HYMANS ROBERTSON

Newsflash

PRA Insurance supervision: 2023 priorities – 16 January 2023

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On 10 January, the Prudential Regulation Authority ("PRA") published its "Dear CEO" letter setting out its 2023 priorities for insurance supervision. Below, we give our views on what this means for you.

Introduction and key headlines

The PRA has maintained many of its priorities from 2022, namely operational resilience, climate risk and encouraging Diversity, Equity and Inclusion. Given the market volatility during the year, financial resilience also continues to be a priority with a focus on liquidity management for life insurers and inflationary risks for general insurers, which was perhaps to be expected. Another unsurprising area of focus is on reinsurance risks associated with longevity offshoring, while exit planning and run-off plans is mentioned, in line with the PRA's 2022/23 business plan. In summary, the PRA's priorities for 2023 are:

- **Financial resilience** – with particular focus on internally rated assets and, for non-life insurers in particular, impacts of short term inflation on claims. Ensuring capital adequacy in the current challenging economic climate, specifically in the context of a predicted prolonged recession and elevated inflation in the near term.
- **Risk management** – including a thematic review into Bulk Purchase Annuities ("BPA"), liquidity risk frameworks, suitability of models in changing market environments and, for non-life insurers, emerging risks.
- **Implementing financial reforms** – Following on from HM Treasury's November 2022 announcements to reform Solvency II, the PRA will engage with affected firms on the technical details of the reforms over the course of the year – implying implementation is unlikely to occur until next year.
- **Reinsurance risk** – focussing on the recapture risk and systemic/concentration risk within longevity and the more complex "funded" reinsurance in the UK life market.
- **Operational resilience** – ensuring operational resilience in the context of a growing number of operational incidents, including operational resilience to cyber attacks.
- **Ease of exit for insurers** – ensuring businesses have adequate plans for an orderly exit from the market, if required
- **Other areas of focus** – ongoing review of non-natural catastrophe (e.g. cyber) risk, climate change, Diversity, Equity and Inclusion and supervisory frameworks.

Financial resilience

With the PRA expecting annuity writers to increase investment in internally rated and valued assets, the PRA focus looks to be on the model risk of such assets. In particular, the reliance of the internal rating to capture all risks of the asset, and the risk that the balance sheet asset values are over-stated based on their mark-to-model values. Some companies may suggest this is nothing new, but it looks like, in addition to having a robust internal ratings process, the PRA will likely focus on an insurer's ability to adequately stress these assets and demonstrate that capital planning is sufficient to cover the credit and concentration risk of internally rated assets.

The 2022 insurance stress test included credit downgrades in its immediate and protracted market shock scenarios, and we will be interested to see the PRA's conclusions on the insurance industry's resiliency once the results have been released.

Overall, life insurers' balance sheets were relatively protected from the market volatility during 2022, due to the various hedging tools and asset liability management being employed. If anything, balance sheets have benefitted from the rising interest rates over the year and should continue to do so in the current environment.

For non-life insurers, the short term inflation continues to apply upward pressure on claims inflation, though the materiality of this widely varies based on business mix and geography.

Ongoing uncertainty over the severity and duration of claims across markets and some business lines compounds the inflationary pressures meaning non-life insurers can expect increased scrutiny of stress testing from the regulator. Notably the PRA has explicitly stated that general and social inflationary risk drivers will need allowing for in underlying pricing, reserving, business planning and capital modelling. Non-life insurers should review these treatments accordingly.

Risk Management

For insurers in the BPA market, there will be a thematic review to look forward to! The BPA market remained buoyant during 2022 (see Hyman Robertson's H1 2022 Report) and we expect growth to continue for at least another decade. It is therefore to be expected that the PRA would ensure that the risk management and internal controls insurers have set can keep pace with the growth in BPA. Little detail is given, but we would expect the thematic review to look at the end-to-end BPA processes (particularly pricing), ensuring Line 2 reviews are suitable, and there is appropriate governance.

An unsurprising result of the Autumn mini-budget is a renewed focus on liquidity risk frameworks by the PRA. Generally, life insurers have dealt well with this – helped, in part, by a dry-run of sorts during 2020 – but we know that insurers have been looking more closely at their liquidity sources and the speed at which they can access them. Stress testing of liquidity is relatively strong in the industry, but insurers may wish to also look at the length of time over which a stressed liquidity event may occur.

For non-life insurers, the letter focuses on new risks emerging over 2023 and ensuring risk frameworks are ready to adapt to novel and emerging risks (this might include climate litigation for example). Model validations should continue to be prioritised to ensure they remain fit for purpose in the current economic climate which may significantly differ to when internal models were originally set up.

Mention is given to a consultation issued to banks on model risk management (CP6/22 Model Risk Management for Banks). A number of the principles set out in the paper are already well covered by insurers, but the PRA has repeated its emphasis on the continual appropriateness of models – i.e. model drift. In particular, focus is given to credit and counterparty credit risk in the context of widening credit spreads, rating downgrades and defaults. In preparation, we would expect insurers to consider their processes to ensure triggers for parameter/calibration reviews remain appropriate and that such reviews have taken place and gone through the required governance.

Implementing financial reforms

On 17 November 2022, HM Treasury proposed a package of Solvency II reforms which mostly impacted on life insurers in the annuity market. As a recap, they are:

- On the Risk Margin, the proposed reforms will legislate as necessary to reduce the Risk Margin by 65% for long-term life insurers and by 30% for general insurers under recent economic conditions.
- On Fundamental Spread, the Government will maintain the existing methodology, though will increase the risk sensitivity by introducing notched ratings to credit assets. Measures will be introduced such as additional stress testing requirements and increased regulatory reporting responsibilities under the Senior Managers and Certification Regime to attest to the suitability of the Fundamental Spread.
- On Matching Adjustment, the proposed reforms will increase the eligibility of assets by moving from the requirement for assets to have fixed cashflows to highly predictable cashflows, allow assets with prepayment risks or construction phases to be eligible, remove the BBB 'cliff', and increasing the range of liabilities eligible by allowing morbidity risk.
- The Government also intend to streamline certain processes including the Matching Adjustment application process, updating internal model approval requirements and increasing thresholds before adhering to Solvency II regulations.

Although the above sounded very positive, the industry is waiting with bated breath for the PRA to set out the details of all of the above – with many in the industry having a healthy dose of scepticism that the reform will be quite as positive as we might like. One of the key unanswered questions is one of timing. The implications from the PRA's letter is that we won't be expecting finalisation in the immediate future, with consultation occurring over 2023 and, therefore, a likely implementation date of end 2024. This may still be at odds with expectations of HM Treasury.

Reinsurance risk

The PRA's concerns on the levels of reinsurance in the life industry, particularly offshoring of longevity risk, has been well documented. For instance, in September 2022, Charlotte Gerken discussed the relatively high levels of reinsurance in the BPA market and discussed the risks associated with this. Her speech focussed on recapture risk (the ability for an insurer to reassume the risk in the case of reinsurer default or breach) and systemic risk (where a high proportion of longevity risk was being ceded to a small number of reinsurers). The speech also discussed the recapture and concentration risks of funded reinsurance as a tool which is increasingly being used by insurers in the BPA market.

Sam Woods had a similar focus in his "striking the balance" speech in July 2022, so it is not surprising that this is an area of focus for the regulator.

Given these concerns, life insurers will need to ensure that risk management frameworks have fully considered the risks associated with traditional and funded reinsurance, that compliance with the Prudent Person Principle is explicit when considering such reinsurance and that Recovery and Resolution Plans are refreshed regularly.

Operational resilience

As the PRA observes operational incidents to occur more frequently, it has renewed its focus on operational resilience. Firms should expect increased scrutiny of their operational risk and resilience with the expectation that insurers should have identified and mapped their important business services and set impact tolerances.

Over the next three years, the regulator will be working with insurers to test their operational capability within those tolerances under a range of severe but plausible scenarios, including from cyber attacks. Insurers should also review their exposure to third parties to manage their outsourcing and third party risk exposure.

Ease of exit

In line with the PRA's 2022/23 business plan, the letter brings renewed focus to reviewing the appropriateness of run-off plans or "winding down plans" to ensure an "orderly exit" should the need arise. The letter states that although larger firms have produced plans in line with the PRA's fundamental rules ("A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services"), this has been a gap for small firms. This, therefore, suggests that the PRA may pay closer attention to run-off plans for small firms in the coming year. From discussion with our clients, we have already seen this focus towards the end of the last year.

Key areas insurers will need to focus on are:

- How they would exit the market
- Understanding of the obstacles to exit and how they would be overcome
- How plans would be executed in a timely manner
- Full documentation of the risks contained in their books of business so that any acquiring firm would fully understand those risks

Other issues

The PRA continues to monitor a number of other areas in the sector including the experience of non-natural catastrophe risk (e.g. cyber); financial risks arising from climate change; Diversity, Equity and Inclusion; and its own supervisory approach.

The ability for insurers to manage their exposure to non-natural catastrophe risk remains immature and the PRA intends to focus on better managing this area of risk over 2023. No specific details are given but this could cover both quantitative modelling and qualitative governance aspects and impact cover that non-life insurers have written as well as operational risk events for all insurers.

Climate change continues to present an increasing and material risk to firms and the financial system. Firms' ability to meet the PRA's supervisory expectations will be assessed on an ongoing basis through supervisory engagement, firm-specific deep dives, and thematic work. Firms will be expected to demonstrate how they are taking steps to address barriers to progress. See our bulletin on the results of the Bank of England's Biennial Exploratory Scenario in May 2022 for further discussion.

The PRA's priorities are wide-ranging. Our rapidly-expanding Insurance & Financial Services team are ideally placed to support you in all areas covered by the PRA regulation and has particular expertise in the areas of capital modelling for life and non-life insurers, internal credit rating assessments, illiquid assets, the bulk annuity market, climate change, reinsurance risk and Solvency II reform. If you would like to discuss any of the topics covered in this Newsflash further, please get in touch with your usual Hymans Robertson contact or any of the authors.

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