The Prudential Regulation Authority's approach to insurance supervision

June 2014

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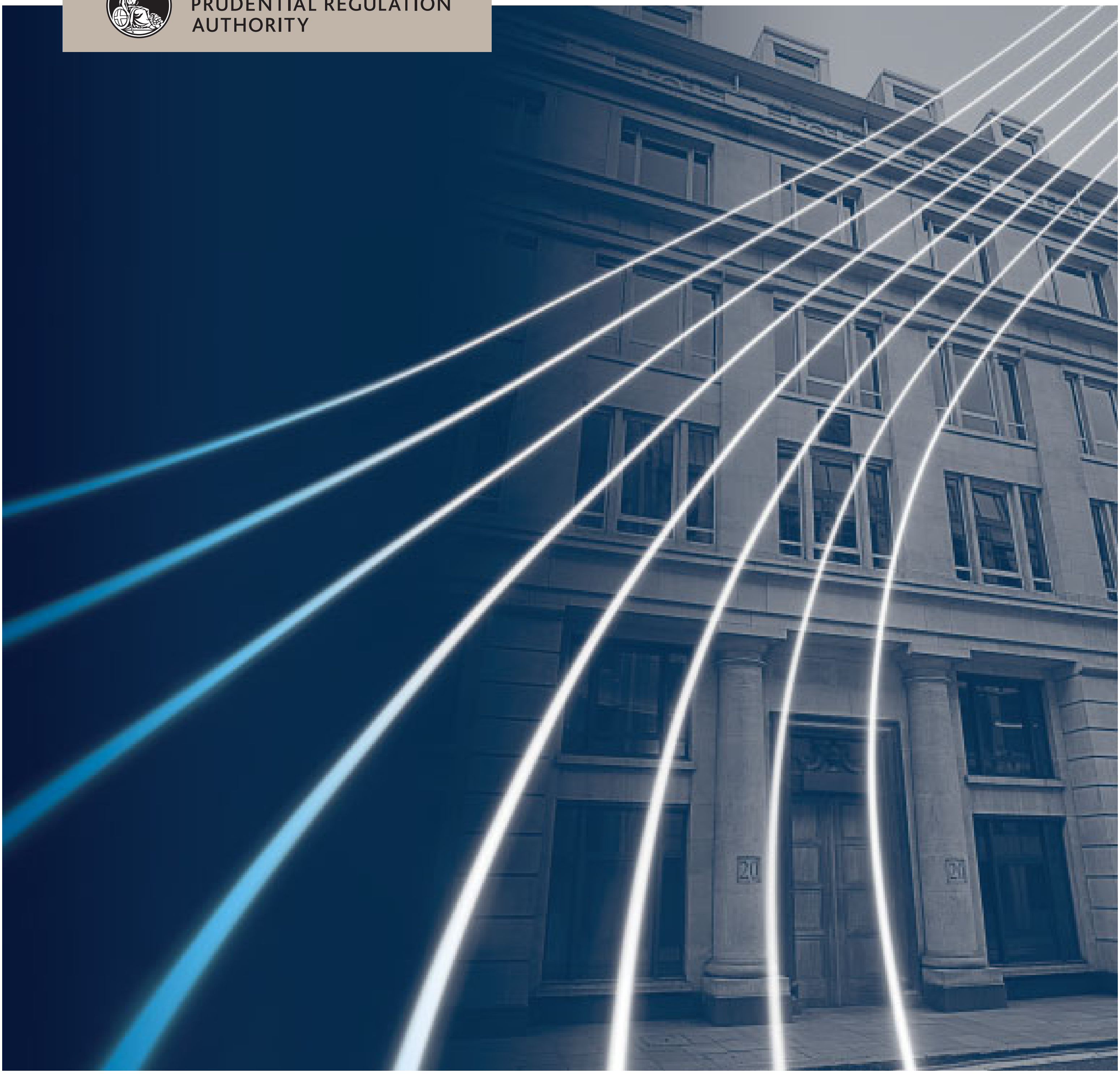

Foreword

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The Prudential Regulation Authority (PRA) is the United Kingdom's prudential regulator of deposit-takers, insurers and major investment firms. As part of the Bank of England, the PRA makes an important contribution to the Bank's financial stability objective of protecting and enhancing the stability of the UK financial system, and likewise supports the objective of the Monetary Policy Committee to maintain price stability in the United Kingdom. In the same way, the work of the Bank of England as a whole supports the PRA in delivering its objectives.

The PRA has two primary objectives: a general objective to promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system; and an objective specific to insurance firms, to contribute to ensuring that policyholders are appropriately protected. In 2014, the PRA gained a secondary objective; to promote effective competition in the markets for services provided by PRA-authorised firms. I welcome this change to our objectives, and the clarity that it provides.

The PRA's objectives are underpinned by the principle that a stable financial system, which is resilient in providing the critical financial services the economy needs, is a necessary condition for a healthy and successful economy. Firms can adversely affect the stability of the financial system through the way in which they carry on their business and in the extreme by failing in a disorderly manner. It will not, however, be the PRA's role to ensure that no firm fails. Rather, the PRA will seek to ensure that any firms that fail do so in an orderly way that avoids significant disruption to the supply of critical financial services, and thus to the PRA's primary objectives.

The introduction of the secondary competition objective will enhance the PRA's focus on competition. The PRA will keep the prudential regime under review to consider changes that might further its competition objective without undermining the PRA's general and/or insurance objective.

This document is revised from the version published in April 2013. It sets out how the PRA will advance its primary objectives in relation to insurers. A companion document covers deposit-takers and designated investment firms. The document contains a number of changes reflecting amendments to legislation, and our supervisory approach since the commencement of the PRA in April 2013. The main changes are summarised in an annex. We intend to publish an explanation of how the PRA will pursue its secondary competition objective, and I envisage that this will be included in the next edition of our approach documents.

We continue to focus our approach on strengthening the UK financial system through being a forward-looking and judgement based prudential regulator. This means that we proactively take action in order to pursue our objectives, for example by undertaking stress tests of insurers and reviewing their preparations for Solvency II implementation.

We remain committed to applying the principle of proportionality in our supervision of firms. In this context, proportionality is judged in terms of the threats that firms can pose to the PRA's primary objectives.

The PRA will evolve its approach to supervision to take account of new developments. For instance, we are reviewing closely the announcement made by Her Majesty's Government in the 2014 Budget regarding the treatment of defined contribution pension savings in relation to the purchase of annuities, and will be considering how these changes might impact our supervision of affected firms.

We continue to co-ordinate closely with the Financial Conduct Authority (FCA). This has been essential to the successful advancement of the PRA's objectives this year. The PRA and the FCA have committed to working together and co-ordinating across a range of areas. The PRA and the FCA have different objectives, though, and the benefits of the new regime will only be achieved if both institutions focus on their own responsibilities. Further detail on how the PRA works with the FCA is set out in the Memorandum of Understanding between the two regulators, and in Box 4 of this document.

The Bank of England recently announced changes to its strategy and structure and in doing so adopted a single mission to promote the public good through achieving and maintaining financial and monetary stability. There is a natural synergy between macro and microprudential regulation and our strategy is to conduct supervision as an integrated part of the central bank. We have already seen the benefits of this in our first year of operations. The PRA has worked in concert with the Financial Policy Committee (FPC) and firms to better understand the principal risks in the Banking system. Our Annual Report(1) sets out the progress we have made.

As set out in the document, the PRA recognises that insurers are not systemic in the same way as banks. Nevertheless, we strongly believe that failure of some insurers could have the potential to pose risks to the stability of the financial system and therefore this will be reflected in the PRA's approach to supervision. We recognise that failing insurers usually exit the market in an orderly manner. However, we cannot be confident that this will be the case for all insurers in all circumstances. We will therefore continue to work at a domestic and international level to review, assess and enhance the resolution arrangements for insurers. The latest status of this work has been reflected in Section III of this document.

Much has been achieved during the first year of the PRA, and I would like to extend my thanks on behalf of the Board of the PRA to all our staff for their dedication and contribution, and to PRA regulated firms for their continued feedback. There remains much still to do, not least ending 'too big to fail' and ensuring the resolvability of large and complex firms. Those are challenges on which we will seek to make decisive progress over the next twelve months, supported by the Bank of England's new Strategic Plan and organisational structure.

Andrew Bailey

June 2014

(1) Available at www.bankofengland.co.uk/publications/Documents/annualreport/2014/prareport.pdf.

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Executive summary

The Prudential Regulation Authority (PRA), as part of the Bank of England, is the United Kingdom's prudential regulator for deposit-takers, insurance companies and designated investment firms. This paper sets out how the PRA carries out its role in respect of insurers. It is designed to help regulated firms and the market understand how the PRA supervises these institutions, and to aid accountability to the public and Parliament.

The PRA's objectives for insurers

Insurance companies enable policyholders to pool and transfer risk so that they are protected against the financial consequences of uncertain future events. Also, some policies enable the accumulation of long-term savings. Usually, policyholders pay premiums in advance in return for payments if and when the insured event happens. And, as with any service where payment is made in advance, policyholders are exposed to the risk that the insurer may fail, and to the fact that the incentives of management and policyholders may not be aligned, particularly in times of stress.

Insurers' liabilities are fundamentally different from those of banks. They are, in general, inherently uncertain, both to the individual policyholder and in aggregate. That is in contrast to the certain commitment that banks make to depositors to return their deposit on demand and in full. This fundamental uncertainty around insurers' liabilities, combined with imbalances in information, means it is difficult in practice for many policyholders to monitor the financial health of their insurer and to make reasonably informed judgements about the levels of risk to which they are exposed. Added to this, for many products (such as annuities), policyholders are constrained in their ability to switch insurer over the period during which the contract is being fulfilled. And for some types of insurance, including long-term savings products, it may be many years until policyholders receive payment.

The PRA has two, complementary, primary objectives in its supervision of insurers: **to promote their safety and soundness as with all firms it supervises and, specific to insurers, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.**

Policyholders are protected both by the PRA as prudential regulator and by the Financial Conduct Authority (FCA) as conduct regulator. 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.** Ensuring continuity of cover requires insurers to be able to meet claims from, and material obligations to, policyholders as they fall due, which, in the case of some policies, may emerge after many years. More generally, the PRA's objectives require insurers to have resilience against failure and avoid disruption to the continuity of financial services. Thus both of the PRA's primary objectives serve to enhance continuity of supply of critical economic functions(1) — a necessary condition for a healthy and successful economy.

The PRA also has a secondary objective to facilitate effective competition. It will, while advancing its primary objectives, so far as reasonably possible, facilitate effective competition in relevant markets. This secondary objective only applies when the PRA is advancing its primary objectives and therefore does not operate as a self-standing objective. The fact that the competition objective is secondary to the primary objectives means that the PRA should not take steps to facilitate competition to an extent that would be inappropriate for the safety and soundness of the firms it regulates. Nevertheless, the PRA must and will be mindful of the likely competition effects of its actions.

As with the primary objectives, the secondary objective only requires the PRA to take action to the extent it is reasonably possible to do so. The PRA will consider a range of factors, including the factors which the PRA is required to have regard by statute and the constraints imposed by EU law.

The PRA is required by statute to promote safety and soundness primarily by seeking to avoid adverse effects on financial stability. **The financial services that insurers provide are essential in supporting the pooling and transfer of risk and savings, and so wider economic activity. Traditional insurers do not, however, generally threaten the stability of the financial system in the same way as banks.** They do not typically undertake maturity transformation and so are less vulnerable to sudden losses of confidence, 'runs' and contagion, than are banks. But their failure, nevertheless, has the potential to disrupt the continuity of financial services and so financial stability, for example if critical insurance services are withdrawn on a scale sufficient to lead to a direct impact on economic activity, or indirectly through other financial institutions.

Accordingly the PRA prioritises its approach to protecting policyholders reflecting both the potential for adverse effects on policyholders if continuity of insurance cover were to be disrupted, and the significance to policyholders of the risk insured, including the importance of timely payments being made by the insurer. For example, the PRA's supervision of life insurers recognises that they provide critical incomes to

(1) The PRA defines critical economic functions that firms provide to be — payment, settlement and clearing; retail banking; corporate banking; intra-financial system borrowing and lending; investment banking; custody services; life insurance; and general insurance.

policyholders through annuities and for some general insurers that they provide mandatory cover without which economic activity cannot take place. Separately, the PRA recognises that the soundness and level of policyholder protection provided by an insurer may vary with the type of insurance. For example, insurers providing cover over long maturities, such as life insurance, or general insurance, where cover extends for many years, may be more vulnerable to adverse developments, and where policyholders may be less able to protect themselves through alternative means. Reflecting these factors, the standards the PRA sets, including its approach to supervision and its approach to the arrangements for dealing with failing insurers, differ.

Contributing to an appropriate degree of policyholder protection and promoting resilience against failure does not mean protecting all policyholders in full in all circumstances, nor does it mean preventing all instances of failure. The statute is explicit that **it is not the PRA's role to ensure that no insurer fails.** Insurer failures happen, but the PRA seeks to ensure that they do not result in significant disruption to the supply of critical economic functions, including by promoting an acceptable degree of continuity for policyholders' cover against insured risks (whether delivered through continuity of cover or the return of premiums paid).

The degree of disruption, and so the PRA's ability to advance its objectives, in the event of an insurer failing of course depends on the efficacy of the statutory regime for dealing with failed insurers and the Financial Services Compensation Scheme's (FSCS) insurance compensation scheme, which protects eligible policyholders, up to certain limits, in the event of failure. Given the PRA's objectives, it is important that there are mechanisms by which all types of insurer supervised by the PRA can exit the market in an orderly manner consistent with the PRA's objectives. The current range of such mechanisms set out in corporate and insurance company law vary in the extent to which they have been used in practice.

Assessing and planning to contain the impact of failure is a core part of the PRA's work. This of course depends on the statutory resolution arrangements, and so the PRA is considering whether its approach to supervision should change to the extent that the resolution arrangements change. In August 2012, HM Treasury launched a consultation(1) setting out proposals on possible enhancements to the mechanisms available for dealing with the failure of systemically important non-banks, including potentially insurers. In response to the consultation, HM Treasury has said that it will consider how best to implement changes if appropriate, and will continue to pay close attention to developments in Europe and to other international work when considering the merits of UK action.

The PRA will therefore continue to work with insurers, HM Treasury, the FSCS and the rest of the Bank of England as appropriate to assess and enhance the resolution framework for insurers in order to support both its objectives of supporting the stability of the system and protecting policyholders appropriately.

The PRA's requirements on firms — Fundamental Rules

The Fundamental Rules are high level rules, which collectively act as an expression of the PRA's general objective and its insurance objective of promoting the safety and soundness of regulated firms and contributing to the securing of an appropriate degree of protection for those who are or may become policyholders respectively. The rules apply to all PRA regulated firms (subject to legal restrictions) irrespective of size and business carried on.

As with the Threshold Conditions, it is **vital that boards and senior management understand the Fundamental Rules**, the more detailed rules in the PRA Rulebook and the directly applicable EU regulations, and **establish within their firms a culture that supports adherence to the spirit and the letter of the requirements**.

The PRA's approach to supervision

Within the statutory framework, **the PRA's approach relies significantly on judgement. The PRA supervises insurers to judge whether they are safe and sound, whether they protect policyholders appropriately, and thus whether they meet, and are likely to continue to meet, the Threshold Conditions.** Supervisors reach judgements on the risks that an insurer poses to the PRA's objectives, and how to address any shortcomings.

The PRA's approach is forward-looking; it assesses insurers not just against current risks, but also against those that could plausibly arise in the future. Where the PRA judges it necessary to intervene, it generally aims to do so at an early stage. Insurers should be open and straightforward in their dealings with the PRA, taking the initiative to raise issues of possible prudential concern also at an early stage. The PRA, for its part, will respond proportionately. Trust can thus be fostered on both sides.

The PRA focuses on those issues and those insurers that pose the greatest risk to the stability of the UK financial system and policyholders. Focusing on key risks inevitably involves the PRA tailoring its activities to an insurer's individual circumstances. And it means that the PRA's approach to supervision and the arrangements for dealing with failing insurers will differ across the life, general, wholesale and reinsurance sectors, recognising, for example,

(1) See https://www.gov.uk/government/consultations/financial-sector-resolution-broadening-the-regime.

the different risks inherent in the business models of life and general insurers given the different maturities of their assets and liabilities, and the different risks to which policyholders are exposed. Consistent with its focus on key risks, the frequency and intensity of supervision applied by the PRA to a particular firm increases in line with the risk it poses to the PRA's objectives. The PRA aims to concentrate on material issues when engaging with firms.

The PRA's supervisory judgements are based on evidence and analysis. It is, however, inherent in a forward-looking system that, at times, the supervisor's judgement will be at variance with that of the insurer. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong. To minimise such outcomes, the PRA needs to be staffed by teams with strong, relevant skills and experience, and its major judgements and decisions involve the PRA's most senior and experienced staff and directors.

The PRA also engages with the boards and senior management of insurers in forming its decisions, using this dialogue both to ensure that it takes account of all relevant information in reaching its judgements, and to communicate clearly the rationale for them. Insurers should not, however, approach their relationship with the PRA as a negotiation.

The PRA's regulatory decision-making is rigorous and well documented, consistent with public law. Its most significant supervisory judgements are taken by its Board — comprising for these purposes the Governor of the Bank of England, the Deputy Governor for Financial Stability, the Deputy Governor for Markets and Banking, the Chief Executive Officer of the PRA, and the independent non-executive members of the Board.(1) The PRA Board is involved in the most important decisions on general policy and individual cases. The Board is, of course, accountable to Parliament, in the same way as are the Monetary Policy Committee and Financial Policy Committee (FPC), the Bank's other statutory decision-making bodies.

The wider context

An effective regulatory framework for financial stability needs to **combine firm-specific supervision with work to protect and enhance the resilience of the financial system as a whole. The PRA therefore works closely with the rest of the Bank of England**, including crucially the FPC, which can make recommendations and potentially give directions to the PRA in respect of its supervision of insurers.

The PRA also co-operates closely with the rest of the Bank on market intelligence and oversight of critical infrastructure. And it works with the Bank's Resolution Directorate and other relevant authorities to review and improve the ways in which failing insurers exit the market.

The PRA co-operates closely with the FCA, which is the conduct regulator for all PRA-authorised firms and the conduct and prudential regulator for many other UK firms. 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.

Reflecting the international nature of the insurance industry, and in particular the United Kingdom's membership of the single market in EU financial services, **the PRA plays a full and active role with its counterparts globally and in the European Union** in developing and implementing prudential standards and in supervising insurers with international operations. The PRA both reflects in its approach, and aims to influence, the work of the European Insurance and Occupational Pensions Authority (EIOPA) in setting prudential policy for insurers. More broadly, the PRA supports initiatives by the International Association of Insurance Supervisors (IAIS) to strengthen the supervisory framework for internationally active insurers which should provide the foundation needed for regulators to work together effectively in supervising complex cross-border insurance groups. It is the PRA's view that for internationally active insurers, the group supervisor should be ready and able to conduct effective consolidated supervision of all activities (regulated and unregulated) within a group.

(1) The CEO of the FCA is also a non-executive member of the Board, but does not take part in regulatory decisions. The addition of the Deputy Governor for Markets and Banking to the PRA's Board and to the FPC was announced by the Chancellor and the Governor as part of the Bank's Strategic Review. For more information see www.gov.uk/government/news/chancellor-announces-three-senior-bank-of-england-appointments.

Introduction

1. The PRA is the United Kingdom's prudential regulator for deposit-takers (banks, building societies and credit unions), insurers and designated investment firms.(1) It derives its responsibilities and powers from the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012) (the Act) and the relevant EU Directives for which it is a competent authority.(2) It also has responsibility for the supervision of compliance with directly applicable EU regulations.

2. This paper sets out how the PRA carries out its role in respect of insurance companies; a second paper relates to supervision of deposit-takers and designated investment firms.(3) Separate publications are necessary to capture the differences in the PRA's supervisory approach for these firms, the different risks they pose, and the additional statutory objective the PRA has in respect of insurers.

3. This paper serves three purposes. First, it is intended to meet the statutory requirement on the PRA to issue guidance on how it intends to advance its objectives. Second, it aids accountability by describing what the PRA seeks to achieve and how it intends to achieve it. Third, it communicates to regulated insurers what the PRA expects of them, and what they can expect from the PRA in the course of supervision.

4. This paper is designed to provide the overall description of the PRA and its approach, acting as a standing reference that will be revised and reissued in response to significant legislative and other developments which result in changes to the PRA's approach.

Structure of this paper

5. Section I describes the PRA's statutory objectives under the Act, and its approach to advancing them. Section II outlines how the PRA determines the focus of its supervision in identifying the key risks to its primary objectives. Section III examines the measures that the PRA expects insurers to have in place to ensure their businesses are run in a safe and sound manner, both in guarding against failure and in reducing the adverse effects that failure could have on policyholders and financial stability. Section IV sets out more detail on the PRA's supervisory approach. Section V outlines the PRA's approach to setting and communicating expectations of insurers.

(1) Most investment firms are prudentially regulated by the FCA. However, the PRA regulates a small number that could present significant risks to the stability of the financial system. The PRA's statement of policy on the designation of investment firms is available at: www.bankofengland.co.uk/publications/Documents/other/pra/designationofinvestmentfirms.pdf.
(2) Specifically, the Consolidated Life Directives and the First, Second and Third Non-Life Co-ordination Directives.
(3) Available at www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf.

I The PRA's objectives and its approach to advancing them

Summary

6. The PRA has two complementary primary objectives in respect of insurance supervision — **to promote insurers' safety and soundness thereby supporting the stability of the UK financial system** and **to contribute to securing an appropriate degree of protection for those who are or may become policyholders.** The financial services that insurers provide are essential in supporting the pooling and transfer of risk, savings and so wider economic activity. A stable financial system that is resilient in providing the critical economic functions the economy needs is necessary to support a healthy and successful economy.

7. Consistent with the Act, **it is not the PRA's role to ensure that no insurer fails.** Rather, the PRA seeks to ensure that any insurer that fails does so in a way that allows for an appropriate degree of protection for policyholders and avoids significant disruption to the supply of critical economic functions. Nevertheless, failure is not costless. Consequently, the PRA expects a given level of resilience to failure from all insurers.

8. To advance its statutory objectives, the PRA sets out policies that it expects insurers to meet both in letter and in spirit, and it supervises insurers to judge whether they meet these policies, at the time of assessment and on a forward-looking basis, taking action if they do not.

The PRA's objectives

9. The PRA has a **general statutory objective to promote the safety and soundness of the firms it regulates.** The Act requires the PRA to advance its general objective primarily by:

- seeking to ensure that the business of the firms it regulates is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- seeking to minimise the adverse effect that the failure of a one of the firms it regulates could be expected to have on the stability of the UK financial system.

In addition, the PRA has a **statutory objective specific to its supervision of insurers: to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.**

Appropriate protection of policyholders

10. Policyholders are protected both by the PRA as prudential regulator and by the FCA as conduct regulator. **The PRA's role in protecting policyholders is to ensure there is a reasonably high probability that an insurer is able to meet claims from, and material obligations to, policyholders as they fall due; and to make sure that where an insurer is unable to meet such claims and obligations, the adverse consequences for policyholders are minimised by ensuring that the insurer fails in an orderly manner.** The PRA contributes to an appropriate degree of policyholder protection by setting standards for insurers and assessing how insurers meet these standards, and by the statutory resolution and compensation arrangements for dealing with failing insurers.

11. The PRA takes a forward-looking approach to assessing an insurer's ability to meet its obligations, being mindful in particular that an insurer's ability to deliver on obligations to existing policyholders can be affected by the terms on which it deals with new policyholders. In consequence, the PRA expects insurers not to write new business where the terms on which it is written would expose either **existing or new** policyholders in aggregate to an unacceptable level of risk. The PRA interprets the definition of 'policyholders' in a broader sense than simply the person who takes out the policy to include those who are the beneficiaries of insurance contracts (for example, third parties under motor policies and employers' liability policies).

12. **The PRA's priorities for protecting policyholders vary according to the significance to the policyholder of the risk insured and the potential for significant adverse effects on policyholders if cover were to be withdrawn or obligations not paid.** Some classes of insurance allow individuals and companies protection against significant risks where the withdrawal of cover could have a very material impact on those policyholders and the economy more generally. For example, certain general insurance activities require, either contractually or as a matter of public policy, insurance cover to be maintained (for example employers' liability insurance or professional indemnity cover). Similarly, disruption to life insurance policyholders caused by any delay in the receipt of, or the absence of, annuity income could be significant in cases where, as is likely, such payments form a significant source of income. And some general insurance policies, for example health insurance, may not be replaceable easily, or in extreme cases at all, should they be terminated unexpectedly. Where the service provided by the insurer is important in any of these ways, the consequences for individual or corporate policyholders of a sudden loss of cover might be severe.

13. **The PRA's priorities vary also in the light of the market failures for that type of insurance** (see Box 3). The PRA recognises that insurers' potential to deliver a lower standard of policyholder protection than is in the public interest varies with the type of insurance. For example, for products where policyholders hold a long-term and illiquid contract (for example whole of life policies or annuities), it may not be straightforward for policyholders to make judgements about

an insurer's financial soundness and to incentivise prudent behaviour over the course of the contract. Similarly, where there are barriers to exit (for example surrender penalties) or where policyholders may find it difficult or excessively costly to spread their risk among a number of insurers, policyholders have a lower capacity to protect themselves from insurer failure.

Stability of the system

14. In general, firms carrying out traditional insurance activities do not pose risk to the system in the same way as banks. They do not typically undertake maturity transformation and the nature of their liabilities means they are considerably less vulnerable to sudden losses of confidence. Nor, on the whole, do they become leveraged to the same extent as banks. And, in general, insurers are considerably less interconnected than banks.

15. **While insurers are not systemic in the same way as banks, their failure nevertheless has the potential to pose risk to the stability of the financial system.**(1) For example, the sudden withdrawal of general insurance in areas such as compulsory motor insurance, trade finance, or marine or aviation cover has the potential directly to affect the ability of individuals or companies to undertake real economic activity. And there could be a more general loss of confidence in financial services should critical services such as annuity payments be affected in the event of a life insurer failing.

16. When insurance is combined with banking in a single group — as is the case for some of the largest UK banks — the failure of the insurer might threaten the financial condition of the bank and so give rise to system-wide risk. In addition, where insurers provide reinsurance or financial guarantees, or are counterparties to many derivatives transactions, they may be highly interconnected with other financial firms and so their failure has the potential to affect the rest of the system.

17. More broadly, insurance companies are significant providers of funds to the banking system both through outright holdings of debt and as effective providers of funds through financing operations such as securities lending. The ability and willingness of insurance companies to provide such financing is an important part of understanding banks' financial soundness, and this in turn is an important aspect of insurers' financial soundness. Indeed, the riskiness associated with this financing may increase as measures are taken to ensure that failing banks are able to do so an orderly way, without exposing public authorities to loss.

18. **An insurer can also adversely affect the stability of the financial system through the way in which it carries on its business in normal times**, including if its activities create the possibility of future stress. Insurers that offer savings products such as life insurance, with some element of guarantee, might be exposed to 'run risk' if policyholders are able to access their savings on more favourable terms than the insurer is able to liquidate the assets in which they have been invested. Similarly, the investment strategy of general or life insurance companies might have consequences for the rest of the system if the scale of their assets means that investment decisions accentuate movements in asset prices. And there is a particular risk arising from fire sales, when solvency is strained, which may lead to further downward price spirals with wider effects on the system as a whole.

19. In all of the above, the capacity of the financial system to carry out activities important to the functioning of the economy (in particular risk transfer, payment services or credit provision) may be impaired. Insurers may also have the potential to affect financial stability by encouraging the unsustainable expansion of credit through the provision of generous financial guarantee products, for example mortgage indemnity insurance or structured credit enhancement. And groups containing an insurer may undertake non-traditional activities including through non-insurance subsidiaries, such as the sale of credit default swaps and the investment of proceeds from securities lending, which bring risk to the system. **The PRA aims to identify these and other examples of risks to financial stability that can be generated by insurers and, together with the FPC as macroprudential authority, where appropriate, it looks to reduce such effects.**

Safety and soundness

20. **The PRA promotes the safety and soundness of the insurers it supervises both to minimise any adverse effects they may have on the stability of the UK financial system and to ensure insurers' ongoing ability to meet their obligations to policyholders.** 'Safety and soundness' involves insurers having resilience against failure now and in the future, and avoiding harm resulting from disruption to the continuity of financial services — either in the course of business or in the event of failure.

21. **The Act includes 'Threshold Conditions', which set out the minimum requirements that insurers must meet in order to be permitted to carry on the regulated activities in which they engage. The Threshold Conditions for which the PRA is responsible are designed to promote safety and soundness and appropriate protection of policyholders.** At a high level, the Threshold Conditions require (see Box 1):

- an insurer's head office, and in particular its mind and management, to be in the United Kingdom if it is incorporated in the United Kingdom;

(1) As set out in section 1I in the Act, 'the UK financial system' refers to 'the financial system operating in the United Kingdom and includes — (a) financial markets and exchanges, (b) regulated activities, and (c) other activities connected with financial markets and exchanges'.

- an insurer's business to be conducted in a prudent manner — in particular that the insurer maintains appropriate financial and non-financial resources;
- the insurer to be fit and proper, and be appropriately staffed; and
- the insurer and its group to be capable of being effectively supervised.

22. Insurers should themselves ensure that they meet the Threshold Conditions at all times. The PRA assesses insurers against them on a continuous basis. The PRA has made Fundamental Rules (see Box 2), which set out at a high level, the requirements placed on firms. These are supported by more detailed rules and directly applicable EU regulations. **A firm must comply with these requirements and must understand what they mean for its business.** A failure to comply with the Fundamental Rules may be relevant to a firm's ongoing compliance with the Threshold Conditions and may result in enforcement or other actions.

Firm failure

23. **As recognised in the Act, it is not the PRA's role to ensure that no insurer fails. Nor is it the PRA's role to ensure that all policyholders are protected in full in all circumstances.** Thus it is a key principle underlying the PRA's approach that the PRA does not seek to operate a zero-failure regime.

24. In the event that an insurer's financial position comes under stress, policyholders should be protected through mechanisms by which insurers can exit the market; and the existence of the FSCS insurance compensation scheme, which protects eligible policyholders, up to certain limits. **The PRA will seek — as far as possible within the statutory arrangements in place for insurers to exit the market — to ensure that any insurers that fail do so in a way that avoids significant adverse effects on policyholders and significant disruption to the supply of critical economic functions.** Considering the impact of insurer failure, and acting promptly to ensure either recovery or orderly exit, are core aspects of the PRA's approach. The PRA will work with HM Treasury, the FSCS, the FCA and the rest of the Bank of England as appropriate to assess and enhance the resolution arrangements for insurers to support both of its objectives, to protect policyholders and to support the stability of the system.

25. Allowing insurers to fail, so long as failure is orderly — that is, so long as a failing firm's provision of supply of critical economic functions is preserved or wound-down in an orderly manner, including by transfer to another firm — reflects the view that insurers should be subject to the disciplines of the market. It is important for insurers to be able to fail in an orderly way without public funds being put at risk since, apart from being an unwarranted subsidy, the public provision of solvency support to an insurer (or its creditors) can create an expectation of future assistance. This 'moral hazard' in turn increases the risk of future financial instability, as it provides incentives for excessive risk taking and reduces market discipline.

26. Although it is not the PRA's role to ensure no firm fails, **a certain level of resilience to failure is required of all insurers.** Failure is not costless. And, while failure of an individual insurer is a feature of a properly functioning market, it is essential for the PRA to ensure confidence in general in the insurers that it supervises in order for it to deliver on its objectives.

Investigations into regulatory failure

27. The Financial Services Act 2012 requires the PRA to investigate and report to HM Treasury on events which indicate possible regulatory failure. The PRA has set out, in a published policy statement, how it will judge whether and when such failures have occurred. Consistent with its statutory objectives, the PRA is clear that firm failures will not automatically indicate regulatory failure.(1)

The PRA's approach to advancing its objectives

28. The PRA supervises around 500 insurers that make up the largest insurance industry in Europe and the third largest insurance industry in the world. A majority of these provide general insurance services — typically commercial, public liability, motor and home insurance — while a smaller proportion are life insurance companies. A handful provide both.

29. Approximately 100 insurers are involved in the largely wholesale London Market, providing a specialised subset of general insurance. These firms include underwriters operating under the franchise of Lloyd's (whose managing agents are authorised by the PRA) and wholesale insurers who are regulated directly by the PRA. The PRA also supervises the Society of Lloyd's in its own right as an authorised firm.

30. The PRA supervises a handful of very large firms that are significant to the insurance industry both domestically and internationally. It also supervises more than 100 small mutual insurers, including friendly societies, the majority of which operate in a particular locality or niche market.

31. The PRA supervises UK-headquartered and international insurers (other than EEA passported branches) operating in the United Kingdom. The majority are incorporated and authorised in the United Kingdom, though around 75 operate as branches. Although the majority of these branches have small operations in the United Kingdom, some are significant, including in particular areas such as reinsurance.

(1) The Statement of Policy on conducting statutory investigations can be found here: www.bankofengland.co.uk/publications/Documents/other/pra/conductstatinvestigations.pdf.

Box 1
The PRA's Threshold Conditions

The Threshold Conditions are the minimum requirements that firms must meet at all times in order to be permitted to carry on the regulated activities in which they engage. PRA-authorised firms need to meet both the PRA-specific and FCA-specific Threshold Conditions. This box reproduces the PRA-specific Threshold Conditions that apply for insurers.(1)

In this extract —
'assets' includes contingent assets;
'consolidated supervision' has the same meaning as in section 3M of the Act;
'functions', in relation to the PRA, means functions conferred on the PRA by or under the Act;
'liabilities' includes contingent liabilities;
'relevant directives' has the same meaning as in section 3M of the Act;
'Society' means the society incorporated by Lloyd's Act 1871 by the name of Lloyd's;
'subsidiary undertaking' includes all the instances mentioned in Article 1(1) and (2) of the Seventh Company Law Directive in which an entity may be a subsidiary of an undertaking.

For the purposes of this extract, the 'non-financial resources' of a person include any systems, controls, plans or policies that the person maintains, any information that the person holds and the human resources that the person has available.

References to the failure of a person are to be read in accordance with section 2J(3) and (4) of the Act.

Introduction
4A. (1) If the person concerned ('C') carries on, or is seeking to carry on, regulated activities which consist of or include a PRA-regulated activity relating to the effecting or carrying out of contracts of insurance, the threshold conditions which are relevant to the discharge by the PRA of its functions in relation to C are the conditions set out in paragraphs 4B to 4F.
(2) If the person concerned ('C') carries on, or is seeking to carry on, regulated activities which consist of or include a PRA-regulated activity relating to managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's, the conditions which are relevant to the discharge by the PRA of its functions in relation to C are the conditions set out in paragraphs 4C to 4F except for sub-paragraphs (5)(d), (5)(e) and (6) of paragraph 4D which are not relevant for that purpose.
(3) If the person concerned ('C') carries on, or is seeking to carry on, regulated activities which consist of or include a PRA-regulated activity relating to the arranging, by the Society, of deals in contracts of insurance written at Lloyd's, the conditions which are relevant to the discharge by the PRA of its functions in relation to C are the conditions set out in paragraphs 4C to 4F, subject to sub-paragraph (4).
(4) Paragraph 4D has effect in relation to persons of the kind specified by sub-paragraph (3) as if —
(a) for paragraph (d) and (e) of sub-paragraph (5) there were substituted —
'(d) the effect that the carrying on of business by C might be expected to have on the stability of the UK financial system or on those who are or may become policyholders of members of C;
(e) the effect that the failure of C might be expected to have on the stability of the UK financial system or on those who are or may become policyholders of members of C;', and
(b) sub-paragraph (6) were omitted.

Legal status
4B. C must be —
(a) a body corporate (other than a limited liability partnership),
(b) a registered friendly society, or
(c) a member of Lloyd's.

Location of offices
4C. (1) If C is a body corporate incorporated in the United Kingdom —
(a) C's head office and,
(b) if C has a registered office, that office, must be in the United Kingdom.
(2) If C is not a body corporate but C's head office is in the United Kingdom, C must carry on business in the United Kingdom.

Business to be conducted in a prudent manner
4D. (1) The business of C must be conducted in a prudent manner.
(2) To satisfy the condition in sub-paragraph (1), C must in particular have appropriate financial and non-financial resources.
(3) To have appropriate financial resources C must satisfy the following conditions —
(a) C's assets must be appropriate given C's liabilities, and
(b) the liquidity of C's resources must be appropriate given C's liabilities and when they fall due or may fall due.
(4) To have appropriate non-financial resources C must satisfy the following conditions —
(a) C must be willing and able to value C's assets and liabilities appropriately,
(b) C must have resources to identify, monitor, measure and take action to remove or reduce risks to the safety and soundness of C,
(c) C must have resources to identify, monitor, measure and take action to remove or reduce risks to the accuracy of C's valuation of C's assets and liabilities,
(d) the effectiveness with which C's business is managed must meet a reasonable standard of effectiveness, and
(e) C's non-financial resources must be sufficient to enable C to comply with —
(i) requirements imposed or likely to be imposed on C by the PRA in the exercise of its functions, and
(ii) any other requirement in relation to whose contravention the PRA would be the appropriate regulator for the purpose of any provision of Part 14 of the Act.
(5) The matters which are relevant in determining whether C satisfies the condition in sub-paragraph (1) or (2) include —
(a) the nature (including the complexity) of the regulated activities that C carries on or seeks to carry on;
(b) the nature and scale of the business carried on or to be carried on by C;
(c) the risks to the continuity of the services provided by, or to be provided by, C;
(d) the effect that the carrying on of the business of effecting or carrying out contracts of insurance by C might be expected to have on the stability of the UK financial system or on those who are or may become C's policyholders;
(e) the effect that C's failure or C being closed to new business might be expected to have on the stability of the UK financial system or on those who are or may become C's policyholders;
(f) C's membership of a group and any effect which that membership may have.
(6) C is 'closed to new business' for the purposes of this paragraph if C has ceased to effect contracts of insurance or has substantially reduced the number of such contracts which C effects.

Suitability
4E. (1) C must be a fit and proper person, having regard to the PRA's objectives.
(2) The matters which are relevant in determining whether C satisfies the condition in sub-paragraph (1) include —
(a) whether C has complied and is complying with requirements imposed by the PRA in the exercise of its functions, or requests made by the PRA relating to the provision of information to the PRA and, if C has complied or is so complying, the manner of that compliance;
(b) whether those who manage C's affairs have adequate skills and experience and have acted and may be expected to act with probity.

Effective supervision
4F. (1) C must be capable of being effectively supervised by the PRA.
(2) The matters which are relevant in determining whether C satisfies the condition in sub-paragraph (1) include —
(a) the nature (including the complexity) of the regulated activities that C carries on or seeks to carry on;
(b) the complexity of any products that C provides or will provide in carrying on those activities;
(c) the way in which C's business is organised;

(d) if C is a member of a group, whether membership of the group is likely to prevent the PRA's effective supervision of C;
(e) whether C is subject to consolidated supervision required under any of the relevant directives;
(f) if C has close links with another person ("CL") —
  (i) the nature of the relationship between C and CL;
  (ii) whether those links or that relationship are likely to prevent the PRA's effective supervision of C, and
  (iii) if CL is subject to the laws, regulations or administrative provisions of a territory which is not an EEA State ('the foreign provisions'), whether those foreign provisions, or any deficiency in their enforcement, would prevent the PRA's effective supervision of C.

(3) C has close links with CL if —
  (a) CL is a parent undertaking of C,
  (b) CL is a subsidiary undertaking of C,
  (c) CL is a parent undertaking of a subsidiary undertaking of C,
  (d) CL is a subsidiary undertaking of a parent undertaking of C,
  (e) CL owns or controls 20% or more of the voting rights or capital of C, or
  (f) C owns or controls 20% or more of the voting rights or capital of CL.

(1) The full Threshold Conditions Order can be found at www.legislation.gov.uk/uksi/2013/555/article/2/made.

Box 2
The PRA's Fundamental Rules

Firms must ensure they are compliant with all applicable PRA rules and directly applicable EU regulations, including the Fundamental Rules,[1] as set out in the PRA Rulebook. The Fundamental Rules require firms to act in accordance with 'safety and soundness' by setting specific high-level requirements on them, namely:

- **Fundamental Rule 1**: A firm must conduct its business with integrity.
- **Fundamental Rule 2**: A firm must conduct its business with due skill, care and diligence.
- **Fundamental Rule 3**: A firm must act in a prudent manner.
- **Fundamental Rule 4**: A firm must at all times maintain adequate financial resources.
- **Fundamental Rule 5**: A firm must have in place effective risk strategies and risk management systems.
- **Fundamental Rule 6**: A firm must organise and control its affairs responsibly and effectively.
- **Fundamental Rule 7**: A firm must deal with its regulators in an open and co-operative way, and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice.
- **Fundamental Rule 8**: A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services.

(1) For the policy statement outlining the Fundamental Rules, see www.bankofengland.co.uk/pra/Pages/publications/ps/2014/ps514.aspx.

32. Some prudential issues are common to the supervision of all insurers. Policyholders pay premiums in advance in return for payments should an insured event occur, leaving them vulnerable to insurer failure. That underlies the PRA's objectives to promote safety and soundness and to protect policyholders — so that insurers are financially sound, and run in a prudent manner — which the PRA advances by setting out policies that insurers should meet in spirit as well as to the letter.

33. The PRA supervises insurers to judge whether they meet these policies, at the time of assessment and on a forward-looking basis, and takes action where needed in support of safety and soundness and appropriate policyholder protection. Recognising the wide diversity of insurers, the PRA tailors its supervision to an insurer's particular business and circumstance, reflecting the fact that differing types of business can adversely affect policyholders, and an insurer's safety and soundness, in different ways.

34. The PRA's policies and supervisory approach are designed to advance its objectives. In designing them, the PRA has regard to a number of 'regulatory principles' set out in the Act. These cover: efficiency; proportionality; the desirability of sustainable UK economic growth; senior management responsibility in firms; recognising differences in the nature and objectives of authorised persons; transparency; disclosure of information relating to persons on whom requirements are imposed by or under the Act; and the general principle of consumers taking responsibility for their decisions.

35. The secondary competition objective for the PRA came into force on 1 March 2014, replacing the regulatory principle to have regard to the need to minimise adverse effects on competition. The PRA is undertaking a programme of work to ensure that this new objective is reflected in its decision-making. It is also taking forward projects reviewing parts of the prudential framework enabling it to consider changes to its approach that might further its competition objective without undermining the general objective.

36. The PRA's approach is necessarily determined in an international context. Insurance is an international industry, with insurers supervised on a co-operative international basis and the prudential policy framework for supervision agreed internationally. Given the international nature of the UK insurance industry, effective international co-operation, in relation to individual insurers and general policy, is essential to the PRA's success.

The PRA's expectations of insurers — policies

37. **Advancing the PRA's objectives relies on insurers conducting their businesses in a manner consistent with safety and soundness and appropriate policyholder protection.**

Box 3
Underlying economic justification for prudential regulation

It is likely that, in the absence of prudential regulation, insurers would be less safe and sound and deliver a lower standard of policyholder protection than would be in the public interest. This box explains the key factors which account for this and which prudential regulation aims to counter.

Core insurance activities are based on an 'inverted production cycle' where revenue is generated through writing policies and collecting premiums before the associated costs of paying claims and other obligations materialise. This fundamental uncertainty associated with insurers' liabilities — over the size and timing of future payments to policyholders — can mean that it is difficult for policyholders to assess the financial strength of their insurer. Policyholders may also have little scope to influence the behaviour of insurers once a policy has been taken out. For example, for some insurance products — such as fixed annuities — policyholders are constrained in their ability to switch insurer once they have taken out cover. And although for most general insurance products, cover relates to a one-year period, it may be many years thereafter before it is apparent to a policyholder that an insured event within the period of cover has occurred, leaving the policyholder exposed to the future financial soundness of an insurer even after the period of cover has expired.

Some policyholders — for example commercial or wholesale policyholders — along with wholesale debt investors, may be better equipped to monitor and exert discipline on insurers (including by pushing for the owners to have a greater stake in the insurer). But they are hampered by the opacity of the value of insurers' assets and particularly their liabilities. And firms undertaking traditional insurance are typically less reliant on external funding than, for example, banks because revenues are generated before costs reducing the likelihood of wholesale debt investors exerting influence on an insurer. Furthermore in practice, the existence of guarantees for policyholders (from the FSCS) — while key to delivering an appropriate amount of protection to policyholders in the event their insurer fails — reduces policyholders' incentive to monitor and control. This may extend to other creditors, to the extent that — as with many regulated industries — there is a perception of implicit support, for example for certain insurers or classes of policyholder.

These factors help to explain why an insurer may have the opportunity to take more risk than is in the interests of policyholders and other creditors. And as with other companies owned by private shareholders, a privately owned insurer will tend to have an incentive to take on additional risk because shareholders, although the first bearers of loss, typically have limited liability in the event of failure but enjoy the unlimited upside associated with successful risk-taking. So maximising the expected return on equity in the interests of shareholders will tend to mean taking on more risk than is in the interests of policyholders and creditors.

It can also be difficult for the owners of an insurer to control the firm effectively. This problem exists for all firms where ownership and control are separate, but it is particularly acute for insurers (and many other financial firms) because of the opacity of the value of their liabilities and assets. Compounding this, it is difficult for owners — who can be a diverse and numerous set of shareholders or members — to co-ordinate themselves to acquire the information that they would need to monitor management's activities effectively. Managers may have their own, different objectives to owners and this may result in them taking excessive risk, for example through pursuing growth in the interests of short-term reward. A further problem can in principle exist between senior management and individual risk-takers, with the latter having incentives to take excessive risk outside the formal control structures of the firm.

Finally, it is possible that individual insurers may adversely affect the stability of the financial system (see Section I), but they have no incentive to take this into account. Other things being equal, an insurer undertaking traditional insurance activities is less likely to pose risks to the stability of the financial system than is a bank. But there are ways in which insurers can adversely affect the stability of the system (with, for example, the scale of their assets such that their investment strategies could accentuate movements in asset prices). At an individual level, insurers have no incentive to take into account such effects, but collectively they share an interest in a stable financial system. They thus face a 'collective action' problem which prudential supervision can help to address.

This requires insurers to act more prudently than they might otherwise choose, in the presence of incentives to take more risk, and thus to impose more risk on policyholders and the stability of the financial system than is in the public interest (see Box 3). Countering this tendency is the primary role of a prudential regulator.

38. The criteria against which insurers are assessed are rooted in the PRA's statutory objectives, the statutory Threshold Conditions for authorisation, and UK and EU law. The Threshold Conditions require insurers to: have adequate financial resources; have appropriate resources to measure, monitor and manage risk; be fit and proper; and conduct their business prudently.

39. **The PRA has set out clearly, including in this paper, the criteria against which it judges whether insurers act in a manner consistent with safety and soundness and appropriate policyholder protection, so that insurers can understand what the PRA expects of them**. This document sets out high-level policies that elaborate on the Threshold Conditions and which are supported in many cases by more detailed material published by the PRA and directly applicable regulations set at EU level. Insurers should refer to these also for further detail on what is expected of them.

40. In general, the PRA at the outset inherited the prudential aspects of the Financial Services Authority's (FSA's) *Handbook* and certain relevant policy materials. However, in the light of its statutory objectives and the Threshold Conditions, and as explained in this document, in assessing insurers the PRA places greater emphasis on certain criteria than was the case with the FSA. In addition, in some specific cases, this document sets out new expectations which have not previously been expressed formally to insurers, including in respect of an insurer taking action in normal times to minimise disruption in the event that it fails. Over time, the PRA will continue to substantially amend and streamline the current *PRA Handbook* and the associated materials carried over from the FSA creating a new PRA Rulebook and body of supporting supervisory statements.

41. Rules set out some of the requirements that an insurer must meet in order for its business to be conducted in a safe and sound manner, and for it to secure appropriate protection of policyholders. But the PRA expects insurers not merely to meet the letter of the requirements nor indeed to game them by engaging in 'creative' compliance or regulatory arbitrage designed to mask the riskiness of activities or business models. **Rather, insurers should maintain sight of the overriding principles of safety and soundness and the protection of policyholders, and act accordingly.** Support for these objectives should be embedded in every insurer's culture. So that there are no ambiguities about its intended outcomes, the PRA has set out in this document and elsewhere the purpose and principles of its approach.

The PRA's approach to supervision

42. The PRA supervises insurers to judge whether they are acting in a manner consistent with safety and soundness and appropriate policyholder protection, and so whether they meet, and are likely to continue to meet, the Threshold Conditions.

43. **The PRA weights its supervision towards those issues and those insurers that, in its judgement, pose the greatest risk to its objectives.** It supervises a wide range of insurers from the life, general, wholesale and reinsurance sectors. And its supervisory approach recognises the different risks inherent in the business models of these different insurers, with the frequency and intensity of supervision experienced by insurers increasing in line with the risks they pose. The PRA aims always to focus on material issues when engaging with insurers.

44. **The PRA is forward looking, assessing its objectives not just against current risks, but also against those that could plausibly arise further ahead.** Where the PRA judges it necessary to intervene to mitigate the risks an insurer is creating, it generally seeks to do so at an early stage. To support this, insurers should be open and straightforward in their dealings with the PRA, taking the initiative to raise issues of possible concern also at an early stage. The PRA, for its part, will respond proportionately. Trust can thus be fostered on both sides.

45. **The PRA's approach relies significantly on judgement.** Supervisors reach judgements on the risks that an insurer is running; the risks that it poses to the PRA's objectives; whether it is likely to continue to meet the Threshold Conditions; and how to address any problems or shortcomings identified. And, in particular, supervisors need to decide which risks are the most material and must be pursued. A judgement-based approach is necessary in a forward-looking regime, where the future state of the world is inherently uncertain. Use of judgement is also necessary in the context of a complex financial system where compliance with detailed rules is, on its own, unlikely to secure acceptable outcomes.

46. The PRA's supervisory judgements are based on evidence and analysis. It is, however, inherent in a forward-looking system that, at times, the supervisor's judgement will be at variance with that of the insurer. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong.

47. In order to minimise such outcomes, the PRA needs to be staffed by people with strong, relevant skills and experience (see Box 9), and its major judgements and decisions involve the PRA's most senior and experienced staff and directors. The PRA engages with the boards and senior management of

insurers in forming its decisions, using this dialogue both to ensure that it takes account of all relevant information in reaching its judgements and to communicate clearly the rationale for them. Insurers should not, however, approach their relationship with the PRA as a negotiation.

48. The PRA will ensure that it recognises promptly when its concerns appear subsequently to be unjustified, and so when its actions may need to be adjusted.

The PRA's risk framework

49. The PRA takes a structured approach when forming its judgements. The risk assessment framework for insurers is the same as for banks, but is used in a different way, reflecting the PRA's additional objective to contribute to securing appropriate policyholder protection, the different risks to which insurers are exposed, and the different way in which insurers fail. The framework used, which is illustrated in **Figure 1**, captures three key elements:

- the *potential impact* that an insurer could have on financial stability and policyholders, both by the way it carries on its business and in the event of failure;
- how the external context in which an insurer operates and the business risks it faces (together, its *risk context*) might affect the viability of the firm; and
- *mitigating factors*, including: an insurer's management and governance and its risk management and controls (operational mitigation); its financial strength, specifically capital and liquidity (financial mitigation); and its resolvability (structural mitigation).

50. The intensity of the PRA's supervisory activity varies across insurers. The level of supervision principally reflects the PRA's judgement of an insurer's potential impact on policyholders and on the stability of the financial system, its proximity to failure (as encapsulated in the Proactive Intervention Framework, which is described later) and its resolvability. Other factors that play a part include the type of business done by the insurer and the complexity of the insurer's business and organisation.

51. Much of the PRA's proposed approach to the supervision of insurers will, in due course, deliver the supervisory activities which the United Kingdom will be required to carry out under Solvency II. This will:

- introduce a risk-sensitive regulatory framework;
- introduce a new forward-looking Own Risk and Solvency Assessment (ORSA);
- place greater emphasis on the importance of disclosure, with the aim of enhancing market discipline;
- introduce a Ladder of Intervention designed to encourage early action by supervisors; and
- strengthen co-operation arrangements between European regulators, particularly through colleges for insurance groups with cross-border operations within the European Union.

All these measures are consistent with the PRA's objectives and approach as described in this document.

52. Much of the detail to support the Solvency II framework is still being finalised. The PRA will consider it important that the technical detail of Solvency II leaves scope for supervisors of individual insurers to make informed judgements about risks posed, and action to be taken, within a clear overall EU-wide policy framework. In the meantime, the PRA has introduced an interim approach that allows insurers to use their Solvency II work to meet, as far as possible, the current regulatory requirements under the Individual Capital Adequacy Standards (ICAS).(1)

53. The following sections: examine in more detail the individual elements of the PRA's risk framework; describe the work the PRA does to support its judgements; and set out what the PRA expects of insurers in these areas. Box 4 sets out how the PRA interacts with other authorities both domestically and internationally, in support of its approach.

Figure 1 The PRA's risk framework

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation		Structural mitigation
Potential impact	External context	Business risk	Management and governance	Risk management and controls	Capital	Liquidity	Resolvability

(1) A letter was sent to internal model firms about this approach — referred to as 'ICAS+' as shorthand, available at www.bankofengland.co.uk/pra/Documents/solvency2/29janletter.pdf.

Box 4
Working with other authorities

Co-ordination with other authorities is essential to the PRA's success. This box outlines the PRA's approach to interaction with these other bodies.

Bank of England and FPC

The PRA is a part of the Bank of England, and is therefore connected to the Bank's other functions — including its work on market intelligence, oversight of financial market infrastructure, prudential policy, financial sector resilience and resolution. This facilitates the flow of information between these functions.

The PRA's objectives of promoting the safety and soundness of insurers, focusing primarily on the harm that they can cause to the UK financial system, and contributing to appropriate policyholder protection complement the Bank's wider objective of 'promoting the good of the people of the United Kingdom by maintaining monetary and financial stability'.

An effective regulatory framework for financial stability also needs to combine insurer-specific supervision with work to protect and enhance the resilience of the financial system as a whole. The PRA therefore works closely with the FPC, which has statutory responsibility for reducing risks to the financial system as a whole.

The FPC can make recommendations and potentially give directions to the PRA on specific actions that should be taken in order to achieve the FPC's objectives. The PRA is responsible for responding to FPC recommendations which may be made on a 'comply or explain' basis, and for complying with the FPC's directions in relation to the use of macroprudential tools, specified by HM Treasury in secondary legislation.(1) The PRA reports to the FPC on its delivery of these recommendations and directions.

There is a frequent two-way flow of information and exchange of views between the PRA and the FPC. The PRA provides insurer-specific information to the FPC, to assist its macroprudential supervision. And the FPC's assessment of systemic risks influences the PRA's judgements in pursuit of its objectives.

Co-ordination between the PRA and the FPC is assisted by the common membership of the Governor of the Bank of England, the Deputy Governor for Financial Stability, the Deputy Governor for Markets and Banking(2) and the Chief Executive Officer (CEO) of the PRA on both the PRA Board and the FPC.

FCA

The FCA acts as conduct regulator for firms prudentially regulated by the PRA. Both contribute to the securing of an appropriate degree of policyholder protection through their separate objectives.

The PRA has a statutory duty to co-ordinate with the FCA in the exercise of its public functions, including policymaking and supervision. A Memorandum of Understanding (MoU) between the FCA and the PRA describes how the two regulators fulfil this duty to co-ordinate in a way that supports each regulator's ability to advance its own objectives.(3)

A key principle for this co-operation, given the regulators' separate mandates for prudential and conduct regulation of PRA-authorised firms, is that each authority should focus on the key risks to its own objectives, while being aware of the potential for concerns of the other.

The MoU details a number of areas where the PRA and the FCA co-operates:

- Sharing of information: both regulators will share information in a 'timely and focused manner' for delivering effective supervision. This will include in making sure, where possible, that request for regulatory data is not duplicated. Although emphasis will be given in protecting the confidentiality of firms where relevant.

- Policy and rule-making: the PRA and the FCA will consult with each other early if either of their policies or rules might have a material effect on the other's objectives.

- Authorisation of firms and approval of individuals: the PRA and the FCA will co-operate on all authorisations and approval cases through a process of 'consult and consent'.

- Supervision of dual regulated firms: the regulators are not required to conduct supervision jointly, but each will share information to reflect adequate supervisory judgement.

- Overseas firms: both regulators will reflect adequate supervision for international firms through co-operation at colleges and various EEA forums.

Co-ordination between the PRA and the FCA is assisted by the membership of their CEOs on each other's board. This cross-board role focuses on areas of overlap and discussions of material relevance to each CEO's own organisation. Co-ordination between the organisations is also assisted by common membership of their CEOs on the FPC.

The FCA and the PRA are also party to other MoUs with the Bank as a whole and HM Treasury on international engagement, and the rest of the Bank on the oversight of financial market infrastructure.

The FCA and the PRA co-ordinate in their supervision of insurers generally under the framework set out in the Memorandum of Understanding described above. However, in the case of 'with-profits' policies, special arrangements are needed. A separate Memorandum of Understanding sets out how the PRA and the FCA work together in order appropriately to protect the interests of 'with-profits' policyholders.(4)

Financial Services Compensation Scheme Ltd (FSCS)

The FSCS is the United Kingdom's compensation fund of last resort for customers of authorised financial services firms. It may pay compensation to eligible claimants if a firm is unable, or likely to be unable to pay claims against it. The MoU between the PRA and the FSCS details how the two authorities co-operate and co-ordinate.(5)

The PRA works closely with FSCS colleagues in order to assess and enhance the resolution framework for insurers in order to discharge its primary objectives. The FSCS supports the PRA's assessment of a firm's resolvability and likelihood that any failure would be orderly. The PRA will seek to ensure that, through the Proactive Intervention Framework, the FSCS has reasonable notice of activity where the PRA may require significant involvement of the FSCS.

Other UK bodies

The PRA often needs to work with other UK regulators, either to pursue its own objectives or to assist them in theirs; this may also include other enforcement agencies.

The PRA has agreements to support the sharing of information and judgements, and the co-ordination of actions. The PRA's general approach to these arrangements and the relationships they underpin is focused on:

- enabling all parties to focus on their own objectives;
- the substantive issues of the potential co-ordination;
- avoiding where possible a detailed, prescriptive approach, to ensure that judgement and flexibility are not lost; and
- provisions for regular review, ensuring that MoUs remain current and embedded within the organisations.

International co-operation

Insurance is an international industry. The PRA performs two important functions within the international regulatory environment. First, it plays a full and active role with its counterparts in Europe and beyond in supervising cross-border insurers. And second, it attaches great importance to being an influential and persuasive participant in international policy debates, seeking to achieve agreement at the global and European level to the reforms necessary for a strong, balanced and coherent prudential framework.

The PRA actively participates in the work of the Financial Stability Board (FSB), the IAIS and other global fora. It supports in particular IAIS initiatives to strengthen the supervisory framework for internationally active insurers, reflecting the view that for these insurers, the group supervisor should be ready and able to conduct effective consolidated supervision of all activities (regulated and unregulated) within a group. The PRA also supports IAIS work to identify potential global systemically important insurers, and to develop an appropriate supervisory framework for such insurers.

The PRA is an active participant in the European System of Financial Supervision established at the start of 2011. Its approach both reflects and aims to influence the EU-wide standards and guidance set out by the European Supervisory Authorities (ESAs), specifically EIOPA, in addition to supporting day-to-day supervision.

(1) See HM Treasury consultation on the FPC's macroprudential tools, published September 2012, available at www.hm-treasury.gov.uk/press_83_12.htm.
(2) The addition of the Deputy Governor for Markets and Banking to the PRA's Board and to the FPC was announced by the Chancellor and the Governor as part of the Bank's Strategic Review. For more information see www.gov.uk/government/news/chancellor-announces-three-senior-bank-of-england-appointments.
(3) See the Memorandum of Understanding: www.bankofengland.co.uk/about/Documents/mous/moufcapra.pdf.
(4) See www.bankofengland.co.uk/about/Documents/mous/mouwithprofits.pdf.
(5) For more information on the MoU between the PRA and the FSCS, see: www.bankofengland.co.uk/about/Documents/mous/moufscspra.pdf.

II Identifying risks to the PRA's objectives

54. The PRA's approach relies on supervisors understanding the significance of individual insurers to the PRA's objectives, the nature of an insurer's business and the wider economic environment, and the potential risks to the PRA's objectives that, together, these entail. This section describes how the PRA assesses these factors.

Potential impact

55. As a core part of its work, **the PRA assesses the significance of an insurer to its objectives.** This 'potential impact' reflects an insurer's potential to affect adversely the PRA's objectives by failing, coming under stress, or by the way it carries on its business.

56. 'Potential impact' has a wider meaning for insurers than it does for banks because of the different objectives the PRA has in supervising insurers. It requires consideration of the channels **for a firm's potential impact on policyholders and the stability of the UK financial system, including in times of wider stress.** The PRA's assessment of potential impact:

- helps to **determine the intensity of supervision for an insurer**; and
- **helps to focus the supervisory strategy**, for example, by identifying particular areas where an insurer provides critical economic functions, and so highlighting likely sources of significant risk to the PRA's objectives.

57. The **potential impact of a firm on policyholders** takes account of its size (the number of policyholders) and the nature of the business it conducts. This captures the disruption to policyholders were they no longer to be covered by existing policies and were there to be no substitute policies available (or where there may be delays or significant additional costs involved in obtaining replacement cover). It also covers policyholders' ability to assess, incentivise and manage their insurer's financial soundness over the course of the contract. In consequence, the assessment of impact on policyholders differs, potentially significantly, across the different types of insurers and insurance contracts (life, general, wholesale, reinsurance) regulated by the PRA. The PRA seeks to contribute to the same appropriate degree of policyholder protection across all insurers.

58. The potential for an insurer to adversely affect the stability of the financial system depends on both the functions it provides and its significance within the system. The assessment of **potential impact on the stability of the system** captures the potential impairment to the capacity of the financial system as a whole to provide services important to the functioning of the economy, for example, compulsory insurance products. In addition, it covers impairment arising from activities related to insurance business (such as stock lending or funding of banks) or other interconnections, for example, via derivatives, reinsurance or financial guarantees, or non-traditional insurance activities that pose particular risk to the PRA's objectives. The scale of an insurer's potential impact depends on its size, complexity, business type and interconnectedness with the rest of the system.

59. The PRA divides all deposit-takers, designated investment firms and insurers it supervises into the five 'categories' of impact below:

Category 1

- The most significant deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.

- Insurers whose size (including number of policyholders) and type of business mean that there is very significant capacity to cause disruption to the interests of a substantial number of policyholders.

Category 2

- Significant deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause some disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.

- 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.

Category 3

- Deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause minor disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.

- Insurers whose size (including number of policyholders) and type of business mean that there is minor capacity to cause disruption to the interests of a substantial number of policyholders.

Category 4

- Deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them very little capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.

- Insurers whose size (including number of policyholders) and type of business mean that there is very little capacity to cause disruption to the interests of a substantial number of policyholders.

Category 5

- Deposit-takers, designated investment firms or insurers whose size, interconnectedness, complexity and business type give them almost no capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector may have the potential to generate some disruption.

- Insurers whose size (including number of policyholders) and type of business mean that there is almost no capacity to cause disruption to the interests of a substantial number of policyholders.

60. The PRA also considers the substitutability of the services that the insurer provides, and the extent to which this could mitigate the impact of failure. It is mindful of the extent to which this is possible in benign and stressed circumstances.

61. The PRA uses quantitative and qualitative analysis to allocate insurers to categories. Numerical scoring based on insurers' regulatory reporting provides a 'suggested' categorisation which supervisors review in light of qualitative analysis to confirm that it presents a full picture of an insurer's potential impact. Supervisors will seek to consider the lines of business and risks insured by the insurer, and whether these have the potential for significant adverse effects on policyholders if continuity of cover were not to be maintained or obligations not paid. If so, consideration will be given to whether these justify the insurer being placed in a different category from that suggested by the initial quantitative analysis. This will enable the PRA to further advance its policyholder protection objective.

62. Insurers are told to which category they have been assigned, providing a broad indication of what level of supervisory interaction to expect. The PRA will publish aggregate statistics on the number of firms in each category in its *Annual Report*.

External context

63. **Any assessment of the risks facing insurers requires an appreciation of the external context in which they operate.** The PRA's assessment therefore includes consideration of system-wide risks, for example, from low interest rates or rising credit spreads, and sectoral risks, for example, medical improvements affecting longevity risk.

64. The PRA draws on work by other parts of the Bank, including the views of the FPC on the macroprudential environment. Sectoral analysis to understand key market developments over the medium term draws upon both market intelligence and, where appropriate, standardised information from insurers.(1) The PRA also considers actions by other regulators, including the FCA, which might materially affect the prudential soundness of PRA-regulated insurers.

Business risk

65. **Business model analysis forms an important part of the PRA's supervisory approach.** The PRA examines threats to the viability of an insurer's business model, and the ways in which an insurer could create adverse effects on other participants in the system by the way it carries on its business. The analysis includes an assessment of where and how an insurer makes money and the risks it takes in so doing. Insurers are assessed at the level of the insurer or the sector as appropriate.

66. The PRA aims to understand a business model's sustainability and vulnerabilities. Vulnerabilities might include: unsustainable expectations of growth of market share without due regard to changing underwriting market dynamics and the adequacy of reserves; the risk of a low interest rate environment affecting the valuation of options or guarantees or the level of future investment returns; or specific vulnerabilities such as catastrophe risk or longevity risk. The PRA uses this work to focus its supervisory activity.

67. For those insurers posing greater risk to policyholders or the stability of the system, the analysis is more detailed. It includes a review of the drivers of profitability, risk appetite, performance targets and underlying assumptions, and an insurer's own forecasts and their plausibility. The PRA uses this analysis to form a projection of the insurer's ability to generate returns and associated risks over the medium term. This projection, and the general picture that supervisors form of the nature of the business, guide the PRA's work in assessing the adequacy of the measures the insurer has in place to mitigate risk. For example the PRA's forward-looking view of an insurer's prospects informs its judgement on the level of capital the insurer requires; and the complexity of an insurer's business informs judgements about its risk management procedures. If the PRA believes that mitigating measures alone cannot adequately reduce material risks to

(1) Data reported in a pre-agreed format by a defined set of insurers, using common definitions.

safety and soundness and policyholder protection, the insurer will be required to change its business model.

68. **Peer analysis forms an important part of this assessment**, providing a diagnostic tool to highlight where individual institutions may be outliers relative to their sector and so in need of further analysis. Such analysis also supports an understanding of common sectoral risks that have the potential to affect the stability of the system, on which the PRA involves the FPC.

69. **The PRA's assessment of business risk also includes an assessment of whether the PRA can effectively supervise the activities that an insurer carries out** — whether it is possible, with a reasonable amount of effort, for the PRA to form a clear view of the risks posed to safety and soundness and policyholder protection by the insurer. Where an insurer's business is particularly complex, the PRA considers whether it is possible to evaluate effectively the prudential risks to the insurer arising from it.(1) Where the PRA identifies material barriers to effective supervision, remedial action will be required.

70. Other key attributes that determine whether an insurer is capable of being effectively supervised are the organisational structure of its group and its ability to provide sufficient information to the PRA. These key attributes are considered in Section III.

(1) The PRA takes this into account in its assessment of a firm against the 'effective supervision' Threshold Condition, that a firm must be capable of being effectively supervised by the PRA.

III Safeguarding safety and soundness and policyholder protection

71. **The PRA assesses whether insurers have in place adequate measures to safeguard their safety and soundness and appropriate policyholder protection in light of the risks they pose to the PRA's objectives.** These mitigating measures include: management and governance, risk management and controls, financial resources and resolvability. This section sets out some of the key criteria against which the PRA assesses the adequacy of these measures. It also outlines some specific supervisory activities that the PRA undertakes to assess them. More general supervisory activities are outlined in the next section.

72. The PRA expects higher standards of risk mitigation from insurers posing greater risks to its objectives. For example, an insurer offering long-term or long-tail cover may be required to have more sophisticated risk management, consistent with the principle that an insurer's approach to risk management should be appropriate to the nature and degree of risk in its business.

73. Where possible, the PRA takes an integrated view of the elements of mitigation that an insurer has in place. This might mean that supervisors may want an insurer temporarily to hold additional capital to make up for perceived shortcomings in risk management. Nevertheless, **insurers must meet a minimum level of adequacy across all areas** in the long term: high levels of capital cannot act as a long-term substitute for sub-standard management, for example.

74. The PRA expects insurers to meet its requirements on both a consolidated basis for groups headquartered in the United Kingdom, for UK subgroups of wider global groups, and at the level of regulated legal entities. A regulated insurer's relationships with other entities in the group may affect its prudential soundness, for example through access to capital, intra-group exposures or contagion.

75. As well as setting expectations of insurers, the PRA advances its objectives by taking action to improve the wider environment within which insurers operate. In particular:

- The PRA works with the FCA and the Financial Reporting Council (FRC) where appropriate to ensure the quality and usefulness of information disclosed by insurers. This includes key information on financial risk and accounting and actuarial judgements, on a consistent basis across insurers. Disclosure of such information assists creditors in judging the risk they take in lending to the insurer. This in turn improves insurers' own incentives to mitigate those risks. The PRA believes that where it is feasible for the authorities to allow insurers to fail, market discipline will become a more powerful force.
- Making rules for the FSCS in respect of the provision of insurance. The existence of an insurance compensation scheme can be key in reducing risks to policyholders and financial stability. The PRA is responsible for the design of the scheme, including for example its funding arrangements, its capacity to support insurer resolution and the arrangements for publicising the extent of cover under the scheme.

76. Upon implementation, the requirements of Solvency II will form a key part of how the PRA delivers its objectives. The PRA's approach to Solvency II is considered in more detail in Box 5.

Management and governance

Overall approach

77. **It is the responsibility of each insurer's board and management to manage the insurer prudently, consistent with its safety and soundness and the appropriate protection of policyholders, and thereby contributing to the stability of the financial system.** This goes beyond complying with the letter of the PRA's detailed requirements, for example on adequate capital and risk management and controls, and it often means insurers acting more prudently than they would otherwise choose. It also goes beyond core responsibilities for all boards and management; such as ensuring that individuals appointed to senior management positions are competent to fill such roles, setting the firm's strategy and policies clearly, and ensuring that these are applied throughout the organisation, with responsibilities clearly apportioned.

78. The boards and management of regulated insurers **must understand the kind of behaviour that delivers an acceptable level of safety and soundness from the point of view of policyholders and the financial system, and act accordingly.** This includes following the PRA's policies in line with their spirit and intended outcome — not managing the business only to the letter, or gaming the rules. And it includes embedding the principle of safety and soundness in the culture of the whole organisation. Without such effective, prudent management and governance, it is not possible for insurers to ensure their own safety and soundness.

79. For an insurer to be permitted to carry out regulated activities, the insurer as a whole must be fit and proper. At initial authorisation the PRA will take into consideration the record of the firm itself, where appropriate, and of those who manage its affairs including the existence of any record of past misconduct.(1)

(1) This includes the existence of any spent and unspent convictions, regulatory investigations and enquiries, prior refusals of authorisations and/or connections with unsuitable persons.

Box 5
Solvency II

Solvency II will be the new European-wide system for insurance regulation. Its main objective is the adequate protection of policyholders and beneficiaries and it sets out a new, risk-based and harmonised EU-wide approach to the assessment of capital adequacy and to risk management and reporting for insurers.

In a number of areas, the PRA's objectives and the requirements of Solvency II will be closely aligned. For example, the Prudent Person Principle within Solvency II will be a tool to implement the Threshold Condition that business must be conducted in a prudent manner and assets must be appropriate; the ORSA will support the Threshold Condition that insurers must have appropriate non-financial resources and robust risk and capital management systems; and the Actuarial Function, Internal Audit and Risk Management Function requirements will help ensure that insurers satisfy the Threshold Conditions that business must be conducted in a prudent manner and that the insurer and its management are fit and proper.

The Solvency II Pillar 1 framework will, when implemented, become the PRA's principal means of implementing the condition that the insurer must have appropriate financial resources. This framework will set out detailed requirements around the nature and quality of capital resources, the appropriate valuation of assets and liabilities, and the appropriate minimum standards for capital adequacy.

Solvency II will set out a framework for the initial approval and ongoing review of the appropriateness of internal models used to calculate capital requirements. As set out in Section 3, the PRA will only approve an internal model if it is satisfied that the systems for identifying, measuring, monitoring, managing and reporting risks are adequate. Following approval, the PRA will require assurance that insurers have put in place systems which ensure that the internal model and associated controls operate effectively at all times.

All insurers in the scope of Solvency II will need to meet its requirements. To ensure that insurers meet the required standards the PRA will, if necessary and appropriate, impose capital add-ons as provided for in the framework Directive, or apply other relevant supervisory measures.

There is a central and underlying principle in Solvency II that all actions taken by supervisors should be proportionate to the nature, scale and complexity of the risks inherent in the insurers' business including insurers and activities which are more complex or more important for financial stability. This is consistent with the PRA approach of categorising insurers as described in Section II.

The transposition date of 31 March 2015 and implementation date of 1 January 2016 were published in the Official Journal of the European Union on 18 December 2013. However, the final requirements of Solvency II are not yet fully agreed. The PRA, in concert with HM Treasury, continues to take a positive approach to helping to shape the developing policy within EIOPA and beyond. In the meantime, the PRA has introduced an interim approach (referred to as 'ICAS+') in light of the delays to the implementation of Solvency II, which allows insurers to use their Solvency II work to meet, as far as possible, the current regulatory requirements under ICAS.

80. This requirement for an insurer to be 'fit and proper' is in addition to the obvious need for an insurer's board and senior management, and in particular its Chair, to have regard to the need for the insurer to comply with all applicable laws and regulations. These obligations are extensive and not limited to the laws and regulations enforced by the PRA. This is because other laws and regulations — for instance, conformity with tax laws — could affect an insurer's fitness and properness, and the probity and reputation of its management.

81. This section elaborates on these broad expectations. In many cases these expectations are directly reflected in PRA rules. More generally they elaborate on the 'prudent conduct', 'effective supervision' and 'suitability' Threshold Conditions. They are broken down into: culture and behaviour, competence and structures.

Culture and behaviour

82. The PRA expects insurers to have a **culture that supports their prudent management**. The PRA does not have any 'right culture' in mind when making its assessment; rather it focuses on whether boards and management clearly understand the circumstances in which the insurer's solvency and viability would be under question, whether accepted orthodoxies are challenged, and whether action is taken to address risks on a timely basis. The PRA wants to be satisfied in particular that designated risk management and control functions carry real weight within insurers.

83. **Individuals, whatever their position in the insurer, should take responsibility for acting in a manner consistent with its safety and soundness and the appropriate protection of policyholders.**

84. The PRA expects insurers to have in place sufficient controls to **minimise incentives for excessive risk-taking** by management and risk-taking staff. Remuneration and incentive structures should reward careful and prudent management.

85. The PRA expects insurers and individuals within them to **deal with the PRA (and other regulators as appropriate) in an open and co-operative manner** as set out in the PRA's Fundamental Rules. That includes taking the initiative to disclose anything relating to the insurer, and the protection of policyholders and financial stability more generally, of which the PRA would reasonably expect notice, and providing the PRA with the information it requests on a timely basis. Boards and senior management are expected to ensure that all staff comply with this requirement.

86. The PRA expects an insurer's **board to take responsibility for establishing, embedding and maintaining the type of culture described above**. The PRA seeks to address serious failings in the culture of firms as part of its supervisory activities (as outlined in Section IV and Box 8).

87. More generally, an insurer's **board should hold management to account for conducting the insurer's business in line with the board's expectations**. That should include the board (and its committees) engaging with management to test the robustness and prudence of the assumptions in the business plan and strategic initiatives, the adequacy and integrity of controls, and the consistency of implementation of the board's decisions. To do this, the board needs to be provided with high-quality management information, both quantitative and qualitative.

88. The PRA considers the **responsibility of board members to be individual, as well as collective**. This means that, should any director have concerns about the insurer or its management and governance, the PRA will expect them to press for action to remedy the matter and, if those concerns are not addressed, to alert the PRA. An insurer's culture should be encouraging of this.

Competence

89. Insurers must be **run by people who are competent to fill their roles**. That means ensuring that individuals have appropriate expertise and experience and, in the case of non-executive directors, give sufficient time to fulfil their obligations to a high standard.

90. It is the **responsibility of an insurer's board to ensure that individuals appointed to senior management positions are competent** to fill them. As an insurer grows and changes, and as the challenges it faces change, it may need different board members and management. The Chair and independent directors should stand ready to have an open exchange of views with the PRA on the performance of senior management, as should the Senior Independent Director on the performance of the Chair.

91. The **board should have a mix and balance of skills so that collectively it can understand the breadth of the business**. The PRA expects many on an insurer's board to have expertise in financial services, though this is not a pre-requisite for all members. The PRA expects all board members, either at the outset or after a set period of time, to develop an understanding of the different areas of the business and the main prudential risks and controls, and so to be able to engage in an informed conversation with the PRA. The PRA expects more than one independent director to understand major lines of business and risk controls, in order to avoid undue reliance on individuals by the board as a whole.

Structures

92. The PRA expects insurers to have in place **clear structures of accountability and delegation of responsibilities** for individuals and committees, including checks and balances to prevent dominance by an individual. Senior individuals should remain accountable for the actions of those to whom they delegate responsibilities, including where insurers use third parties in respect of outsourced functions.

93. Within a financial group, **boards and senior management of all authorised entities, including those subject to consolidated supervision, should take responsibility for ensuring that the business is conducted in a prudent manner**. Boards cannot delegate this responsibility.

94. Not all legal entities within a group are necessarily directly authorised by the PRA. Nonetheless, unregulated group entities can be important to the functioning of the group as a whole (for instance, by providing important support services), or can undertake activities which have the potential to create risks for the group as a whole and so for authorised insurers. The PRA expects all boards of legal entities within groups, as a result of the responsibilities of their holding companies and their regulated affiliates, to have regard to the PRA's objectives. **In cases where the most senior legal entity within a group is a holding company, which is not itself authorised under the United Kingdom's statutory regulatory regime, the PRA will expect to have extensive contact with its board and senior management, and will consider whether it is suitable to exercise control over a regulated firm.** The PRA will expect the holding company to take responsibility for the group as a whole having due regard to the PRA's objectives. And the PRA will consider whether the insurers' membership of a group affects whether the insurer satisfies the Threshold Conditions, including if the ownership structure compromises the ability of the insurer to be supervised effectively by the PRA. Further, if the PRA believes that it would be desirable, to further either of its objectives, or for the effectiveness of consolidated supervision, it will exercise the power conferred by the Act to direct the holding company.(1)

95. **These requirements on the boards and management of legal entities within groups apply equally to overseas insurers** which establish separately incorporated entities within the United Kingdom. In particular, the PRA expects boards and senior management of these insurers to have proper regard to the PRA's objectives, both for the group as a whole and for individual insurers (and subgroups) in the United Kingdom, since issues at the parent or group level could have an effect on the PRA-authorised entity and the PRA's objectives more generally.

96. Insurers are able to operate in the United Kingdom as branches of overseas legal entities, meaning that there is no separate legal entity in the United Kingdom. Such branches can take one of two forms: those where the legal entity overseas is located within the EEA; and those located outside the EEA. Regardless of the corporate structure and location of the parent, the PRA expects all UK branches, like UK subsidiaries, to act responsibly in a manner that is consistent with safety and soundness and the appropriate protection of policyholders. The PRA expects branches to appoint a senior individual with authority to act as a primary contact with the PRA in relation to their affairs. This individual should also act as a channel for communication with the parent. Box 7 sets out how the PRA aims to ensure that its objectives are met in respect of overseas insurers.

Supervision — Approved Persons

97. The PRA has the power under the Act to require individuals in identified roles with a significant influence on the affairs of an insurer (Significant Influence Function roles) — and who are critical to the advancement of the PRA's objectives — to seek PRA approval before taking up their position. Such individuals are known as 'Approved Persons'. Approval is granted only if the PRA as prudential regulator and the FCA as conduct regulator are both satisfied that an individual is fit and proper.

98. PRA Significant Influence Function roles include all members of a firm's board(2) and the heads of the finance, risk, internal audit and actuarial functions.(3) Over time the PRA will review its Approved Persons regime and may consider including other roles with responsibility for managing parts of the business which are considered significant in the context of the PRA's supervision of that individual firm. In addition, the PRA may give views to the FCA on applications for an FCA controlled function where the approval, or rejection, of applications to that role may have a material adverse effect on the PRA's advancement of its objectives.

99. All individuals applying for the above roles are subject to a basic review of probity, reputation and financial soundness, which may include criminal record and credit checks. The PRA also performs an assessment of an individual's competence and capability to carry out the role. Assessing probity and integrity reduces the risk of behaviour intentionally misaligned with the PRA's objectives; assessing competence is necessary given the prime role of these individuals in ensuring an insurer's safety and soundness and the protection of policyholders. The nature and intensity of the PRA's assessment will depend on the potential impact of the insurer.

(1) The PRA's statement of policy regarding the power of direction over holding companies can be found at www.bankofengland.co.uk/publications/Documents/other/pra/powerdirection.pdf.
(2) Or the equivalent governing body where the firm is not a body corporate.
(3) Including, where relevant, the 'With-Profits' actuary.

100. The PRA may interview individuals applying for the above roles. Interviews include an assessment of the technical experience of the applicant and his or her understanding of the risks posed to the viability of the insurer and the risks posed by the insurer to the wider financial system. The PRA will assess whether the insurer has conducted an appropriately rigorous recruitment process and will take into account the due diligence done by the insurer on the applicant.

101. The PRA reviews the fitness and properness of individuals on an ongoing basis, including as part of its supervisory assessment of an insurer against the Threshold Conditions.

102. While the PRA's Approved Persons regime applies only to individuals holding certain senior roles, the PRA expects all individuals within an insurer to act in a manner consistent with its objectives.

Disciplinary action against individuals

103. While the PRA's preference is to use its statutory powers to secure *ex ante*, remedial action, it also has a set of disciplinary powers which it will use *ex post* if necessary.

104. The PRA has disciplinary powers over individuals approved to perform a Significant Influence Function by the PRA or the FCA and is empowered to use these where an individual fails to comply with the PRA's *Statement of Principles and Code of Practice for Approved Persons*, or has been knowingly involved in a contravention by their firm of a requirement imposed by the PRA.(1) The powers enable the PRA, among other sanctions, to impose penalties to censure an individual publicly, to withdraw approval from individuals holding Significant Influence Functions, and to prohibit individuals from holding Significant Influence Functions in the future.

105. In assessing whether to take disciplinary action against Approved Persons, the PRA considers a variety of factors, including:

- the impact the individual's behaviour has had or is having on the PRA advancing its objectives — including the behaviour of other persons in the insurer over whom the individual should exercise control — and thus whether that behaviour calls into question the person's fitness and properness as an Approved Person (be it an isolated incident or a course of conduct);
- whether taking action will serve to deter the person who committed the breach, and others who are subject to the PRA's requirements, from committing similar or other breaches; and
- the individual's behaviour towards the PRA, including the level of co-operation and openness with which the individual deals with the PRA and the appropriateness of the individual's actions in response to concerns raised.

Risk management and controls

Overall approach

106. The PRA attaches particular importance to insurers managing risk effectively because it is the crystallisation of risk, or concerns about risks crystallising in the future, which causes problems for insurers' safety and soundness and so policyholders and the stability of the financial system. Insurers should have robust frameworks for risk management and financial and operational control, commensurate with the nature, scale and complexity of their business. Competent and, where appropriate, independent control functions should oversee these frameworks.

107. This section sets out the PRA's expectations regarding an insurer's approach to risk management, its control framework, and its risk management and control functions. In many cases these expectations are directly reflected in PRA rules. More generally they elaborate on the 'prudent conduct' and 'effective supervision' Threshold Conditions.

Risk management approach

108. **The PRA expects insurers to articulate for themselves the amount of risk they are willing to take across different business lines to achieve their strategic objectives.** This risk appetite should be consistent with the PRA's objectives, and the insurer should pay appropriate attention to identifying, measuring and controlling risks, including those arising in unlikely but very severe scenarios.

109. The PRA recognises that it is always possible to identify a stress scenario in which an insurer fails, and it does not expect insurers to be able to withstand all such events. The PRA considers it important, however, for insurers' senior management and boards to have an explicit understanding of the circumstances in which their firm might fail.

110. The PRA expects an insurer's risk appetite to be integral to its strategy and the foundation of its risk management framework, so that the whole insurer operates within this appetite. This requires a **robust risk management framework and its effective and consistent implementation throughout the organisation**. Members of staff in both business and control functions should manage risks as a central part of their role: responsibility for risk should not be delegated to risk management and control functions. This is a key aspect of a culture which supports the prudent management of the insurer.

(1) http://fshandbook.info/FS/html/PRA/APER.

111. The PRA expects key decisions, both on assuming new risks and managing existing ones, to be taken at the appropriate level, including, where they are sufficiently important, at the level of the board. Risks should be reported to the board and senior management on a timely basis, with risks outside the agreed risk appetite and key sensitivities highlighted.

Control framework

112. An insurer's control framework encompasses the processes, delegated authorities and limits that put into effect an insurer's approach to risk management and control. The PRA expects an insurer's control framework to be comprehensive in its coverage of the whole firm and all classes of risk, to be commensurate with the nature, scale and complexity of the insurer's business, and to deliver a properly controlled operating environment (including, for example, through segregation of duties and reconciliations or through the processes to report and act on any breaches of limits).

113. **The PRA expects insurers to observe high standards in the management of operational as well as financial risks.** For example, **insurers should have procedures in place to ensure continuity of critical services**, such as the payment of claims to policyholders. Insurers are expected to comply with standards for resilience set in this area, including where they outsource material operational functions to third parties.

114. The PRA expects **insurers to have available the information needed to support their control frameworks**. This information should be of an appropriate quality, integrity and completeness, to provide a reliable basis for making decisions and so to control the business within agreed tolerances. It should be produced in a sufficiently timely manner. And it should be able to be accessed and analysed in aggregate for the business as a whole, across the group, and for each business line and legal entity within it, to facilitate understanding and swift management of the risks to which the insurer is exposed. It is also relevant to the Threshold Condition that insurers are capable of being supervised effectively by the PRA. The senior management of a firm and the PRA need to be able, with a reasonable amount of effort, to form a clear view of the safety and soundness of the insurer and how policyholders are protected. This includes forming a view of the financial position of the rest of the insurer's group and the risks posed by other individual entities within it.

115. As part of insurers' responsibility to have robust information, they should have sight of the likely path of, and risks around, future earnings. It is also important for insurers to have processes in place explicitly to assess uncertainties in the valuation of assets and liabilities so as to ensure that material uncertainty is reported to the board and senior management.

116. Models have been used in understanding and managing insurance risks for many years. But, while recognising that quantitative models can play an important role in supporting insurers' risk management and helping to determine the regulatory capital an insurer holds, the PRA expects insurers **to be prudent in their use of such models given the inherent difficulties with risk measurement**. Senior management and the board should therefore understand the extent of reliance on models for managing risk, as well as the limitations from the structure and complexity of models, the data used as inputs and key underpinning assumptions. Models, and their output, should be subject to effective, ongoing and independent validation to ensure that they are performing as anticipated. The PRA expects senior management to have a clear understanding of key assumptions supporting the models, the risks that are not adequately captured by them, and the alternative risk management processes in place to ensure that such risks are adequately measured and incorporated into the firm's overall risk management framework.

Risk management and control functions

117. Insurers should have in place separate risk management and control functions — notably risk management, actuarial, finance and internal audit functions — to the extent warranted by the nature, scale and complexity of their business. The PRA expects these functions to support and challenge the management of risks across the business as a whole, by expressing views on the appropriateness of the level of risk being run and the adequacy and integrity of the associated governance, risk management and financial and other control arrangements.

118. To the extent warranted by the nature, scale and complexity of the business, the PRA expects these functions to be **independent of an insurer's revenue-generating functions**, and to possess sufficient authority to offer robust challenge to the business. This requires these functions to be adequately resourced, to have a good understanding of the business, and to be headed by individuals at senior level who are willing and able to voice concerns effectively. For example, for general insurers in particular, it is important that there are appropriate controls and governance systems in place to manage potential conflicts of interest between pricing and reserving teams.

119. An effective **risk management function ensures that material risk issues receive sufficient attention from the insurer's senior management and board**.

120. The PRA expects insurers to have in place an operationally independent actuarial function commensurate with the nature, scale and complexity of the risks inherent in the firm's business. The PRA considers the actuarial function to be integral to the effective implementation of a firm's risk

management framework and therefore expects the actuarial function to be engaged with all aspects of risk management.

121. An insurer's finance function should deliver an accurate understanding of the firm's financial position, including through the effective challenge of valuations.

122. Internal audit should provide **independent assurance over insurers' internal controls, risk management and governance**. And, in the absence of an internal audit function, there should be a review performed by an independent third party. The PRA has worked closely with professional bodies for internal auditors as they develop and publish a code that sets out principles for the internal audit function of insurers.

123. Senior management and the board should hear and heed the views of these functions. This means that they require access to the board and (where an insurer has one or both) the board's Risk and Audit Committees, which should oversee these functions to ensure their independence and effectiveness.

Financial resources

Overall approach

124. Unlike banks, insurers operate a liabilities-led business. For some types of insurance (such as most life insurance), liabilities are long term and losses emerge slowly. For other types of insurance (such as, but not all, general insurance) liabilities are shorter term and losses emerge relatively quickly. But, in both cases, assets with appropriate characteristics of safety, yield and marketability and which are diversified and adequately spread must be held to match these liabilities so that the liabilities incurred in writing insurance policies are matched with assets of an appropriate nature and term. Long-term life insurance will typically be matched with assets providing cash flows with appropriate matching nature and term, often taking on some investment risk within these constraints (for example by investing in corporate debt). As the term of insurance gets shorter, or the liabilities more volatile, business may well be matched with more liquid assets. **Capital is required to allow for uncertainty over the valuation of both liabilities and assets. And an insurer must be able to meet its liabilities as they fall due,** holding liquid assets when appropriate, for example cash or government securities.

125. **Insurers should maintain adequate capital resources, both in terms of quantity and quality, taking into account the risks to which they are exposed and consistent with safety and soundness and the protection of policyholders**. Having enough capital of sufficiently high quality reduces the risk of an insurer becoming unable to meet the claims of its policyholders and creditors, and is therefore crucial for maintaining their level of protection. In addition, where an insurer is owned by private shareholders, having more shareholder equity — the highest quality form of capital — gives owners a greater interest in the firm being run prudently.

126. **The PRA's assessment of insurers' financial strength is designed to judge its solvency, ie whether it is able and will continue to be able to meet its obligations to policyholders and other creditors, including in times of stress**. This includes assessing: the level of capital held by an insurer and the firm's ability to raise more; reserving of general insurers and the adequacy of technical provisions for all insurers; the profitability of underwriting (for example by scrutinising the claims and other performance ratios of general insurance firms); whether the insurer is exposed to particular concentrations of risk (including to particular loss events or large or clustered exposures); whether the insurer is significantly exposed to non-traditional, non-insurance activities; the approach to liquidity management (including contingency planning); and the adequacy of key assumptions (for example, discount rates being applied to technical provisions and life insurers' longevity assumptions).

127. **The PRA analyses the adequacy of insurers' solvency positions on a forward-looking basis, including in times of stress when asset valuations may become strained and capital positions are impaired as a consequence.** Supervisors assess whether insurers are properly funded and whether they are able to meet their obligations as they fall due. The PRA also seeks to consider whether an insurer has plausible recovery actions that it could take, including in times of general market stress.

128. **As with all elements of its approach, the PRA expects insurers in the first instance to take responsibility for ensuring their solvency**. But, reflecting the incentives insurers have to run their business in a less prudent manner than the public interest would indicate, there is also a clear role for the PRA as prudential regulator to specify a minimum solvency requirement for insurers to meet. This does not, however, diminish the need for insurers themselves to judge their own solvency needs in an appropriately prudent manner, since that is necessary to maintain the level of protection of policyholders and creditors. Insurers should engage honestly and prudently in such solvency assessments, not least because the PRA may not be in a position where it could be expected to identify and evaluate all the risks that insurers may face.

129. The rest of this section sets out what, at a high level, the PRA expects around the quality and quantity of insurers' capital, including the main elements of the regulatory framework that inform the levels of regulatory capital that insurers should maintain. It also sets out the PRA's expectations of insurers' funding positions. In many cases these are directly reflected in PRA rules, and more generally elaborate on the 'prudent conduct' Threshold Condition. In

due course, much of the PRA's expectations in this area will be achieved through the implementation of Solvency II requirements.

Quality of capital

130. The PRA expects a significant part of an insurer's capital to be ordinary shares and reserves. These are the highest-quality form of capital as they allow insurers to absorb losses on a going concern basis — that is, without prompting the winding up or legal reorganisation of the insurer and consequent disruption and loss of value. Going forward, permissible capital instruments for insurers will be those included in Solvency II, which will set out the type and quality of capital allowed.

131. **The PRA expects all capital to be capable of absorbing losses in the manner indicated by its place in the capital structure.** Upon implementation, Solvency II will set out the types and quality of capital which can be recognised as permissible capital instruments for insurers. The PRA will expect all capital instruments to meet these Solvency II criteria regarding the definition of capital, and it will object to insurers issuing regulatory capital instruments that are deliberately structured to meet the letter but not the spirit of these criteria, notably where their incentive is to minimise issuance cost and promote the attractiveness to investors at the expense of genuine loss-absorbing capacity. Until Solvency II criteria are fully implemented, the PRA expects insurers to anticipate the enhanced quality of capital that will be needed when issuing or amending capital instruments.

132. While less valuable in terms of the PRA's objectives, lower-quality capital (for example, subordinated loan capital) can play a role if an insurer has failed. Since an insurer's capital — including subordinated loan capital — protects the FSCS, and since costs incurred by the FSCS are mutualised among other insurers, so subordinated loan capital helps reduce the impact of failure on other insurers. Such capital can also be valuable in the event of an insurance business being transferred from an insurer that has entered, or is about to enter, an insolvency proceeding. The PRA supports the principle that in the event of insolvency, insurance policyholders' claims are preferred above those of other unsecured creditors, including above reinsurance policyholders' claims.

Location of capital

133. The PRA is mindful that capital resources are not always freely transferable around a group when it matters most. Therefore, **the PRA expects capital to be located in the regulated entities where it is needed**. Policyholders', creditors' and counterparties' claims are on specific legal entities, not on groups, and should an insurer fail, its orderly resolution will be facilitated if individual legal entities, and UK subgroups, hold capital commensurate with their risks. For example, amounts held in a 'with-profits' fund, or some other segregated fund for a particular group of policyholders or other creditors, may be available to absorb losses arising in that fund but may not be readily available for transfer elsewhere within the firm or group. Alternatively, the need for capital to be held in a particular group entity may be reduced if the insurer or the PRA limits their intra-group exposures net of any collateral.

Level of capital

134. **The PRA expects insurers to take responsibility for maintaining at all times an adequate level of capital, taking into account the risks to which they are exposed, and consistent with their safety and soundness and the protection of policyholders.** Capital should be sufficient to absorb unexpected losses, including those arising from uncertainties about provisions and valuations, in a wide range of severe but plausible stresses, both market-wide and firm-specific. The PRA expects insurers to maintain a capital buffer above the Individual Capital Guidance. Such an approach is designed to maintain the confidence of an insurer's creditors and protection of its policyholders even in stressed circumstances.

135. The PRA itself forms judgements about how much capital insurers need to maintain, given the risks to which they are exposed and uncertainties about the values of assets and liabilities. The PRA assesses the extent to which the insurer has considered life and non-life underwriting risks and credit, market and operational risks adequately in its assessment of capital adequacy, and also assesses the scale of other risks which the insurer faces. The PRA's judgements should inform insurers' own assessments. **But the PRA expects insurers in the first instance to take responsibility for determining the appropriate level of capital they should maintain.** Insurers should engage honestly and prudently in the process of assessing capital adequacy, and not rely on regulatory minima. And they should not rely on aggressive interpretations of actuarial or accounting standards, especially in calculating technical provisions.

136. **The PRA expects all insurers to develop a framework for stress testing and solvency assessment, through forward financial projections, that enables them to monitor the assumptions underlying their assessments, and the significance of any volatility in their earnings or in their capital and reserves including in a range of severe yet plausible scenarios.** In assessing risk, the PRA expects insurers and insurance groups to employ a range of stress-testing techniques proportionate to the nature, scale and complexity of their business. In support of this, the PRA expects all insurers to ensure that assets and liabilities are appropriately valued and that reserves and provisions are adequate. For its part, the PRA ensures the stresses applied are appropriately prudent.

137. **The PRA expects insurance groups to consider the cashflow implications of these different financial projections, including under stressed conditions**. In particular, groups should assess whether they will still be able to generate sufficient available cashflows in the stress scenario (eg from surpluses released from long-term funds, dividends from other subsidiaries, etc). These cashflows should cover any payments of interest or capital on loans to finance new business and to meet proposed group dividends, along with any other anticipated group liabilities as they fall due.

138. **Insurers and groups are expected to develop, as a matter of routine, planned management actions in response to stress scenarios that are realistic, credible, consistent with regulatory expectations, and achievable and which should be approved by their boards. They should also consider whether any of the actions identified should be taken in advance as precautionary measures, or whether they would be relevant/desirable only in the stress scenario**. Such plans — designed to return insurers to a stable, sustainable position following firm-specific or market-wide stress — should include options to address capital shortfalls through generating capital internally and externally. Plans to generate capital internally should include restricting dividends and variable remuneration. The PRA assesses the appropriateness of insurers' plans in terms of the adequacy of the recovery options identified and the triggers and governance to activate them.

The framework for determining regulatory capital

139. **The PRA assesses a firm's financial strength to analyse the adequacy of its solvency position on a forward-looking basis, including in times of stress when asset valuations may become strained and the adequacy of reserves may, in consequence, come under stress.** Particular emphasis is placed on reviewing a firm's approach to reserving. The PRA ensures that insurers have a robust approach to the setting of reserves and that there is appropriate and adequate oversight of reserving processes. Underwriting concentrations and performance are also considered, including reviewing sensitivities to longevity and discount rate assumptions.

140. The PRA comes to a view, currently through the use of Individual Capital Adequacy Standards (ICAS), on whether any adjustments are necessary to the overall required level of capital the insurer should hold to reflect adequately the particular risks it takes. The PRA's view is informed by the insurer's own assessments, but it also reflects its views of the risks to its objectives. It has particular regard to the idiosyncratic risks facing the insurer, in the context of its business model, the wider circumstances or external context, and the effectiveness of the insurer's governance and of its management of the risks it faces. Following the implementation of Solvency II, the PRA will carry out this assessment in a manner consistent with the provisions of the Directive.(1)

Internal capital models

141. The PRA's overarching principle is that it **expects insurers to maintain at all times an amount of capital that adequately reflects the risks to which they are exposed.** In consequence, if an insurer is to use an internal model in calculating its regulatory capital requirements, the PRA expects the model to be appropriately prudent.

142. The use by an insurer of quantitative techniques or 'models' is an inherent part of judging its liabilities and understanding its risks. Indeed, the modelling of non-economic risks in the insurance sector is long-standing.(2) For example, in life insurance, longevity and mortality tables are used to understand an insurer's liabilities, while non-life insurance models are used to assess the probability and severity of possible future seismic, meteorological, epidemiological and industrial events.

143. The use of quantitative techniques that seek to describe the risks around individual liabilities, such as weather patterns or longevity, is unlikely to change the nature of the risk being modelled. This contrasts with many financial risk models used to manage financial assets, including in banking, where the assessment of risk can drive investment decisions and hence asset returns, giving rise to potentially destabilising feedback loops. Such models also contrast with those where underlying risk parameters, for example default probabilities or correlations, are unobservable.

144. Within this context, the PRA recognises that **internal models introduce additional risks that should be understood and managed appropriately by an insurer and its senior management,** for example:

- the extension of modelling techniques to assets potentially exposes insurance models to the same vulnerabilities as seen in risk models in banks;
- although not necessarily complex, internal models can in practice obscure the key underlying assumptions and biases from management and supervisors, and thereby make meaningful challenge and oversight difficult; and

(1) In the meantime, the PRA has introduced an interim 'ICAS+' approach which allows insurers to use their Solvency II work to meet, as far as possible, current ICAS requirements.
(2) The use of modelling to estimate some technical provisions was introduced by The Insurance Companies Act 1909. Historically, modelling by insurers has mainly been on the liabilities side of the balance sheet, with the use of models to estimate capital requirements being relatively new.

- implementation of internal models, including across the balance sheet as a whole, can rest on a great number of firm-specific judgements and assumptions, for example about correlations across risks, both explicit and implicit. Where insurers use an internal model to determine required capital, additional supervisory scrutiny is therefore needed to ensure that the model and its governance are appropriate.

145. Internal models should be supported by **adequate testing and justification of the model on an ongoing basis.** Insurers will be expected to explain any significant changes in capital requirements arising from modelled approaches. Insurers should not select between internal model-based and non model-based 'standardised' approaches to calculating capital adequacy on the basis of lower capital requirements.

146. To complement the use of models, management should **assess the financial impact of a range of scenarios, including stressed scenarios calibrated to be equivalent to, or more severe than, the model calibration, and including reverse stress tests.** They should also assess the effect, and the appropriateness, of the management actions that they would propose to take in these scenarios. The financial impact of these scenarios and reverse stress tests, as well as their appropriateness, should be assessed independently from the development of the internal models. Management should consider the reliability of the output of the internal model compared with the results of these tests.

147. To monitor the ongoing appropriateness of internal models, the PRA uses early warning indicators based on metrics that are independent of the model calculations. In cases where the PRA has reason to doubt the prudence and appropriateness of models, it will require a firm to hold a capital add-on in respect of risks inadequately captured. Importantly, the PRA expects that where internal models are used for regulatory capital purposes, they should contribute to prudent risk management and measurement. And they should be updated regularly in order to reflect the insurer's risk profile and not just to ensure compliance with the letter of the PRA's requirements.

Liquidity and funding

148. **Insurers have to be able to meet their liabilities on an ongoing basis with sufficient confidence, including in stressed circumstances, consistent with their safety and soundness and the protection of their policyholders.**

149. As with all elements of its approach, **the PRA expects insurers in the first instance to take responsibility for ensuring they are able to meet their liabilities with sufficient confidence, and to have appropriate risk management strategies and systems in place for managing their liquidity**. Reflecting the incentives insurers have to run their business in a less prudent manner than the public interest would indicate, however, there is a clear role for the PRA as prudential regulator in ensuring that insurers have an appropriate degree of resilience to liquidity stresses.

150. The PRA recognises that insurers generally do not suffer from the same liquidity risks as banks. Indeed, in the case of life companies, insurers may, through their ability to match cash flows from assets and liabilities, be able to be providers of liquidity to other parts of the financial system. However, the PRA expects insurers at all times to maintain sufficient liquid assets to enable them to meet their liabilities as they fall due, including under a range of severe but plausible stress scenarios. Insurers should consider potential liquidity stresses affecting both assets (for example stressed financial market conditions) and, where relevant, liabilities (such as increases in policy surrenders or simultaneous claims). An insurer's approach to managing its liquidity should reflect also its use of asset-liability matching and its management of liabilities, for example by ensuring a spread of maturities or lengthening the liability term structure.

151. Liquidity swaps and collateral upgrade transactions have the potential to transfer liquidity risk from the banking to the insurance sector. The PRA expects to be notified by insurers prior to significant transactions. More broadly, the PRA expects insurers that engage in such non-traditional, non-insurance activities to manage the greater liquidity risks potentially associated with this business appropriately.

152. Insurers have failed in other jurisdictions in recent years because of liquidity concerns — for example as access to wholesale funding has dried up. The PRA takes the view that this is potentially a serious risk for the sector, and one that may rise in future if insurers become more closely engaged in providing liquidity for other parts of the financial sector.

153. The PRA is mindful that liquidity resources are not always freely transferable around a group when it matters most, and also that they may be transferred away from one area which needs them to support other areas. The PRA therefore **expects liquidity to be available without impediment, including in stressed times, in the regulated entities where it is needed.** For life insurers, the PRA expects liquidity to be adequate in the portfolio as a whole and in its component funds. This includes not only the shareholders' funds, non-profits funds and with-profits funds but also unit-linked funds. Insurers should ensure that the liquidity in these funds is adequate in stressed conditions as well as normal business conditions.

Resolvability

Overall approach

154. One of the key channels through which insurers can adversely affect the PRA's objectives is through disorderly failure that disrupts the continuity of supply of critical economic functions to policyholders, causes dislocation in financial markets and results in spillovers to the wider economy.

155. To mitigate this risk, it is important for there to be mechanisms by which **all types of insurer supervised by the PRA can exit the market in an orderly manner: that is, with minimal disruption to the supply of critical economic functions, including the degree of continuity for policyholders' cover against insured risks** (delivered either through continuity of cover or compensation for premiums paid). An insurer's resolvability reflects the extent to which it can exit the market in such an orderly manner, preserving the supply of critical economic functions and minimising adverse effects on financial stability and the wider economy, consistent with the PRA's objectives, and without exposing taxpayers to loss.

156. Insurers typically do not fail in the same way as banks. At least in their traditional activities, insurers do not undertake significant maturity transformation, and so they are less susceptible to 'fast-burn' failure than are banks. In consequence, insurers are likely to have more time in which to attempt to restore their solvency and viability (such as by raising additional capital). And where insurers exit the market, they can typically do so over a longer time period than is usually the case for banks.

157. At present, the United Kingdom does not have a special resolution regime for insurers. When insurers fail, they exit the market via:

- *Run-off*: the firm is closed to new business and the liabilities 'run off' over time. Insurers may use a scheme of arrangement approved by a court under the Companies Act to agree a compromise with their creditors and to accelerate the process.
- *Statutory reorganisation/winding-up*: an insurer that is insolvent may enter a modified administration or liquidation procedure. A new administration order came into effect in 2011 which requires the administrator of a failed insurer to continue to carry on the insurer's business so far as that business consists of carrying out the insurer's contracts of long-term insurance with a view to the business being transferred out as a going concern. Such continuity might be achieved by reducing the value of policies, by transferring policies elsewhere, or by finding replacement cover. The FSCS provides compensation to policyholders for claims against insurers that are declared to be in default, or seeks to ensure continuation of cover.

158. These arrangements vary in the extent to which they have been put into practice. To date, for example, no life insurance firm of a significant size has required compensation from the FSCS to be paid to its policyholders. Nor has an insurer with a large derivatives portfolio been put into insolvency in the United Kingdom. But that does not mean such events could not happen, and it is not clear that existing arrangements would be adequate in such an eventuality.

159. To be more confident that all insurers are resolvable, a strengthening of these arrangements may be needed. In August 2012, a consultation by HM Treasury(1) sought views on whether improvements are required to the current insolvency framework for insurers and whether a comprehensive resolution regime with stabilisation powers, as is currently available for banks, is required also for systemically important insurers. In response to the consultation, HM Treasury has said that it will consider how best to implement changes if appropriate, and will continue to pay close attention to developments in Europe and to other international work when considering the merits of UK action.(2) Having regard to HM Treasury's overall policy on resolution, the PRA and the Bank will continue to pursue both domestic and international work in this area.

160. Internationally, the United Kingdom, along with other G20 members, has signed up to the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*.(3) So where firms are systemically important, the applicable resolution arrangements should meet these standards. Where appropriate, this will include the establishment of crisis management groups, the development of recovery and resolutions plans and the assessment of an insurer's resolvability. In addition, the PRA actively supports the work of the IAIS on Global Systemically Important Insurers (G-SIIs), and it is continuing to work with the European Commission on non-bank resolution in the European Union.(4)

161. Domestically, an important part of the existing framework is the protection provided via the FSCS. The FSCS is required to seek continuity of cover for life business providing certain conditions are met, and has the discretion to do so for general insurance business. If continuity is not appropriate, or cannot be secured, the FSCS can instead pay compensation. The PRA is able to make rules to ensure that the FSCS compensation regime advances its objectives, and intends to review the rules applying to the FSCS. The review

(1) See www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf.
(2) See www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime_responses.pdf.
(3) See www.financialstabilityboard.org/publications/r_111104cc.pdf.
(4) See http://ec.europa.eu/internal_market/consultations/2012/nonbanks_en.htm.

will aim to ensure the rules support the PRA's objectives, in particular the PRA approach to policyholder protection, while balancing this with principles of simplicity and consistency. The PRA is considering bringing forward proposals to enhance the operational effectiveness of the FSCS in providing continuity of cover and compensation.

162. Assessing and planning to contain the impact of failure is a core part of the PRA's work. The PRA therefore works with insurers to assess, and improve where possible, their resolvability in the context of the current statutory arrangements. The PRA is also working with HM Treasury, FSCS and the rest of the Bank to assess and enhance the resolution arrangements for insurers to support its objectives to protect policyholders appropriately and promote safety and soundness.

163. The remainder of this section outlines the PRA's expectations of insurers' resolvability in the context of existing arrangements, elaborating on the 'prudent conduct' Threshold Condition and in some cases reflecting PRA rules.

Expectations of insurers

164. **Insurers should provide to the PRA on request all information needed to perform an assessment of their resolvability.** This includes: relevant information on group structure, including intra-group risk management and reinsurance arrangements; information on derivatives exposures and use of financial market infrastructures; analysis of the critical economic functions provided by the insurer and the potential consequences if these were disrupted; information on shared services which are necessary to maintain those critical economic functions; and information on the extent to which the firm undertakes non-traditional insurance activities (such as collateral upgrade transactions or liquidity swaps) which may lead to contagion elsewhere in the financial system. This also includes ensuring **the FSCS and any insolvency practitioners likely to be appointed in respect of the insurer have sufficient understanding of insurers' systems that they can undertake their functions effectively including maintaining payments to, and cover for, policyholders in the event of an insolvency**, should that be needed.

165. **Where significant barriers to resolvability are identified by the insurer or by the PRA, the PRA expects insurers to propose and implement adequate changes to reduce these.** This may involve changes to business practices, legal and financial structure or organisation.

166. Failure of an insurer is not, however, costless. **Insurers are therefore expected to set out credible steps to maintain or restore their business to a stable and sustainable condition in the event of stress.** And the less resolvable an insurer is, the greater the degree of supervisory focus that will be applied to such a plan and the actions implied by the firm's proximity to failure (as set out in the Proactive Intervention Framework).

167. The PRA is currently considering whether and how to introduce rules requiring insurers to have Recovery and Resolution Plans. Any requirements for such plans will be proportionate and tailored to insurers. The PRA will also monitor and contribute to international developments in this area, including obligations arising from the FSB Key Attributes.

Supervision — what the PRA does to assess and enhance resolvability

168. The PRA assesses the extent to which insurers are resolvable, taking into account the structure of the group to which a firm belongs, the different critical economic functions carried out (for example life versus general insurance) and the ability of the FSCS to provide appropriate continuity of cover in the event of failure.

169. The PRA recognises that — since they do not write new business — insurers in 'run-off' are subject to different incentives and pressures to other insurers. The PRA therefore requires insurers entering run-off to provide and maintain a scheme of operations, specifically to address how they intend to deal with their liabilities. Any proposed transaction (such as a scheme of arrangement or 'Part VII' transfer) that has the potential materially to change an insurer's risk profile, and so its ability to meet obligations to policyholders, must be discussed with the PRA.

170. The PRA will supervise any insurer under administration or liquidation proceedings until all of its permissions are withdrawn and its authorisation cancelled, working with insolvency practitioners and the courts as appropriate, and with the FSCS.

IV Supervisory activity

171. This section describes how in practice the PRA supervises insurers, including the PRA's approach to authorising new insurers (see Box 6). As part of this, it describes the Proactive Intervention Framework and the PRA's high-level approach to using its legal powers. For UK insurers, the PRA's assessment covers all entities within the consolidated group.

172. The PRA's supervision involves engagement with insurers at all levels of seniority. At a senior level, boards as a whole, and the independent directors in the absence of executive management, should expect regular dialogue with the PRA, either in groups or on an individual basis. The PRA always focuses on material issues in its engagement with insurers.

Assessing risk

173. The PRA aims to develop a rounded, robust and comprehensive view of an insurer, in order to judge whether it is being run in a safe and sound manner. **The PRA conducts its assessment work on a continuous cycle**, regularly updating its overall view of an insurer, the risks it faces and the risks it poses.

174. The PRA undertakes a set of core supervisory activities to inform its overall assessment. Reflecting the PRA's focus on the biggest risks to its objectives, the work making up this core increases in frequency and intensity in line with an insurer's potential impact (ie its Category). It also recognises the different risks inherent in the business models of insurers from the life, general, wholesale and reinsurance sectors. Activity also varies with other factors including whether or not the insurer is incorporated in the United Kingdom. The PRA contributes to securing the same appropriate degree of policyholder protection across all insurers. But 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. For example, supervision of life insurers recognises that they provide critical incomes to policyholders through annuities and for some general insurers that they provide mandatory cover. And insurers providing products with long maturities and illiquid contacts, such as life insurance or long-tail general insurance, bring greater opportunity for failure and a lower ability for policyholders to protect themselves.

175. Additional work is performed where necessary to provide information on particular areas of concern, taking into account an insurer's viability and resolvability, the prevailing market and economic conditions and the business model of the insurer.

176. Supervisory concerns will influence the PRA's future supervisory approach to an insurer. For example, concerns about management or systems and controls will influence the PRA's attitude to the growth of a business (including via acquisition), or to new appointments to Significant Influence Functions.

177. **The PRA is not formulaic about the supervisory activity it performs, since the focus on key risks means that this activity depends inevitably on an insurer's particular circumstances.** Nonetheless, its supervisory work comprises a selection of possible activities described below.

Supervisory activities and tools

178. In forming supervisory judgements, the PRA draws on a broad set of information and data. **Supervisors require insurers to submit sufficient data, of appropriate quality, to support their judgements about key risks.** Given the importance of this, the PRA periodically validates insurers' data, either through on-site inspection by its own supervisory and specialist risk and actuarial staff or by third parties. In addition, insurers' annual returns are subject to external audit.

179. The PRA gathers and analyses some information on a regular basis, including relevant information in the public domain, for example insurers' annual reports and disclosures. Also, it may request additional, firm-specific data from insurers (for example management information or forecasts). It is essential, however, that supervisors are not overwhelmed by the amount of information that they have to analyse.

180. To support its broad information-gathering and analysis, the PRA requires insurers to participate in meetings with supervisors at a senior and working level. Some discussions are strategic in nature, while other interactions focus on information-gathering and analytical work.

181. The PRA also, as appropriate, conducts detailed on-site testing or inspections of a particular area. In-depth, focused reviews, for example of material aspects of an insurer's governance or risk management arrangements, such as its reinsurance programme, asset/liability management or board effectiveness, involve discussions with staff, reviews of internal documents and some testing. In addition, the PRA may review an insurer's approach to stress testing, or undertake bespoke stress testing of its own. The PRA involves its risk-specialist, actuarial and other technical staff in on-site work, stress testing and other assessments as appropriate. And the PRA may use insurers' risk, compliance, internal audit and actuarial functions to identify and measure risks, where it feels it can rely on their effectiveness.

182. Insurers' external auditors can and should play a role in supporting prudential supervision, given their ability to identify and flag to the PRA current and potential risks in an insurer. As required by the Act, the PRA maintains arrangements to provide an insurer's external auditors with

Box 6
Authorising new insurers

Firms wishing to effect or carry out contracts of insurance must apply to the PRA for authorisation (permission) to do so. The PRA assesses applicant insurers from a prudential perspective, using the same framework that is employed for supervision of existing insurers. Thus, the PRA determines whether, if authorised, an applicant insurer would meet the Threshold Conditions, at the point of authorisation and on an ongoing basis. This includes an assessment of whether it could exit the market in an orderly way.

At the same time, the FCA assesses applicants from a conduct perspective. An insurer will be granted authorisation only where both the FCA and the PRA are satisfied that an insurer meets the relevant requirements. As provided for in the MoU, the PRA leads and manages a single administrative process. This includes co-ordinating the process and transmitting all formal notices and decisions to the applicant insurer.

The PRA sets out the information that it requires insurers to supply in order to complete its assessment. It stands ready to answer questions where necessary, though this does not extend to providing consultancy on completing applications. The PRA, along with the FCA has committed to engaging with applicants at an early stage via pre-application meetings, which will aim to produce as complete an application as possible.

The PRA takes a proportionate approach to the assessment of authorisation applications based upon the risk the applicant poses to the PRA's objectives. All applicants will be subject to a minimum level of assessment.

The PRA will ensure that, at the point of authorisation, and consistent with EU requirements, new insurers hold capital sufficient to cover the risks that they run.

The PRA's aim through this proportionate approach is for barriers to entry to be kept to the minimum consistent with its objectives, so enabling the PRA to contribute to a competitive insurance market.

relevant data and information, for example, if it considers an insurer's valuations of less liquid assets or its approach to reserving to be significantly out of line with its peers, as well as exchanging opinions with those auditors as to the implications of such information. The PRA expects to work with insurers' external auditors in an open, co-operative and constructive manner and will maintain rules setting out the duties external auditors have to co-operate with the PRA in connection with its supervision of PRA-authorised firms. It expects auditors to disclose to the PRA emerging concerns within insurers, where this would assist the PRA in carrying out its functions. The PRA has published a *Code of Practice* detailing the arrangements it maintains with firms' external auditors in order to promote a mutually beneficial and constructive relationship. Given their role in assessing the risks to which an insurer is exposed, actuaries can play an important part in supporting prudential supervision. Full, regular and timely dialogue between actuaries and supervisors should form a key part of supervision, so the PRA seeks also to maintain a constructive relationship with actuaries, as a profession and individually, so enabling the PRA to understand and critically challenge actuarial judgements within insurers. Engagement with the FRC Board and its advisory Actuarial Council and the Institute and Faculty of Actuaries is an important part of this dialogue.

183. To assist with its risk assessment, the PRA may at times use its statutory powers — in particular its information-gathering power and its powers to commission reports by Skilled Persons on specific areas of interest (under sections 165 and 166 of the Act respectively). The PRA may enter into contracts with Skilled Persons directly, following a transparent and consistent approach to selecting and appointing them.

184. The PRA also makes use of the FCA's findings on insurers' key conduct risks and any material prudential risks in relation to FCA-authorised subsidiaries of dual-regulated groups, where they are materially relevant to the PRA's objectives.

185. The PRA is not a 'fraud' regulator; this role is filled by other authorities. The PRA's on-site inspections are not therefore designed to uncover all instances of malpractice. Rather, the PRA aims to assess the adequacy of an insurer's control framework in preventing serious fraud that could threaten its safety and soundness and the protection of policyholders, drawing to the attention of the relevant authorities any suspicion or information that may be of material interest to them.

Proactive Intervention Framework

186. Supervisors consider an insurer's proximity to failure when drawing up its supervisory plan. **The PRA's judgement about proximity to failure is captured in an insurer's position within the Proactive Intervention Framework (PIF).**

187. Judgements about an insurer's proximity to failure are derived from those elements of the supervisory assessment framework that reflect the risks faced by an insurer and its ability to manage them — namely, external context, business risk, management and governance, risk management and

controls, capital, and liquidity. The PIF is not sensitive to an insurer's potential impact or resolvability.

188. **The PIF is designed to ensure that the PRA puts into effect its aim to identify and respond to emerging risks at an early stage.** There are five clearly demarcated PIF stages, each denoting a different proximity to failure, and every insurer sits in a particular stage at each point in time (see **Table A**). When an insurer moves to a higher PIF stage — that is, as the PRA determines the insurer's viability has deteriorated — supervisors will review their supervisory actions accordingly. Senior management of insurers will be expected to ensure that they take appropriate remedial action to reduce the likelihood of failure. And the authorities will ensure appropriate preparedness for resolution.

189. An insurer's PIF stage is reviewed at least annually, and in response to relevant, material developments.

190. The PRA considers it important for markets and counterparties to make their own judgements on the viability of an insurer. The PRA will not therefore routinely disclose to the market its own judgement on an insurer's proximity to failure, not least given the possible risk that such disclosures could act to destabilise in times of stress. The PRA would prefer to disclose PIF stages to insurers as a means of summarising the PRA's overall judgement on safety and soundness. In view of the current disclosure obligations in European legislation, however, the PRA has decided not to do so, given the risk that in some cases the insurer may be under a legal obligation to disclose its PIF stage publicly. The PRA is engaging with HM Treasury on whether it would be appropriate to pursue changes to relevant European legislation to support disclosure of such supervisory judgements to insurers but not to the market generally.

191. The PRA will publish aggregate statistics on the number of firms in each PIF stage on the Bank of England website.(1)

Mitigating risk

192. The PRA continually reviews its judgement of the risks that insurers pose to its objectives, on the basis of the supervisory activities undertaken. It communicates these judgements to insurers, and requires them to take action as a result.

193. There are annual internal stock-take meetings for all insurers to discuss the major risks they face, the supervisory strategy and proposed remedial actions, including guidance about the adequacy of an insurer's capital (as described in Section III). There is strong senior-level involvement in these assessments, such that major judgements are made by the PRA's most senior and experienced individuals. These formal assessments are also subject to rigorous review by those not directly involved in day-to-day supervision — including risk specialists, independent advisers and relevant participants from the rest of the Bank.

194. **There are clear and direct links between the risks that the PRA identifies and the actions it expects from insurers in consequence.** For example, if the PRA has identified deficiencies in an insurer's forecasts of earnings, or an excessive level of proposed employee remuneration or dividends to shareholders, leading to risks to its financial health, the PRA will require the insurer to take steps to tackle this. This may involve direct restrictions on payments, or requirements on the insurer to improve its forecasting, systems or governance as appropriate. Or the assessment may have revealed that senior management has an inadequate view of the insurer's aggregate exposures, compromising the effectiveness of the insurer's governance and, in consequence, the firm's soundness. The PRA may then expect the insurer to enhance internal systems for monitoring aggregate exposures or to review the design and effectiveness of its governance and reporting lines.

Conveying supervisory messages

195. The PRA focuses on outcomes. **The PRA highlights issues of concern and the outcomes it wishes to see, but as it is the responsibility of an insurer to manage itself, in general the ways in which insurers achieve these outcomes are a matter for them.** In some cases the PRA may choose to be directive in terms of the action required, if it considers it necessary in order to reduce risks to its objectives.

196. The PRA sends an annual letter to each insurer's board, clearly outlining the small number of key risks that are of greatest concern, and on which it requires action. **The test of materiality for points raised with insurers is high, with a focus on root cause analysis rather than symptoms, and with supervisory interventions clearly and directly linked to reducing risks to the PRA's objectives.** The PRA expects to verify itself that action is taken on these key risks, and communicates to the board when and how it intends to do this. The PRA sends individually tailored letters to all insurers, except those with the lowest potential impact where a standard letter outlines issues relevant to all insurers in that group, except where specific issues have been identified with a particular insurer. The PRA actively engages with an insurer's Audit Committee and its non-executive directors on progress made in dealing with the most significant risks identified.

197. Insurers may sometimes disagree with the PRA's decisions. This is inherent in a forward-looking system. The PRA in general actively discusses issues with insurers in reaching its decision, and carefully considers representations made, not least to ensure that its decisions are made on

(1) For more information, see www.bankofengland.co.uk/pra/Documents/supervision/pifscores.pdf.

Table A Stages in the Proactive Intervention Framework

Stage	Possible supervisory actions
Stage 1 – Low risk to viability of insurer	— Insurer subject to the normal supervisory assessment process and required to plan for stressed conditions and identify appropriate recovery actions or exit strategies. — The PRA to assess insurer resolvability.
Stage 2 – Moderate risk to viability of insurer Supervisors have identified vulnerabilities in an insurer's financial position or deficiencies in its risk management and/or governance practices.	*Recovery* — The intensity of supervision will increase and the insurer will be required to reassess the appropriateness of recovery actions and exit strategies. — The PRA may set additional reporting requirements, and make use of information gathering and investigatory powers. — The PRA will review the insurer's risk profile and the regulatory capital requirements and consider realigning the latter, as well as setting restrictions on the insurer's activities until remedial actions have been completed. *Resolution* — The PRA will identify and instigate any initial contingency planning needed, potentially including information gathering and liaison with the FSCS.
Stage 3 – Risk to viability absent action by the insurer Significant threats to an insurer's safety and soundness or policyholder protection have been identified.	*Recovery* — The insurer will be required to submit a recovery plan designed to address specific current problems and to initiate recovery actions in a timely manner to address the vulnerabilities identified. Actions may include: capital raising; asset disposal; and business transfer or sale of the insurer. — Other actions the PRA may require include: changes to management and/or the composition of the board; limits on asset disposal/acquisition or capital distribution; restrictions on existing or planned activities; a limit on balance sheet growth; and an assessment of the effectiveness of risk transfer arrangements such as reinsurance. — At insurer or PRA initiative, an insurer's authorisation to carry out new business may be removed. *Resolution* — The PRA will intensify contingency planning for resolution. — The PRA will co-ordinate with FSCS to ensure it has obtained the information necessary to evaluate continuity of cover or payout options (this will include an assessment of the potential exposure of the FSCS).
Stage 4 – Imminent risk to viability of insurer The position of an insurer has deteriorated such that the PRA assesses that there is a real risk that the insurer will fail to meet the Threshold Conditions, but some possibility of corrective action remains.	*Recovery* — In most cases, the PRA will remove the insurer's authorisation to write new business. — Insurer to accelerate and complete recovery actions, demonstrating to the PRA that these have mitigated the imminent risk to the viability of the insurer. *Resolution* — The PRA, working with the FSCS, will complete all necessary actions for resolution of the insurer including planning for commencement of orderly liquidation or administration and with the assistance of the insolvency practitioner in waiting.
Stage 5 – Insurer in resolution or being actively wound up	*Resolution* — As necessary, the PRA will trigger the appropriate insolvency process and the insolvency practitioner will work with the FSCS and PRA to effect continuity of cover and/or compensation to eligible claimants. — As appropriate, the PRA will monitor insurers exiting the system.

the basis of all the relevant evidence. But **insurers should not approach their relationship with the PRA as a negotiation**.

198. Any less significant issues that have arisen — and of which the PRA feels the insurer should be aware — are conveyed to the insurer, but with the onus on the insurer itself to address these. The PRA expects self-certification by the most appropriate senior individual within the insurer, for example the CEO, Chief Actuary, Finance Director or chair of the Audit Committee, that issues have been closed. The link between the issues raised and the PRA's objectives remains clear and direct.

Tailored application of the Supervisory Assessment Framework

199. The PRA is responsible for the supervision of a diverse range of insurance companies. This includes life, general, wholesale and reinsurance. Even within these broad categories there is substantial diversity in firm structures and

sizes as well as products, which shapes the business models and risks to which these insurers are exposed. The PRA tailors its application of the supervisory assessment framework to take account of this diversity.

Lloyd's

200. The PRA is the prudential supervisor of the Society of Lloyd's and the managing agents that operate within the Lloyd's market. The unique legal framework of Lloyd's means that the PRA needs, where appropriate, to tailor its approach in order to reflect the Lloyd's structure.

201. In supervising the Lloyd's market, the PRA has regard to two principles.

202. First, 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.

203. Second, supervision of the various entities that make up the Lloyd's market should take place primarily at the level in the market where risk is managed. The PRA therefore applies supervision at two levels — to the Society of Lloyd's itself (which provides central functions, including the maintenance of the New Central Fund),(1) and to each of the managing agents (which carry out the underwriting and risk management functions for Lloyd's members).

204. The power is reserved to the PRA to intervene directly with individual members of Lloyd's (or with all of them together) and/or to direct the Council or the Society (acting through the Council) if it determines that such action is necessary for the purpose of advancing its objectives.

205. The MoU between the FCA and the PRA sets out how they co-ordinate in respect of the supervision of the Lloyd's market. In general the FCA and the PRA will consult with the other before using a power of direction over members and, in particular, will obtain consent from the other when exercising powers to require members of Lloyd's to become authorised. The PRA will, where appropriate, enter into new arrangements with the Society of Lloyd's that reflect the PRA's objectives and focus as the market's prudential supervisor.

With-profits insurers

206. The FCA and the PRA co-ordinate in their supervision of insurers generally under the framework set out in the Memorandum of Understanding described above. In the case of with-profits policies, however, special arrangements are needed because the returns on with-profits policies are not well defined, and are at the discretion of the insurer. A separate Memorandum of Understanding sets out how the FCA and the PRA work together in order appropriately to protect the interests of with-profits policyholders.(2)

207. As part of its ongoing assessment of the insurer's financial resources, the PRA seeks to ensure that any discretionary benefit allocations or other changes with financial implications that the insurer has proposed are compatible with its continued safety and soundness. The FCA has responsibility for monitoring whether the proposed changes are consistent with the insurer's previous communications to policyholders, the FCA's conduct rules and the insurer's overriding obligation to treat customers fairly.

208. There may be circumstances where the proposed discretionary benefit allocations call into question the safety and soundness of the firm as a whole and so its ability to meet its obligations to policyholders generally. In such circumstances, the PRA will work with the insurer and the FCA to explore alternative ways those allocations could be made without materially impairing the insurer's safety and soundness. If no reasonable alternative exists, and given the risk to the insurer's overall safety and soundness and its ability to meet obligations to policyholders, the statute gives the PRA the power to take action to prevent such allocations being made. Where the PRA is satisfied that the insurer's decisions, or the FCA's requirements, do not materially affect the overall safety and soundness of the firm, the PRA will not take action.

Low potential impact insurers

209. This section summarises the PRA's approach to supervising insurers with the lowest potential impact on the PRA's objectives. There are a large number of insurers within this category, made up in practice primarily of small overseas insurers (branches or subsidiaries) and mutual insurers.

210. Although at an individual level, these insurers have almost no capacity to cause significant harm to the stability of the system, the PRA's statutory objective to contribute to securing an appropriate degree of protection for all policyholders motivates a baseline level of supervisory monitoring for all insurers. Further, there is a risk that several insurers may fail together through a common exposure, with possible wider impact on financial stability.

211. Given that these insurers are likely to pose low risks to the PRA's objectives, it supervises them on a portfolio basis. Automated tools, analysing insurers' regulatory returns, issue alerts highlighting outliers and trends, and insurers are in general examined individually only when their regulatory returns trigger such an alert.

(1) As provided for in the Lloyd's New Central Fund Byelaw (Number 23 of 1996).
(2) Available at www.bankofengland.co.uk/about/Documents/mous/mouwithprofits.pdf.

212. The PRA also examines individual insurers when a risk crystallises (as discovered through, for example, a visit to the insurer, or an approach from the insurer itself), or in response to authorisation requests from the insurer (for example a request to change its permissions to undertake regulated activities, or to extend the nature or scale of its business).

213. The PRA conducts peer group analysis across sectors as a whole, to develop a clear understanding of the risks posed by both small insurers in aggregate and by a typical insurer. The PRA conducts annual assessments of these insurers, but in large peer groups.

214. In contrast to the higher-impact insurers, those insurers in the lowest category contact the PRA through a centralised enquiries function and do not have an individual-named supervisor.

215. Insurers in this category are not visited by the PRA on a fixed, regular schedule. Notwithstanding this approach, all insurers, regardless of category, are subject to on-site work by the PRA — with a period of notice — at any time.

Mutual insurers

216. The PRA's approach to the supervision of mutual insurers is consistent with the approach adopted for other insurers. It reflects variety in the sector — for example different constitutions, different governance frameworks, and different policyholders. It also recognises that there are issues that are specific to the mutual sector, for example constraints on raising external capital.

Reinsurers

217. The PRA's approach to supervising reinsurers is based on the same principles as its supervision of primary insurers. However, reinsurance may give rise to a greater degree of connectivity with other parts of the financial system than is usually seen with primary insurance business. Undertaking an appropriate degree of supervision of the reinsurance business transacted in the United Kingdom is therefore an important element in meeting the PRA's objectives.

218. Reinsurance is transacted through UK-regulated vehicles (both inside and outside the Lloyd's market) and through incoming EEA branches (see Box 7). The PRA seeks to understand to the greatest extent feasible the activities of reinsurers operating in the United Kingdom and their potential impact on its objectives.

Using powers in the course of supervision

219. The PRA has a variety of formal powers available to it under statute, which it can use in the course of supervision, if deemed necessary to reduce risks. These include powers by which the PRA can intervene directly in a firm's business. For example, it may vary an insurer's permission or impose a requirement under Part 4A of the Act to prevent or curtail an insurer from undertaking certain regulated activities, which may require a change to an insurer's business model or future strategy. It may also, as noted above, use its powers to require information from insurers.

220. **While the PRA looks to insurers to co-operate with it in resolving supervisory issues, it will not hesitate to use formal powers where it considers them to be an appropriate means of achieving its desired supervisory outcomes.** This means that, in certain cases, the PRA will choose to deploy formal powers at an early stage and not merely as a last resort. This can include addressing serious failings in the culture of firms, as detailed in Box 8.

221. The PRA considers when and how to use its formal powers on a case-by-case basis and assesses the particular facts and circumstances of each case. In all cases, the PRA is likely to consider a number of factors in connection with the possible deployment of such powers, including:

- the confidence supervisors have that insurers will respond appropriately to the PRA's requests without the use of powers;
- the PRA's view of the insurer's proximity to failure, as reflected in its PIF stage; and
- the likely impact — on policyholders and the stability of the system — of the firm's failure.

222. In addition, the PRA may use its powers to approve or allow certain changes requested by insurers (for example, a change in an insurer's controller or in its permissions to perform regulated activities or outward passporting of a UK insurer). Where those changes could adversely affect the PRA's objectives, the PRA may use its powers to refuse such requests.

Enforcement powers

223. The PRA's preference is to use its powers to secure *ex ante*, remedial action, given its approach of intervening early to address emerging risks.

224. **The PRA does, however, have a set of disciplinary powers, including the power to impose financial penalties or publish public censures, for cases where such a sanction is an appropriate response to the insurer failing to meet the PRA's regulatory requirements.**

225. The PRA deploys disciplinary powers to advance its objectives in line with its priorities. Use of enforcement powers can achieve this by changing, and promoting high standards of behaviour among firms; sending a clear signal to the insurer, and to the regulated community more widely,

about the circumstances in which the PRA considers an insurer's behaviour to be unacceptable; and deterring future misconduct.[1] In this way, *ex post* enforcement against one firm can help serve a wider preventative purpose.

226. The PRA has the power to institute criminal proceedings in respect of a small number of criminal offences. When it decides whether or not to bring criminal proceedings in England, Wales or Northern Ireland, the PRA will apply the basic principles set out in the Code for Crown Prosecutors.

227. The PRA may also prohibit any individuals — not just those who currently hold a Significant Influence Function — from performing functions in relation to a regulated activity carried on by a PRA authorised firm. The PRA may only do this where it appears to the PRA that an individual is not a fit and proper person to perform such functions. The PRA will consider using this power in appropriate cases.

228. These powers are additional to those that the PRA holds in relation to Approved Persons (as detailed in Section III).

(1) For more information on the PRA's policy on its use of its powers, see www.bankofengland.co.uk/pra/Pages/publications/approachenforcement.aspx.

Box 7
International approach

Insurance is an international industry. Supervision of overseas insurers operating in the United Kingdom, and consolidated supervision of international groups operating in the United Kingdom through supervisory colleges, are therefore important parts of the PRA's work.

The PRA's legal powers and responsibilities vary depending on the location of the parent and the legal form of its operations in the United Kingdom. Regardless of this, the PRA's supervisory approach is to assess all insurers to the same prudential standards. Where the PRA does not have direct powers against such insurers, it will raise any concerns that it has with the insurer's home state supervisor or at the appropriate international forum.

Overseas insurers operating in the United Kingdom

Many overseas insurers, including some reinsurers, operate in the United Kingdom and are significant providers of financial services to the UK economy. As with UK insurers, the PRA's supervision of overseas insurers operating in the United Kingdom reflects an assessment of the potential impact of the UK entity on the PRA's objectives, including through risk from overseas, its legal status (branch or subsidiary) and the nature of the home country regulatory regime (if the insurer originates from a non-EEA country).

For UK subsidiaries of overseas insurance groups, the PRA has full powers and responsibilities and so its approach is to treat such insurers equivalently to UK-owned insurers, applying its full prudential requirements to the UK subsidiary, including for example stress testing for the most significant insurers. Consistent with its objectives, the PRA assesses and limits as necessary the (potentially complex) interlinkages with the rest of the group.

For UK branches of EEA insurers, the PRA's powers and responsibilities are very limited under European law. In order to assure itself that risks to its objectives from such branches are adequately managed, the PRA looks to engage with the home state supervisors (in particular through supervisory colleges) where it believes the failure of one of these insurers would have a material effect on policyholders or financial stability in the United Kingdom. The PRA focuses on receiving assurances about the safety and soundness of the parent insurer. The PRA expects UK branches of EEA insurers to appoint a senior individual with authority to act as a primary contact with the PRA in relation to the branch's affairs. This individual should also act as a channel for communication with the parent.

Where the PRA is not able to assess the risk of an insurer satisfactorily, the PRA works with the home authority, promotes public understanding of the limits of its powers, and uses whatever tools it can to reduce the impact of these limitations.

In some cases the PRA may judge that an EEA insurer applying to passport into the United Kingdom poses risks to its objectives, but does meet the requirements set out by the relevant EU Directives, and thus as a legal matter has a right to conduct business in the United Kingdom. In such cases, the PRA will carefully consider the tools available to it as a host prudential regulator, acting in co-operation with the home regulator, to mitigate the resulting risks.

For UK branches of non-EEA insurers the PRA's authorisation applies to the whole insurer. At the point at which a new non-EEA insurer seeks initial authorisation to establish a branch in the United Kingdom, and then on an ongoing basis, the PRA will form a judgement on the adequacy of the home regulator including its ability and willingness to share confidential information. Where it considers the home supervisor not to apply to that insurer a regime 'broadly equivalent' to that of the United Kingdom, the PRA will refuse authorisation of the branch. It may instead decide to authorise a stand-alone subsidiary, in which case it may limit the interlinkages with the rest of the group or ring fence the subsidiary (for example where it considers the home supervisor does not deliver effective consolidated supervision). In assessing a non-EEA firm against the Threshold Conditions, the PRA may also have regard to the opinion of an overseas regulator in any country or territory in which the non-EEA firm carries on regulated activities. In considering how much weight to attach to that opinion, the PRA must have regard to the nature and scope of the supervision exercised by the overseas regulator.

For existing UK branches of non-EEA insurers where the home regime is not considered to be equivalent, the PRA's supervisory work is aimed at mitigating the risks of non-equivalence in the relevant areas. Its supervision focuses on issues such as the financial strength of the whole insurer, including the adequacy of its capital and its resolvability (collaborating with the home authorities in colleges as applicable), taking into account the importance of the insurer to the PRA's objectives.

For UK branches of non-EEA insurers where the PRA is satisfied that the home regulatory regime applied to the insurer as a whole is equivalent and where the PRA has assured itself over the home regulator's supervisory approach, the PRA relies where possible on the home regulator's prudential supervision as regards the whole insurer. In these cases, the PRA focuses on collaboration with home regulators (including via supervisory colleges). In addition, the PRA exercises additional supervision over the branch activities and takes a close interest in what would happen in the event of failure (in particular the assets available to pay branch policyholders) and ensures that there are senior individuals in the United Kingdom who are clearly responsible for management of both the UK operations and business booked in the United Kingdom. The PRA discusses and agrees with home regulators the areas in which the PRA will seek to rely on the home regulator's supervision.

Supervisory colleges

The PRA is an active participant in international co-ordination of supervision for major insurers. Where invited to do so, it participates in supervisory colleges for all insurers with significant operations in the United Kingdom, whether a legal entity or a branch.

For UK insurance groups, the PRA organises and chairs the supervisory college. To be fully effective, colleges must operate in a manner which enables supervisors to be open and transparent with each other, and to address the difficult issues. The PRA seeks to adopt this approach when it runs colleges and expects other authorities to participate on the same basis. As the lead authority and college chair for UK insurance groups, the PRA is prepared to tackle instances where it believes that other authorities are not acting in a manner consistent with the PRA's objectives. And the PRA encourages other authorities to challenge it if they have concerns.

The PRA's future approach to the supervision of non-EEA insurers operating through branches within the United Kingdom will be affected in 2016 by the implementation of Solvency II. Further guidance is currently being drawn up at European level and will be published in due course.

Box 8
Use of powers to address serious failings in the culture of firms

The PRA expects firms to have a culture that supports their prudent management, and the PRA seeks to address serious failings in culture as part of its approach to supervision. If serious failings in culture are identified, the PRA has a variety of powers which it may use if deemed necessary to reduce risks and achieve desired supervisory outcomes. The PRA acts pre-emptively to tackle concerns it identifies and to prevent a firm posing risks to its objectives.

The PRA has a power to impose a requirement under Part 4, section 55M of the Act on a firm to undertake or cease a particular action. One of the grounds for exercising this power is if it appears to the PRA that it is desirable to exercise the power in order to advance any of the PRA's objectives. It therefore enables the PRA to take early intervention action should failings in the culture of a firm pose a risk to the PRA's objectives.

There is substantial flexibility for the PRA to tailor requirements specific to the circumstances of a firm and the nature of the PRA's concerns, including serious cultural failings. Requirements may include (but are not limited to), requiring the firm to address concerns identified by the PRA, requiring the nomination of an individual within a firm to have responsibility for recommendations specified by the PRA, or requiring the retention of an independent individual to ensure compliance with PRA recommendations, as judged necessary by the PRA (the latter can also be achieved under section 166 of the Act).

The PRA does not have to publicise the imposition of Requirements if publication would be unfair to the person concerned, prejudicial to the safety and soundness of a firm, or prejudicial to securing the appropriate degree of protection for policyholders.

It may also be appropriate to use the PRA's own-initiative variation of permission power under section 55J of the Act to change the firm's permissions in certain circumstances, or to agree a voluntary variation of permission with the firm.[1]

(1) For more information see the PRA's Statement of Policy on the use of PRA powers to address serious failings in the culture of firms, available at www.bankofengland.co.uk/pra/Pages/publications/powersculture.aspx.

V Making policy to support the PRA's general approach

229. Prudential supervision is based on policies which ensure that judgements about risks to the PRA's objectives are made within a clear and coherent framework.

230. This section details the PRA's approach to setting and communicating these policies, common across all the insurers that it regulates and relevant to both of its statutory objectives.

The PRA's approach to published policy material

231. **The PRA aims to establish and maintain published policy material which is consistent with its objectives, clear in intent, straightforward in its presentation and as concise as possible, so that it is usable by the senior management of firms.** Taken as a whole, the set of published policy material is intended to set out clearly and concisely what the PRA expects of firms in terms of intended outcomes, so that they can meet these expectations through their own actions. When the PRA judges that it is necessary to take action against a firm to mitigate risks to the PRA's objectives, the basis for its judgement should be clear from its published policies.

232. As noted in Box 7, the policy framework for the PRA's supervision is to a large extent agreed internationally, both at a global level, for example through the IAIS, and within the European Union. The policy framework is increasingly being codified at EU level. Relevant EU Directives are implemented in the United Kingdom through legally binding PRA rules. Any relevant EU Regulations, including binding technical standards, that apply directly to UK insurers will not be reproduced in the PRA's rulebook but will be part of the PRA's requirements of insurers. Insurers are also subject to guidance issued by the European Supervisory Authorities.

233. Where the PRA issues rules in areas not covered by EU law, it aims to do so in a manner which is clear about the intended outcome, straightforward to understand and as concise as possible to achieve this.

234. On 1 April 2013, the PRA adopted the prudential aspects of the *FSA Handbook*. The PRA is reviewing the *Handbook*, and will replace it with a rulebook, containing only the PRA's rules. The PRA intends to limit strictly the use of guidance material in the rulebook. Other relevant types of material currently in the *Handbook*, for example procedures manuals, and information on how the PRA itself will act, will be published separately.

235. The PRA does not plan to issue significant amounts of detailed guidance to clarify its policy, whether in the form of general guidance issued publicly or advice given by supervisors to individual insurers. Where the PRA judges that general guidance material is required, this is issued in a consistent format as papers entitled Supervisory Statements. Such material is focused on the PRA's expectations, aimed at facilitating insurers' judgement in determining whether they meet these expectations, and will not be overly detailed.

236. Insurers are expected to engage directly with policy material, including rules, EU material and Supervisory Statements, and determine — bearing in mind the overarching principles of safety and soundness and policyholder protection — whether they meet the PRA's expectations.

What the PRA does in delivering and maintaining its policy

237. **The PRA attaches great importance to being an influential and persuasive participant in international policy debates and negotiations.** It seeks agreement at both global and EU levels to policy reforms which deliver and maintain a strong, coherent and clear prudential framework that allows the PRA effectively to advance its objectives.

238. **The PRA performs careful analysis to determine whether and what revisions to its set of policies may be appropriate, whether negotiating policy internationally or acting autonomously.** The PRA only proposes or supports a policy reform where it is justified by the presence of current or potential market failures relating to its objectives; and where it believes that the net effect of the reform will be beneficial for the PRA's objectives. This includes consideration of the implications of PRA action for competition in the relevant markets. The PRA also has regard, in reaching its view, to the regulatory principles set out in the Act, UK economic growth, and differences in the nature and objectives of authorised persons. The PRA assesses the impact of its policy on regulated firms and the wider economy. Quantitative estimates of costs and benefits are included in its published documents only where they can reasonably or practicably be estimated.

239. The PRA actively reviews the continued effectiveness of its policies and their coherence, with the aim of ensuring that as the financial system develops, the prudential regime remains effective and proportionate.

240. The **PRA solicits comment on policy proposals, for example on the likely effect of proposed reforms and on different ways of achieving its intended policy outcome.** The PRA has a statutory duty to consult when introducing new rules and a public law duty to consult widely on any other measures that significantly affect firms. This will include consultation of the PRA Practitioner Panel and the FCA. The PRA aims to communicate policy proposals (including an analysis of their effect and an explanation of their purpose) to all parties likely to be affected by them. This is usually done through publication of a consultation on the PRA's website, in addition to other channels as appropriate. The PRA carefully considers the representations made to it. Consultation periods are consistent with Government guidelines.

Box 9
Staffing the PRA

The PRA's approach to resourcing is to employ staff with the necessary skills to carry out the forward-looking, judgement-based approach to supervision necessary to advance its objectives.

The PRA's approach is advanced primarily by its front-line supervisors. They need to have the right capabilities to make judgements about current and future risks to an institution's safety and soundness, and to make interventions early before risks crystallise. Their judgements need to be grounded in analysis, supervisory experience, and a strong understanding of the sectors they supervise gained through direct exposure to the industry. On this basis they will have credibility with the senior management of firms, and be able to deliver robust messages.

The PRA's front-line supervisors are supported by risk specialists. These provide important knowledge and technical expertise to support analysis and supervisory judgements.

In addition, the PRA employs policy experts to develop the policies that underpin its supervision. Since, as noted above, the policy framework is to a large extent agreed internationally, the PRA seeks to ensure that its policy experts have the necessary skills and experience to influence international policy debates — at both global and EU levels — to ensure that the PRA's views are properly represented.

In delivering its objectives, the PRA will ensure that there is an efficient allocation of resources. As illustrated in **Chart A**, over 90% of staff are directly involved in supervision and policy. About 60% of staff are involved in front line supervision with a further 30% performing policy and specialist roles. The PRA is structured as shown in **Figure A**.

The allocation of resources, illustrated in **Table 1**, shows that around one third of supervisory staff are focused on the 25 or so firms with the highest potential impact (Category 1); a further third are focused on the next 54 most significant firms (Category 2) while the remaining supervisors focus on around 1,300 lower-impact firms (in Category 3 and below).

The PRA's rank mix (see **Chart B**) reflects its approach to advancing its objectives, with the highest proportion of senior and experienced supervisors responsible for supervising those firms that present the greatest risk to the financial system.

The PRA aims to have a larger proportion of more experienced and senior supervisors compared with the past. The process for delivering this has already started and implementation is continuing. This will involve development of the PRA's own supervisors as well as external recruitment. Internal career development is an important aspect of building the PRA's capability in the long term.

The Bank's recruitment, talent management and career development programmes have been extended across the PRA, the objective being to ensure that staff have the opportunity to develop to their full potential, and that there is a strong pipeline of talented senior supervisors.

The PRA's focus on prudential supervision develops supervisors with in-depth experience of the key issues that pose a risk to the safety and soundness of firms and the PRA's objectives. It

Chart A PRA split by function

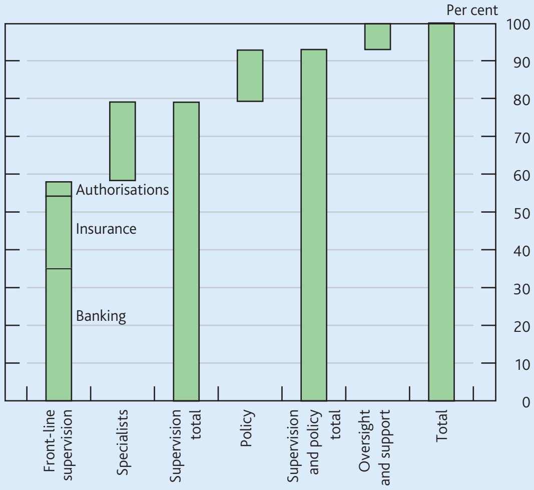
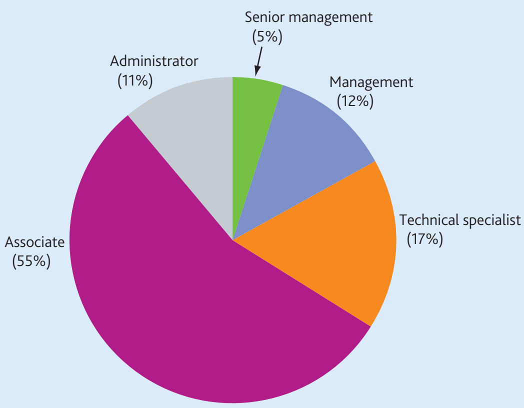


Table 1 PRA resource allocation

Category 1:	c. 25 firms (1.8% of total), 212 supervisors, average ratio of 8:1.
Category 2:	c. 54 firms (4% of total), 133 supervisors, average ratio of 3:1.
Category 3–5:	Category 3-5: c. 1,257 firms (94% of total), 178 supervisors , average ratio of 0.1:1.

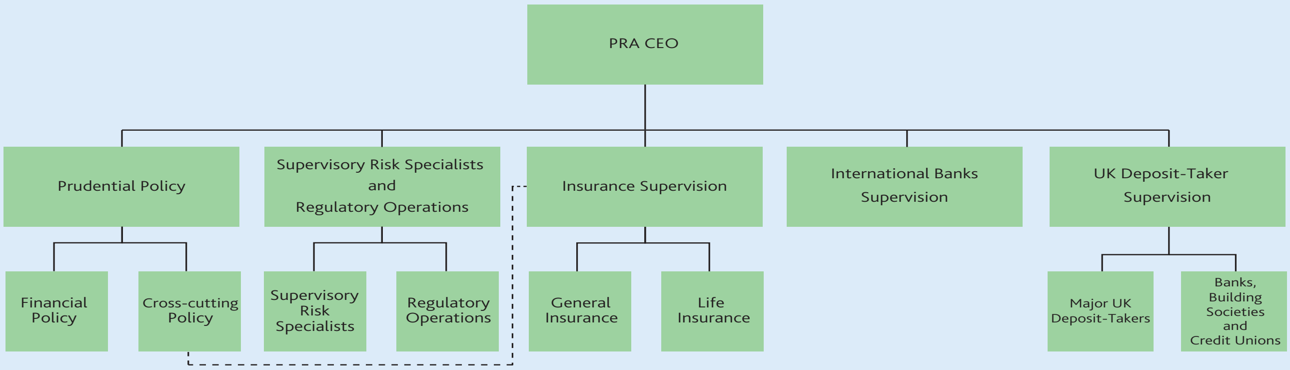
Note: These are approximate numbers.

Chart B PRA rank mix



is important to ensure that this experience is retained for the PRA to benefit fully from supervisors' regulatory knowledge and expertise. Retaining staff requires the PRA to offer compelling careers centred around intellectual challenge and excellence, and a commitment to public service through its public policy objectives. Graduates undertake a three-year development programme. And staff at all levels are coached by their managers on the exercise of supervisory judgement. Secondment opportunities to and from the industry and to overseas regulators are made available to staff. Additionally, staff have the opportunity to work in other parts of the Bank as a way of broadening their knowledge and management experience, and similarly the PRA is open to staff moving from other parts of the Bank.

Figure A PRA organisation structure



(a) The figure shows the PRA's new organisation structure following on from the launch of the Bank's Strategic Plan. For more information see the Bank's public announcement, available at www.bankofengland.co.uk/about/Pages/strategicplan/default.aspx.

Annex

This issue of *The PRA's approach to insurance supervision* contains amendments reflecting feedback received and other recent developments. Key changes include:

- updates explaining the PRA's new secondary objective (page 5);
- addition of the PRA's 'Fundamental Rules' which replaces the 'Principles of Business' (page 6);
- addition of an extra box (Box 2) to list the Fundamental Rules (page 13);
- additional text to reflect the way insurers will be categorised (page 19);
- additional text to clarify the PRA's overall approach to Financial Resources (page 28);
- updated text (Box 7) regarding the PRA's international approach to insurance supervision (page 41);
- addition of Box 8 to outline the use of PRA powers to address issues with culture in firms (page 43); and
- Box 9 has been updated to reflect the current staff information and the PRA's new organisation structure following on from the Bank's Strategic Plan.