policy briefing

The Prudential Regulatory Authority's (PRA) approach to insurance supervision.

June 2011

Summary

Following the Government's recent White Paper[1] (published 16 June) on reforming the regulatory architecture, the FSA and Bank of England have published a document specifically about the future prudential regulation of insurance firms. Amongst other things it discusses:

- How **judgement-based** supervision will work in relation to insurance
- The new **risk assessment framework**
- The **Proactive Intervention Framework**
- The importance of working with **European regulators**
- The need for cooperation with the **Financial Conduct Authority**

Next Steps:

- Late June: FSA to publish paper on the philosophy of the new conduct of business regulator.
- 8 September: deadline to respond to White Paper
- Later in 2011: The Bank and the FSA will publish a paper setting out their plans to deliver operational coordination.
- End of 2011: Introduction of Financial Services Regulation Reform Bill to Parliament.
- Mid-2012: legislation expected to be passed.
- End-2012: new regulatory framework in place.

Link to paper:
http://www.bankofengland.co.uk/publications/other/financialstability/uk_reg_framework/pra_approach2.pdf

Background

Over the last year the Government has developed its plans to reform the UK's regulatory architecture. The FSA is to be disbanded and a 'twin peaks' approach adopted whereby the Bank of England would have responsibility for macroeconomic stability through the Financial Policy Committee (FPC) and prudential supervision for 'systemically important' firms through the Prudential Regulatory Authority (PRA).

In addition, a new regulator with the title Financial Conduct Authority will be created to identify and mitigate against risks associated with conduct of business and wholesale markets.

Our latest briefing summarising and commenting on the reforms was published on 17 June and can be accessed via: http://www.cii.co.uk/pages/research/briefings.aspx

Following pressure from the insurance industry as well as the CII, the Government has proposed to ensure that the future regulatory architecture takes proper account of the different risks posed by insurance relative to banking. The latest FSA and BoE paper sets out their thinking on the future approach to regulating insurance under the PRA.

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[1] The White Paper can be found via: http://www.hm-treasury.gov.uk/consult_finreg_blueprint.htm

CII

Prudential Regulatory Authority

Scope: an additional insurance objective

The PRA will be responsible for the prudential regulation of all 'systemically important firms' defined as those firms that pose a risk for the financial system if they were to fail. The PRA will be responsible for the regulation of all institutions that accept deposits or which accept insurance contracts. This will mean that the PRA will authorise and supervise all banks, building societies, credit unions and insurers.

The FSA and BoE have been working to reassure the insurance industry that a 'one-sized fits all' regulator will not emerge from the current regulatory review. A new section has therefore been added to the draft legislation which makes clear the specific responsibilities the PRA will have in relation to insurers. The new insurance objective is:

> ***"Contributing to the securing of an appropriate degree of protection for those who are or may become policyholders"***

Judgment-led approach

The PRA's judgment-led approach will be characterised by a move away from rules-based regulation and a focus on forward looking analysis including an assessment of how a firm would be resolved if it were to fail, the impact this would have on the system as a whole and the use of public funds. The aim is therefore to "pre-empt risks before they crystallize". Central to the new approach is a new risk assessment framework.

Risk assessment framework

The BoE and FSA state that the new framework will operate in a way that reflects the PRA's additional objective to protect policyholders as well as the financial system. The framework will capture three elements:

1. **The potential impact** on policyholders and the financial system of a firm coming under stress of failing
2. How the **macroeconomic and business risk** context in which a firm operates might affect the viability of its business model
3. **Mitigating factors**, including risk management, governance, financial position including its solvency position and resolvability.

On announcing this new framework, FSA Chief Executive Hector Sants said that supervisors must be wary of the limitations of measures deployed which are intended to reduce the risks posed by firms. Ultimately what is appropriate under certain stressed conditions may not be appropriate under others. The PRA must therefore have good oversight of firms, and supervision must involve senior and experienced individuals.

Figure 1. the new risk assessment framework

Gross risk			Safety and soundness				
1. Potential impact	2. Risk context		3. Operational mitigation		4. Financial mitigation		5. Structural mitigation
Potential impact	External context	Business risks	Risk management and controls	Management and governance	Liquidity	Capital	Resolvability

The intensity of supervision

The intensity with which firms will be supervised will depend on their level of riskiness. However, all firms will at least face a **'baseline level of monitoring'.** This will involve:

- Ensuring compliance with prudential standards for capital.
- Liquidity, asset valuation, provisioning and reserving.
- At least an annual review of the risks posed by firms or sectors to the PRA's objectives.
- Assessing a firm's planned recovery actions and how it might exit the market.

During his speech at the launch event Hector Sants said:

"The PRA will engage in baseline supervision of all insurance companies. Relative to their size and complexity it is likely this oversight will be more intense than that of an equivalent bank, given the need to address the obligation to look after policy holders forward looking expectations."

Beyond baseline monitoring, the paper asserts that the nature and the intensity of supervision will be commensurate with the level of risk an insurer poses to the PRA's statutory objectives*. "The PRA's approach will…be tailored to recognize the different risks that arise across the carried set of insurance companies it supervises, particularly taking into account.. the differences across life and general insurance companies."*

In order to deliver the new supervisory approach, the PRA will demand more information from firms. The PRA will therefore periodically verify firms' data and risk management systems, either on site or using third parties such as external auditors.

Proactive Intervention Framework (PIF)

PIF will be designed to ensure that the judgment-led approach will be applied proactively where a supervisor has concerns about a firm and where action is taken. As a firm moves through each stage of PIF, the intensity of supervisory monitoring and the intrusiveness of supervisory actions will increase, and contingency planning will be stepped up. There are five stages in the PIF from **low risk** to **resolution/winding up under way**. Firms will be made aware of where they sit within the framework

The regulation of Lloyd's of London

The PRA will be the lead regulator for Lloyd's as a whole though the FCA will take responsibility for certain conduct of business issues. The draft legislation confirms this:

> ***"The Society of Lloyd's and Lloyd's managing agents will be dual regulated firms; Lloyds members' agents and Lloyd's brokers will be FCA-regulated firms".***

Coordination with the Financial Conduct Authority (FCA)

The FSA and BoE have stated that effective delivery of the PRA's intended supervisory framework will require coordination with the FCA. Coordination arrangements "will take particular account of the nature of liabilities arising where insurers have written with-profits policies."

Engagement with Europe

The FSA and BoE stress that the PRA will play an *"active and constructive role in shaping the development of international regulatory standards, with the aim of ensuring that the broader international developments support its judgment- based approach".*

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Ben Franklin
Chartered Insurance Institute
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