Supervisory Statement | SS43/15

Non-Solvency II insurance companies – Capital assessments

November 2015

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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1 Overview

1.1 This supervisory statement (SS) is addressed to non-Solvency II insurance firms that are not friendly societies. For the purposes of this statement, these firms are described collectively as non-Directive insurance companies.

1.2 This statement should be read alongside relevant statutory legislation, as well as the Insurance Company – Overall Resources and Valuation Part of the Prudential Regulation Authority (PRA) Rulebook.

1.3 This statement was consulted on in CP27/15[1] and expands on the PRA's general approach[2]. By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the Regulatory Principles and relevant provisions of the Legislative and Regulatory Reform Act 2006.

2 Overall resources

2.1 Non-Directive insurance companies must maintain adequate overall financial resources in accordance with Insurance Company - Overall Resources and Valuation 2.3 of the PRA Rulebook.

2.2 The liabilities referred to in this rule include a firm's contingent and prospective liabilities. They exclude liabilities that might arise from transactions that a firm has not entered into and which it could avoid by taking realistic management actions, such as ceasing to transact new business after a suitable period of time has elapsed. They include liabilities or costs that arise both in scenarios where the firm is a going concern and those where the firm ceases to be a going concern. They also include claims that could be made against a firm, which ought to be paid in accordance with the fair treatment of customers, even if such claims could not be legally enforced.

2.3 This supervisory statement is not intended to signal a change in expectations regarding a firm's ability to at all times meet this rule. The PRA therefore does not expect this supervisory statement to change a firm's assessment of its current capital levels.

2.4 The PRA does not intend to assess regularly and set Individual Capital Guidance for non-Directive insurance companies. Rather Insurance Company – Overall Resources and Valuation 2 requires a firm to identify and assess risks to its being able to meet its liabilities as they fall due, to assess how it intends to deal with those risks and to quantify the financial resources it considers necessary to mitigate those risks. This is referred to as a capital assessment, which should be carried out in accordance with Insurance Company – Overall Resources and Valuation 2.

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1 PRA Consultation Paper 27/15 *The prudential regime for non-Solvency II insurance firms and consequential amendments*, August 2015; http://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp2715.aspx

2 *PRA's approach to insurance supervision*; June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1406.pdf

2.5 The method a firm chooses to carry out such a capital assessment should be proportionate to the size and nature of its business. The PRA expects a firm to be able to carry out these assessments for a time horizon of 3 to 5 years.

3 Purpose

3.1 A capital assessment should reflect both a firm's business model and its commercial objectives and give the required level of confidence that a firm's liabilities to policyholders will be paid. A firm should consider, and be able to provide an explanation for, all material risks which may arise before the policyholder liabilities are settled based on a reasonable assumption of the expected likelihood of these risks crystallising.

3.2 A capital assessment should demonstrate that a firm holds sufficient capital to be able to make any planned investments and take on new business (if it wishes to do so). It should also ensure that if a firm had to close to new business (if it has not already done so), it would be able to meet its existing commitments. Where possible, the reasonableness of the results should be supported by considering complementary evidence of the financial resources needed.

4 Methodology

4.1 The methodology used within the capital assessment should allow a firm to quantify the financial effect of risks. It should also reflect the nature of a firm's business and be consistent with the way in which a firm identifies and manages risk.

4.2 A firm’s capital assessment should:

- reflect the firm's assets, liabilities, and future business plans;
- be consistent with the firm's management practice, systems and controls;
- consider all material risks that may have an impact on the firm's ability to meet its liabilities to policyholders; and
- use a valuation basis that is consistent throughout the assessment.

4.3 The results of the capital assessment should be supplemented by analysis of the sources of the risks to which the firm is exposed, discussion of the events which are most likely to threaten the safety and soundness of the firm and the potential mitigating actions which the firm may take to manage them.

5 Representative of firms’ characteristics

5.1 A firm should consider the impact of potential new business on capital required and available capital in their capital assessment. Any contract that a firm is legally obliged to renew should be considered part of a firm's existing liabilities and not treated as new business.

5.2 Where a firm has not already closed to new business, the capital assessment should be made on the basis that a firm closes to new business after an appropriate period.

5.3 Where the capital assessment assumes that a firm may move capital from one part of its business to another across legal or geographical boundaries, the firm should explain how it

would satisfy itself that it could achieve the necessary capital movements in times of distress and why such items are free from restriction on their transferability. The firm should also consider any associated costs or restrictions in the amount of capital that would be able to be transferred.

6 General assumptions

6.1 A firm's management should determine their own risk appetite or confidence level and a risk measure that they believe is suitable for the management of the business. Firms should however consider Chapter 8 of this statement.

6.2 A firm should be able to explain its rationale for choosing its approach to risk and assessment of capital.

6.3 A firm should be able to evidence the reasoning and judgements underlying its assessment and, in particular, justify the:

- assumptions used;
- appropriateness of the methodology used; and
- results of the assessment.

6.4 A firm should also be able to identify the major differences between the assessment at a confidence level of 99.5% over one year and any other assessments carried out using a different confidence level.

6.5 Key parameters and assumptions should be reviewed regularly. A firm should consider the relevance of the data and the nature and value of any expert judgement used to support the choice of these assumptions especially where these data and judgement determine the most financially significant assumptions and provide justification for the calibration of these assumptions.

6.6 Where relevant, a firm should consider all risks in aggregate if intending to make appropriate allowance for diversification when completing its capital assessment. A firm should be able to describe and explain any diversification benefits allowed for.

6.7 Where there is a concentration of business from a single source (for example, a single sales channel or cedant), consideration should be given to the greater impact of a risk crystallising, compared to that for a well-diversified portfolio.

7 Material risks

7.1 A capital assessment should consider risks to the number of claims, the amount paid and the timing of a firm’s liabilities which could result in a change in the cost of those liabilities.

7.2 The assets that a firm holds carry risk, both in their own right and to the extent that they do not match the liabilities that they are backing. The risk associated with these assets should be considered over the full term for which the firm expects to carry the liabilities.

8 Valuation basis

8.1 The valuation of assets and liabilities should reflect their economic substance. A realistic valuation basis should be used taking into account the actual amounts and timings of cash flows under any projections used in the assessment.

8.2 In carrying out a capital assessment, wherever possible the value of assets should be marked to market. Where marking to market is not possible, the capital assessment should use a method suitable for assessing the underlying economic benefit of holding each asset.

8.3 The methods and assumptions used in valuing the liabilities should contain no explicit margins for risk, nor should the approach be optimistic. The valuation of liabilities should be consistent with the valuation of assets. To the extent the market price includes an implicit allowance for risk, this should be included within the valuation.

8.4 The methodology used to place a value on an asset or a liability following a risk event should be consistent with the methodology used prior to the risk event.

8.5 Approximate valuation methods may be used by the firm for minor lines of business or to capture less material types of risk. However, the firm should avoid methods which underestimate the risk in aggregate.

8.6 The firm should carry out a broad reconciliation of key parts of any balance sheet used in the capital assessment with the corresponding entry from audited results where possible.

9 Documentation

9.1 In accordance with Insurance Company – Overall Resources and Valuation 2.10 these assessments should be documented so that they can be easily reviewed by the PRA if the PRA chooses to undertake an assessment of the adequacy of the firm's capital resources.

9.2 Where the PRA requests a firm to submit to it a written record of the firm's assessment of the adequacy of its capital resources, the PRA expects firms to be able to make an assessment on its request comparable to a 99.5% confidence level over a one year timeframe that the value of assets exceeds the value of liabilities. Firms may choose to base any regular assessment on an alternative confidence level.

10 Stress testing and scenario analysis

10.1 A stress test is for the purposes of evaluating the impact of different adverse scenarios on the capital position of a firm. For example, simultaneous movements in a number of risk categories affecting all of a firm’s business operations, such as business volumes, investment values and interest rate movements.

10.2 Depending on the nature, scale and complexity of a firm’s business, carrying out stress tests (including reverse stress tests) and scenario analyses can be an appropriate way for a firm to estimate the financial resources it would need to continue to meet Insurance Company - Overall Resources and Valuation 2.3. Such testing should reflect the potential range of outcomes for the risks being quantified and should take into account an appropriate range of adverse circumstances and events relevant to the firm's business and risk profile. For example, circumstances and events occurring over a protracted period of time or sudden and severe events, such as market shocks or other similar events or a combination of the two.

10.3 The nature, depth and detail of the analysis will depend, in part, upon the firm's capital strength and the robustness of its risk prevention and risk mitigation measures.

10.4 Stress tests and scenario analyses can be used to carry out the capital assessment and, if so, should be documented in line with Insurance Company – Overall Resources and Valuation 2.10.

10.5 The overall assessment of capital may require the aggregation of results from the stress and scenario testing. The firm should be able to explain its choice of aggregation approach and its understanding of the implications of combining the individual risks. The firm should be satisfied that the resultant capital provides the appropriate degree of confidence, given the variability of the underlying risks and the uncertainty associated with those risks. A useful component of this process is the characterisation and explanation of a range of possible circumstances that could give rise to a loss of this magnitude.

10.6 If carrying out stress tests and scenario analyses, firms should estimate the financial resources that it would need in order to continue to meet Insurance Company – Overall Resources and Valuation 2.3 and the Capital Resources Requirement (Insurance Company – Capital Resources Requirements 3.1) in the adverse circumstances being considered. It should only include financial resources that could be reasonably relied upon in those circumstances and take account of any legal or other restriction on the use of financial resources.

10.7 A firm should assess how risks aggregate across business lines or units, any material non-linear or contingent risks and how risk correlations may increase in stressed conditions.

10.8 A firm should undertake a broad range of stress tests which reflect a variety of perspectives, including sensitivity analysis, scenario analysis and stress testing on an individual portfolio as well as a firm-wide level. Firms are reminded that they should also consider undertaking reverse stress testing.

11 Management actions

11.1 Where the benefit of prospective management actions are incorporated in a firm's capital assessment, firms should understand the financial effect and any preconditions that might affect the value of management actions as risk mitigants. In addition, firms should be able to justify the choice and realism of prospective management actions and the assumptions used. A firm should be able to show the financial impact of a management action.

11.2 A firm should be able to identify any realistic management actions intended to maintain or restore its capital adequacy in a stress scenario and estimate the effects of the stress scenario with and without such management actions.

11.3 A firm may consider scenarios in which expected future profits will provide capital reserves against future risks. However, it would only be appropriate to take into account profits that can be foreseen with a reasonable degree of certainty as arising before the risk against which they are being held could possibly arise.

11.4 Where pension obligation risk is considered, a firm should assess any risks that may increase its current funding obligations towards the pension scheme and that might lead to the firm not being able to pay its other liabilities as they fall due.

11.5 A firm is expected to determine where the scope of any stress test impacts upon its pension obligation risk and estimate how the relevant measure of pension obligation risk will change in the scenario in question.