BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Dear Chief Executive Officer,

**Prudential Regulation Authority (PRA) insurance supervision: 2021 priorities**

Over the course of 2020, the PRA has worked closely with insurance firms as they worked through the Covid-19 pandemic to continue to provide critical services to their customers, and we would like to thank your staff for their cooperation and engagement.

Our overarching aim is that the insurance sector continues to be able to provide financial protection and security to its customers when they need it. The sector faces an unusually uncertain economic environment and a number of longer-term risks. Our focus will be on: financial resilience; credit risk; the operational impact of Covid-19; risks resulting from the end of the transition period; and climate change. This is the first time we have set out our priorities for the sector in this way, and we trust it will be helpful as you seek to understand our areas of focus in 2021.

Our sector-wide priorities complement the supervisory work plan for your firm, which will continue to focus on the most material prudential risks identified in the Periodic Summary Meeting and communicated to you following that meeting.

**Economic and regulatory context**

The Covid-19 pandemic has had a significant impact on households, financial markets, and business operations. While the insurance sector has been resilient so far, the economic outlook remains uncertain. It depends on the evolution of the pandemic and the measures taken to protect public health, as well as the response of households, businesses, and financial markets to these developments. Moreover, factors that may have been eclipsed by the pandemic remain live – whether geopolitical, long term demographic trends, sustained low interest rate environment, changes in conduct environment, or climate change. The UK insurance industry will continue to change shape, for example via a shift to specialisation and Brexit-related business transfers.

The insurance sector has a crucial role to play in supporting economic recovery through provision of risk pooling to individuals and to businesses, both new and existing; long term investment; and providing security of retirement income. Our goal is to exercise effective prudential supervision so that insurers adapt and respond to changes that threaten to disrupt their business models, while maintaining standards of governance, risk management, and resilience that result in the continued provision of vital insurance services to the real economy.

HM Treasury's consultations on the Future Regulatory Framework and review of the Solvency II regime provide an opportunity to tailor the regulatory regime to the UK market, whilst continuing to support the fundamental principles and framework underlying Solvency II. We look forward to engaging with the industry and other stakeholders as the review progresses.

**Supervisory priorities for 2021**

## 1. Financial resilience

The outlook for **credit risk** remains highly uncertain due to the factors noted above, and insurers are exposed to downgrades and defaults that would accompany any deterioration in credit fundamentals. In view of the illiquid nature of much of the sector's credit exposure, both through direct investments and counterparty risks in, for example, reinsurance contracts, we expect your board to satisfy itself that the firm is resilient to a wide range of potential adverse credit scenarios in the short and medium term. Scenarios should vary in both severity and scope, encompassing for example both general deterioration via an economic downturn as well as deeper distress in sectors to which the firm has concentrated exposures or which are particularly exposed to current risks. The assessment of resilience should encompass both the firm's capital position and the risk management of illiquid exposures – management of concentration risk in line with the requirements of the prudent person principle for example, and early engagement with potentially distressed debtors.

In 2020, we expected firms to use a number of approaches and analyses, such as stress and scenario testing, to assess risks and consider the increased risk of losses from multiple sources and the increased uncertainty due to Covid-19 and the wider economic outlook. We want to see firms continue to improve the stress and scenario testing they undertake to inform boards and board risk committees' decision-making, including around risk and capital appetite, and strategy setting.

The PRA intends to build on previous, sector-wide **insurance stress test** (IST) exercises to develop stress testing as a supervisory tool for measuring sector resilience to specific shocks and to explore its use to provide a top-down assessment of individual firms' capital adequacy.

We will run another comprehensive IST in 2022; we will engage with industry to understand lessons to be learned from the 2019 exercise and where investment is needed to improve stress testing capability in order to produce results, particularly in the life sector, that are robust and can be aggregated meaningfully. In March this year, we wrote to insurers to remind them of the PRA's existing expectation (set out in Supervisory Statement 4/18)[1] that when deciding on **distributions** – **including dividends** – boards should satisfy themselves that each distribution is prudent and consistent with their individual exposures and risk appetite. Firm-specific stress testing of affordability is a key input into this decision, which the PRA will continue to scrutinise. In light of an unusually uncertain outlook for the UK, insurers should continue to take an appropriately prudent approach to distributions.

In 2021 we will develop our approach to **recovery and resolution planning**. Although the PRA operates a non-zero failure regime, we have very low tolerance for disorderly failure and its costs for policyholders and the wider economy. We will expect firms to demonstrate – in a manner proportionate to their impact – that they have a suitable structure and business model, and adequate contingency plans to be able to exit the market smoothly without detriment to policyholders or spill-overs to other firms.

## 2. LIBOR transition

The continued reliance of global financial markets on LIBOR poses a risk to financial stability that can only be reduced through a transition to alternative risk-free rates (RFRs). While progress was made in certain areas during 2020, Covid-19 made others areas such as client engagement more challenging. The time available for action is reducing, so the PRA will expect to see intensive efforts and early progress in 2021. We will be monitoring firms' progress against the targets of the Working Group on Sterling Risk Free Reference Rates (RFRWG)[2] and targets for non-GBP exposures where relevant, as we expect all firms to play their part in meeting these milestones. We will also be closely monitoring how firms are managing the risks associated with transition through regular review meetings with a range of firms and by reviewing the data we collect on firms' exposures. We will keep a range of supervisory tools under review for use where we see insufficient progress, or incidents of poor risk management or governance of transition.

## 3. Operational resilience

Following the recent consultations on operational resilience and outsourcing, we will expect firms to consider the steps they will need to take to meet the standards that will be set during 2021. We encourage

1 May 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/financial-management-and-planning-by-insurers-ss.

2 https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor.

firms to implement the lessons learned from the pandemic, and review how their experiences during that time might impact development of operational resilience as a continuing discipline.

The Covid-19 pandemic has reinforced the importance of operational resilience of the financial sector. Firms have demonstrated a satisfactory level of resilience to date, but changes in working patterns have increased reliance on technology infrastructure. In response, we expect firms to place greater emphasis on **resilience to cyber threats**. We are also developing a cyber underwriting scenario for the 2022 IST. Firms should maintain their preparations for other operational disruptions or from the ongoing impact of Covid-19.

**4. Financial risks arising from climate change**

In April 2019, we issued a supervisory statement on enhancing firms' approaches to managing climate-related financial risks (SS3/19).[3] As explained in our letter to CEOs in July 2020,[4] firms should have fully embedded their approaches to managing climate-related financial risks by the end of 2021. This means that, by the end of 2021, your firm should be able to demonstrate that it has implemented and embedded the expectations set out in SS3/19. In doing this, you should continue to take a proportionate approach that reflects your firm's exposure to climate-related financial risk and the complexity of its operations, but we do see climate change necessitating some action by all firms.

Five UK life insurers and six UK general insurers will participate in the **Climate Biennial Exploratory Scenario** (CBES), which will launch in June 2021. Its objective is to test the resilience of the current business models of the largest banks, insurers, and the financial system to the physical and transition risks from climate change. CBES will focus on sizing risks, rather than assessing capital requirements and will facilitate the identification of gaps in firms' data and the development of risk management processes.

We expect firms not participating in the CBES to assess the impact of climate risk on their balance sheets in different scenarios and, from these, identify any major risks.

**5. Changes in PRA responsibilities following the EU withdrawal transition period**

Following the end of the transition period, the PRA will assume a number of functions previously carried out by the European Insurance and Occupational Pensions Authority, including the publication of technical information (TI) used in the calculation of insurance liabilities. A Statement of Policy[5] published on Wednesday 2 December 2020 explains how the PRA will fulfil its obligations in this regard. From and including 11:00pm on Thursday 31 December 2020, for regulatory reporting, firms should use the TI published by the PRA on its website.

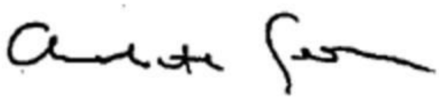
In addition to the priorities set out in this letter, the PRA continues to see strong governance at firms as underpinning progress in meeting the PRA's expectations. The PRA will continue to make full use of the Senior Managers Regime to support our objectives in 2021.

We trust that this letter, in conjunction with the Periodic Summary Meeting letter, conveys a sense of our planned work for this year, which we will apply proportionately to your firm.

We look forward to working with you next year.

Yours sincerely,

**Anna Sweeney**
Executive Director, Insurance



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3 April 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.

4 https://www.bankofengland.co.uk/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change.

5 https://www.bankofengland.co.uk/prudential-regulation/publication/2020/the-pras-approach-to-publication-of-sii-technical-information.