BANK OF ENGLAND

Speech

Current regulatory issues and PRA expectations in current market conditions

Speech given by

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Thank you for the invitation to speak today.

We are three months into 2016 and Solvency II has ‘gone live’. We are now operating under a new prudential regulatory regime, in what may be described as the biggest change to EU insurance supervision in a generation.

I would like to take the opportunity to acknowledge that a significant amount of Board time, energy and effort has been devoted to the transition to Solvency II. Towards the end of last year, the Bank of England approved 19 internal models for the insurance sector as well as 4 as part of wider group applications. This was a significant milestone for the industry and one of which we can all be proud. Solvency II, however, was always about more than ‘just the model’ and we have now commenced the Senior Insurance Managers Regime (or “SIMR”) intended to be a proportionate and efficient implementation of the ‘fit & proper requirements’ of Solvency II. And shortly, we are expecting the first tranche of the Day 1 Solvency II data submissions. Alongside this, we have also seen the introduction of a new, dynamic risk management ‘centre piece’, designed to capture key risk and solvency considerations – I refer, of course, to the ORSA. And these are just some of the myriad developments the industry has had to embrace.

So, whilst it might appear that much of the work of transitioning to the new regime has been completed, in reality, we have just stepped over the starting line and there is still much to do across the industry to embed the various changes in business as usual practices. For example, the Solvency II reporting and market disclosure requirements are being phased in over the next couple of years, and the embedding of governance and risk management requirements, and the cementing of various senior insurance management functions (SIMF), will take time as we learn to live with a new regulatory regime.

Obviously, it remains to be seen how firms will operate as the Solvency II framework develops over the next couple of years and we will be proportionate in our expectations during this transition period, continuing to provide firms with feedback when appropriate. We would, however, expect firms to listen to, and act on, that feedback and at all times remain prudent in their management of the business.

From the PRA’s perspective, we also have much to do in order to embed the new framework in “business as usual” supervision. Today, I want to draw out some of the more recent Solvency II developments and how these may impact on our supervision of firms. I also, however, want to take the opportunity to stress that, amongst all the change created by the implementation of a new regulatory framework, our fundamental objectives as a regulator and our approach to supervision remain unaltered. As I set out in my letter to CEOs last December, we must not lose sight of the basic principles of a sustainable insurance sector, which should form the foundations of our collective expectations as both regulators and directors; namely disciplined underwriting, appropriate reserve setting and robust risk & capital management.

Let me first elaborate a little more on some of the most recent developments under the new regime.

Current regulatory issues

SII – IMAP lessons learnt and model change

As I mentioned, the end of last year saw the approval of the first internal models. As we reflect on 'lessons learned', we will look to refine processes where necessary and be ready for the next tranche of internal model approvals.

One area that we are currently considering is 'model change'. Firms with approved models may be contemplating various model changes. While we recognise the need to refine models, to ensure they continue to reflect a firm's risk profile, we need to balance this with the practicalities of reviewing and authorising model changes. More importantly, however, we are cognisant of 'model drift' where, by focusing on areas where the model is deemed 'conservative' (rather than on areas where capital might be considered less adequate), firms' capital requirements trend inappropriately downwards over time.

By way of example, if your firm's capital modelling team comes up with five recommendations for model changes, three of which would reduce the firm's capital requirement while two would increase it, how does the firm decide on which model changes take priority? More to the point, will there be a temptation to reduce capital requirements through selective model changes, particularly as pressure builds to deliver on return on equity targets?

For this reason, we expect firms to have a robust process to identify, collate and manage all sources of potential model changes and the Board to be well sighted on the governance framework covering the internal process for identifying, approving and implementing model changes. At all times, we expect the Board to ensure that capital requirements remain commensurate with the firm's risk profile during the on-going evolution of the internal model.

This is an area that we will be monitoring and I would encourage you, as Board members, to do the same.

SII – ORSA

I would also like to touch on the ORSA process, given this is a new requirement under the Solvency II framework.

By now, most firms will have had two years' of experience of producing ORSAs. Therefore, the PRA expects that firms will be familiar with the concept of assessing risks on a forward-looking basis, covering such things as business plans, strategy threats and financial projections and reflecting the specific risk profile and governance framework of your firm.

Based on the not insignificant number of ORSA reports we have reviewed to date (including a second or third iterations for some firms), our overall assessment is that the quality of ORSAs is improving. Given that the ORSA requirements are relatively new, we apply a proportionate approach and have some tolerance for reports that require improvement. We do, however, expect firms to learn and take our feedback on board and ultimately have an ORSA process that is well embedded in the business, producing a living document that is useful to, and therefore used by, the Board.

An ORSA document that is done well should form the 'centre piece' of a firm's own risk and solvency assessment, shining a penetrating light onto a business's current and prospective risks. We should, therefore be aligned as non-executive directors and regulators in wanting to see the on-going development and improvement of these important documents.

And that means that a good ORSA has to work for you, its target audience. We have seen reports that are too long to be readily digestible and others that are too short, missing out key areas of information. I think firms need to strike the right balance for the ORSA to be effective, and it needs to highlight the key messages and metrics, clearly sign-posting supporting documentation. I would strongly encourage you to ensure that the information contained within the ORSA is presented in a format that you, as non-executive directors can engage with and use.

SII - Senior Insurance Managers Regime (SIMR) and Corporate Governance

Another 'change' which you'll be aware of is the introduction of the Senior Insurance Managers Regime.

The PRA recognises that Non-Executive Directors in scope of SIMR do not manage a firm's business in the same way as executives and therefore the responsibilities for which they are accountable are more limited.

Accordingly, Non-Executive Directors under SIMR are neither required nor expected to assume executive responsibilities but are expected to take on certain responsibilities, all of which are non-executive in nature; these are set out in the Supervisory Statement on Strengthening Individual Accountability in Insurance. From my perspective, I consider SIMR to be positive as it clarifies and formalises the individual responsibilities which 'in scope' Non-Executive Directors already have in practice.

Whilst on the subject of governance, I would also like to take the opportunity to draw your attention to the Supervisory Statement, released at the end of March, on "Corporate Governance – Board Responsibilities", which has not changed materially from the consultation paper (CP 18/15) that was issued in May last year. This statement underscores the collective responsibilities shared by board members and it therefore complements the individual accountabilities introduced through SIMR. Whilst much of the statement reflects existing good practice, I wish to emphasise PRA's expectation on the independent governance of significant subsidiaries.

The PRA recognises the fiduciary duties of directors of subsidiaries, including the duty to promote the success of the company for the benefit of its shareholders. However, subsidiary boards must be capable of acting in the best interests and safeguarding the safety and soundness of the firm for which they are responsible. Therefore, the PRA considers that the principles of good governance should also apply to significant subsidiaries, and this includes the independence of the Chairman; and having a substantial and effective independent presence across the board. Striking an overall independent balance will help to ensure that the subsidiary board is alert to the potential for conflicts of interest and be able to take decisions independently where required to meet its own legal and governance responsibilities or in the best interests of the subsidiary. If you have not yet had a chance to review the Supervisory Statement, I would recommend it as a worthwhile read as our attention will turn to firms that are outliers with these basic principles.

Soft market conditions in the UK GI Sector continues

I want, however, to return to my central theme. Whilst we have all been working hard to ensure a successful transition over to Solvency II, we find ourselves continuing to operate in very tough market conditions. As Directors and regulators, it is import that we are aligned in our challenge of executive management on the risks created by current trading conditions.

Soft market

The soft rating environment in the London market I highlighted in my letter last year is, absent of any significant market changing event, likely to continue in much the same vein in 2016. We see premium rates in several lines continue to fall and, at the same time, extended terms and conditions are being accepted. Underwriting results have been helped in the last year by the continued absence of significant natural catastrophe losses, and prior year reserve releases, which have somewhat insulated many firms' results from the full impact of current trading conditions.

Despite these features, many business plans will still contain some element of growth for 2016. I want to be quite clear that we don't consider this, in itself, to be problematic. It is, however, important that firms that are looking to expand in current market conditions do so in a responsible and sustainable manner and are transparent with Boards about how they intend to attract business. I mention this because, as you might expect, we talk to lots of firms about market rates – and it's always someone else who's driving prices down! Again, I want to be clear that the PRA is not a pricing regulator; but you should expect us to be interested in the apparent disconnect between individual supervisory discussions with firms and observed collective market behaviour.

It is in this context that the Dear CEO letter was sent to the market late last year. The letter articulates the PRA's expectations in relation to underwriting; reserving, reinsurance and capital requirements in light of current market conditions. With apologies for those who have seen a copy of the letter, I thought it would be helpful to briefly recap the key points under each of these headings, before spending more time on our expectations of board engagement in these areas. I make these comments, not to tell you how to do your job, but because I believe these are areas where our expectations as regulators and directors should be fully aligned.

Underwriting

Turning first to underwriting… Continued soft market conditions make underwriting controls of paramount importance. In the current environment, we expect Boards to be relentlessly inquisitive in understanding and challenging the effectiveness of underwriting controls, pricing trends, exposure changes and rate adequacy in order to make informed decisions, and provide meaningful challenge, to the business.

Fundamentally, the Board should seek evidence that underwriters are maintaining appropriate discipline. To the extent that the business objectives of growth, profitability and adequate pricing can be conflicting, the Board should ensure this is effectively managed. This includes oversight of the firm's remuneration system, with particular regard as to how this could incentivise inappropriate behaviours.

The Board should also ensure that it is provided with adequate information to gauge pricing trends; for example, risk adjusted rate changes, and rate adequacy relative to technical price or benchmark. We would expect the Board be provided with timely, accurate and complete management information that tells the full story including the limitations, if any, of the current pricing approach (recognising, for example, that 'technical price' means different things to different people). These are just some of the key tools to allow you to make informed decisions and challenge on the appropriateness of the business strategy and business plans.

As part of this underwriting oversight, we would expect Boards to want to satisfy themselves that appropriate governance & controls exist around expansion into new products and markets to ensure risk selection and aggregation is appropriately managed and monitored. For example, we would expect the Board to consider management information that reports and tracks exposure accumulation by geography, product or industry sector. Where exposures do not readily lend themselves to modelling, we would expect firms to utilise an appropriate, common sense approach to aggregate management, informed by appropriate stress and scenario testing.

The Board also needs to be satisfied that the management information it receives adequately explains how "risk" is measured. Such oversight is important where policy coverage is being expanded, by for example extended coverage periods, broader terms and conditions or new exposures such as cyber, which invariably results in higher risk exposure for the firm and may be difficult to measure using standard metrics.

Accordingly, we expect the Board to understand the firm's pricing capabilities and key judgements and limitations of any rate analysis as well as being clear on the firm's approach to monitoring and managing its exposures, particularly as firms look for new revenue streams. As I previously mentioned, while the PRA is not a pricing regulator, we are alive to the implications that mispricing has on prudential risk, such as reserving adequacy, and the long-term viability and sustainability of firms' business models.

Reserving

We continue to see the market releasing prior year reserves. Again, I want to be quite clear that this is not problematic in itself as long as it is driven by genuine reserve redundancy and not a short-term temptation to improve current year results. I would emphasise that a robust approach to the setting of reserves and appropriate and adequate oversight of the reserving process is paramount in this current environment. As both regulators and Non-Executive Directors, I am sure that a common set of questions come to mind when we see a clear trend of reserving releases over time. How sustainable is this trend? What is driving the reserve releases? How do trends in prior year reserve movements tie back to a firm's reserving philosophy? To this end, we expect Boards to demonstrate independent challenge of key issues, material uncertainties and significant assumptions in the reserves and the rationale for their choice of booked reserves

The Board should also expect clear feedback loops between underwriting, claims and reserving supported by appropriate MI to allow for the regular monitoring of, and timely intervention in, key trends. I would draw this point to a close by noting that reserving will be an area of continued supervisory focus and our core expectation, that firms set adequate technical provisions, remains unaltered.

Reinsurance

In my letter, I also highlighted that we are aware of suggestions that more complex reinsurance arrangements are starting to re-emerge in the market. Now, I fully appreciate that reinsurance is an integral part of most firms' risk management frameworks and can be a highly effective, and efficient, means of reducing volatility. However the PRA has, and will continue to, challenge firms to demonstrate that reductions in capital requirements that arise from these arrangements are commensurate with real risk transfer taking place. We expect the Board to ensure that the economic impact of the reinsurance transaction is appropriately reflected in business plans, capital setting and reserving; and to be alive to the wider risks to which reinsurance placements can give rise. This includes ensuring the total risk and uncertainty over the claims run off has been captured in your risk management system and considered within your ORSA.

I would also highlight another risk, which might be categorised as over-reliance on models in the purchase of reinsurance. Anecdotally, we hear that there may be an increasing reliance on models to inform the purchase of reinsurance up to the 1 in 200 point. While this may be efficient from a regulatory capital perspective, I would caution you to challenge the uncertainty that surrounds the estimation of the 1 in 200 point and ensure that you understand the 'noise' either side of it.

Capital

Finally, when I wrote to CEOs in December, I highlighted that soft market conditions can have a material impact on a firm's risk profile and, consequently, its assessment of its capital requirement. We note that a number of general insurers are increasing risk appetite through increased retention, and there remains the possibility of widening terms and conditions as part of a prolonged soft market. We expect the Board to receive adequate management information in order to understand how the firm's risk profile has changed in this context. Is exposure still within risk appetite? How does the capital requirement respond to this change so that it appropriately reflects the firm's risk exposure? We expect Boards to ensure that firms assessment of risk and capital requirements remain valid in this very difficult trading environment.

Summary

In summary, given current market conditions, we expect Non-Executive Directors to pose tough questions to executive management, based on robust MI that explains what is really happening to the business; to the firm's risk profile; to its underwriting and reserving controls, its capital requirement and what, if any, innovation the firm is taking in reinsurance or new product propositions. I would caution that this is not an exhaustive list but some of the fundamental elements on which I am sure you are already seeking assurance. As I said earlier, there is a need, in difficult market conditions, to reflect on core 'market' values, and self-discipline, and to misquote John Major's 1993 speech, not so much get 'back to basics' but ensure we don't lose sight of them.

Thank you for the opportunity to speak today. James and I are happy to take questions on anything I have covered today or general insurance regulatory matters more broadly.