Dear Chief Executive Officer,

Insurance supervision: 2023 priorities

We are writing to update you on the Prudential Regulation Authority’s (PRA) priorities for the supervision of life and general insurers in 2023. The insurance sector plays a critical role in supporting large areas of economic activity through risk pooling, long-term investment, and provision of retirement income. Our overarching supervisory aim is for the insurance sector to be able to provide financial protection and security to policyholders at all times, including those of stress.

Insurers need to adapt to changes that threaten to disrupt business models, while maintaining high standards of governance, risk management, and resilience that result in their continued provision of vital insurance services to the real economy. Our main focus for 2023 will be on: financial resilience; risk management; implementing financial reforms; reinsurance risk; operational resilience; and ease of exit for insurers. Cross-firm supervisory activities relating to these priorities are set out in Annex A.

These priorities will form part of our ongoing assurance work, alongside firm-specific actions that you will have received following the most recent Periodic Summary Meeting (PSM) for your firm. This letter is being sent to all insurers, including third-country branches, supervised by the PRA.

Please see below our priorities for 2023 in more detail.

Charlotte Gerken
Executive Director, Insurance Supervision

Shoib Khan
Director, Insurance Supervision

10 January 2023
Financial resilience

The latest projections by the Bank of England’s Monetary Policy Committee describe a very challenging outlook for the UK economy, which is expected to be in recession for a prolonged period with CPI inflation remaining elevated in the near term. The challenging economic outlook is likely to present different challenges to both the life and general insurance sector.

For life insurers, growing concentrations, in particular to assets that are internally rated and valued, may result in a greater exposure to credit and concentration risk. We expect life insurers to stress test their capital planning against prolonged adverse credit scenarios robustly.

For general insurers, 2023 will likely see a continuation of pressures on claims inflation, as we mentioned in our October 2022 insights from our recent thematic review across the general insurance sector. Our review identified a number of observations relating to how claims inflation differs by line of business and geography. There is uncertainty in the severity and duration of claims inflation expected, and there may also be a lag before it materialises. Consequently, this gives rise to additional uncertainty around future claim settlement costs. Therefore, we expect general insurers to factor general and social inflation risk drivers into their underlying pricing, reserving, business planning, and capital modelling.

Risk management

In light of the multiple external uncertainties facing insurers, it is important that firms take proactive steps to assess the adequacy of their risk management and control frameworks. Firms should be able to respond to market and credit risk conditions different from those that prevailed for a long time. Firms need to be prepared for novel risks, changes in risk correlations and increases in distressed assets. We expect firms to assess their credit and counterparty credit risk management capabilities in light of widening credit spreads, rating downgrades, and defaults.

Given the central role that models play in supporting risk assessments, we expect firms to reassure themselves of the continued validity of their models, considering the extent to which the model risk management principles for banks set out in Consultation Paper (CP) 6/22 – ‘Model risk management principles for banks’ could be applied and, in particular, whether current validation remains robust in the face of multiple concurrent

stresses. We will be focused on how well insurers’ capital models are operating in conditions that differ substantially from those that prevailed when much of current modelling was developed.

Risk appetite for bulk purchase annuity (BPA) deals is increasing across a number of life insurance firms. Through a thematic review, we will seek assurance that associated risk management disciplines are keeping pace with any increase in BPA growth ambitions.

Recent events such as the Liability-Driven Investment shock has highlighted gaps in insurers’ liquidity risk frameworks, further reinforcing the importance of sound risk management practices. We expect insurers to test the resilience of liquidity sources to market dysfunction and to re-evaluate potential liquidity demands created by use of derivatives for risk management.

Implementing financial reforms
Following the Government’s announcements in November 2022 to legislate reforms to Solvency II, the key decisions will now be for Parliament. These decisions, to be enacted via legislation, will nonetheless require extensive detailed rulemaking in order to implement these faithfully and make them operational. A number of other aspects of the Solvency II review will be enacted directly via PRA rulemaking and work has already started on reforming reporting requirements and the simplification of the internal model review process. Over the course of 2023, we will seek to engage constructively with affected firms on the technical details of reforms, in advance of formal consultation. We will also engage with the life insurance sector on the extent to which the stress testing framework may need to adapt.

We will continue to ensure authorisation of branches of international insurers remains smooth and orderly. We expect to complete our assessment of any outstanding branches currently within the Temporary Permissions Regime in 2023 as well as set out our proposed supervisory approach to branches. This remains underpinned by the principles of ‘responsible openness’ and our ability to place reliance on strong and co-operative Home State Supervisors.

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Reinsurance risk

We are paying close attention to whether the continued high level of longevity reinsurance and the emergence of the more complex ‘funded reinsurance’ in the UK life market\(^7\) reduce the protection UK policyholders should have, beyond the risk tolerance. In particular, we see the potential for offshored counterparty concentration risk to arise from rapidly growing levels of reinsurance. These concentrations can arise for firms individually and for the sector as a whole. We expect UK authorised firms to consider their compliance with the Prudent Person Principle (PPP) for the risks associated with their reinsurance activities. Insurers need to consider the reinsurer’s resilience over the whole duration of the exposures, as well as the potential impact from a mass recapture event where large concentrations to a small number of counterparties exist. Our own work on counterparty and concentration risk will examine the need for policy action on reinsurance structures and limits, to mitigate systemic risks to policyholders.

Operational resilience

Given the increase in crystallised operational incidents, we continue to maintain our focus on operational risk and resilience. A large part of this will be the continued assessment of firms against the PRA’s operational resilience rules as set out in Supervisory Statement (SS) 1/21 – ‘Operational resilience: Impact tolerances for important business services’.\(^8\) At this point, we would expect insurers to have identified and mapped their important business services and set impact tolerances.

Over the next three years, insurers will need to demonstrate their ability to operate within those impact tolerances under a range of severe but plausible scenarios, including cyber-attacks. Applying the principle of proportionality, we will be working closely with firms to review the appropriateness of impact tolerances, the identification of dependencies, as well as robustness of testing plans. Insurers must make sure their important business services can remain within impact tolerances even when relying upon third party providers. To that end, firms should also be able to demonstrate that they meet the expectations relating to outsourcing and third party risk management set out in SS2/21 – ‘Outsourcing and third party risk management’.\(^9\)

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Ease of exit for insurers

As set out in our 2022/23 Business Plan,\(^\text{10}\) we are focused on improving ease of exit for insurers. While some work has been done in this area by the larger insurers, many smaller firms remain without any plans for exit. Insurers are required by Fundamental Rule 8\(^\text{11}\) to prepare for resolution so that they can exit the market in an orderly fashion if required and during 2023, we will consult on requirements for insurers to prepare exit plans (to a level of detail commensurate with the size and impact of the insurer) so that we can provide more specific expectations. In the meantime, we expect firms to begin considering how they might exit the market if the need arose, what the obstacles might be, and how they might be overcome. These plans should be executable on a timely basis and appropriately prudent. In particular, firms considering transferring run-off books of business to other firms should ensure that, before disposal, they are fully cognisant of the risks contained in those books, and that those risks are fully understood by the acquiring firm.

Other areas of focus

Non-natural catastrophe risk

Our work in recent years indicates that exposure management capability in relation to non-natural catastrophe risk (including cyber) remains immature.\(^\text{12}\) Insurers, particularly those operating in the London Market, will see this risk continue to grow and evolve as portfolio composition shifts towards casualty classes. Firms that are not able to size potential losses from non-natural catastrophe risks (including emerging risks) or establish commensurate risk management measures are exposed to the risk of outsized losses and may underestimate capital requirements. Over 2023, we intend to work with the industry to enhance practice and better manage risk in this area.

Financial risks arising from climate change

While a number of more immediate risks have heightened for the sector over the last 12 months, climate change continues to present an increasing, material risk to firms and the financial system. In 2022, we started actively supervising firms against our


supervisory expectations.\textsuperscript{13} Our recently published letter to CEOs\textsuperscript{14} highlighted the progress made by firms since the publication of SS3/19 – ‘Enhancing banks’ and insurers’ approaches to managing the financial risks from climate change\textsuperscript{15} and provided feedback on the Bank of England’s Climate Biennial Exploratory Scenario (CBES) exercise. Firms’ ability to meet the PRA’s supervisory expectations will be assessed on an ongoing basis through supervisory engagement, firm-specific deep dives, and thematic work. We expect firms to be able to demonstrate how they are responding to our expectations and to set out the steps they are taking to address barriers to progress. We will keep a range of supervisory tools under review where we consider that firms are not adequately addressing risks or are making insufficient progress.

**Diversity, Equity, and Inclusion**

Diversity, Equity, and Inclusion (DEI) remains an important focus and a topic we expect firms to continue to embed in their cultures. Building upon our joint Discussion Paper (DP) 2/21 – ‘Diversity and inclusion in the financial sector’ published in July 2021\textsuperscript{16} and the voluntary pilot survey,\textsuperscript{17} we plan to issue a CP in 2023 setting out proposals to introduce a new regulatory framework on DEI in the financial sector.

**Supervisory approach**

As set out in our 2022/23 Business Plan, we continue to strengthen our supervisory approach. As part of this, and with effect from January 2023, we have updated our approach to categorising the ‘potential impact’\textsuperscript{18} of firms, reducing the number of categories from five to four. We have also refined our risk assessment framework and our core assurance work. Where this results in any changes to the PRA’s supervisory workplan for any individual firm, we will communicate this directly to the firm. Until they are informed otherwise, firms should continue to work with the workplan communicated


\textsuperscript{14} \url{https://www.bankofengland.co.uk/prudential-regulation/letter/2022/october/managing-climate-related-financial-risks}.


\textsuperscript{17} \url{https://www.bankofengland.co.uk/prudential-regulation/publication/2021/july/diversity-and-inclusion-in-the-financial-sector}.

\textsuperscript{18} A core part of the risk assessment framework is the potential impact assessment. We assess the significance of a firm to the stability of the UK financial system. This ‘potential impact’ reflects a firm’s potential to affect adversely the stability of the system by failing, coming under operational or financial stress, or because of the way in which it carries out its business.
to them following their last PSM. We will also update our published supervisory approach documents during the first half of 2023.¹⁹

The Financial Services and Markets Bill, which is currently being considered by Parliament will – if passed into law – introduce a new secondary competitiveness and growth objective for the PRA. The new objective would require the PRA to act in a way which, subject to aligning with relevant international standards, facilitates the international competitiveness of the UK economy and its growth in the medium to long-term. If appropriate, the PRA’s supervisory approach will be updated to reflect changes that are made to its statutory objectives.

We look forward to working with you over the course of 2023.

Yours sincerely,

Charlotte Gerken
Executive Director
Insurance Supervision

Shoib Khan
Director
Insurance Supervision

## ANNEX A: 2023 PRA-led cross-firm work

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<td>• The PRA will engage with firms that were identified as outliers in the general insurer claims inflation thematic review.</td>
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<th>Risk management</th>
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<td>• The PRA will be conducting a BPA thematic review.</td>
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<td>• The PRA will implement the Government’s Solvency II reforms, and enact a number of other aspects of the Solvency II review directly via PRA rulemaking.</td>
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<td>• The PRA will work with general insurers to enhance risk management capabilities in relation to non-natural catastrophe.</td>
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