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Speech

Meeting the challenges of a changing world – the view from the PRA

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Thank you for inviting me to speak today. It is just over three months since the new system of financial regulation in the UK came into being. There are over 700 insurers in this country now subject to prudential supervision by the PRA and conduct supervision by the FCA (in addition, insurance brokers are entirely supervised by the FCA). Today, I want to talk about how the PRA is going about the prudential supervision of insurers. There are good reasons to argue that the insurance industry has been relatively little affected by the financial crisis in terms of instability in the industry, but of course that does not extend to arguing that the industry is unaffected by the consequences of the financial crisis, that could never be the case. So, there are very real challenges for insurers.

Why do we single out banks and insurers for prudential supervision by the PRA? The reason for locating insurance and banking in the PRA is that we have learned during the crisis that our job as prudential supervisors is to ensure that the public and users of financial services, including the corporate sector, can be assured of continuous access to the critical services on which they depend. Let me also make clear at the outset that insurance supervision matters as much to us as bank supervision. The crisis has given us more challenges with banks, but our statutory objectives make clear that our attention must be on both industries.

Many financial services may be regarded as critical by their users, but some are distinctive because it is hard for consumers to replace their provider with a substitute without unacceptable cost and loss. Insurers provide critical services to the public in terms of risk transfer and very long-lived savings contracts. This last point draws out that insurance is not a single homogenous industry – general and life insurance are very different activities – and we recognise that in our supervision. It would not be acceptable to the public for their access to risk transfer through, say home or car insurance, or professional indemnity insurance, to name but a few, to be withdrawn in a disruptive and unannounced way. In the same way, savings contracts that are long-lived and provided by life insurers, and are often an individual's primary pension provision, are critical financial services that are difficult to replace without unacceptable cost. There is therefore a common feature of banking and insurance in terms of continuity of access to critical financial services.

The PRA has the general objective of ensuring the safety and soundness of the firms under its regulation. Safety and soundness is defined in terms of the resilience of the financial system, which in itself is closely linked to the access of users to critical financial services on a continuous basis. But for insurance we have a second objective, namely the protection of policyholders.

Why do we have a second objective for insurance? For me, the reason is that continuity of insurance protection – of risk transfer and long-term savings products – requires a greater assurance that the policyholder has access to their contract – in other words, it is quite contract specific, and in some cases those contracts are long-term in nature. For banks, depositors want continuity of access to funds, but they have less need of access to the exact contract – deposits can be moved. Put another way, most of the underlying risks to banks arise from their assets, whereas for insurers they arise from liabilities and assets. So, we need somewhat different objectives for prudential supervision.

The traditional model of supervision has been quite industry specific. The FSA regime introduced in 1997 created a single authority, but within the FSA the framework of rules applied to insurance supervision was unique to the industry. It is true that in the run-up to the start of the crisis, and for some time thereafter, the FSA mingled insurance and bank supervision in terms of its operating units, but I think that did not work effectively, and the FSA and now the PRA moved to a clear distinction, with insurance supervision headed by Julian Adams. Insurance supervision is a skill of its own, and while our supervisors do move roles between insurance and banking in both directions, we want to ensure that we have groups of truly expert insurance and banking supervisors.

Recently, we have taken a further step on insurance supervision by formalising two directorates, for General and Life Insurance, reporting to Julian, and headed by Chris Moulder and Andrew Bulley respectively. Chris and Andrew bring a wealth of experience of insurance supervision and for Chris auditing. Alongside Julian, Chris and Andrew is a policy directorate headed by Paul Sharma who is, I think I can say, a true veteran of insurance supervision. And, I am delighted that Nick Prettejohn has joined the PRA Board. Nick brings extensive insurance expertise to our work as a board.

Most important of all, we have a new Governor and Chairman of the PRA Board, Mark Carney. I am delighted to be working with Mark, and he also brings his experience as Chairman of the Financial Stability Board, which is spearheading the work to create simple global capital standards for insurers as a central plank of its work on insurers which are of significance to the financial system. I will say some more on this later.

I hear occasionally the charge that the PRA and the Bank lack senior level knowledge and experience in insurance. As I hope you can tell, I don’t accept that argument.

The Bank of England has the objective of promoting financial stability by ensuring a more resilient financial system that, inter alia, is able to support the credit creation and asset allocation necessary to build and sustain economic recovery. A more resilient financial system will support that recovery, and by reforming and bringing the Bank’s monetary and financial stability objectives closer together, I can assure you that we are working very hard to use our toolkit to the best advantage. And this includes insurance supervision, where the new arrangements have already brought about a closer understanding of the role of insurers in the transmission of monetary policy, and the issues that arise in a world of sustained very low interest rates and Quantitative Easing.

A key part of the new structure of the Bank of England is the Financial Policy Committee. The FPC has the so-called macro-prudential responsibility which has at its heart the resilience of the financial system as a whole. The FPC has a crucial role both to scan the financial system for threats to that resilience, and to ensure by recommendation, or in some situations direction, to those bodies such as the PRA and FCA directly charged with institutional regulation, that mitigating actions are put in place. It is therefore quite natural that the FPC is interested to know that the PRA is conducting stress testing of insurers, and to know whether those tests are appropriate to the objectives of financial stability. Moreover, the FPC needs to question whether, even if individual firms are doing the right thing, the system as a whole is resilient. This is the essence of macro-prudential regulation. It can, and should, ask questions which transcend firm level supervision, such as whether the level of inter-connectedness of participating firms is a cause of excessive weakness in its own right.

We want the public to have confidence in the financial system, and let's face it in some areas we have a lot of hard work to do. Now, to do that, we have to build a better understanding of the new regime and what we are trying to do to achieve our statutory objectives. The old ways of doing things were surrounded by some mystique and a lot of privacy. There is a need for appropriate privacy because the firms we regulate embody important private interests, and those are crucial to a functioning market economy. Regulators do not run firms; that is not our job. We represent the public interest with objectives given to us by Parliament, for which we are accountable to Parliament. We must be, and no doubt will be, held to high standards as we seek to balance our pursuit of the public interest with a properly functioning market economy.

We have set out how we supervise insurance companies in our approach document. We are a judgement-based supervisor, based on evidence and against a framework of rules. Judgement must be forward-looking as we have to assess risks to our objectives. I know that this emphasis on judgement can ruffle feathers – it can make us seem intrusive. I want our use of judgement to be always focussed on the key risks to our objectives.

We are though conscious of the need to be proportionate in our approach and to take account of the regulatory burden we are placing on firms. In order to do so, insurers are divided into five categories of impact. Category one insurers pose the greatest risk to the PRA objectives through their size, interconnectedness, complexity or business type and category five insurers pose the least risk. Every firm has been told which category they are in and this should provide an indication of the level of supervisory interaction they can expect from the PRA. Moreover, we are not aiming to be a "no firm failure" regulator; rather, we aim to minimise adverse consequences if a firm fails.

An important part of our new supervisory approach is a focus on business model analysis. This might come across as a bit of a fad, but it isn't meant to be. Instead it is grounded in such basic questions as: where does the firm make money; are the revenue streams sustainable; how well does the firm stand up to tests of stresses on its balance sheet; does it generate cash flow to cover dividends; is the leverage of the firm sustainable; what are the risks from competition on premium income; are there conduct risks which could pose a prudential threat? These are basic questions, but in another field, if the answers to such questions had prompted action in the past by banks, history would be different.

What I have just described is judgemental supervision that must be forward-looking to the risks that may arise. This is crucial, and was not properly a part of the pre-crisis approach to supervision. Let me give a few current examples of this for insurers.

We are focused on the impact of very low interest rates staying with us for a protracted time, and when I say this I am offering no view whatsoever on the likely course of monetary policy. Likewise, we want to know that the prudential position of firms also captures the possible impact of an unexpected upward shift in the slope of the yield curve, and again I am offering no view on monetary policy.

The FPC in its most recent recommendations, from last month, has asked us, working with the FCA and other areas of the Bank, to provide an assessment to the FPC of the vulnerability of borrowers and financial institutions to sharp upward movements in long-term interest rates and credit spreads in the current low interest rate environment. There will be a report back to the FPC in September. This work will include insurers, and it will go along with the stress testing under way, which also – rightly – includes a "rates stay low for long" outlook too.

Another example of business model risk I would give comes from the impact of conduct issues. I am a very strong advocate of our new system, not least because it recognises that conduct and prudential supervision of insurers are different specialisms. My interest is in the possible prudential threats from any conduct issues. I am therefore keenly interested in Martin Wheatley's assessment of these consequences and threats.

Finally, on business models, the work that we are doing to assess risks at an individual firm level and a sector level is complementary to the work that we expect firms to be undertaking. We believe that it is important that senior management of all insurers, big and small, take responsibility for understanding and mitigating the risks in their business and be able to demonstrate to us that they are doing this. I realise that the Parliamentary Commission chaired by Andrew Tyrie was about banks and their record. But it raised an important theme that has to be considered more widely, namely that our approach to supervision of firms ensures that senior individuals are properly accountable and thus incentivised. The record of the banking crisis indicates that this senior accountability was not effective in banks that failed. Often, the simplest points are the most powerful, and complexity is a poor guide. Andrew Tyrie and his colleagues have done a great service by making a simple but powerful point – as supervisors we must incentivise and hold to account those at the top, and not seek to do the job of management by influencing excessively further down.

I could not end without talking about Europe and Solvency II and wider global developments in insurance regulation. A month or two ago I ruffled a few feathers by criticising the cost and time taken preparing for a European Directive that isn't finalised. I have no regrets, because as public officials we have to speak honestly and transparently. I was making a point on behalf of firms because I feel strongly that you have been put to too much expense and time spent by management and boards. But, in saying this, I should be clear that the PRA has not withdrawn from involvement in Solvency II, far from it.

As Tidjane said this morning, the insurance industry and its regulators cannot operate in a vacuum. This is why we continue to invest a large amount of our time engaging with our counterparts in Europe as well as with the European Supervisory Authorities, the ESAs. We liaise closely with EIOPA, the European Insurance and Occupational Pensions Authority. Julian Adams sits on the EIOPA Board of Supervisors and Management Board and this gives us an opportunity to participate at a European level.

A few weeks ago, EIOPA reported on the critical issue of the long-term guarantees assessment and closed its consultation on proposals for preparatory guidelines. We now have acceptance that the classic matching adjustment is a prudent measure, which is hugely important for the UK life insurance industry. We know that many of you still have concerns around the restrictions built into the classic matching adjustment, particularly around the assets that can be used and the effect of possible downgrades in portfolios which are held for the long-term. We will continue to push for a prudent solution that will meet the needs of UK insurers and allows for the continued provision of annuities to policyholders. In doing so, we recognise that some restrictions are needed for the classic matching adjustment to be an effective and prudent measure.

The importance of the EIOPA recommendations and their acceptance by the European Commission should not be underestimated. We have come a long way from the suggestion last year that a matching adjustment would not be part of the directive at all. The focus now has to be on making sure that we end up with an operable system which doesn't introduce procycliality.

The negotiations on the long-term guarantees assessment and other outstanding areas of Solvency II, such as the third country equivalence regime, are expected to continue over the summer, with a conclusion expected in the autumn. At the same time, EIOPA will be finalising the preparatory guidelines. We are hopeful that there will be final agreement by the end of the year, but we cannot make any promises. It is then critical that we have a clear and credible timeline for implementation so that firms can ensure that they will be compliant when the new rules are introduced. The official implementation date for Solvency II of 1 January 2014 is clearly unrealistic, and late last year we set a new planning horizon of 31 December 2015 for us and for the UK industry. During that period, we are allowing firms to put to use the significant investment in Solvency II internal models to meet the current regulatory requirements under the Individual Capital Adequacy Standards (ICAS) – referred to as 'ICAS plus'. We believe that the UK's current prudential framework for insurers is a good basis for a smooth transition to the new regime under Solvency II.

We are forward looking and judgement based and this will be the way that we approach Solvency II implementation. We believe that the Solvency II Own Risk and Solvency Assessment, the ORSA, will help give us a better understanding of an insurer's business. It is therefore logical for us to make early adjustments to our existing regime to incorporate the ORSA under ICAS plus. This will mean that UK insurers are better prepared for the introduction of Solvency II.

To monitor the on-going appropriateness of internal models, we have introduced the use of early warning indicators based on metrics that are independent of the model calculations. In cases where the indicator's threshold is breached it will trigger an immediate supervisory response; a capital add-on is, in all but exceptional cases, likely to be the most effective way to restore compliance with the Solvency II calibration requirement (i.e. 99.5% over a one-year period). Importantly, we expect that where internal models are used for regulatory capital purposes, they should contribute to prudent risk management and measurement. And they should be updated regularly in order to reflect the insurer's risk profile and not just to ensure compliance with the letter of our requirements.

My view is that we still have a good way to go to make the Solvency II regime manageable in its use and implementation. I have to say that I think the early design did not come up to the mark in this respect. Our use of early warning indicators is precisely because we have learned the hard way with banks that excessive reliance on modelled capital requirements lends itself to cutting capital levels too low. In banking supervision we are playing catch-up by working to raise capital levels from ones that were too low. We can avoid that outcome for insurance by acting now to introduce sensible backstops.

Turning finally to the broader global environment, the financial crisis has led to a great deal of debate around whether insurers contribute to systemic risk in the financial system. The IAIS has been considering whether there are insurers which can be classed as Globally Systemically Important. In doing so, it has developed a methodology to identify insurers whose distress or disorderly failure, because of their size, interconnectedness, and the nature of their activities would cause significant disruption to the global financial system and economic activity. This work is at an advanced stage and we should hear shortly from the Financial Stability Board on a list of global systemically important insurers. The implications for being labelled as a GSII will then need to be considered. The PRA recognises that insurers are not systemic in the same way as banks. However, we strongly believe that failure of some insurers could have the potential to pose risks to the stability of the financial system or to directly disrupt economic activity through the availability of risk transfer.

A single insurer failing could have far-reaching consequences, with the ripple effect stretching beyond simply the impact on policyholders of the insurer. Where an insurer has a large market share of a particular type of insurance, the failure of the insurer has the potential to have a wider impact, especially if it is difficult for policyholders to get replacement cover elsewhere.

The IAIS/FSB work on GSIIs is obviously of major significance, but it needs to be viewed alongside the work to identify and agree a simple backstop capital regime, perhaps of the early warning indicator type, on a global basis. The IAIS and FSB will take this forward. For me, it is critical because if we get this right, we can deal more effectively with issues of cross-border recognition, and more generally seek to simplify the capital regime. The prize is therefore big, and firms need to be involved with us in the work.

In conclusion, there is a lot going on in insurance regulation. The IAIS work is important, because it means that Solvency II isn't the be all and end all of insurance regulation. We have a lot to do on these fronts, but the work is crucial, and it will require your involvement.

Thank you