BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Speech

Current issues for the Prudential Regulation Authority as a General Insurance supervisor

Speech given by

Julian Adams, Deputy Head of the Prudential Regulation Authority and Executive Director of Insurance

At the Insurance Institute of London

2 October 2013

I am delighted to be here today to open the Insurance Institute‘s 2013/14 lecture programme. I want to talk today about the Bank of England’s role in supervising insurance companies, how we have adapted our approach to take into account lessons from the crisis and how we are applying our new supervisory approach in an example which will be of particular interest to this audience – namely the impact which alternative capital providers may be having on parts of the London Market.

But first some background. As you know, the Bank of England through the Prudential Regulation Authority - PRA - took on responsibility for prudential regulation of insurers and banks in April this year.

When the Government announced the reforms to the UK regulatory structures in 2010, we knew that there was some concern in the insurance industry that the Bank didn’t understand insurance and that we would read across all aspects of banking supervision to insurance, without an appropriate understanding of the differences in firms’ business models in the two sectors.

Six months into the new arrangements, I hope some of the market’s initial concerns in this area have now been allayed. Not only do we have a specific statutory “policyholder protection” objective to hard-code in statute the basis of much of our work on insurance, I believe we have demonstrated in practice that we really do understand that the business models of banks and insurers are fundamentally different, and have tailored our supervisory approaches accordingly.

We have also recognised this in our organisational structure, through the creation of a single Insurance Directorate, which I lead, to help ensure that insurance has an appropriate focus within the organisation. In total, staff working on insurance account for about a third of the total PRA staff so it is a significant part of the organisation and many of our staff have specialist insurance experience drawn either from a regulatory background or from the industry – or both. And within insurance, we are now organised into separate Life and General Insurance Divisions, to reflect appropriately the distinct characteristics and issues facing these two very different segments of the market.

So within the Bank there is a strong appreciation of the differences between banks and insurers. However, we shouldn’t be, and are not, blind to where we might learn from experience that we have had in one sector and apply those lessons to other sectors.

In my view, there are a number of lessons we can draw on from our experience of dealing with the financial crisis. In particular there are five lessons which I think are every bit as relevant to the insurance sector as to banks:

First, the need for a prudential supervisor to focus on the risks that might materialise for firms in the future, not just how a firm is placed today or how successful it may have been in the past.   This is what we mean when we say the PRA takes a “forward-looking” approach to supervision. So within the insurance sector this might involve examining the longer-term effects on firms' business models and solvency positions of continued low investment returns or how general insurers are reacting to emerging risks such as the build-up of future PPO claims.

Our focus on being forward-looking means we inevitably have to make judgements about what might happen in future and the risks this might pose. This takes us outside the realms of dealing with empirical evidence and hard facts, to one in which we have to imagine different possible future states of the world. And as regulators, it is our job to be professional pessimists, focusing on tail events. No-one can predict the future, but we can consider the possible impact on firms if different issues were to materialise, and expect firms to think about how their businesses might have to respond.

Second, it is not enough to focus on static point-in-time assessments of firms' solvency positions. To do our jobs properly, we need to understand firms' businesses in a much more dynamic and interactive way than in the past. In particular, we need to understand how firms are making money; the key drivers of this and what impact future trends in the market might have on firms' future capital and cash flow generation and, ultimately on the long-term sustainability of their business model and the capital required to underpin this. As we know from the crisis, the nature of the environment that may have supported firms' business models in the past can change, and their long-term viability may depend on the extent to which they can adapt successfully to these changes. Our role is not to stand in the way of changes to market structures, but we must consider the transitional risks that these changes might generate, and what prudential risks might be posed as firms seek to adapt to the changing environment.

Third, the understanding that for some issues it is not enough to just look at the risks within individual firms and address them at an individual firm level. Instead, we need to supplement this analysis with work across the system as a whole, to identify cross-cutting issues or phenomena that may result in a build-up of system-wide risk or interconnectedness. This was clearly true of the build-up and distribution of credit risk within the banking and shadow banking sectors prior to 2007.

Fourth, the need for clarity about the objectives of prudential regulation. Regulators have long said that they operate a "non-zero failure" regime, by which they mean that the level of regulation in a market should not aim to eliminate all risk of a firm failing. That remains our stance. But the crisis has also taught us that in practice some firms could not be allowed to fail without causing an unacceptably large risk of wider disruption to customers, the real economy and/or to wider society. So as well as reforms to reduce the likelihood of future firm failures, in particular by ensuring firms hold sufficient capital, we have also given much greater emphasis to thinking through how we can ensure that where firms do fail they can do so in an orderly way, and not cause wider disruption. And within insurance, one aspect of this is a much greater focus on ensuring policyholders can have an appropriate degree of continuity of cover in the event of firm failure. Indeed, we have recently published two consultation papers which illustrate this in the particular context of general insurance – namely on capital extraction in the run-off sector, and our attitude to firms which propose to use schemes of arrangement.

And the fifth lesson is the need to have multiple reference points when assessing firms' capital positions. Simple crude measures are not sufficient in themselves, but neither are complex models. I will come back to this later in a Solvency II context.

But, rather than talk further about the PRA's approach to supervision in general terms, I thought it would be more helpful to take one of the issues that we know the market is currently grappling with to illustrate our approach in a real-life example. The issue I have chosen is one that is receiving significant attention within the London Market – namely the recent growth in the provision of alternative capital to the global reinsurance markets. It's certainly not the only example I could use – if I were speaking to a life insurance audience, for example, I could refer to some of the work we have been doing on issues such as the implications of their move into longer-term infrastructure lending or the potential implications of future interest rate scenarios for the resilience of individual business models. But I suspect this audience is more interested in our attitude towards alternative capital.

Much has been written and spoken about recently about this subject and it was a major focus of the debates at Monte Carlo. So I don't need to go over all the background or data here. Suffice to say, the recent growth in supply of alternative capital to the insurance markets seems to have been driven by some combination of three main factors – (i) the continued low interest rate environment and the impact that has had on investment returns, (ii) the appeal for institutional investors of a historically high-return asset class which also offers a low level of correlation to other investment assets and (iii) relatively low barriers to entry for firms wishing to invest in and model catastrophe risk given the availability of technology such as GPS, proprietary catastrophe risk data and models. And, alongside the focus on different alternative capital structures, we are also seeing signs that other overseas carriers who have not historically written large lines in the international property area are becoming more active in this market too.

It's important not to overstate these developments. Some of these alternative structures have been a feature of the market for almost twenty years, so it's hardly a completely new phenomenon. That said it is also clear that the volume of capital coming into the market in recent years has been more significant. It remains to be seen whether this represents a structural shift which will persist in the longer term, or whether investors' appetite will wane over time as global monetary conditions eventually normalise. In addition, investor appetite has not recently been tested by a significant insurance event, and it is always possible that some investors may choose not to reinvest further capital in the sector in future if they suffer significant losses. However, the consensus seems to be that at least some of this additional supply of capital is likely to persist, either because the market believes that relatively low investment returns on other asset classes may be with us for some time to come, but also as investors with a more long-term investment horizon – such as pension funds – seem to be increasingly attracted to the sector.

We do not regulate these alternative capital providers themselves or the appropriateness of their decisions to invest in these sectors. This is definitely an area in which investors need to satisfy themselves that they understand the risks they are taking on before investing. And whilst the investor base currently appears to be overwhelmingly professional, I know there has also been some commentary about whether these structures might eventually feed through into funds available for retail investors. Nor do we supervise the brokers who clearly exercise an important role in this market in facilitating the placement of risks between insurer and insured. These issues are matters firmly for our counterparts at the conduct regulator – the Financial Conduct Authority.

However, the PRA as the prudential supervisor for insurers operating in the UK does have a clear interest in these developments because the availability of this additional capital inevitably affects the decisions made by insurers and reinsurers on the underwriting and pricing of risk, and on the viability and sustainability of important lines of their business.

Even though some of these trends may not become clear for some time, we are already seeing some effects of these developments now. Most notably, the additional capital has impacted mid-year renewal rates for North American catastrophe reinsurance and has prompted some firms to shift the balance of their business between reinsurance and the primary markets. At the same time, we have also seen the re-emergence of some broker facilities – a traditional soft market phenomenon – generating specific challenges for the Lloyd's subscription market.

As a regulator, I want to be clear about where we see our role in relation to these developments. The fact that these changes may pose questions for some incumbent firms' existing business models does not, in itself, make a case for regulatory intervention. Indeed in general, we see potential benefits for both the insurance and banking sector of removing unnecessary barriers for firms entering or leaving the market, provided they can do so in an orderly way. The reason for our interest in the impact of these trends relates to the way in which they could impact over time on firms' business models. This isn't just an exercise in intellectual curiosity. In other instances where incumbent firms have suffered competitive pressure in particular business lines, it is not uncommon for such firms to be tempted to increase the level of risk they run to protect their market positions, or 'diversify' into other areas in which they may not have the same level of expertise. So you should expect us as the prudential regulator to be especially alert when firms' traditional business comes under pressure.

As a prudential supervisor that is consciously trying to be forward looking in its anticipation of risks, there are a number of questions for firms which we think the current capital markets trends pose, and which our supervisors are asking about and pressing firms to actively consider.

To start with - what work have firms done to think through how these trends might impact on key business lines which could impact over time on their existing business models and the implications that might have for their strategies or risk profiles? For example, could the pricing pressure in cat markets prompt reinsurers to refocus on other lines, or to less well-modelled areas of cat risk? If so, might this cause firms' business mix to become more concentrated/specialised and if that is the case, how would this affect the level of diversification assumed for business purposes and indeed capital modelling purposes?

Next - what assumptions are firms making about the lines which are likely to be relatively more or less affected by these trends? Again we must be careful not to exaggerate the impact of alternative capital. To date, the direct effects have been concentrated in the North American property cat area. And even within that line of business, we have seen differential effects with alternative capital providers seemingly preferring to operate at the higher layers, possibly leaving more room for more traditional reinsurers to operate lower down the programmes. But it is possible that over time, investor appetite might increase further down the layers of a cat programme, or broaden into other geographies or classes of business.

Then - what could these trends mean for the long-term rate of return that insurers might be able to generate on their core underwriting activity, given that new capital providers are often able to operate at a lower cost of equity than traditional insurers? How do these firms respond to reconcile the return historically demanded by equity providers, with the business need to maintain a high A rating to operate within the market and at the same time maintain underwriting and reserving discipline?

Then - to what extent might firms need to diversify by developing their own capital markets divisions or vehicles to attract and/or manage capital from other investors, and what implications does this have? Such a move could help firms preserve their strategic options, but will change the dynamics of the overall business to some extent, for example by changing the overall mix of earnings to include more fee-type income – this might be a more stable earnings stream, but might generate a lower return on equity. We will want to know how firms manage such a transition, and ensure their incentive structures are appropriately aligned with underwriting of risk.

Where insurers look to take advantage of capital provided by these structures to help them manage and mitigate their own risks, we will want to know how well they understand the terms and conditions attached to the structures, and the extent to which risk is actually transferred. We would expect firms to have a particularly good understanding of this. Some of these structures may introduce basis risk, for example, between the risks insured and the protection purchased. And some of these structures do not offer the same sort of reinstatement cover as traditional reinsurance. Where firms look to include alternative mechanisms alongside traditional reinsurance programmes, we will be interested to understand how the overall programme works in its entirety and in particular how losses might be traced through the programme.

We expect firms to analyse carefully the collateral arrangements which form part of these deals, to ensure that they are satisfied that cover will respond in all the circumstances that the insurer expects and that they understand whether there are any circumstances in which collateral may be insufficient or possibly withdrawn. And it may be that the collateral mechanisms in these structures may need to adapt further if investor appetite changes. For example, collateral arrangements may need to respond differently if investor appetite moves away from a focus on the top layers of catastrophe cover, to lower layers where they might be more exposed to attritional losses.

Where insurers delegate underwriting decisions to others, they must continue to monitor and oversee the aggregate risks to which they are exposed to an appropriate level, to understand the implications for the overall profile of the business they write – and be able to demonstrate this to us. This issue is not a new one to the market but some of the recent developments underline its importance. It is also important that all those individuals who make decisions affecting UK insurers are captured by our approved persons regime.

With margins under pressure, we will want to know the extent that firms are looking to adjust their cost base and what additional risks this might pose. For example, how these developments are affecting firms' assessments of the minimum viable size needed to compete in the market. We see some participants arguing that a rational strategic response to these developments is to seek consolidation, particularly amongst the smaller players. This might help if a firm's sole limiting factor is one of the scale needed to compete and there are synergy benefits of combining two businesses. However, firms need to be careful that there is an underlying business logic to such deals beyond cost reduction. If there are similar underlying issues with the viability of two firms' business models or financial performance, creating a larger combined business will not necessarily address these structural issues.

All of these are questions which we are asking as a micro-prudential supervisor of individual firms. But as I said earlier, recent experience with the banking sector reminds us that we also need to be alert to the wider macro picture. I want to make two points here. The first relates to the *opportunity* which alternative capital provides. As various commentators have pointed out, the global demand for insurance in the coming years from the growth of emerging economies may well outstrip the capacity of the existing traditional market to supply the capital needed, so some might say there is a big opportunity for the market if it can find ways to harness this additional capital. And in this regard, the London Market has a well deserved reputation for innovation and for being open for business in global markets, as well as in managing the inflows and outflows of capital depending on the attractiveness of the rating environment.

The second point relates to the potential build-up of system wide risk that may go unrecognised.

To some, the potential emergence of an originate/distribute business model in the field of reinsurance has unwelcome overtones of failed banking business models. To my mind, whilst there may be superficial similarities, there are important differences between the banking and insurance world. I need not rehearse at length to this audience the fundamental differences in balance sheet structures between the two sectors, the comparative lack of inter-connectedness of insurance companies, nor the fact that insurers do not engage in maturity transformation. There is also little evidence so far of the multi-layered intermediation and structuring/restructuring of exposure that became a central feature of the pre-crisis banking and shadow banking world.

Nevertheless, history teaches us not to be complacent and as supervisors we are focusing on the extent to which insurance companies are taking on leverage, by which I mean in this context some measure(s) of the level of capital held backing each unit of exposure. For example, we will be looking to assess, at a system-wide level, the extent to which these structures are enabling the system to reduce the overall level of capital backing a given level of catastrophe exposure, the extent to which line sizes are increasing, and the impact this might have on cat aggregates both in absolute and regional terms over time and the average rate on line firms are able to achieve.

In raising these questions we do not see that these issues are necessarily insurmountable barriers which create a case for regulatory intervention. Rather, I have tried to highlight the fact that the trends pose a number of natural questions for existing firms on which we will be keen to understand their views and approaches, and how your responses might change your prudential risk profile. You can expect us to continue to engage with you on these issues in the months ahead. It is in this way that the Bank is shifting towards a more forward-looking and judgement-based style of prudential supervision.

No such occasion with the insurance industry would be complete without saying where we are on Solvency II. I have stressed on a number of occasions that we are very conscious of the significant time, effort and money that insurers have spent on preparing for Solvency II implementation. We have been as frustrated as much of the industry on the continued uncertainty about the EU timetable, which has been caused by a number of outstanding policy issues. Many of these issues are more on the life side than the GI side, but they clearly affect the GI market to the extent that a failure to conclude these issues has held up the EU timetable.

Negotiations are on-going within the European bodies to conclude these outstanding issues, so I cannot give you a definitive update on timing today. But I am cautiously optimistic that a conclusion will be reached on these issues in the near future. All the relevant policymakers in Europe are working extremely hard to conclude the negotiations as quickly as possible, and in the process are addressing some genuinely difficult policy issues. From our perspective, it is important that an appropriate degree of prudence should balance the pragmatism which will be needed to arrive at a compromise. In particular we would not want to see any reduction in policyholder protection or solvency standards as a result of the implementation of Solvency II compared with the current regime, particularly during the transitional period.

Closer to home for London Market firms, we have been engaging for some time with Lloyd's and the wider London Market to assess the readiness of firms to use internal models, and we are pretty well progressed through this work. And you will be aware that we have been working hard to enable firms to make early use of their investment in Solvency II models by incorporating the output into our existing ICAS solvency regime. Again we are making good progress on this.

I mentioned at the beginning of this speech that one of the lessons of the crisis is that no single solvency measure can provide a perfect representation of firm's solvency position. Internal models are no different in this regard.

The implementation of internal models inherently rests on a great number of judgements and assumptions, both explicit and implicit. Our experience suggests that over time, if internal model performance is not appropriately monitored and models updated, these assumptions and judgements can become less appropriate leading to an overall reduction in solvency standards.

To help counter this downwards drift of model outputs over time, we plan to introduce a simple set of early warning indicators - or EWIs - independent of the output of models, which will give us another way to view a firm's capital position. We make no apologies about either the need for this, or the fact that we propose this to be a simple measure. That is the point. We are committed to introducing these indicators and we wouldn't expect firms who fall beneath them to release capital until we, and they, have reviewed the appropriateness of the modelled calibration.

And this is not just a domestic initiative – the need for these indicators is gaining increasing international recognition and support within Europe and more widely. EIOPA has recently started work on the development of internal models on-going appropriateness indicators, of which EWIs are a subset. And at a global level, the Financial Stability Board has asked the International Association of Insurance Supervisors (IAIS) to actively look at how it might set backstop capital requirements as part of the policy framework for the small number of designated Global Systemically Important Insurers or GSIIs. There is an open question about the extent to which such indicators might be used more broadly within internationally active insurance groups, and the IAIS is currently considering different options.

We are currently trialling our early warning indicators ahead of the implementation of Solvency II. We are using this period to inform our use of the indicators, to test the proposed calibration and to monitor the behaviour of the indicators over time. We are paying particular attention to the potential for pro-cyclical behaviour of the indicators. We continue to welcome industry feedback on improvements to both the indicators themselves, and their calibration during this trial period.

I hope that has given you a good sense of the overall approach the PRA is taking and demonstrated to you that the Bank of England takes insurance supervision seriously. We are involved both at an individual firm level and at a macro-prudential level which allows us to look at firms' business models and across the risks in the sector. Having the insurance supervisor as part of the central bank allows us to have a better overview of the risks affecting insurers and also allows us to feed into the broader policymaking framework.

The market changes I have discussed are important developments which inevitably raise questions for both you and us about the way the market will adapt. And while it is clear that these issues pose some challenges for firms, they equally open up other opportunities. Either way, you can expect us to be interested in the changes you may need to make and the impact that they might have.

Thank you