Supervisory Statement | SS4/14

Capital extractions by run-off firms within the general insurance sector

April 2014

(Updated July 2016)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Contents

1 Introduction

1.1 The purpose of this statement is to set out the Prudential Regulation Authority's (PRA's) expectation of compliance with existing prudential provisions within the PRA Rulebook for run-off firms in the general insurance sector.[1]

1.2 This statement is aimed at general insurance firms in run-off and highlights some factors that the PRA expects the senior management of a run-off firm to take into account when considering making a request to the PRA to extract capital from the firm during the course of a run-off. This statement also explains the approach that the PRA intends to take when considering such requests.

1.3 Insurers must comply with relevant provisions in the PRA Rulebook including the Risk Management chapter of the Conditions Governing Business Part of the PRA Rulebook, which includes requirements to undertake an Own Risk and Solvency Assessment (ORSA). This supervisory statement complements another PRA supervisory statement — SS3/14 'The Prudential Regulation Authority's (PRA's) approach to Schemes of arrangement proposed by PRA-authorised insurers under Part 26 of the Companies Act 2006'[2] and the two should be read together for general insurers in run-off.

1.4 This supervisory statement provides additional clarification of the PRA's expectations of firms in respect of these existing requirements. Its purpose is to explain the PRA's expectations that:

- firms in run-off hold sufficient regulatory capital to continue to meet their obligations to policyholders as they fall due; and
- firms satisfy themselves and the PRA that this remains the case after a proposed capital extraction.

1.5 This statement expands on the PRA's general approach as set out in its Approach Document,[3] and is designed to help ensure the PRA meets its statutory objectives of ensuring safety and soundness of the firms it regulates and securing an appropriate degree of protection for policyholders.

1.6 to 1.13: Deleted, see Appendix 1.

Background to capital extraction requests

1.14 General insurance firms in run-off occasionally approach the PRA with requests to extract capital. The PRA recognises that this may be a legitimate request in certain circumstances, for example where claims estimates have developed favourably over a long period, and where significant levels of surplus regulatory capital have been generated.

1.15 However, capital extractions during the life of a run-off inevitably weaken the level of protection available for remaining policyholders. This is of particular concern for the PRA in respect of firms in run-off, since these firms, compared to other insurers, may have more

1 On 28 July 2016, this SS was updated – see Appendix 1 for full details.
2 PRA Supervisory Statement 3/14, 'The Prudential Regulation Authority's (PRA's) approach to schemes of arrangement proposed by PRA-authorised insurers under Part 26 of the Companies Act 2006', April 2014; www.bankofengland.co.uk/pra/Pages/publications/schemesss.aspx.
3 The Prudential Regulation Authority's approach to insurance supervision is available at www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.

limited access to further capital, and often have fewer management actions available to them to restore capital levels if the need subsequently arises. For example, the financial position of run-off firms can be adversely affected by unexpected reserve deterioration as new risks emerge or through changes in the expected frequency or severity of known risks. In addition, the historic policy data available to some run-off firms can be incomplete, making it more difficult to estimate potential future claims with a high degree of accuracy.

2 PRA expectations of run-off firms proposing capital extractions

2.1 The PRA expects senior management and boards of run-off firms to assess carefully the level of capital required on an ongoing basis to ensure that the firm can run-off their business in an orderly fashion, including under adverse conditions. If a firm in run-off wishes to extract capital during the course of a run-off, the PRA expects the firm's board and senior management to consider such proposals carefully and to be satisfied that the financial position after the proposed extraction will still remain adequate for the duration of the run-off.

2.2 Where a run-off firm wishes to undertake a capital extraction, the PRA expects the firm first to take the following steps:

(a) The firm should undertake a thorough review of its capital position in order to assess the adequacy of its financial position after the proposed extraction. For firms subject to the requirements of Solvency II (Solvency II firms), this analysis should include a review of the firm's Solvency Capital Requirement (SCR) and its overall solvency needs as required for inclusion in a firm's ORSA. In assessing its capital needs, a firm should take into account relevant factors such as:

(i) any restrictions on availability of capital; and

(ii) the quality of the policy records it holds and how this might impact its ability to estimate potential future claims, and make allowance for these factors as appropriate. The firm should also consider as far as reasonably practicable how its financial position might change in the future.

(b) As well as assessing its current capital needs, the firm should consider the expected future progress of the run-off of the business, including as a minimum over the next 3–5 years, based on realistic assumptions on relevant factors such as claims, reserve development and investment income, and taking into account any other expected changes in the business. These assumptions should reflect the firm's experience during the run-off to date, and be consistent with the firm's business plans. The firm should use this information to prepare a projection of its likely capital resources and capital requirement (ie SCR for Solvency II firms) over this future period. For Solvency II firms, the projection should also incorporate the forward looking computation of its overall solvency needs over a 3-5 year period. The firm should also consider plausible downside risks to these projections and show the possible effects of these scenarios on the future capital position.

(c) The firm should seek board approval for the capital extraction proposal, having taken into account the results of the capital review, the future projections referred to above, and any other relevant information. The PRA expects a firm's board to approve a capital extraction proposal only if the board is satisfied that the firm will be able to maintain adequate financial resources after the proposed extraction — including that it would expect to continue to meet its capital needs, (including the SCR and overall solvency needs for

Solvency II firms) at all times over a 3–5 year period, including in the event of a change in the stress scenario.

3 PRA review process

3.1 The PRA expects firms to request its views at an early stage and ensure that any concerns it may have in relation to a proposed capital extraction are properly addressed before the proposal is implemented. Any request to the PRA should be made by the CEO or CFO of the firm and confirm that the board has approved the proposal having considered all the factors outlined in this statement.

3.2 Alongside its request, the firm should provide the PRA with a copy of the analysis submitted to its board showing the projected evolution of the financial resources and capital needs and requirements, and the downside risks to this position. Solvency II firms should also provide a copy of the firm's most recent ORSA.

3.3 Where a firm has commissioned any independent actuarial review of its analysis, or other relevant factors such as an analysis of the adequacy of its policy records, it should make the PRA aware of this. The PRA may request copies of this analysis from the firm as part of its assessment of the capital extraction request. Where a firm has not already done so, the PRA may consider asking a firm to commission an independent review to provide assurance on the data underlying the request or the robustness of the analysis undertaken by the firm — for example, covering the actuarial assumptions used or the completeness and accuracy of the firm's policy records. The PRA may be more likely to request such an opinion where, for example:

- a capital extraction request is significant in size;
- the proposed extraction results in the projected financial resources in a stressed scenario being less than either its overall solvency needs or SCR; and
- it has concerns about the accuracy of the firm's data or analysis.

3.4 : Deleted, see Appendix 1.

3.4A The PRA expects Solvency II firms to seek to hold capital to manage and mitigate the risks identified in the ORSA and capital extractions should be considered accordingly. The PRA will not expect Solvency II firms to seek capital extractions which would bring the level of capital below its overall solvency needs as set out in the firm's ORSA, even if this figure is above the SCR.

3.5 In considering a proposed capital extraction, the PRA will take into account: the firm's capital position immediately after the proposed extraction; the firm's projections of its financial position including over a 3–5 year period; the appropriateness of the assumptions underlying these projections; the possible downside risks to these projections; and any other information that the PRA deems to be relevant.

Appendices

1 SS4/14 updates

Appendix 1 – SS4/14 updates

SS4/14 was first published in April 2014 following CP7/13 'Capital extractions by run-off firms within the general insurance sector' September 2013.[1]

This appendix details changes made to this SS following its initial publication in April 2014.

2016

On 28 July 2016 SS4/14 was updated to reflect the proposals consulted on in Consultation Paper 42/15 'Capital extractions by run-off firms within the general insurance sector',[2] following the change in the UK insurance regulatory regime from Individual Capital Adequacy Standards (ICAS) to Solvency II. The SS has been updated to set out the PRA's expectations regarding the factors that senior management of general insurance firms in run-off should take into account when considering making a request to the PRA to extract capital from the firm during the course of a run-off. This statement has also been amended to reflect the revised approach the PRA takes when considering such requests. Specifically:

- paragraphs 1.1 and 1.3 have been updated to refer to the relevant parts of the PRA Rulebook;
- paragraphs 1.6 to 1.13 on 'Consultation feedback' (following the initial consultation in CP7/13), and 'Obligations on firms relating to the adequacy of financial resources' have been deleted;
- paragraphs 2.1 and 2.2 on capital extractions have been updated; and
- on the PRA's review process, paragraphs 3.1, 3.2, 3.3 and 3.5 have been updated, paragraph 3.4 has been deleted and a new paragraph 3.4A added.

1 www.bankofengland.co.uk/pra/Pages/publications/geninsusec.aspx.
2 November 2015: www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp4215.aspx.