

Policy Statement | PS10/18

Financial management and planning by insurers

May 2018



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback to responses to Consultation Paper 23/17 'Financial management and planning by insurers' (CP23/17),¹ and the final Supervisory Statement (SS) 4/18 'Financial management and planning by insurers' (Appendix).

1.2 This PS is relevant to all UK insurance firms and groups in scope of the Solvency II Directive, and to the Society of Lloyd's and managing agents (collectively referred to as 'insurers').

Background

1.3 CP23/17 proposed a draft SS that set out the PRA's expectations for financial management and planning by insurers. These proposals included a framework for the:

- development and maintenance of a risk appetite statement by an insurer;
- application of this risk appetite to an insurer's business and financial plans, and
- assessment of the suitability and sustainability of capital distribution plans in the context of this risk appetite.

1.4 As explained in 'The PRA's approach to insurance supervision'² the PRA expects to see proper board scrutiny and challenge of the ongoing financial management of the insurer, including the sustainability of its capital management and dividend policies, in the context of its risk appetite.

1.5 In CP23/17, the PRA proposed confirmation that it no longer normally expects insurers (other than those insurers in run-off) to ask for the PRA's non-objection to dividends, provided the insurer is within risk appetite; the proposed dividend leaves its capital position within risk appetite, and likely to remain so; and the insurer's Solvency Capital Requirement (SCR) coverage ratio is above 100%.

Summary of responses

1.6 The PRA received seven responses to CP23/17. These responses generally welcomed the clarity the PRA expressed regarding the importance of a robust risk appetite framework in the management and monitoring of key business activities, and agreed that many of the proposals set out in the proposed SS were in line with the current financial planning and management of firms, and would reinforce current good practices. They also supported the general principle that the PRA should issue an SS on financial management and planning by insurers.

1.7 One respondent said that being explicit about the factors that should be considered in setting risk appetite, and also the role of the risk appetite in the business planning process, can be expected to increase consistency across the industry and, more importantly, provide boards with the information needed to exercise effective oversight and governance.

1.8 Several respondents referred to the need for an appropriate balance between the risk appetite statement being sufficiently stable to provide the relevant governance bodies with confidence, and being sufficiently dynamic so that it remains relevant in developing conditions.

1 November 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/financial-management-and-planning-by-insurers.

2 www.bankofengland.co.uk/prudential-regulation/supervision.

1.9 Respondents noted that management actions taken in actual stress situations might differ from those developed from hypothetical scenarios.

1.10 Respondents welcomed the PRA formally publicising that it no longer requires pre-approval of dividends, though one respondent asked the PRA to look again at how this change in approach has been implemented in practice.

1.11 One respondent asked the PRA to apply the relaxation of its non-objection policy for insurer firm dividends also to the return of premium by a mutual.

1.12 There were also a number of specific comments on the proposed text of the SS, which are set out in Chapter 2 below, alongside the PRA's feedback to these responses.

Changes to draft policy

1.13 Following consideration of respondents' comments to CP23/17, the PRA has made several changes to the final SS, including:

- enabling more proportionality to be applied by insurers in meeting the expectations in the SS;
- clarifying the reference to 'reasonably foreseeable market conditions' in paragraph 2.3 of the SS;
- including some specific wording to explain how the expectations in the SS may be applied by Lloyd's and managing agents;
- noting that most insurers have a policy whereby they review their risk appetite each year in the context of their risk profile, or following some major external event;
- a paragraph on consistency of an insurer's risk appetite with its external communications;
- clarifying that deviations from an insurer's business plans that are not within risk appetite should result in appropriately timed actions;
- noting that management actions, and decisions on capital distributions (including dividends), that are taken in actual stress situations, might differ from those developed from hypothetical scenarios;
- relating the use of trigger points for planned management actions specifically to the implementation of any management actions that insurers take into account in the calculation of their technical provisions or the SCR; and
- clarifying that the SS would apply also to mutual firms in respect of a return of premiums to their members.

Details of the above changes are set out in Chapter 2. The changes to the draft policy enhance the clarity and proportionality of the relevant expectations, and will therefore lessen the burden on firms relative to the original proposals in CP23/17.

1.14 The clarification of the applicability of this SS to mutual protection and indemnity insurers (P&I Clubs) is consistent with the PRA's policy objective to take appropriate account of different corporate structures, and in particular firms with mutual status. The PRA considers

that the impact on mutuals of the other changes to the text of the SS will be no different from the impact on other PRA-authorized firms.

1.15 The final SS is compatible with the PRA's secondary objective of facilitating effective competition, as it will help to ensure that insurers operate under comparable standards of financial and risk management, which have regard to the need to maintain an adequate financial position, and will not materially increase barriers to entry or exit for responsible insurers.

Implementation

1.16 SS4/18 will take effect on the day of publication.

2 Feedback to responses to CP23/17

2.1 This chapter sets out a more detailed summary of the specific comments made by respondents on each chapter of the proposed SS in CP23/17, alongside an explanation of how the PRA has addressed these comments.

Risk appetite statement

2.2 A number of respondents thought the proposed SS was too prescriptive in places over the various elements to be included in a risk appetite statement, some of which might be included elsewhere. The PRA considers that firms should take account of all relevant factors, and acknowledges that reference may be made in the statement to other documents reviewed by the board, such as a statement on dividend policy.

2.3 Some respondents requested clarification over how the wording relating to 'reasonably foreseeable market conditions' in paragraph 2.3 of the SS should be interpreted. The PRA has considered this response and amended the wording of this paragraph of the SS to provide some more clarity on this.

2.4 One respondent thought that paragraph 2.3 of the SS could be seen as setting a direct supervisory expectation that firms have to maintain a capital buffer over the SCR, and thought that this could have an adverse effect on costs and competition.

2.5 The PRA acknowledges that boards of insurers will have the responsibility to determine their risk appetites for the levels of capital to be maintained by the firm in different market conditions. The guidance in the SS is intended not to add to the benefits associated with the PRA's rules, but to increase the likelihood of their being realised. Firms did not provide any evidence for increased costs in their responses, and the PRA would expect that any costs that might be incurred would be commensurate with these realised benefits (eg it is likely to be less costly for a firm to establish capital while it has more than 100% cover for its SCR).

2.6 The PRA considers that its final policy is compatible with its secondary objective of facilitating effective competition.

2.7 Consequently, if firms take account of a full range of relevant factors, as outlined in the SS, for the purpose of drawing up their risk appetite statement, then the PRA considers that would not have an adverse effect either on the balance between costs and benefits, or on competition.

2.8 One respondent requested clarification on how the SS might be applied by managing agents at Lloyd's. The PRA has considered this response and added a new paragraph 2.5 for this purpose.

2.9 Some respondents raised a concern around the need for proportionality and materiality, in relation to the application of the expectations in paragraphs 2.4 and 2.6 of the risk appetite statement. The PRA has considered these comments and added some specific references to these concepts of proportionality and materiality in these paragraphs.

2.10 One respondent noted that insurers may have a 'no appetite' position for some of the risks to be identified in the risk appetite statement (eg loss of the matching adjustment or volatility adjustment), while taking a range of operational measures to ensure as far as possible that this is achieved. The PRA acknowledges that this approach would meet the expectations in paragraph 2.3 of the SS.

2.11 Several respondents said that given the changing factors that could influence the risk appetite, they believe that it needs to strike an appropriate balance between being sufficiently stable to provide the relevant governance bodies with confidence, and being sufficiently dynamic so that it remains relevant in developing conditions.

2.12 The PRA has considered this view, and decided to expand paragraph 2.7 of the SS to recognise that firms will normally have a policy to review their strategy and business plans, including their risk appetite, either annually or following some major external event. However, as generally agreed by respondents, the PRA does not expect the risk appetite to be changed solely to justify, or regularise, particular actions, such as the assumption of a new risk, a change in investment policy, or a dividend payment.

2.13 One respondent commented on the need to maintain consistency between an insurer's risk appetite statement and its external communications with stakeholders. The PRA agrees with this comment and has correspondingly added a new paragraph 2.10 in the SS.

Business and financial plans

2.14 One respondent noted that a firm's risk appetite for deviations from its business plans was not always binary, and that some events might result in longer-term actions being applied rather than some immediate action. The PRA acknowledges this comment and has replaced 'timely actions' with 'appropriately timed actions' in paragraph 3.3 of the SS for the responses by firms to those deviations from their business plans that are not within risk appetite.

2.15 Several respondents noted that management actions taken in a real stress situation might differ from those developed from hypothetical scenarios. The PRA recognises that in a real event, internal and external circumstances may differ from those envisaged in planning scenarios, and firms should only take action after careful consideration by management of the specific situation. The PRA has therefore amended paragraph 3.7 of the SS, as also specifically suggested by one respondent, so that this refers to 'identifying and analysing potential management actions' rather than 'developing planned management actions'. Similarly, paragraph 3.8 of the SS has been amended to refer to understanding dependencies on third parties or external market conditions for 'identified' (rather than 'planned') management actions. Paragraph 3.9 of the SS explains that insurers should consider the circumstances under which their identified management actions might be applied.

2.16 One respondent noted that any definition of 'trigger point' for a management action should allow insurers flexibility to make appropriate choices in the specific scenario emerging, and not compel them to take pre-agreed actions because a trigger has been reached, without reviewing the appropriateness of such action in the live situation. The PRA acknowledges this comment and has amended paragraph 3.9 of the SS so that the expectation on the consideration and establishment of trigger points by insurers, relates specifically to the point at which they would intend to implement any planned management actions that they take into

account in the calculation of their technical provisions or the SCR. The PRA considers that there should be some certainty over the process that is applied by insurers when taking credit in advance for such management actions.

Dividend suitability and sustainability

2.17 One respondent commented that firms would not normally decide in advance how dividends might be adjusted in the event of future adverse financial performance. The PRA acknowledges this comment, and has amended the wording of paragraph 4.2 in the SS to say that firms are expected to consider how their dividends may be adjusted in the event of such adverse financial performance.

2.18 In response to a comment by a respondent, the PRA has added the phrase 'for example' in paragraph 4.3 of the SS, so that the reference to identifying the sources of capital generation when considering dividend sustainability may be read proportionately.

2.19 Respondents welcomed the PRA confirming that it no longer requires pre-approval of dividends. However, one respondent observed that, in practice, some insurers have not experienced any change in the process with the main difference being that the PRA no longer provides a formal non-objection at the end of the process. They asked the PRA to reconsider how this change in approach has been implemented in practice to ensure this is consistent across firms and is delivering the intended streamlining.

2.20 The PRA confirms that its revised approach of no longer providing a non-objection for dividend payments is being implemented. It is clear within this that insurers should continue to notify the PRA of intended dividend payments in the course of the normal supervisory relationship, and the wording has been amended slightly to clarify the PRA's expectations. As long as the provisions as set out in paragraph 4.4 of the SS are met, the PRA will not ordinarily conduct analysis of the affordability of the intended dividend. As noted in the SS, the PRA may wish to review the sustainability of insurers' capital management and dividend policies as part of regular supervision.

2.21 One respondent asked that the PRA should apply the relaxation of its non-objection policy for insurer firm dividends also to the return of premium by a mutual P&I Club. The PRA considers that this would be consistent with its policy objective to take appropriate account of different corporate structures, and in particular firms with mutual status. Insurers are reminded though that the PRA may still wish to monitor the quality of an insurer's capital resources, as explained in the PRA's approach to insurance supervision.

Appendix

**Supervisory Statement 4/18 'Financial management and planning by insurers' available at:
www.bankofengland.co.uk/prudential-regulation/publication/2018/financial-management-and-planning-by-insurers-ss**