance

The nature of failure within the context of insurance is different to that in banking, reflecting differences in both the nature of insurance business and in the available regulatory tools. For example, the failure of an insurance firm could well be a relatively slow process as insurers are less exposed to liquidity risk (or a 'run' on liabilities) than banks, meaning there may be more time for supervisors to intervene to facilitate an orderly run-off (where a firm ceases to write new business, but continues to service existing contracts — see Box 3 in Section 2). And while with banking there is an established resolution framework, no such framework exists in relation to insurance.

More generally, the capacity for policyholder detriment in the event of firm failure depends on a number of factors, including the extent to which the insurer has sufficient funds to service existing contracts, the ease and cost to policyholders of switching to an alternative provider and the nature (and availability) of any policyholder compensation arrangements. For example, if a failing insurer providing long-term insurance is unable to service existing policies then there may be material policyholder protection concerns — the process of replacing the existing contract with a new one may be difficult and costly, and there may be substantial policyholder detriment associated with discontinuity of cover.

Among senior supervisors, our evaluation found a strong degree of consensus that controlled, solvent run-off of a firm in difficulty is an acceptable outcome. There was less consensus as to whether controlled, solvent run-off constitutes failure (in the context of the PRA's stated non-zero failure approach). Some supervisors, for example, appeared to associate failure only with the insolvency of insurers — that is, where a firm's assets are judged insufficient to meet all expected future claims when they fall due. In our view, the different forms of failure within insurance could be usefully clarified — including the question of whether solvent, orderly run-off constitutes an (acceptable) form of failure, or is instead another facet of 'business-as-usual' supervision.

We also noted scope for greater clarity about the PRA's appetite for failure in the context of insurance. The PRA does not quantify the number, scale or frequency of insurance 'failures' that are within its risk tolerance (although, as noted above, Solvency II does set capital requirements such that firms should be resilient to a 1-in-200 year adverse event).

If solvent run-off is considered failure, revealed practice would suggest that there is a reasonable degree of appetite for insurer failures within the PRA. Indeed, around 60 firms are currently in run-off (although a number of these have been in run-off since before the PRA's inception). If, however, failure within insurance is determined to mean insolvency, then the appetite for failure is less clear. Only a very small number of PRA-authorized insurers have been declared insolvent since the PRA's inception, and only one has sought recourse to the FSCS.

More generally, discussions with supervisory staff during the course of the evaluation (through the case studies workstream, structured interviews, and focus groups) pointed to occasions where small, non-systemic insurers which generated concerns as to their short-term solvency position had commanded considerable supervisory resource and senior airtime (see also Section 5.2), leading some to question the degree to which the PRA was, in

Box 6

The Financial Services Compensation Scheme (FSCS)

The FSCS was set up under FSMA and came into operation in 2001. It consolidated a number of existing compensation schemes, including the Policyholders Protection Board. As there is no resolution regime for insurance, the FSCS provides the final safety net for the majority of individual and small business insurance policyholders.

The PRA's responsibility with regard to the FSCS has several facets:

- Appointing FSCS board members (jointly with the FCA, and in respect of the Chair and Chief Executive, subject to approval by HM Treasury). Once appointed, the Chair and Board act independently in administering the scheme.
- Making the rules by which the FSCS acts (in respect of firms authorised by the PRA).
- Co-ordinating in the event of a firm failure.
- Ensuring that the FSCS can carry out its duties; the FSCS is accountable jointly to the PRA and FCA.

A Memorandum of Understanding between the PRA and the FSCS details how the two authorities co-operate and co-ordinate.

Some specific classes of insurance may receive up to 100% compensation under the Scheme; namely: long-term insurance benefits; compulsory insurance (eg third party motor and employers' liability); professional indemnity insurance; and claims arising from the death or incapacity of the policyholder due to injury, sickness or infirmity. All other classes of insurance may receive compensation of up to 90% of the insured sum. Prior to the change to the limits structure agreed by the PRA and implemented in 2015, only compulsory insurance received up to 100% compensation.

FSCS payouts are funded by a levy on the industry. The current maximum levy for compensation and specific costs is £690 million a year for life insurance and pensions providers and £600 million a year for general insurance providers. The levy is typically collected once a year and is usually a small fraction of the maximum, with firms contributing proportionately.⁽¹⁾ The money collected is used to pay compensation costs arising from any failures, and to fund the transfer of policies or the issue of new, substitute policies.⁽²⁾ (There is also a levy to cover management expenses.)

If the maximum compensation levy cannot cover claims paid in respect of firms in default in a particular year, the FSCS has recourse to borrow from the National Loans Fund (NLF), which can then be paid back through collection of the levy over subsequent years.⁽³⁾ The FSCS also has access to commercial borrowing for liquidity, and makes recoveries from the estates of failed insurers.

Since its creation in 2001, the FSCS has paid out more than £1 billion in insurance claims. However, most recent failures affecting the FSCS have been cross-border insurance firms operating in the United Kingdom.⁽⁴⁾ Indeed, of the six insurance firms which have been declared in default and triggered claims under the FSCS since the PRA's inception, five have been cross-border firms passported into the United Kingdom.

Concerns have been raised that if a larger insurer were to fail, it could take many years of charging the maximum levy to repay the NLF. While the maximum may be affordable in a single year, paying this amount annually for a period of time could cause financial difficulties for other insurers.

(1) Firms currently contribute in proportion to their net premium income and gross technical liabilities (non-life) and net premium income and mathematical reserves (life).

(2) In relation to long-term insurance, the FSCS has an obligation to seek continuity of insurance subject to certain conditions being met. For general insurance, securing continuity of cover is one of a range of measures that may be taken by the FSCS where the insurer is in financial difficulty.

(3) The National Loans Fund (NLF) was established on 1 April 1968 to account for government borrowing and lending. It was set up in order to separate government revenue and expenditure on the one hand and government borrowing and lending on the other. The NLF is administered by HM Treasury. Most of the NLF's borrowing needs are met indirectly through borrowing on its behalf by the Debt Management Office and National Savings and Investments.

(4) Under EU law, EEA insurers authorised in any EEA state can sell insurance in any other EEA state or establish in any other EEA state on a cross-border basis. The exercise of this right is known as 'passporting'. The firm remains regulated by its home regulator rather than the PRA, but its eligible policyholders are covered by the FSCS, subject to the rules of the Scheme.

practice, operating a 'non-zero failure' regime. Some supervisors also noted the potential stigma associated with being a supervisor to a failed firm.

Overall, our view is that there is scope for greater clarity both about what the PRA considers as failure within the context of insurance, and about the PRA's tolerance for insurer failure. We believe it is important that the PRC takes a view on this issue, and communicates it clearly, both internally and externally. A clearer definition of failure, alongside a determination of the PRA's appetite for such failures, may also have important implications for both the PRA's supervisory approach in general, and towards the FSCS in particular.

The role of the FSCS within policyholder protection

As outlined in more detail in Box 6, the FSCS is designed to compensate a majority of retail and small business policyholders in the event of insurer insolvency. As such, the FSCS contributes to the protection of policyholders; it additionally leads to increased confidence in insurers of all sizes, benefitting competition. As described more fully in Box 6, the PRA has a number of important responsibilities in respect of the FSCS, including in setting FSCS rules and compensation limits for insurers. And, as noted above, considerations of policyholder protection were observed to play a meaningful role in determining the PRA's approach.

Another aspect of the PRA's approach towards the FSCS is the extent to which insurance supervisors should take the existence of the scheme into account. Some are of the view that the existence of the FSCS — while valuable — should not be taken into account by insurance supervisors. An alternative viewpoint is that in some instances, the existence of the FSCS could have implications for the PRA's supervisory approach. Specifically, there is a question of how intensively the PRA should resource the supervision of firms who have a high probability of failure, whose policies are readily substitutable, and whose policyholders the FSCS is able to compensate at relatively low cost to the industry.

We believe that it would be helpful if the PRC were able either to endorse the view of some that insurance supervisors should not take into account the existence of the FSCS, or — if it takes a different view — to provide an articulation of its preferred approach. This has the potential to lend further clarity to the PRA's articulation of its approach to and tolerance of failure within insurance, and of the extent to which all policyholders are considered equal, and would allow both internal supervisory guidance and the PRA's published *Approach* to be updated accordingly (Section 4).

3.3 Recommendations: articulation

The PRA has considerable discretion when discharging its policyholder protection responsibilities, and, in our view, a clear articulation of its strategy and approach is essential. A large body of work to articulate the institution's responsibilities was carried out in the period leading up to, and shortly after, the transfer of responsibility for insurance supervision to the PRA. Our view is, however, that there is more to do to on articulation, and we believe it important that the PRC discusses this issue in depth, and comes to a settled view on its preferred approach, including in those areas where it has been afforded discretion. This includes on the interaction between the General and Insurance Objectives and the interface between the PRA's and FCA's policyholder protection responsibilities.

We are also of the view that there is further to go in defining the level and nature of the protection for policyholders that the PRA is seeking to achieve, including the extent to which the degree of protection provided differs between different types of policyholders. In our view, there would also be value in the PRC articulating more fully its view of failure in the context of insurance, particularly in the case of potential insolvency, and considering the degree to which this articulation is consistent with the current supervisory approach, including the PRA's approach to the FSCS.

Table 3.A Recommendations: articulation

High-level recommendation	Detailed recommendations
1. Articulate more fully the PRA's strategy and approach with respect to its policyholder protection responsibilities	<p>(A) The PRC to articulate more fully the PRA's policyholder protection responsibilities, taking account of:</p> <ul style="list-style-type: none"> (i) The interaction of the General and Insurance Objectives (ii) The relationship between the PRA's policyholder protection objective and the FCA's complementary responsibilities <p>(B) The PRC to articulate more fully the level and nature of policyholder protection that it is seeking to achieve, taking account of:</p> <ul style="list-style-type: none"> (i) The degree to which 'appropriate' levels of protection differ between different types of policyholders (ii) The meaning of non-zero failure within the context of insurance, and the PRA's appetite for failure (iii) The extent to which PRA supervisors should explicitly take into account the existence of the FSCS.

4 Evaluation — approach

As discussed in Section 3, the PRA is afforded considerable discretion in its approach to its policyholder protection responsibilities. In our view, the scope for discretion places a high premium on the PRA articulating its approach fully, and on ensuring that this approach is communicated clearly, and widely understood, both internally and externally.

This section considers the extent to which a clear approach to policyholder protection can currently be observed within the PRA. We consider public statements and internal supervisory guidance (Section 4.1), as well as staff understanding, both stated and as revealed by supervisory approach in practice (Section 4.2). Section 4.3 concludes and outlines recommendations.

The evidence set out in this section of our report is particularly relevant to our first evaluation criterion: the extent to which the PRA's Insurance Objective, including its interaction with the General Objective, is clearly articulated and commonly understood across all levels and functions of the PRA. It is also relevant to the second: the extent to which the PRA's supervisory strategy, framework, tools and approach support the delivery of the Insurance Objective. This part of our evaluation draws on the desktop framework review and case study workstreams.

4.1 External statements of approach and internal guidance

The PRA sets out its supervisory approach externally in a number of publications, including supervisory statements and the PRA Rulebook (Prudential Regulation Authority (2016b)), and — less formally — speeches by senior staff.⁽¹⁾ The PRA's consolidated approach is, however, most clearly articulated at a high level in the PRA's *Approach to insurance supervision* (Prudential Regulation Authority (2016c)). This sets out how the PRA carries out its role in practice and is designed to help regulated firms and the market understand how the PRA supervises insurers, as well as to aid accountability to the public and Parliament. Meanwhile, internal guidance for supervisors takes a number of forms, including guidance documentation for supervisors, and the provision of supervisory training.

Section 3 highlighted that there are a number of areas in which the PRA's approach to its Insurance Objective would benefit from fuller articulation. And while some features of the PRA's approach are clearly set out in external statements of supervisory approach and internal supervisory guidance, unsurprisingly, gaps in articulation can also be observed.

As **Table 4.A** shows, there are a number of important elements of the PRA's approach that are set out clearly in external and internal guidance. However, there are other areas that are covered less fully, including elements of the statutory framework. These include:

- **The interaction between the PRA's General and Insurance Objectives:** Neither external nor internal documentation explains that the PRA's General and Insurance Objectives are tethered together through the statutory provisions contained in FSMA, and thus the PRA's remit when carrying out its general functions is to contribute to policyholder protection where this also has the capacity to impact on safety and soundness. Within the *Approach* document, little consideration is given to the possibility that, in some circumstances, the two objectives may need to be balanced.

(1) See, for example, Woods (2015) and Rule (2017).

Table 4.A Key features of PRA approach to policyholder protection communicated externally and internally

Approach document	<ul style="list-style-type: none"> • States that the significance to policyholders of the risk insured and the potential for significant adverse effects on policyholders if cover were to be withdrawn, is a key factor in the PRA's prioritisation of its approach to protecting policyholders, implying that all policyholders need not be treated equally. • Makes clear that a key principle underlying the PRA's approach is that the PRA does not seek to operate a zero-failure regime; that policyholders should be protected through mechanisms by which insurers can exit the market, as well as the FSCS; and that the PRA will seek to ensure that any insurers that fail do so in a way that avoids significant adverse effects on policyholders and recourse to public funds. • Makes clear the PRA's commitment to working closely with the FCA, and that both institutions have a role to play in policyholder protection. • Makes clear that policyholder protection is particularly an issue in relation to the supervision of with-profits policies, and the importance of co-ordination between the PRA and FCA on this point.
Internal guidance documentation for supervisors	<ul style="list-style-type: none"> • Sets out the text of both primary objectives and explains that the PRA has discretion to balance the two objectives where they come into conflict. • Makes clear that firm categorisation (see Section 5) helps determine the intensity of supervision for a firm. • Mentions the existence of the FSCS and encourages liaison between supervisors and the FSCS to protect policyholders of potentially failing firms.
Training for supervisors	A number of courses exist for staff at different levels of experience and seniority, and in several cases this training explicitly covers the statutory framework for insurance supervision.

- **The interaction between the PRA's Insurance Objective and the FCA's consumer protection responsibilities:** Neither the *Approach* document nor internal supervisory guidance make clear that the FCA has by far the greater role in the policyholder, and broader consumer, sphere.
- **The PRA's discretion to determine the 'appropriate degree' of protection provided to policyholders:** Guidance for supervisors does not explicitly make clear that the appropriate degree of protection may vary with the type of product (or other factors the PRA considers relevant) and, in common with the *Approach* document, contains little information as to how discretion is exercised in this area. It is also not clear how the PRA exercises its discretion in deciding between the interests of different generations of policyholders when this is necessary.
- **The PRA's discretion to determine the form of protection provided to policyholders:** Little information is given on how the PRA chooses what form of protection is appropriate in particular circumstances. It is also unclear the extent to which the existence of the FSCS is taken into account by insurance supervisors (see Section 3.2 for further discussion).
- **The meaning of failure within insurance:** As noted in Table 4.A, the *Approach* document highlights that the PRA's approach to supervising insurers is non-zero failure, but does not make clear the meaning of failure in this context (see Section 3.2 for further discussion). Meanwhile, internal supervisory guidance sets out the PRA's approach to recovery, resolution and run-off, but does not give any indication of the PRA's appetite for failure. For example, there is no mention of the PRA's non-zero failure approach, nor of the meaning of failure in this context.
- **International approach:** Neither the *Approach* document nor internal supervisory guidance outline what the PRA's policyholder protection responsibilities mean (if anything) for policyholders in subsidiaries and branches of UK insurance firms located outside of the United Kingdom.

In addition, there are some areas of the PRA's work where the Insurance Objective can be seen in particularly sharp relief (such as the PRA's general approach to Part VII transfers, or run-off) that are not covered in much, if any, detail in the *Approach* document, or internal supervisory guidance. Other documentation, for example supervisory statements, lend some clarity in these areas, but at the same time contribute to what we consider to be a somewhat diffuse set of communications of the PRA's approach. We believe there would be value in a consolidated public statement of the PRA's approach to its Insurance Objective. This would include a high-level articulation (as recommended in Section 3), but would also synthesise current practices in relation to areas where the Insurance Objective has particular relevance, such as those outlined in Section 2. This articulation should also be reflected in enhanced internal supervisory guidance.

4.2 Staff understanding

A common understanding of the Insurance Objective, shared throughout the PRA, is essential for a consistent, considered and proportionate supervisory approach. As part of our evaluation, we considered the degree to which PRA supervisory and policy staff could articulate clearly their responsibilities with respect to the Insurance Objective (for example, through structured interviews, focus groups and a survey). We also assessed the approach taken by supervisors in practice, primarily through selected case studies.

As discussed below, in terms of supervisors' stated understanding of the Insurance Objective, our view is that there is more to do. Supervisors were often not able to articulate fully the PRA's responsibilities with respect to the Insurance Objective. This is not entirely surprising since the PRC (and formerly PRA Board) has not considered in-depth the institution's approach, and — as noted above — the absence of such a high-level articulation is reflected in published statements of approach and internal supervisory guidance. But perhaps the most important element of staff understanding is their revealed approach — that is, what is being done in practice. And on this point, expanded below, we have observed numerous positive instances of supervisors taking appropriate steps to advance prudential policyholder protection.

(i) Supervisors' stated understanding

Through the course of its evaluation, the IEO observed that supervisors were alert to issues of policyholder protection, and displayed some level of understanding of the scope of the PRA's role in this area. For example:

- In focus groups, staff indicated that policyholder protection was seen as the cornerstone of insurance supervision and that in most cases, it was achieved through safety and soundness. For this reason, limited thought was given to the areas of difference between the two objectives — nevertheless, supervisors were able to suggest and explain examples of supervisory decisions that they viewed as being influenced by the Insurance Objective.
- Even where focus group participants did not articulate the FCA's greater role in the policyholder protection field, it seemed from the broader discussion to be implicit in their thinking. For example, participants struggled to identify an issue to which safety and soundness was irrelevant that would not obviously be an FCA responsibility.
- A majority of respondents to the IEO's survey of staff⁽¹⁾ believed that there was a common understanding of the PRA's interpretation of its Insurance Objective. In addition, most survey respondents were clear that the 'appropriate degree' of protection afforded to policyholders was a matter of discretion for the PRA.

At the same time, however, it was not always clear that a detailed understanding of the PRA's responsibilities with respect to policyholder protection was common across the supervisory population. For example:

- The IEO's survey of staff revealed that, among survey respondents, it was not widely understood that the FCA had by far the greater role in the policyholder sphere, and that the PRA's General and Insurance Objectives were 'tethered together' (ie that the PRA's statutory remit for contributing to policyholder protection links this to areas which have the capacity to affect safety and soundness).
- In a similar vein, there was mixed evidence from structured interviews of an appreciation that the PRA's two Objectives were linked in this way and, consequently, of the boundary between the PRA's and FCA's responsibilities.
- In addition, understanding of the factors which might weigh in the PRA's determination of the 'appropriate degree' of protection afforded to policyholders differed among survey respondents.

We also took the opportunity to ask staff in both the structured interviews and in the focus groups about their perceptions of public understanding of the role of the PRA in respect of policyholder protection, and the scope of

(1) The IEO's survey of staff was completed by 56% of staff involved in insurance supervision.

its responsibilities in this sphere. The near-unanimous response in these discussions was that the PRA's responsibilities with respect to policyholder protection were not well understood externally.

(ii) Supervisors' revealed approach

During the course of the evaluation we gathered evidence of PRA supervisors considering in detail, and, in many cases, acting upon, policyholder protection issues. There was no sense in any of our evidence gathering that policyholder protection was unimportant to supervisors, or ignored in decision-making. Rather, as exemplified in the case studies, we found evidence of supervisors acting to advance the 'right' (ie prudential) form of policyholder protection in practice:

- In the case of with-profits allocations, supervisors drew on actuarial judgements to consider whether a discretionary profit distribution was appropriately prudent, and also did not disadvantage any particular group of policyholders.
- In the case of firms in run-off that were considered to be on the path to insolvency, there was very clear evidence that policyholder protection contributed to supervisors' decisions of whether (and when) it would be appropriate for any such firm to close. Supervisors were actively balancing the merits of (i) encouraging further claims by announcing closure; and (ii) enabling more claims to manifest themselves by allowing the firm to continue for a longer period, aware that some may arrive only after the remaining funds had been exhausted.
- In the case of the Part VII transfers we evaluated, the PRA considered the impact of the proposed transfer on both of its objectives (as noted in Box 4 (Section 2), a Part VII transfer is a mechanism that allows insurers and reinsurers to transfer certain portfolios of insurance business from one entity to another). In particular, we found evidence of supervisors judging whether any groups of policyholders involved in the transfer would be made materially worse off. We also found clear evidence of PRA supervisors insisting that the independent expert's report to the court was of a high quality in terms of how it considered the impact on different groups of policyholders.
- In the case of the PRA decision to increase FSCS limits in 2015, there was significant evidence that while considering the appropriate level of compensation for the different classes of insurance, the PRA examined, alongside other technical factors, the role that the limits would play in ensuring an appropriate degree of protection for policyholders. Particularly in the formative stages of the work, there was detailed consideration of the Insurance Objective.

4.3 Recommendations: approach

It is clear that PRA supervisors are motivated to deliver on the Insurance Objective. This evaluation has found clear evidence, from multiple sources, and in a range of settings, of supervisors taking meaningful actions to advance policyholder protection.

But it is also clear that the gaps in the PRA's articulation of its approach to the Insurance Objective (Section 3) have manifested themselves in gaps in external and internal communication, and, to a degree, in staff understanding. Once the PRC has had the opportunity to discuss and articulate its preferred approach, our view is that there is a case for this to be communicated clearly to both supervisors and regulated firms through a programme of internal and external communication. This is likely to include an update to the published *Approach* document, and to internal guidance for supervisors, reinforced by staff training.

Table 4.B Recommendations: approach

High-level recommendation	Detailed recommendations
2. Communicate the PRA's preferred strategy and approach, both internally and externally	(A) The PRA Executive to communicate the fuller articulation under Recommendation 1 (Table 3.A): <ul style="list-style-type: none"> (i) Internally, through an update to guidance for supervisors, reinforced by training for new and existing staff (ii) Externally, including through an update of the PRA's published Approach document for insurance supervision, and other vehicles for external communication (eg speech, <i>Quarterly Bulletin</i> article)

5 Evaluation — resourcing

The PRA has at its disposal a number of means of delivering its desired degree of policyholder protection, including its approach to regulation and policy, its supervisory strategy and its operating model — including its approach to allocating supervisory resource.

The PRA's resourcing strategy is underpinned by its commitment to forward-looking, judgement-based supervision. Supervisory staff and expertise are allocated to firms that pose the greatest risk to the PRA's objectives and the financial system more widely. This section focuses specifically on the influence of policyholder protection on resourcing and organisation (Section 5.1), linking back to the questions raised in Section 3 concerning the level of policyholder protection that the PRA is seeking to achieve (Section 5.2). Section 5.3 concludes.

This section addresses our third evaluation criterion: the extent to which insurance supervision has appropriately allocated resources, and is organised effectively, to support the fulfilment of the Insurance Objective. It draws on the desk-based review of the PRA's framework (which analysed staffing data; past reviews of resourcing conducted by the PRA; structured interviews; and focus groups) and selected case studies.

5.1 How policyholder protection considerations influence resourcing

As set out in Section 2, the PRA's two primary objectives for insurance supervision — safety and soundness (the General Objective), and policyholder protection (the Insurance Objective) — are not easily separated. Most of the time, supervisory actions pursue both safety and soundness and policyholder protection simultaneously. And key aspects of the PRA's approach to resourcing, which focuses resource on those firms which pose the greatest risk to the PRA's objectives, can be thought of as supporting both the General and Insurance Objectives.

But there are a number of areas of supervision where the PRA's policyholder protection objective can be seen in particularly sharp relief. These include discretionary profit allocations for with-profits funds, firms in run-off or approaching closure and firms or funds undergoing structural change through a Part VII transfer. This section briefly reviews how policyholder protection considerations influence the PRA's overall approach to resourcing, before considering areas where the PRA's policyholder protection responsibilities have particular relevance.

(i) The PRA's overall approach to resourcing

As outlined in Section 3, the *Approach* document (Prudential Regulation Authority (2016c)) states that the size of a supervisory team allocated to any particular insurance firm, together with the amount of senior-level airtime that a firm receives, are in large part driven by judgements about (i) the potential impact of a firm on the PRA's objectives; and (ii) the likely proximity of a firm to failure. The first of these judgements is underpinned by the PRA's firm categorisation process and the second by the PRA's Proactive Intervention Framework (PIF).

Specifically:

- The PRA's firm categorisation framework is a key process for allocating resources across firms. The PRA splits all insurers it supervises into categories based on the significance of each firm to its objectives from Category 1 (the largest and most significant firms) to Category 5 (the smallest firms). When allocating firms to categories, the PRA explicitly considers the potential impact of a firm; this is primarily done via numerical scoring based on regulatory reporting that captures the size of the firm. Supervisors additionally review qualitative analysis to confirm that a firm's categorisation presents a full picture of its potential impact.
- Another important determinant of resourcing is an insurer's proximity to failure, which is captured by the insurer's position within the PRA's PIF. There are five clearly demarcated PIF stages, each denoting a different

proximity to failure (with financially healthy firms at PIF stage 1 or 2, and failing firms at PIF stage 5). Every insurer sits in a particular stage at each point in time. Insurers with higher PIF scores (where, by definition, there is a greater risk of policyholder detriment), will typically receive greater supervisory resource and senior-level airtime (see also Section 5.2).

This approach means that firms whose failure would impact the largest number of policyholders typically receive the greatest level of resourcing. And the number of policyholders has therefore been seen as a proxy for resourcing based on policyholder protection considerations.

Further detail on the PRA's general approach to resourcing insurance supervision, and on the firm categorisation and PIF processes, is provided in Annex 2.

(ii) Specialist resource supporting areas where policyholder protection has particular relevance

There are certain areas where the PRA's policyholder protection responsibilities can be seen in particularly sharp relief. While the supervisory approach is no different for these firms, which must also be safe and sound, the supervisor is likely to also need to consider the relative position of different types of policyholder.

As set out in Section 4, during the course of the evaluation we observed numerous examples of PRA supervisors considering in detail, and, acting upon, policyholder protection issues. Much of that activity stemmed from the approach of a number of specialist resources:

- For smaller (Category 3–5) firms that are undergoing a Part VII transfer, or any firm that is in run-off, the Insurance Directorate is organised such that there are two teams that specialise in leading supervision in those circumstances: the 'Insurance Transfer and Crystallised Risk Team' and the 'Run-Off Team'.
- Larger (Category 1 and 2) firms have a more significant resource carrying out 'business-as-usual' supervision. Part VII transfers will typically be dealt with by the firm's supervisors in the first instance, as they have existing specialist knowledge of the firm or fund. But they will be supported by the 'Insurance Transfer and Crystallised Risk Team'.
- The Insurance Directorate employs around 80 actuaries to support supervisors, for example in making judgements around the appropriateness of discretionary with-profit allocations, as proposed by firms.
- There is a 'Recovery and Compensation Team' in Prudential Policy Directorate (PPD)⁽¹⁾ that is responsible for policyholder protection issues in terms of formulating the rules governing the FSCS's protection of policyholders, and for the PRA's relationship with the FSCS.

Taken together, the allocation of these resources to areas where policyholder protection responsibilities have particular relevance provides positive evidence of the PRA using its resources to advance its Insurance Objective.

5.2 The level of policyholder protection that the PRA is seeking to achieve

As set out in Section 3, the PRA has considerable discretion when discharging its policyholder protection responsibilities. There are numerous aspects to this discretion, including that the PRA has flexibility (within the constraints of EU and domestic law) to determine what it deems to be an appropriate level of policyholder protection. The PRC has not yet had the opportunity to discuss in detail a number of aspects of its approach to policyholder protection (Section 3.2). As such, there is not yet an explicit 'top down' resourcing strategy that links resourcing and organisational considerations to the PRC's preferred approach.

Section 3 highlights two open questions that will ultimately help to determine both the level and the nature of the policyholder protection that the PRA is seeking to provide: (i) the extent to which certain types of policyholders are prioritised; and (ii) how the PRA aims to deliver a 'non zero failure' regime within the context of

(1) A Directorate of the Bank that leads on prudential policy formulation and reports jointly to the Deputy Governor for Financial Stability and the Deputy Governor for Prudential Regulation.

insurance (including the role of the FSCS within policyholder protection). At present, in the absence of an explicit top-down strategy, the PRA's resourcing approach in these areas can be observed as a series of relatively localised decisions, which nevertheless potentially have an important bearing on how the PRA is currently discharging its policyholder protection responsibilities. This section considers each question in turn.

(i) To what extent are certain types of policyholder prioritised?

As discussed in Section 3, in late 2013 and early 2014, shortly after the inception of the PRA, consideration was given to policyholder protection by the SRPC, the most senior supervisory committee below the PRC. As part of its discussions, the SRPC considered how the PRA might embed the differential approach to policyholder protection signalled in its published *Approach* document. Specifically, the *Approach* document indicated that priority was determined according to the extent of market failure that was present, and the potential impact on policyholders of a failure to pay claims or a loss of continuity of cover.

In considering a framework for giving greater effect to this approach, the SRPC agreed a number of factors that were of particular relevance. These included: scope for poor policyholder outcomes (for example in relation to long-term policies which could not be transferred); the scale of the potential impact of failure on policyholders; and whether the policyholder could be made materially worse off in the event of insolvency. Under this approach, the SRPC suggested that the types of policy that might warrant more protection could include: annuities; compulsory insurances (eg employers' liability and third-party motor); term assurance; and professional indemnity insurance.

The SRPC agreed that the differential approach should be embedded by explicitly taking into account particular classes of policyholder during the firm categorisation process. The quantitative approach to firm categorisation places most weight on the largest firms — it does not account for the type of policy offered by the firm or the specific risks to which the firm is exposed. And so the SRPC decided that supervisory judgement should be used to override the categorisation based solely on the size of the firm, where appropriate (through 'qualitative overrides').

While the *Approach* document was updated following the SRPC discussion to reflect the new approach to qualitative overrides based on the type of policy provided, we found mixed evidence of the extent to which the SRPC's decision on firm categorisation had been implemented in practice (Box 7). Neither is it clear that internal supervisory guidance was updated along the lines of the *Approach* document. Structured discussions with PRA staff also pointed to a range of views on the degree to which the SRPC decision on firm categorisation had been implemented.

We would note, however, that the firm categorisation process is only one influence on resourcing decisions. And it is possible that the type of policyholders to which the SRPC intended to provide more protection are receiving additional protection via resourcing through channels other than firm categorisation. For example, in focus groups, staff told us that annuitants can receive greater resourcing, reflecting local resourcing decisions or discretion.

As set out in Section 3, our recommendation is that the PRC should be sighted on the SRPC decision regarding firm categorisation. If the PRC agrees with the SRPC decision, then it should be implemented in full. We would also observe that, if the PRC decides that different classes of policyholder should be treated differently, this is likely to have broader implications for resource allocation (and indeed for the supervisory and policy approach more generally). Our view is that these broader implications should be discussed and implemented where appropriate.

(ii) Is the approach to resourcing consistent with the PRA's appetite for insurer failure?

In Section 3 we noted the desirability of the PRA articulating more fully its appetite for insurer failure. While the PRA has stated that it operates a non-zero failure regime, some ambiguity appears to exist internally as to the meaning of failure in this context for insurance. In this subsection, we focus on the degree to which current resourcing practices illuminate the PRA's appetite for insurer failure.

Box 7

Qualitative overrides to firm categorisation

As set out in Section 3, the SRPC decided in 2014 that the firm categorisation process should be amended to explicitly take into account particular classes of policyholder through qualitative overrides. This box examines the extent to which the SRPC decision has been implemented in practice.

A relatively large number of qualitative overrides are made during the PRA's firm categorisation process as supervisory judgement is applied. And so here we have focussed on the reasons given for all of the positive overrides applied (that is, insurers moved to a higher impact category) in 2015. Specifically, we looked for any evidence of positive overrides for firms whose policyholders were identified by the SRPC as warranting greater protection (eg annuities, compulsory insurance).

Overall, we found limited evidence of positive overrides having been made in line with the SRPC decision. In 2015, of the 16 positive overrides to insurer categorisation that were made, only one firm had its category boosted on account of the type of policy it provided. That firm was re-categorised on the grounds that they provided a critical service in a niche market. But we did not observe any upgrades to categorisations based on firms being large providers of policies such as annuities or with-profits. Instead, the majority of overrides reflected data issues or firm complexity considerations.

While there was only one example of a positive override for the type of policy provided by the insurer, we did see a number of other ways in which policyholder protection considerations had affected categorisation. For example, a number of firms had their categorisation downgraded on account of providing unit-linked business, for which investment risk sits more explicitly with the policyholder.

A minimum level of supervision is provided for small insurers

Smaller firms receive a greater level of resource than measures of 'potential impact' would suggest. While the categorisation process means that smaller firms receive less resourcing than larger ones, there is not a linear relationship between the estimates of a firm's potential impact on the PRA's objectives and the level of resourcing. This has been linked to a number of factors:

- A minimum amount of supervision that must be carried out for each firm in order for supervision to be credible, such that there is a fixed resource cost to supervising a firm. In 2015 the PRA carried out a review of the way it organised itself — that is its Target Operating Model. The review is discussed in more detail in Annex 2. It noted that, in the absence of a skew of resources towards smaller insurers, supervisors of Category 5 insurers would be responsible for an unreasonably large number of entities. The review also noted that resource demands of firms do not increase in a linear way as their scale or impact increases.
- The requirements of Solvency II imply a certain level of supervisory action must be undertaken for all but the very smallest firms, leading to a fixed overhead and greater resourcing at lower categories.
- Niche markets are often served by smaller specialist insurers, where it might be difficult to secure continuity of cover in the event of firm failure.

The skew of resources towards supervision of smaller insurance firms arguably supports the PRA in delivering policyholder protection. However, in our view, it is also possible that the skew may feed into the perception among supervisors that the PRA may not be operating a non-zero failure regime in practice (see also Section 3.2). It would be helpful for the PRC to discuss the intensity of resourcing of small firms in light of a clearer articulation of its approach to firm failure.

Resources can be altered significantly as risks to objectives change

As explained in Section 5.1, an important determinant of a firm's supervisory resourcing is the perceived viability of the firm. The Proactive Intervention Framework (PIF) is designed to ensure that the PRA identifies and responds to emerging risks at an early stage.

The PIF is not applied in the same way for the very smallest firms. The stated approach for supervision of Category 5 firms is reactive, rather than proactive. Risks to policyholders at smaller firms are therefore unlikely to be identified as early as for larger firms. However, if small firms begin to approach failure, staff note and we have observed that Category 5 insurers can be resourced intensively, despite their small size. For example, in one of our case studies, we observed a Category 5 firm that had seen a marked increase in resourcing, including at a senior level.

It is at higher PIF stages that policyholder protection issues typically come to the fore. So the reallocation of resources as a firm's PIF stage increases would appear to be supportive of the PRA's policyholder protection objective. As noted in Section 3, however, a clearer articulation of the PRA's approach to firm failure would help when judging whether the extent of reallocation of resources in light of increased risks to a firm's solvency is appropriate. In our view, this would help address the perception of a mismatch between the PRA's stated 'non-zero failure' approach and business-as-usual supervisory practice.

5.3 Recommendations: resourcing

We observe a large number of ways in which insurance supervision is resourced that should support the policyholder protection objective, including through firm categorisation, PIF scoring, and specialist teams dedicated to issues relevant to policyholder protection.

However, as discussed in Section 3, the PRC has not yet explicitly articulated a number of aspects of its strategy towards policyholder protection, including the level of policyholder protection that it is seeking to achieve. And, as a consequence, the PRA's resourcing strategy in respect of policyholder protection can perhaps be best characterised as a 'bottom up' series of localised resourcing decisions, rather than an explicit 'top down' approach that is clearly linked to an articulated strategy.

Once the PRC has had the opportunity to come to a settled view on its preferred approach towards policyholder protection, including in those areas where it has been afforded discretion, it should then consider the appropriate resourcing strategy required to deliver that approach. This includes clarifying, in the context of the SRPC's discussion in 2014, whether and how to prioritise protection for some policyholders via the firm categorisation framework.

Table 5.A Recommendations: resourcing

High-level recommendation	Detailed recommendations
3. Implement the PRA's preferred strategy and approach effectively, including via a clear and consistent approach to firm categorisation	<p>(A) Building on Recommendation 1 (Table 3.A), the PRA Executive to ensure that the PRA's wider resourcing strategy is aligned with the preferred approach to policyholder protection, including considering any wider implications for the supervisory strategy and operating model</p> <p>(B) The PRC to consider the extent to which it prioritises protection for some policyholders via the firm categorisation framework, and the PRA Executive to implement this as appropriate through clear guidance for supervisors</p>

6 Evaluation — FCA co-ordination

Co-ordinating effectively with the FCA — the UK financial conduct regulator — is important to all aspects of PRA supervision and policy-making. Throughout the PRA, supervisory and policy staff liaise frequently with their FCA counterparts at all levels — including the arrangement whereby the PRA's Chief Executive serves on the FCA's most senior decision-making forum and *vice versa*.⁽¹⁾ Policyholder protection is a particularly important area of PRA-FCA interaction, given the overlap in the two regulators' objectives. This section looks at this topic in more depth, considering both the framework for co-ordination between the two institutions (Section 6.1) and the nature of the interactions in practice (Section 6.2).

The evidence set out in this section is particularly relevant to our fourth evaluation criterion: whether the PRA interacts effectively with other relevant regulatory bodies on the Insurance Objective. And it draws primarily on our case studies and on the desktop framework review (Section 2).

6.1 The framework for PRA-FCA interaction

Under the United Kingdom's post-crisis structure for financial regulation (enacted through the Financial Services Act 2012), the PRA and FCA share responsibility for regulating certain types of firm, including insurers. The PRA's overarching remit is prudential regulation while the FCA's is conduct.

When this regulatory structure was being set up, concern about 'underlap' between the regulators' responsibilities was an important consideration in the drafting of the statutory framework. This was addressed in two main ways. First, the statutory framework, by construction, contains no 'hard' delineation of responsibility between the PRA and the FCA. Second, the PRA and FCA are required by statute to maintain Memoranda of Understanding, in order to facilitate close co-ordination and co-operation.

In terms of the overlap between the PRA's and FCA's responsibilities, policyholder protection is an important element of both institutions' objectives. Yet the legislation also recognises the regulators' differing roles and remits. While the PRA is required to 'contribute to securing an appropriate degree' of protection for policyholders as one of two primary objectives, the FCA has several operational objectives in statute, one of which is to 'secure an appropriate degree' of protection for consumers. These differences are indicative of the relative role of the two authorities in this space. Policyholders are a subset of consumers, and the FCA has by the far the greater role in this sphere.

More generally, as set out in Box 5 (Section 3), our understanding is that the focus of the PRA's responsibilities should be on prudential policyholder protection. Where an action has no capacity to impact on the PRA's General Objective (safety and soundness), the PRA may find it difficult when carrying out its general functions to justify that action and it will generally be for another body (often the FCA) to take the lead. In its published *Approach* document (Prudential Regulation Authority (2016c)), the PRA explains the difference between the two regulators' objectives as follows: 'The FCA seeks to ensure that consumers are treated fairly in their dealings with insurers, whereas the PRA's focus is to ensure that policyholders have an appropriate degree of continuity of cover for the risks they are insured against'.

The differing nature of the remits and statutory objectives of the PRA and FCA also reflect themselves in differences in organisational design. The PRA supervises around 600 insurance firms and organises insurance supervision at the level of the firm, with a named supervisor responsible for each supervised entity. By contrast, the FCA supervises around 6,500 insurance firms and brokers, as well as additional appointed representatives.

(1) The Chief Executive of the PRA sits as a member of the FCA Board, while the Chief Executive of the FCA is a member of the Bank of England's Prudential Regulation Committee.

Box 8

The Memoranda of Understanding between the PRA and FCA

There is a statutory requirement for the FCA and PRA to have a Memorandum of Understanding (MoU) to clarify the role of each regulator in matters of common interest and how the two regulators will co-ordinate with one another (the 'main MoU'). There is a further requirement for a memorandum in respect of co-ordination between the two regulators relating to regulation of with-profits insurers. While it is possible under statute for this second memorandum to be combined with the first, there is currently a separate MoU in respect of with-profits business (the 'with-profits MoU').

The main MoU between the PRA and FCA sets out areas for co-ordination and co-operation between the two authorities, which cover information and data sharing, and consultation and co-operation on a range of policy issues, including rule changes, authorisations, firm-level supervisory colleges, regulatory processes, enforcement, and matters relating to the Society of Lloyd's and FSCS.

In addition, the main MoU requires: the CEO of each regulator to sit on the other's Board; for the two regulators to meet quarterly at a senior level; and for the Boards of each regulator to review the MoUs annually and report findings in their respective annual reports.

The with-profits MoU has a good deal in common with the general MoU but has some specific features. In particular, it outlines that the FCA has primary responsibility for supervising with-profits discretionary allocations, but that it is for the PRA to consider the affordability of such bonuses. The PRA has the final say where its views differ with those of the FCA on a proposed relevant action and those differences cannot be reconciled (ie the PRA feels the FCA's proposed actions are a threat to the safety and soundness of a dual-regulated firm).⁽¹⁾ The with-profits MoU also makes clear that each regulator must share concerns relevant to the other's objectives.

The *Approach* document (PRA (2016c)) explains the rationale for the with-profits MoU as follows: 'Policyholder protection is an element of both the FCA's and the PRA's objectives, and so they co-ordinate to ensure that their separate mandates secure overall protection. In the case of with-profits policies, additional co-ordination arrangements are needed: this is because the returns on with-profits policies are not well defined, and are at the discretion of the insurer'.

(1) Note: this statutory veto has not been used since the two regulators were set up in 2013.

Only a minority of these are supervised on a so-called 'fixed' basis — that is with a named supervisor or team. The remaining firms are supervised on a 'flexible' basis.⁽¹⁾ In addition, the FCA undertakes analysis of thematic issues. We return to these organisational differences below, as they have implications for co-ordination between the two institutions.

Effective co-ordination and co-operation between the two regulators is supported by two MoUs, which the PRA and FCA are required by statute to maintain — as set out in Box 8. During our evaluation, we considered the Memoranda of Understanding from the relatively narrow perspective of how they dealt with policyholder protection issues of mutual interest to the PRA and FCA.

6.2 Interaction between the PRA and FCA in practice

In practice, interaction between the PRA and FCA takes a number of forms. As well as the formal provisions for co-ordination and co-operation contained in the MoUs, there are, as one would expect, a variety of other more informal methods of interaction.

(1) Currently firms supervised by the FCA on a flexible basis are supervised out of a large flexible supervisory resource, however the FCA is moving towards a model where each firm will have a named supervisor or team of supervisors.

The view of the regulators is that co-ordination and co-operation between them generally works well. For example, the PRA states in its 2016 *Annual Report* (PRA (2016a)) that: 'Over the reporting period [year to end-February 2016], co-ordination remained strong with any material failures of co-ordination being remediated at the earliest opportunity'. This view was echoed by the FCA in the course of our evaluation.

Third-party reviews have also concluded that co-operation between the regulators has been effective. For example, the International Monetary Fund, during the review of insurance supervision conducted during its UK Financial Sector Assessment Programme (International Monetary Fund (2016)), noted that: 'Co-operation and communication between the PRA and FCA is good. No major violations of the MoU have been reported in the established quarterly reports. Furthermore, there is frequent practical collaboration between the PRA and FCA'.

Consistent with that is the annual survey of PRA-supervised firms conducted by its Supervisory Oversight Function. In 2015/16, around half of the firms surveyed felt that the PRA and FCA were appropriately co-ordinated in their supervision⁽¹⁾ — with the proportion highest for insurance firms. Only 10% of surveyed firms expressed discontent about co-ordination arrangements.

The remainder of this section provides observations about the effectiveness of formal and informal co-ordination mechanisms made during the course of the IEO evaluation.

(i) Formal co-ordination

In a formal sense, an important aspect of the interaction between the PRA and FCA is set out in the MoUs. These are designed to ensure that where the PRA learns of information related to conduct issues, there are clear routes for sharing information quickly and effectively with the FCA.

Channels for information sharing outlined within the MoU include:

- Quarterly meetings at CEO level for the first year following the PRA's inception, and subsequently at 'senior executive' level.
- Working-level meetings to be held to give effect to the MoUs.
- Information gathering, and reporting, on a quarterly basis about how the MoU is working. Breaches of the MoU must be publicised.

While, overall, co-ordination and co-operation between the PRA and FCA seem to be working reasonably well, we would make two observations about the effectiveness of existing formal co-ordination arrangements.

First, we note that some of the formal processes (for example, meetings) undertaken in line with the MoU were typically undertaken in a relatively informal manner. For example, our observation was that formal agenda points and minutes were not systematically circulated for meetings held to give effect to the MoUs.

Second, we observed a strong preference among front-line supervisors to use informal channels (rather than the formal reporting processes of the MoUs) for escalating issues that could not be readily resolved through working-level contact with the FCA. The MoUs were generally seen as too onerous, and potentially too public, a framework to resolve issues of this type. Instead, the preferred route for supervisors was to work through a range of other, less formal channels, as discussed further below.

(ii) Informal co-ordination

In addition to the formal MoU arrangements, the PRA and FCA meet regularly at a variety of levels to promote co-operation around policy, authorisations and the approach towards firms jointly supervised.

(1) The PRA's Supervisory Oversight Function surveyed 69 PRA-regulated firms during 2015/16, with the aggregated results reported in the PRA *Annual Report* (PRA (2016a)). 51% of surveyed firms either agreed or strongly agreed with the statement that the PRA and the FCA were appropriately co-ordinated in their supervision, with only 10% of firms disagreeing, and 39% neither agreeing nor disagreeing with the statement.

Table 6.A Different ways in which insurance issues can be raised with the FCA

Type of contact	Examples from case studies and structured discussions with PRA supervisors
Formal escalation through the MoU	None of the cases we reviewed considered using the MoU to raise issues with the FCA. PRA supervisors reported that it can be seen as too public and onerous a method.
Escalation by formal letter	In one case study a formal letter was sent to the FCA to raise an issue. The same issue was also raised informally by email with the FCA, and in a bilateral Head of Division level meeting.
Escalation by informal meeting, email or phonecall	We considered several case studies where issues were raised bilaterally with known contacts at the FCA.
Escalation via the PRA whistleblowing team	We considered one issue that was raised with the FCA through the PRA's whistleblowing team. This initial contact was then followed up by a PRA Head of Division.
Escalation via Regulatory Action Division	We considered one issue that was raised with the FCA through the PRA's Regulatory Action Division, which is responsible, where appropriate, for the deployment of the Bank's formal supervisory powers in circumstances where it is likely to be contested by firms.

Our evaluation suggested that, to a large extent, these informal co-operation channels were effective. Informal co-operation between the two regulators was clearly seen as valuable by both sides. And throughout our case studies, we found no evidence that staff at the PRA felt reluctant or unable to raise issues with the FCA.

The overlapping nature of the two institutions' responsibilities with respect to policyholder protection, together with the PRA's firm-level focus, puts the PRA in a position where it is relatively likely to come across information of potential relevance to conduct regulators through the course of its business-as-usual supervision. During our evaluation, we considered how PRA supervisors dealt with issues that fell primarily within the remit of the FCA.⁽¹⁾

Often, issues of this nature could be readily resolved informally through regular, working-level contacts. But there were occasions when this was not the case. Examples include issues uncovered by PRA supervisors during their business-as-usual supervision that were primarily conduct in nature, but were not immediately able to be actioned by the FCA — for example, because they did not score sufficiently highly within the FCA's prioritisation framework. We observed occasions where PRA supervisory time and effort was allocated to issues that were arguably conduct in nature. For example, several supervisors reported situations to us where, in order to engage the FCA on a matter, they undertook additional investigation of conduct issues in order to present the full picture to the FCA.

It was not clear to us that there was a single route by which actions raised at working-level PRA-FCA meetings were escalated, where necessary. Supervisors observed that they tended to use a range of channels to gain traction within the FCA when an issue could not be readily resolved at working level. These included escalation by formal letter, or escalation by informal letter, email or phone call (**Table 6.A**). The choice of escalation channel appeared to depend upon the individual supervisor, rather than an agreed escalation process or framework.

6.3 Recommendations: FCA co-ordination

This section has considered the effectiveness of the PRA's relationship with the FCA with respect to insurance supervision, where we found multiple examples of good co-operation between the two regulators. We found no evidence that staff at the PRA felt reluctant or unable to raise issues with the FCA, and the sense from both regulators is that co-operation and collaboration generally works well.

Effective co-ordination between the PRA and FCA is particularly important in relation to the Insurance Objective, because of (i) the degree of overlap between the two institutions in respect of policyholder protection; (ii) the FCA's greater role in the consumer sphere, of which policyholders are a subset; and (iii) the differences in organisational approach between the PRA and the FCA (where, as noted above, the PRA have designated supervisors for all firms, in contrast to the FCA). The confluence of these issues means that it is likely that the

(1) It is important to note that the resource implications of differences in organisational approach between the PRA and FCA are not one-way; PRA supervisors highlighted examples of thematic issues of relevance to the PRA's objectives on which the FCA have taken the lead in the early stages.

PRA will uncover issues outside of the remit of a prudential regulator, yet — given their resourcing model, and the number of firms they supervise — the FCA will not always be able to take those issues forward.

It is important to note that we encountered no evidence of formal overreach (the PRA exercising formal supervisory powers without legal basis) — indeed, the probability of this occurring seems very low, given the checks and balances that exist within the PRA framework.

However, our view is that the reliance on informal methods of communication for resolving issues between the two regulators nonetheless has the potential to give rise to a range of risks for the PRA, including:

- Inconsistency of approach, since informal methods of communication used can vary widely.
- Lack of high-level visibility of issues when they are not escalated via the formal MoU mechanisms.
- An inefficient use of resources, where the PRA uncovers issues not within the remit of the prudential regulator.
- The potential for overreach (though, as noted above, we believe formal overreach to be unlikely on account of the checks and balances which exist).
- A deterioration in the effectiveness of co-ordination over time as legacy personal relationships between supervisors at each of the regulators inevitably fade (around half of the PRA's current Insurance Directorate staff previously worked for the Financial Services Authority, the forerunner of the PRA and FCA).

These risks may be accentuated by other factors, including the lack of clarity among some PRA supervisory staff of the boundaries of the PRA's responsibilities (Section 4), as well as the legacy of the pre-PRA regulatory regime where prudential and conduct supervision were conducted in tandem.

We believe that further work could be undertaken to enhance the PRA's framework for co-ordination with the FCA. An important step is greater clarity in understanding and articulating the boundaries of, and interaction between, the two authorities' responsibilities (Section 3). Once that is done, we believe that there would be benefit in further work to consider how to minimise the risk of PRA supervisors inadvertently being drawn into areas beyond the scope of responsibility of the prudential regulator. Some formalisation of existing working practices may be desirable, as may an update of the relevant MoUs between the two authorities, in the light of the experience of operating the post-crisis regulatory regime.

We would note that a similar issue exists within the Bank's Markets Directorate with the gathering of Market Intelligence that might pertain to the FCA's (but not the Bank's) objectives. This was explicitly considered during the Bank's Market Intelligence Review (Bank of England (2015)), following which a framework and processes were established to ensure that all information that might be relevant to the FCA was appropriately considered and communicated. The PRC might consider whether a similar approach might usefully be adapted for the PRA in respect of insurance supervision, and in particular policyholder protection.

Table 6.B Recommendations: FCA co-ordination

High-level recommendation	Detailed recommendations
4. Enhance the PRA's framework for co-ordination with the FCA in respect of policyholder protection	<p>(A) The PRC to consider — in conjunction with the FCA as appropriate — how best to mitigate the risk of PRA supervisors being drawn into areas beyond the scope of responsibility of the prudential regulator. This should include consideration of whether:</p> <p>(i) There should be some formalisation of existing working practices</p> <p>(ii) An update of the relevant Memoranda of Understanding with the FCA is needed</p>

Annex 1 Background to the evaluation

This annex expands on the remit of the evaluation outlined in Section 2. It explains how the project met the criteria for an IEO evaluation; it describes the evaluation team and the various support that it was able to draw on; and, lastly, it briefly outlines the IEO team's methodology, and the sources of data for this evaluation.

Meeting the criteria for an IEO evaluation

As noted in Section 2, the Bank's Court of Directors commissioned the IEO to evaluate the PRA's approach to its Insurance Objective in April 2016. The evaluation satisfied the criteria agreed by Court for in-depth evaluations conducted by the IEO in that it was a relatively new statutory duty.

The Bank's Court of Directors endorsed the IEO's proposal to undertake a 'process' evaluation.⁽¹⁾ Specifically, Court agreed that the IEO should consider: whether the PRA's framework is delivering what was intended in statute; whether there is a consistent understanding of, and approach to, the policyholder protection objective throughout the institution; and the nature of any challenges that have arisen in pursuit of it. It followed that the project would not provide commentary or judgement on individual policy or supervisory decisions made by the PRA — reflecting the founding principle of the IEO that live policy is out of scope (Ashley and Paterson (2016)), as well as the need to avoid duplicating work of the PRA's Supervisory Oversight Function.⁽²⁾

The evaluation team

This evaluation, as with previous IEO assessments, drew on internal Bank of England secondees as well as external expertise. Internal Bank secondees were not drawn directly from the business areas under review, though the IEO team collaborated closely with these areas.

From within the Bank, the evaluation was able to draw on the insight of two of the PRC's External Members with extensive experience in insurance, David Belsham and Norval Bryson, as well as three of the PRA's Senior Advisors, Ron Baxter, Nick Dexter and Ian Marshall. PRA Senior Advisors have worked in senior roles within the financial sector and are engaged by the PRA on a part-time basis to provide independent challenge and support to PRA staff.

It also benefited from advice and challenge, as well as assurance of quality and independence, from three independent experts: Nick Prettejohn, previously a Non-Executive Director of the PRA Board, a former Chief Executive of Lloyd's of London and currently Non-Executive Chairman of Scottish Widows; John Stewart, former Non-Executive Chairman of Legal & General and a former Non-Executive Director of the Bank's Court; and Mark Zelmer, who was previously Deputy Superintendent of Financial Institutions at the Office of the Superintendent of Financial Institutions (OSFI), Canada's main insurance regulator, and Head of Financial Stability at the Bank of Canada, and, from October 2016, a PRA Senior Advisor. The evaluation team met with these external experts on a number of occasions during the evaluation to discuss progress and to invite feedback on emerging themes.⁽³⁾

The review team sought views from co-regulators from elsewhere within the (domestic and international) regulatory sphere — including HM Treasury and the FCA, as well as a number of other insurance supervisors

(1) Best practice guidelines on policy evaluation distinguish between 'process' evaluations (which seek to evaluate how a policy is being implemented and delivered) and 'impact' evaluations (which seek to evaluate the difference that a policy is making to eventual outcomes).

(2) The Supervisory Oversight Function (SOF) provides firm-level assurance to the PRA Board and Executive on the quality and effectiveness of PRA supervision. In doing so, it promotes the PRA's aim to deliver high-quality, forward-looking, and judgement-led supervision. Most of SOF's work takes the form of firm-specific reviews, covering the supervision of a specific firm or groups of firms. They also undertake thematic reviews, such as on the use of a supervisory tool. Both types of reviews identify good practices and make recommendations to improve the quality of supervision.

(3) Mr Prettejohn and Mr Stewart were not remunerated for their contribution and had no access to firm-level information. From October 2016, Mr Zelmer was remunerated by the PRA in line with its established rates for Senior Advisors; as with all Senior Advisors, Mr Zelmer is required to comply fully with all aspects of 'Our Code', the Bank's conduct and ethics policy, including its provisions on information security.

internationally (see Section 1). In January 2017, the IEO discussed themes and recommendations from the evaluation with the PRA's Practitioner Panel.⁽¹⁾

In line with established practice in the evaluation field, we established an advisory group whose members included senior internal Bank stakeholders, together with the aforementioned PRC External Members and PRA Senior Advisors, as well as legal expertise.⁽²⁾ The group provided us with quality assurance and challenge throughout the project, and was a useful venue for the exchange of ideas as our analysis and evaluation developed. This group was constituted on a purely advisory basis, however. A founding principle of the Bank's IEO is its independence: its work is conducted at arm's length from local business areas, and it reports directly to the independent Chairman of Court.

Methodology and data sources

As noted in Section 2, the IEO drew on a number of different approaches and techniques within the evaluation. This is in line with best practice in the evaluation field. Combining insights from different approaches to research questions recognises that any individual approach has its drawbacks; looking for common themes across different approaches should improve the robustness of evaluation results (see, for example, HM Treasury (2011) for further discussion).

Specifically, our work drew on three complementary workstreams:

- (1) a consideration of **how the PRA interprets its Insurance Objective**, what is required in statute, and where there is scope for discretion;
- (2) a desk-based review of **how the PRA's interpretation of its statutory objective for policyholder protection had been transposed** into its supervisory framework and approach; and
- (3) six in-depth **case studies aimed at building an understanding of how the policyholder protection objective had been applied in practice**.

The starting point of our analysis was to consider the **PRA's interpretation of its Insurance Objective**. We distilled this work into a one-page summary of the interpretation of the Insurance Objective (a version of which appears in Box 5 (Section 3.1)). This work formed the foundation of the remainder of the evaluation.

A desk-based **review of the PRA's framework for insurance supervision**, which comprised a number of aspects:

- A review of externally published documents, including the PRA's *Approach to insurance supervision* (PRA (2016c)), supervisory statements, policy statements, consultation papers and relevant speeches.
- A review of key internal documents such as guidance for supervisors, previous reviews of the PRA's approach (eg its operating model) and staffing data.
- A review of issues relating to insurance considered by the PRA Board and the SRPC between 2013 and 2016.
- Structured interviews with a range of stakeholders, including PRC members, Executive Directors, Directors and Senior Advisors. This helped us understand how the Insurance Objective influenced supervisory decisions at a high level.
- Focus groups with heads of supervisory divisions and senior supervisors to further our understanding of supervisory practices at a more working level, and — in the later stages — to receive feedback and challenge on emerging themes and recommendations.

(1) The Practitioner Panel is an independent statutory panel required under the Financial Services and Markets Act 2000 to represent the interests of practitioners: www.bankofengland.co.uk/practitionerpanel.aspx.

(2) Full membership of the Senior Advisory Group: PRC External Members David Belsham and Norval Bryson, PRA Senior Advisors Nick Dexter, Ron Baxter and Ian Marshall, CCBS Advisor and former Deputy Head of the PRA, Paul Fisher, two Executive Directors of the Bank, David Rule and Victoria Saporta, two Directors of the Bank, Andrew Bulley (until June 2016) and Chris Moulder, and Vivienne de Chermont of the Bank's Legal Directorate. The advisory group was chaired by Lea Paterson, IEO Director.

- A survey of staff working in insurance supervision and policy, which explored their understanding of and approach to the Insurance Objective.

To gain a deeper understanding of the approach to supervision we **compiled six detailed case studies (Table A1.1)**. They were selected using so-called 'purposive sampling', in that the studies represented characteristics thought to be relevant to our research questions, rather than providing a statistical representation of the research population. Specifically, we identified case studies involving supervisory decisions where policyholder protection issues could be seen in particularly sharp relief (discussed in Section 2.2).

Table A1.1 Case studies used in evaluation

Case Study	Why is it of interest?
With-profits	With-profits allocations can potentially give rise to a conflict of interest between achieving a balance between safety and soundness through capital adequacy, and the fairness of the profit distribution (including between different generations of policyholder). This tests the PRA's interface with FCA and the with-profits MoU.
Latter stages of life cycle: closure of a firm in run-off	There is a potential conflict between policyholders desiring continuity of cover, and shareholders, who may wish to close a firm or exit a particular line of business altogether as opposed to maintaining run-off. This also tests the interface with FSCS.
International insurance groups	Supervisory responsibility for protection of policyholders in subsidiaries and branches of UK firms located outside of the UK varies and not all will fall under the PRA's supervision.
Small firms	The protection of policyholders at small insurance firms may require a disproportionate allocation of resources; with a smaller balance sheet there may be also greater potential for idiosyncratic policyholder issues to impact on safety and soundness.
Part VII transfer	Possible conflict between different groups of policyholders in the firm or fund being transferred and the firm receiving the transfer. This tests the interface with the FCA.
FSCS policy	Test of the extent to which protection of policyholders, and the use of FSCS as a tool to protect policyholders, has been a consideration in setting compensation limits.

Annex 2 Resourcing and organisation of insurance supervision in the PRA

The resourcing and organisation of insurance supervision reflects a number of factors — some of which were considered in Section 5 in the context of how the PRA is organised and resourced to fulfil its policyholder protection remit. This annex explores four factors relevant to the resourcing and organisation in Insurance Directorate more generally: a recent review of the PRA's Target Operating Model; the size of firm-specific teams and the link to categorisation; access to specialist resources; and decision making, challenge and assurance.

Insurance supervision is located within the PRA's Insurance Directorate. It consists of around 320 members of staff, about 300 of which are involved in front-line supervision. The Insurance Directorate reports to the statutory PRC through the Deputy Governor for Prudential Regulation.

The PRA's Insurance Directorate is organised into two areas, one covering life insurance and the other general insurance. The majority of firms fall into one of these two categories. Some firms provide both types of policy, and most of those are covered by the large firm division in the life insurance area. Within areas, supervisors tend to be allocated to firm-specific teams.

Reviewing the PRA's Target Operating Model

The PRA's Target Operating Model (TOM) was developed between 2011 and 2013, in preparation for legal cutover on 1 April 2013. It set out the expected supervisory activities, processes and organisational design that would be required to support the PRA's forward-looking, judgement-based supervisory approach.

In 2015, the PRA carried out an assessment of whether its TOM — the way the PRA organises and resources itself to meet its strategy — was meeting the organisation's objectives. Both banking and insurance supervision were covered. The review looked at various questions around the allocation of supervisory resources, such as the distribution of resources between small and large firms, banks and insurers, and policy and supervision.

The PRA Board concluded that the PRA was organised appropriately to deliver on its statutory objectives. It was noted that the historical relative emphasis on small firms in insurance remained appropriate.

While discussions of insurance supervision formed an important part of the TOM review, the early conclusion that the PRA's resource allocations as a whole were broadly appropriate, meant that the TOM review did not take resource discussions further and consequently the resource model for policyholder protection was not discussed.

Firm-specific teams and firm categorisation

A founding principle of the PRA is its judgement-based, forward-looking approach to supervision. This applies to supervision of all types of firms for which the PRA is responsible. This principle underpins the PRA's overall resourcing strategy, which is designed to ensure that supervisory staff and expertise are allocated to firms that pose the greatest risk to the PRA's objectives and the financial system more widely.

Reflecting this principle, the size of firm-specific teams is in large part determined by the firm categorisation process and Proactive Intervention Framework (PIF) scoring, which are explained in Boxes 9 and 10. PIF scoring represents a quantitative judgement about a firm's proximity to failure. Allocating resources along these lines is key to the PRA's judgement-based, forward looking approach.

Within categories, there can be significant variation in the level of resourcing that firms receive, reflecting supervisory judgement. Factors such as the risks facing the firm, the complexity of the firm, and differences in firm size within a category can all affect resourcing.

Access to specialist resources

The supervisors within each team have access to a range of specialist resources to assist in the supervisory process:

- **Actuaries:** The Insurance Directorate (ID) includes around 80 actuaries. This is in contrast to banking supervision where specialist support is accessed via the stand-alone Supervisory Risk Specialists Directorate (SRSD) — a specialist area of the PRA that focuses on technical aspects of risk. It should be noted that ID also access SRSD (eg on issues relating to credit, counterparty and operational risk) as well as employing specialist resource elsewhere within ID, including in its Data Analytics Division and Technical Agenda Team.
- **PRA Senior Advisors:** The PRA employs a small number of senior people with extensive industry experience or specific skills as Senior Advisors. Senior Advisors typically have no line management responsibilities and report directly to Senior Executives within the PRA. Most commonly they work part-time, on fixed-term contracts. They have an explicit remit to challenge and support the judgement of supervisors at all levels.
- **Legal support:** Insurance supervisors draw on Legal Directorate expertise through the Insurance Division and through the Regulatory Action Division (RAD) within Legal Directorate. The Insurance Division advises supervision on a wide range of issues, from Solvency II powers of intervention, to Part VII transfers and on the day-to-day interpretation and application of regulatory requirements. RAD is responsible for the deployment of the Bank's formal supervisory tools in circumstances where this is likely to be contested by the firm. RAD also leads on all enforcement matters across the Bank.
- **Reports by a skilled person:** Where appropriate, under Section 166 of the Financial Services and Markets Act, the PRA may appoint a skilled person to provide it with a report or require a firm to provide it with a skilled persons report. When deciding to use this tool, the PRA will consider whether the expertise required to conduct the review is available within the PRA itself, and whether the exercise would be the best use of PRA resources at that time.

In addition to these specialist resources, the Insurance Directorate frequently interacts with insurance policy staff in the Prudential Policy Directorate (a Directorate of the Bank that reports jointly to the Deputy Governor for Prudential Regulation and the Deputy Governor for Financial Stability). While the Insurance Directorate is responsible for day to day supervision, it is the Insurance Policy Division that develops insurance policy, designing and maintaining the prudential policy framework for insurance companies.

Decision making, challenge and assurance

Decision making

The PRA's decision-making framework aims to ensure that the level of seniority of the decision maker (or committee) is appropriate to the importance, urgency and complexity of the decision, and commensurate with the risk to the PRA's objectives. In the insurance context, for example, the PRC reserves to itself matters relating to 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.

Challenging supervisory judgement

A key element of the PRA's supervisory approach is to organise itself so that there are frequent opportunities to debate and challenge the approach taken by the supervisory teams. This is particularly the case for large firms and those with high PIF scores.

Similar to banking supervision, an important part of the oversight process is the Periodic Summary Meetings. These are annual meetings that allow management to monitor and challenge the supervisory strategy and workplan for a firm or group of firms.

Box 9

Firm categorisation

A key process for deciding the allocation of resources across firms is that of firm categorisation. The PRA splits all insurers it supervises into categories based on the significance of each firm to its objectives. When allocating firms to categories, the PRA considers the potential impact on both policyholders and the stability of the UK financial system.

The PRA uses both quantitative and qualitative analysis to estimate the potential impact of an insurer and allocate it to a category. Numerical scoring based on insurers' regulatory reporting provides a 'suggested' categorisation. This quantitative element primarily captures the size of the firm. Supervisors review this suggested category in light of qualitative analysis to confirm that it presents a full picture of an insurer's potential impact (see Section 5.2). And they then decide whether the qualitative analysis justifies the insurer being placed in a different category.

Insurers are divided into five 'categories' of impact. At one end of the spectrum are Category 1 firms. These are insurers whose size and type of business mean that there is very significant capacity to cause disruption to the interests of a substantial number of policyholders. At the other end are Category 5 firms. These are small firms who are judged to have almost no capacity to cause disruption to the interests of a substantial number of policyholders. The number of insurance firms within each category increases from six Category 1 firms to more than 250 Category 5 firms.

Box 10

Proactive Intervention Framework

A second key determinant of resourcing is an insurer's proximity to failure, which is captured by the insurer's position within the Proactive Intervention Framework (PIF). There are five clearly demarcated PIF stages, each denoting a different proximity to failure (with financially healthy firms at PIF stage 1 or 2, and failing firms at PIF stage 5). Every insurer sits in a particular stage at each point in time.

The PRA maintains a list of firms that Supervision believes are at risk of failure, known as the 'Watchlist'. It typically includes firms that are at PIF Stage 3 or higher, and is designed to enhance security of firms that pose an increased risk to the PRA's objectives. There is no mechanical link between PIF stage and resourcing level, and any increase in resourcing will depend upon the nature of the risks that the firm faces.

For the largest firms, the meetings are firm specific and are chaired by the Executive Director, with a number of members of the SRPC (the most senior committee below the PRC) and Senior Advisors in attendance. Any significant issues arising from these meetings are then escalated to the PRC. For Category 5 firms, the PSM meetings cover a peer group rather than individual firms. The meetings are chaired by a manager, although there is also an option for Senior Advisors to attend, and any significant issues are elevated to Heads of Division.

Assurance

An important mechanism for effective governance is the process of assurance — in the case of public policy, for example, using available information to demonstrate to key stakeholders that (statutory) objectives have been met. The PRA has a well-established assurance framework, the cornerstone of which is its Supervisory Oversight Function — an embedded function whose role is to provide firm-level assurance to the PRC and PRA Executive on the quality and effectiveness of firm-level supervision. The PRA continues to take steps to bolster its approach in this area.

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