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PRUDENTIAL REGULATION
AUTHORITY

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Dear Chief Executive Officer

Insurance Supervision: 2022 priorities

We are writing to update you on the Prudential Regulation Authority's (PRA) 2022 priorities for life and general insurers operating in the United Kingdom. This letter sets in context our supervision of your firm and the feedback you will have received following the most recent Periodic Summary Meeting. We are sending this letter to all insurers, including third country branches, supervised by the PRA.

Our overarching supervisory aim is that in good times and bad, the insurance sector can continue to provide financial protection and security to policyholders. Insurers' risk management needs to keep pace with the demands of a complex interaction of external risks, and with the changes insurers are making to their businesses, in order that the sector continues to be both financially and operationally resilient.

As we noted in our 2021 priorities letter, the UK insurance industry continues to change shape, including a shift to specialisation. While recognising benefits from the latter, increased concentrations in business and/or operating models bring vulnerabilities that need effective risk management and mitigation.

The Government's review of Solvency II will continue to be a focus for both the PRA and insurance firms throughout 2022. We are working towards a package of reforms that, when implemented, will align the prudential regime and its resilience requirements better with the shape of the UK insurance sector and its risks. Our priorities for 2022 are as follows:

1. Financial resilience

As Covid-19 continues to affect the UK and other economies, the resilience of the financial sector remains paramount to ensure the financial system can continue to support businesses and households. Firms need to assess and address the challenges of a changing economic and claims environment.

The full impact of Covid-19 on credit portfolios is yet to be felt, and recovery is likely to be uneven across sectors as official sector support schemes are withdrawn. All firms, in life and general insurance, will need to monitor closely credit risk within their portfolios and the impact on provisioning. Some life insurers have increased the profitability of writing long term annuity business by backing their liabilities with a greater proportion of higher spread assets, which may result in a greater exposure to credit and concentration risk, and in some cases greater liquidity risk. We expect your board to ensure that you have a clear understanding of exposure to credit downgrades and defaults, the impact this would have on your financial position, and your ability to recover from losses. You need to have adequate risk management in place in relation to this risk, with the board setting appropriate risk appetites, ensuring these appetites are put into practice throughout your business, and assessing your position against a range of scenarios.

Higher levels of general economic inflation than those experienced in recent years are likely to persist into 2022. We expect insurers to monitor risks around economic inflation and understand the impact this may have on their cost of claims. Social inflation can – and has already in some parts of the market - result in insurer claim costs rising at a rate above general economic inflation. We expect you to consider the potential impact of general and social inflation on financial resilience across a range of scenarios and factor into prudent reserving decisions.

Covid-19 has demonstrated the potential for systemic risks to result in losses across the insurance sector. For general insurers, we have seen limited evidence to show insurers have properly considered their aggregate exposures, including from silent cyber risk. Firms may be continuing to place reliance on rarely tested policy exclusions which could be threatened in an extreme event.

We expect retail general insurers to manage the impact on their business models of the updated rules on pricing set out in Financial Conduct Authority (FCA) Policy Statement (PS) 21/5.[1] We will monitor the impact of these rules on insurer business models and underwriting practices across the market, and expects firms to continue to underwrite on a sustainable basis.

The financial resilience of the sector will be assessed by the Insurance Stress Test (IST) 2022.[2] This is a key priority for the PRA and insurers this year. We expect those firms involved in the IST to engage fully in the exercise and provide comprehensive responses to PRA requests. As discussed with relevant life insurers, the first IST in which they participated did not deliver sufficiently consistent results to enable us to publish aggregate results in the form planned. In 2022, we need to publish aggregate results that will enable the PRA and other stakeholders to assess the resilience of the sector to systemic shocks.

2. Operational risk and resilience

Enhancing the operational resilience of the financial sector remains a strategic priority for the PRA. Covid-19 continues to reinforce the importance of firms' ability to prevent, adapt, respond to, recover, and learn from operational disruptions. We will continue to challenge firms to develop a dynamic, effective risk and control framework to manage the hybrid working environment and operational disruptions proportionate to their size and business functions, including from cyber-attacks. We expect firms to develop their security controls and capabilities to manage the increasing risk of cyber threats, as set out in Supervisory Statement (SS) 1/21.[3] We encourage all firms, regardless of size, to test their resilience against such threats.

By Thursday 31 March 2022, firms must have identified and mapped their important business services; set impact tolerances for these; and initiated a programme of scenario testing. Impact tolerances provide a standard which boards and senior management should use for prioritising investment and making recovery and response arrangements. We will continue to review firms' programmes and their implementation.

We also introduced new expectations on outsourcing and third party risk management (SS2/21)[4] to strengthen our expectations on operational resilience, and to facilitate greater resilience of services provided by third parties including the cloud and other technologies. Under SS2/21 firms should maintain an updated register of their outsourcing arrangements. UK insurers are heavily reliant on third-party outsourcing to carry out many functions, and it is critical that you ensure that services provided via third-parties can also remain within impact tolerances.

3. Financial risks arising from climate change

Climate change presents a material and increasing financial risk to firms and to the financial system. Minimising the future risks from climate change requires action now and remains a key PRA priority. Some firms have made good progress in embedding the PRA's supervisory expectations (as set out in SS3/19)[5], but progress has not been consistent across all firms, with further work required by many to

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1 May 2021: PS21/5: General insurance pricing practices market study: feedback to CP20/19 and final rules | FCA.
2 August 2021: Insurance Stress Test 2022 (IST 2022).
3 March 2021: SS1/21 Operational resilience: Impact tolerances for important business services.
4 March 2021: SS2/21 Outsourcing and third party risk management.
5 April 2019: Enhancing banks' and insurers' approaches to managing the financial risks from climate change.

meet those expectations. We note the risks of overly focusing on the business opportunities presented by climate change and remind firms that climate change also presents an increasing business risk that is foreseeable and demands action now.

This year we will incorporate supervision of the financial risks posed by climate change into our core supervisory approach. Our approach will be informed by information gathered from the 2021 Climate Biennial Exploratory Scenario (CBES).[6] We thank participating insurers for their engagement on CBES, and look forward to providing feedback on this exercise in the first half of this year. The assessment of a firm's management of climate-related financial risks will be included in all relevant elements of the supervisory cycle. Firms should take a forward-looking, strategic and ambitious approach in managing climate-related financial risks across their business, including in both underwriting and investment. This approach should be proportionate to the scale of the risks and the complexity of a firm's operations. As our collective understanding of climate-related risks, data, tools and best practice evolves, we expect firms to refine and innovate to better integrate climate-related financial risk management across their organisation. We will keep a range of supervisory tools under review for use where we see insufficient progress by firms in effectively managing their climate-related financial risks.

There could also be benefits from insurers conducting further research on emerging climate-related financial risks. This includes for instance the potential impact of litigation risk on their balance sheets and the impact of physical risks on assets and liabilities.

4. Regulatory change

We continue to work with the Government on the review of Solvency II, and thank you for your engagement to date. The outcome of the review cannot be prejudged, and there will be further opportunities to respond to consultations on any proposed changes to regulation or legislation. We see the objectives of the review as mutually reinforcing: growth, innovation, and investment can be best delivered by an insurance sector on a sound prudential footing. We are working with HMT to deliver a package of reforms that reduces the regulatory burden on firms and has incentives aligned with prudent risk management and with Government priorities.

We now have the benefit of the industry's extensive responses to the Quantitative Impact Study[7] and accompanying qualitative questionnaire; we are grateful for the substantial effort involved in providing this information in 2021. In the early part of this year, we will be augmenting this data through detailed technical engagement on policy measures that might best meet the objectives of the review, ahead of formal consultation on a package of measures later in the year.

We are also working with the Government to develop a targeted resolution regime for the insurance sector. A regime that ensures that insurers can be resolved in an orderly manner will reduce the risk that individual insurer failure poses to PRA objectives.

We are also continuing to explore ways to improve our approach to authorising ILS vehicles and other wholesale insurance firms to ensure the process and time taken are proportionate to the risks.

Regulatory change will be introduced with an appropriate period of notice and transitional measures where necessary. However, we expect you to be prepared to implement changes in your approach, in particular in the areas identified as a focus here. This preparation should include identification of areas where change may result in the most material impact for your firm, and consideration of the effectiveness and capacity of your change management function.

5. Third-country branches seeking authorisation in the UK

We expect to process c.150 third country branch applications from insurers currently in the Temporary Permissions Regime (TPR) throughout 2022-23. In order to ensure timely processing of, and decisions on, authorisation applications, it is crucial that applicant firms cooperate with the PRA in an open and transparent manner.

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6 June 2021: Key elements of the 2021 Biennial Exploratory Scenario: Financial risks from climate change.

7 December 2021: Review of Solvency II: Quantitative Impact Study (QIS).

The PRA will continue to use its powers, including the power to direct firms to make applications under Part4A of FSMA during a specified period, to ensure that the flow of applications is managed effectively.

6. Diversity & Inclusion

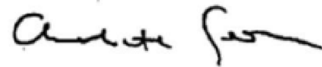
Discussion Paper (DP) 2/21[8] sets out our ambition to support the resilience of the financial services sector, by encouraging diversity within firms. We see a clear link to our objectives: diversity helps bring a mix of views, perspectives and experiences within firms. An inclusive culture where staff can freely raise concerns and participate appropriately in decision-making can reduce the risk of groupthink, encourage debate and innovation, and support the safety and soundness of firms.

We have received positive feedback from industry on the proposals in DP2/21. While we recognise that change takes time, we expect firms to consider the themes set out in DP2/21, challenge themselves to understand their gaps and consider where they can make progress within their institutions.

We look forward to working with you over the coming year.

Yours sincerely/faithfully,

Anna Sweeney
Executive Director, Insurance Supervision



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8 July 2021: DP2/21 – Diversity and inclusion in the financial sector – working together to drive change | Bank of England; and DP 21/2: Diversity and inclusion in the financial sector – working together to drive change | FCA.