BANK OF ENGLAND

News release

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Insurance supervision at the PRA – speech by Sam Woods and report by the IEO

Speaking at London Business School, Sam Woods explores the PRA's role in maintaining "a resilient insurance sector which does not pass risks back to policyholders when they crystallise". Following the implementation of Solvency II, the Deputy Governor's speech coincides with today's publication of the Independent Evaluation Office's (IEO) report on the PRA's approach to its policyholder protection objective, alongside the PRA's response. Sam concludes that "now is the ideal time to refresh our approach to insurance supervision".

Recent debates must seem to some like a "cacophony of acronyms, statistics, models and assumptions" emanating from a "magic circle of insurance enthusiasts". But there is a more human motivation to protecting policyholders. Some of the oldest and most vulnerable in our society have invested their life savings into long-term annuity contracts. By pooling and transferring many kinds of risks – from cyber to marine – insurers provide cover which is essential for economic activity. And by protecting for critical illness or personal accident, insurers commit to being there when you need them most.

The UK has a world-leading insurance sector. It employs 300,000 people in the UK, provides cover for nearly 27 million households, and has £2.4 trillion of assets. Sam says that "it has proved its mettle in turbulent times and the country can be proud of it".

Sam believes that "a necessary precondition to such success is world-class insurance supervision". Last year, the Court of the Bank commissioned the IEO to evaluate the PRA's approach to its objective to 'contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders'. Its recommendations cover: articulating the PRA's approach to its policyholder protection responsibilities fully; communicating this approach clearly; implementing it effectively; and ensuring an appropriate framework for co-ordination with the FCA.

The PRA welcomes the IEO's "informative and balanced assessment", and has agreed a set of actions in response. Court will monitor implementation as part of its wider follow-up framework for IEO reports.

Sam believes the PRA should be clear that supervisors do not seek to protect all policyholders equally. It is "entirely appropriate that the PRA directs more of its resources towards policyholders who will suffer greater financial hardship if their policies do not pay out as promised, or those for whom there is the greatest asymmetry of information between company and customer, or who face the highest possibility of being unable to replace cover if it is lost". The PRA's resourcing model already works to some extent in this way, but the IEO challenges it to think more deeply about this. The Executive Director for Insurance Supervision, David Rule, will take forward discussion with the new Prudential Regulation Committee.

This day-to-day business of *supervising* PRA-regulated insurers – which has included authorising 19 new insurance companies and Lloyd's managing agents into the industry since 2013 – takes place in the context of a lively debate about insurance *regulation*.

Now that Solvency II has applied, how do we take it forward? Sam acknowledges that the enormous task of implementation "has left all of us facing some degree of indigestion". When faced with live market conditions and commercial realities, "some aspects of the regime have been found wanting". Sam believes that it is in nobody's best interests to make wholesale changes. "But that does not mean that we cannot make a series of tweaks and improvements to the overall system, by way of a digestif".

Take the risk margin. A sensible concept, but "its current design and implementation does not achieve the intended goals". Rather than "breaking glass" with a unilateral quick fix in the UK, we need to fix these problems at source – while using the mechanism available to mitigate the short-term impact, the Transitional Measure on Technical Provisions. The PRA recently closed a consultation on proposals for making this process as straightforward as possible, and plans to confirm its approach later this year.

Insurers currently benefit to the tune of £59 billion of Matching Adjustment (MA), including for infrastructure assets in sectors like healthcare, social housing and telecoms. A certain "clunkiness" in its design reflects that the rules were written on the assumption that insurers generally match annuities with simple securities rather than more long-term investments. Given a completely free hand, Sam would probably make modest changes, such as with slightly greater flexibility around the definition of "fixity". But firms rightly should clear a high bar to demonstrate that they have adequate systems and controls to manage these illiquid bespoke loans. In any case, the number one problem raised by firms is the lack of suitable infrastructure investment opportunities, not the regulatory framework.

Insurers with internal models approved under Solvency II in effect set their own regulatory capital requirements. That is why the PRA approaches model approval "diligently, sceptically and rigorously". Sam recognises that modelling credit risk is a complex business. So contrary to claims that it has been 'over-zealous' in implementing Solvency II, the PRA has approved internal models with credit components that do not meet its quantitative indicators, where it gains assurance from the firm that risks are otherwise addressed.

The PRA has given around 85% of Solvency II firms in the UK the opportunity to avoid around 70% of the quarterly reporting burden they would otherwise face. Sam acknowledges there may be a case for further lowering the burden, if its supervisory benefit turns out not to be commensurate with its cost.

Sam acknowledges that some of the more arcane aspects of insurance can rapidly turn off everyone except the regulator and the regulated. But “policyholder protection is not really about the Risk Margin, the view to ultimate, the Matching Adjustment or corporate bond spreads. It’s about making sure that insurance companies are there to help when disaster strikes. That’s why we take this part of our job so seriously”.

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Notes to Editors

Link to speech by Sam Woods
http://www.bankofengland.co.uk/publications/Pages/speeches/2017/967.aspx

Link to IEO report
http://www.bankofengland.co.uk/about/Documents/ieo/evaluation0317.pdf

Link to management response
http://www.bankofengland.co.uk/about/Documents/ieo/praresponse0317.pdf

Link to further information on the PRA
http://www.bankofengland.co.uk/pra/Pages/default.aspx