BANK OF ENGLAND

Speech

Policy priorities for prudential regulation and supervision

Speech given by

Chris Moulder, Director of General Insurance, Bank of England

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Thank you for the invitation to speak today.

Although my speech is titled ‘policy priorities for prudential regulation and supervision’, I think these priorities fit neatly with the overarching themes for the day of regulation, competition and innovation.

On regulation, it would be remiss not to touch briefly on Solvency II and how this will shape our future supervisory approach, in particular with the additional data we will receive.

With regards to competition I plan to cover some of the risks and consequences of soft markets for insurers and reinsurers and areas of supervisory interest for the PRA.

You might not expect the regulator to be a natural innovator but I intend to use the developing approach to Periodic Payment Orders to illustrate the creative thinking needed on the part of both firms and regulators to truly anticipate evolving risks and the long term implications these may have for insurers.

Solvency II

On the subject of Solvency II, I am pleased to say that the work for day one is largely complete and Solvency II becomes ‘business as usual’ in 29 days’ time. What had seemed remote for so long is now less than a month away.

Though there may be a temptation to breathe a great sigh of relief and move on to other things, we expect a similar number of internal model applications over the next two years. Though we have learned from the first tranche this still represents a material body of work for firms and supervisors.

There will inevitably be work for us to do to embed our supervisory approach under the new regime. Part of this approach will be to monitor the capital position of firms and, with policyholder protection in mind, guard against a downwards drift in capital requirements where the profile of the firm is unchanged.

Solvency II will provide the PRA with much richer and more-timely data to carry out this sort of analysis. A key priority for us over the last several months has been to build the tools to extract as much value as possible from this additional data. I expect it to be used by supervisors to further enhance and enrich the quality of conversations with regulated firms and to facilitate our forward-looking and judgement-based approach to supervision.

On this point specifically, I believe that retaining this ‘future focus’ is the key to successful supervision and meaningful interaction with firms. I see it as highly complementary to the Solvency II regime. We will continue to supplement this analysis with firms’ management information, meetings with key individuals at firms and their advisors along with reviewing regular management information and seeking external assurance reviews where appropriate.

While we have sought to keep up the tempo of business as usual supervision during the implementation of Solvency II, it has naturally taken priority, particularly through the last phase of IMAP.

With Solvency II under our belts I expect to see additional attention given to some of the broader risks we see in the market. Along with those that I will cover in more detail today we see the maturity of risk management, IT transformation risk, governance, cyber risk and alternative capital structures as just some of a number of evolving risks in firms and for the wider sector.

When we add market uncertainty from the referendum on EU membership, a low yield environment and cross-sector risk transfers, it is clear there are a number of themes to focus the minds of boards and regulators in the coming years.

Competition

Under the heading of competition I plan to focus on some of the consequences of soft market conditions, in particular for underwriting, reserving, reinsurance and capital.

With persistently low interest rates and another year without significant natural catastrophes, competitive pressures in many sectors continue. In several lines premium rates are continuing to fall and extended terms and conditions are being offered and accepted. In addition, there is an abundance of capacity, which in part is driven by capital market structures that allow investors increasingly easy access to specific insurable risks.

In the current environment some insurers may be tempted to increase their reserve releases, rely on top line growth or purchase specific forms of reinsurance to meet business plan and market expectations of profitability.

As regulator, the PRA has responsibility to ensure firms continue to have an adequate level of resilience to meet current and future policyholder obligations. We expect boards to challenge where a firm’s strategy either threatens this objective, or where the strategy compromises the ability for adequate oversight.

Underwriting

Underwriting, and specifically underwriting controls are the first line of defence in identifying the extent, and the potential impact of continuing soft market conditions. In the build up to Solvency II, the PRA has had a broad focus on capital and reserving. We will begin to prioritise work on underwriting and pricing governance.

We will be interested to understand the extent to which the board receives adequate information to be able to understand pricing trends; for instance, consideration of whether the information received is adequate to assess risk-adjusted rate changes, rate adequacy, claims inflation as well as changes in terms & conditions. As rates continue to deteriorate we will also seek to understand how boards ensure effective management of the conflict between business plan objectives, the firm's pricing practice and setting of reserves.

We will also look for strong governance around expansion into new products and markets, as well as transparency around the ability to manage and monitor aggregate exposure. This is especially relevant where insurers are expanding policy coverage to more than one line of business, offering extended coverage periods, or for those insurers providing covers in new areas such as cyber (whether explicit or implicit through existing products).

Reserving

In terms of reserving, we expect firms to be able to demonstrate strong governance around the reserve-setting process. As part of this they should be able to demonstrate independent challenge of key issues, material uncertainties and significant assumptions as well as the rationale for the choice of booked reserves. We will seek to understand how firms take account of underwriting, reserving and economic cycles when setting reserves. More holistically, supervisors will want to see clear feedback loops between underwriting, claims and reserving and management information that enables firms to monitor reserve strength that enables the board to take appropriate and timely action, if required. Larger firms can expect the PRA to continue to follow a cycle of external assurance reviews of reserves.

Reinsurance

The PRA recognises that reinsurance is an integral part of risk management for most insurers; assisting firms with the management of uncertainty, volatility and ultimately their capital requirements.

In assessing a firm's reinsurance arrangements supervisors will want assurance that boards understand the risk transfer taking place and the extent to which the economic impact is adequately recognised in business planning, reserving and capital-setting. They will also look for a wider appreciation of the risks associated with reinsurance structures, as the PRA set out in recent Solvency II Directors' updates.

We are aware that more complex reinsurance arrangements appear to be re-emerging in the market. For these, as for all reinsurance contracts, we expect appropriate treatment, both with respect to preparing regulatory statements, and with regards to capital requirements. We expect Boards to ensure reductions in capital requirements properly reflect the real extent of risk transfer from the reinsurance arrangement.

Capital

As the market for certain lines of business continues to deteriorate we expect general insurers and their boards to consider whether the assessment of risk continues to be valid. This is particularly important for underwriting risk, which includes risks on policies yet to be written, and on less favourable terms and conditions than in the past. Two examples that highlight the issue are as follows:

1. As the market continues to soften, the difference between the projected business plan and the expected underwriting results will tend to increase. Monitoring, ensuring transparency and providing a clear bridging analysis around these differences can assist boards in understanding the likelihood of achieving plan, as well as potentially highlighting additional risks; and

2. Soft market conditions reduce the level of premium as a percentage of exposure. All else being equal we expect that as premium rates reduce, the level of capital relative to exposure should increase.

We are also aware that a number of general insurers are increasing their risk appetite resulting in increased risk retentions, both at an account and line of business level. While we acknowledge that this in part reflects increased geographic, product and industry diversification, we expect boards to be given sufficient information to satisfy themselves that the assessment of risk remains robust. In particular, we expect boards to understand and challenge the extent to which changes in limits, diversification and the soft market contribute to changes in their firm's assessment of capital requirements.

PPOs / Innovation

I am going to finish with some thoughts on PPOs. The PRA has had to push hard to encourage firms to grapple with the range of possible reserving and capital outcomes associated with PPOs. These long term annuity liabilities introduce new risks to the General Insurance market that firms have not had to manage in the past. For me, they exemplify how the traditional world of insurance does change over time and the importance of a forward-looking regulatory regime.

We can define a PPO as a deferred, wage inflation linked, guaranteed, impaired life annuity.
They are awarded by Court as part of a compensation package to severely injured people following road traffic injuries. They are the element of the compensation package that is designed to cover the costs of the claimants future care needs.

To give you a sense of scale and perspective, the average award is a lump sum of some £2 million, plus a PPO that starts at about £100,000 per annum and increases in line with a wage index and is payable for the rest of their life. The average PPO has an economic value of some £4 to £5 million.
It is notable that the economic value of a PPO settlement is typically more than 50% higher than one settled in cash up front. The difference in these two approaches may have fairness implications and insurers cannot assume that the current propensity for PPO settlements will remain at around 30%. We can see that even a small change to this one assumption may have critical implications for insurer balance sheets.

The average PPO annuitant is expected to live for another 40 years, but PPOs have been awarded to children who could live for another 80 years. For the individuals concerned these have material value, and it matters to them that the insurer continues to pay them the money for the rest of their lives.

PPO uncertainty

You might ask why the PRA has such an interest in PPOs. We are interested because they are so uncertain, and because of the potential consequences arising should any of these uncertainties crystallise. Unlike many other risks on insurers' books, there is a real possibility that the risks associated with PPOs are correlated across the market, meaning that if something went wrong then there might be an issue across the sector rather than in isolated firms.

The total amount of reserves for PPOs at an industry level will only grow. Estimates suggest that current reserves for PPOs might be 10 to 20% of the total motor insurance reserves. As these annuities cover extended periods, it is inevitable that their share of reserves will grow very significantly.

Firms also face the challenge of deriving appropriate inflation assumptions. Most PPOs inflate with an earnings index, typically ASHE. In fact this presents two challenges – one is investing to match an earnings index. The other is that opinions differ on what the correct long term assumption is for how care worker earnings will inflate compared to underlying RPI. No bank is yet selling ASHE derivatives.

Another key factor adding to reserving uncertainty is how long the claimant will live. Life insurers have large portfolios of similar risks and lots of data. The law of large numbers means that, on average, their estimates are likely to be more reliable, but even for them impaired lines present a greater challenge.

For a PPO, the data set is small and even the experts cannot decide on their 'best estimate' prognosis, let alone at more extreme confidence levels. As a whole, people receiving PPOs are currently assumed to live for around 10 or 12 years less than they would have done, had they not been injured. Because PPOs are so new, it will take some years before we know what the true picture is.

The reserves that insurers have to hold are based upon what is expected to happen. The capital they have to hold is based upon views of what could happen. Once we start asking questions about what could happen to mortality over such a long period it is clear that the range of uncertainty is much wider than general insurers might be used to thinking about.

This increased uncertainty translates directly into a need to hold more capital which we would expect to drive up premiums for these insurers. Given how wide the range of uncertainty is, it is possible to construct a scenario where for some players it becomes uneconomic to continue writing motor business. Forcing insurers to change their business models.

PPO reinsurance

Another key challenge for an insurer exposed to PPO risk is in how reinsurance operates. The first challenge faced is whether the reinsurance will actually respond in the first place. For the average size of PPO, if reinsurance starts at £3million, then the initial settlement might not breach the deductible and there is a risk that the future annual payments might not escalate fast enough to ever catch the inflating deductible, leaving the insurer with a bigger net claim than they expected at the outset.

The second is where, even when the reinsurance responds, this leaves the insurer having to consider whether the reinsurer will be able to pay the reinsurance for the term of the PPO. Previously they will have been thinking about credit risk over a much shorter period of time.

To manage their own exposure to PPO risk, many reinsurers are now offering varieties of excess of loss cover with capitalisation clauses that specify exactly what they will pay when a claim settles with a PPO. This gives them a route to achieve certainty and to avoid the on-going, and uncertain nature of the underlying annual PPO payment. Conversely this increases uncertainty for the primary motor insurer.

Conclusions

To conclude, when you pile propensity, inflation, mortality and reinsurance uncertainties on top of one another we end up with a very wide range of possible outcomes. PPOs are already changing the risk profile and balance sheets of motor insurers significantly. This will have consequences for the industry. It is why we at the PRA are so interested in them and why we expect the industry to think very carefully about the long term impact from them.

To close, I hope this talk has given you a feel for some of the PRA’s current priorities. We expect firms to engage proactively with the broad range of risks I have mentioned today. For me this means that firms need robust governance and monitoring arrangements to give boards the information to make the key judgements necessary to manage risk. On our side of the fence supervisors will be looking for evidence that firms think carefully about the potential long term evolution of some of these risks and reflect that thinking in ORSAs, stress tests and ultimately pricing, reserving and capital management.

Thank you for the opportunity to speak today. I am happy to take questions on anything I have covered or indeed on the subject of prudential regulation more widely.