BANK OF ENGLAND

Speech

A ‘D to Z’ of current issues in Insurance Supervision

Speech given by

David Rule, Executive Director of Insurance Supervision

Bank of America Merrill Lynch 23rd Annual Financials CEO Conference, London

26 September 2018

Today I want to take you on a quick tour of a number of live issues in our supervision of insurers. Why a ‘D to Z’ and not an ‘A to Z’? Because I am not going to talk about ‘A’ for assets as I gave a speech earlier this year on the use of illiquid assets and particularly equity release mortgages to back annuities. I am not going to talk about ‘B’ for Brexit. And I am not going to talk about ‘C’ for Climate Change, on which the Bank is today releasing our banking climate change review. I will though:

- update on progress towards a global Insurance Capital Standard;
- talk about the fledgling UK market for Insurance-Linked Securities and our own new insurers unit;
- reiterate the messages on underwriting and reserving in wholesale insurance and reinsurance markets from Anna Sweeney’s Dear CEO letter earlier this year;
- discuss capital management, building on a Supervisory Statement we published in May;
- share some data we collect on the sensitivity of the capital surpluses of UK life insurers to various market movements and
- encourage greater consistency in disclosure of such sensitivities by insurers as well as of the drivers of changes in their capital positions over time.

Update on progress towards an International Capital Standard

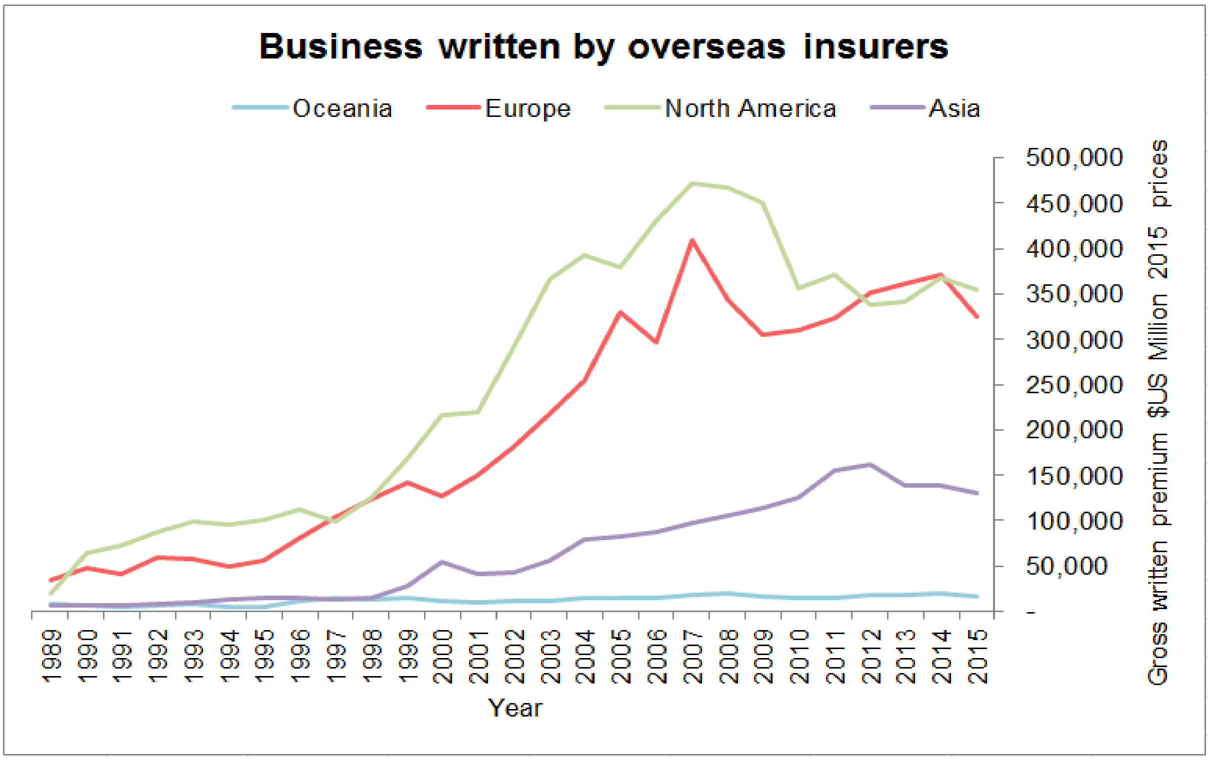
The International Association of Insurance Supervisors (IAIS) began work on an international capital standard (ICS) for Internationally-Active Insurance Groups[1] in 2014. A third consultation paper on ICS version 2.0 will close on 30 October. I encourage UK insurance groups to take part in this consultation and in the final round of field testing next year. The Standard will then be finalised ahead of a five-year monitoring period starting in 2020. During this period Internationally-Active Insurance Groups will report a reference ICS confidentially to their group-wide supervisors, including for discussion in regulatory colleges. But it will not be the basis of their regulatory capital requirements. Calculation of the reference ICS and the additional reporting is not meant to be burdensome. Groups will be permitted to use simplifications, simplifying assumptions and proxies, although we would expect that need to reduce as the monitoring period progresses.

The Bank of England supports the development of international regulatory standards, such as the ICS. As both a home supervisor of UK insurance groups with businesses around the world and a host supervisor of branches and subsidiaries of insurance groups from many different countries, I also welcome the monitoring period approach. It will give regulatory colleges a common language for measuring group risk and defining capital. No capital framework is perfect and ICS will be no different. But having agreement on common metrics will be a big step forward. It should further enhance supervisory cooperation and help build trust. Over time, it might reduce the need for multiple overlapping practices in measuring the same risks and help to limit fragmentation of capital requirements.

[1] The IAIS identifies an Internationally-Active Insurance Group as being an insurance group that has total assets of at least USD 50 billion or gross written premiums of at least USD 10 billion (on a rolling three year average basis). In addition, its premiums are written in three or more jurisdictions and at least 10% of the group’s total gross written premium is written outside the home jurisdiction.

Part of the case for an international capital standard is that insurance markets have become more global over the past few decades, even if that trend appears to have steadied after the financial crisis (Chart 1). This is most obvious in wholesale general insurance and reinsurance, where the underlying rationale for insurance provision arises from the law of large numbers and the benefits from pooling and diversifying across risks. Recent cross border mergers and acquisitions, and with talk of more to come, suggests the increase in the amount of business written by overseas companies might resume.

Chart 1: business written by overseas insurers



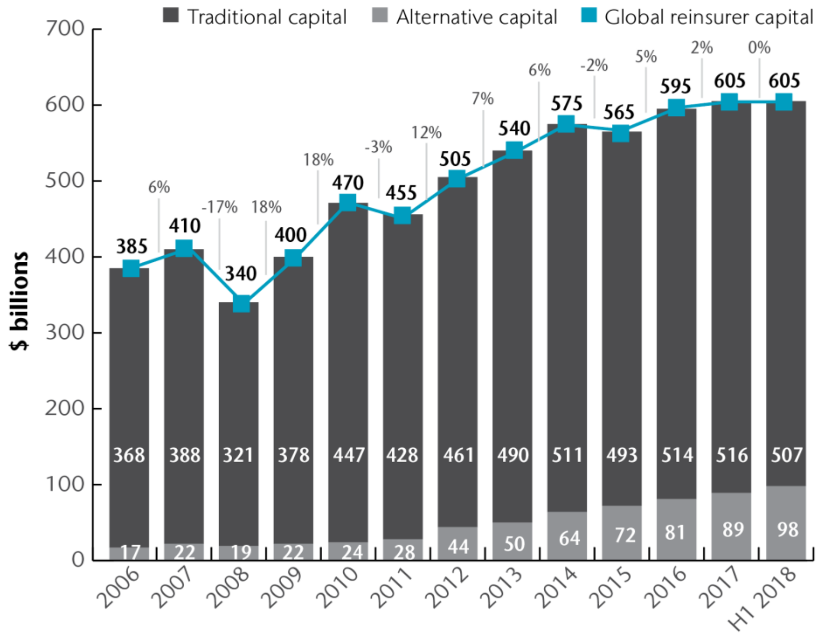
Source: OECD and Bank calculations

Mergers and acquisitions are in part a response to the prolonged period of soft conditions in wholesale general insurance and reinsurance markets. For many insurers underwriting returns are now below the levels required to achieve sustained profitability, even in years of 'normal' natural catastrophe activity. Our sense is that until this year, many had thought that market conditions would improve cyclically: for example, following a large loss event. They had therefore sought to maintain their market position and wait for better times. The limited increase in market prices following the losses from the 2017 hurricanes in the US and Caribbean has, however, caused a number of boards to look more fundamentally at the sustainability of their current businesses.

<u>Insurance linked securities and new insurers</u>

One response has been to move in the direction of introducing and managing rather than providing risk capital. Insurance-linked securities and other forms of alternative insurance capital, such as sidecars and the like, allow insurers to transfer risks to capital markets. These markets have been growing for some time, forming an increasing share of global reinsurance capital (Chart 2). They seem to have absorbed losses from the 2017 hurricanes without major hiccups. With the continuing search for yield and diversification by institutional investors, growth seems likely to continue.

Chart 2: Share of alternative capital in global reinsurance capital



Source: Aon: ILS Alternative Capital Fortifies Its Position September 2018

Last year the government established a tax and regulatory framework for Insurance-Linked Securities in the United Kingdom. It is intended to help cement London's position at the forefront of global reinsurance business. The PRA has since authorised a number of Insurance Special Purpose Vehicles, which can either be for one transaction or multiple transactions from one or more cedants. We are taking a proportionate approach to their supervision, consistent with the risks posed to our objectives and compliance with Solvency II requirements. We are keen to work with the industry to ensure we capture any learning as we both develop our experience of operating the new regime. I encourage any potential issuers to look at the page on our website[2] and speak to us at an early stage.

More generally, jointly with FCA and consistent with our secondary competition objective, we recently launched a new insurer start-up unit as the sister of our new bank start-up unit, which has been around since 2016. It gives prospective UK insurers the information and support needed to apply for authorisation, covering the early stages of thinking about becoming an insurer, what you need to get an application started, the application process and life as a new insurer. Again, I point anyone interested to the pages on our website, including our helpful new guide[3]. We recognise that insurers can have very different business models and corporate forms. Our initiative is not just targeted at innovative Insurtech firms but equally at

[2] https://www.bankofengland.co.uk/prudential-regulation/authorisations/insurance-special-purpose-vehicles

prospective firms with more traditional business models. We see that many start-ups find it more efficient to operate as an agent and obtain capacity through an existing insurer or reinsurer, piggy backing on existing scale and diversification. But for those that do chose to be independent, our message is clear: our door is open and we welcome applications from new UK insurers.

Pricing, underwriting and reserving in wholesale general insurance and reinsurance markets

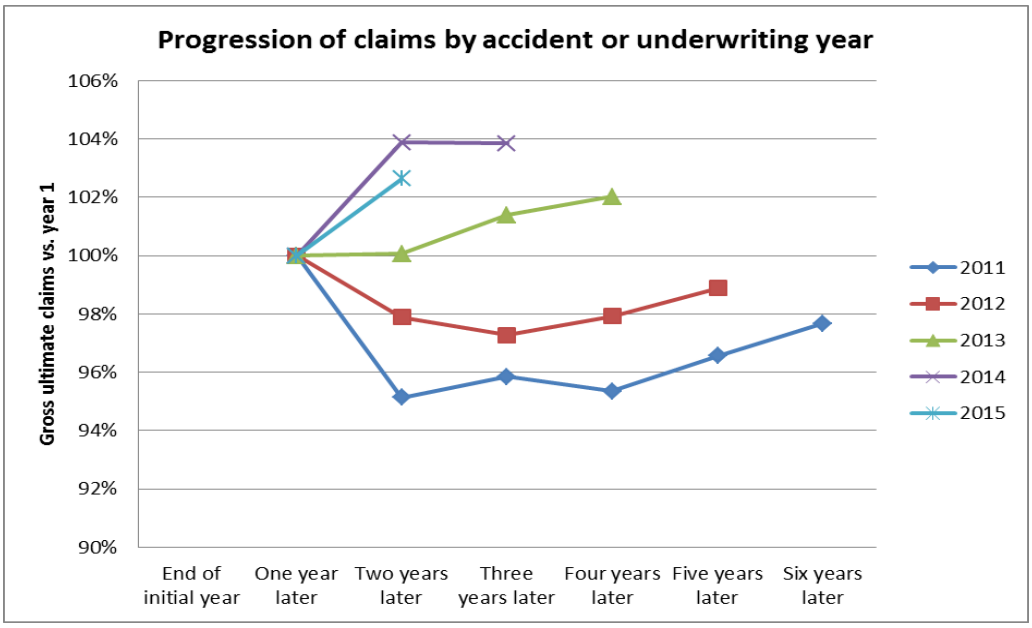
Our primary prudential concern about current market conditions is that pressure on pricing will lead to weakening of underwriting standards, under-reserving against risks and insurers being tempted to take short cuts on capital. On underwriting and reserving, Anna Sweeney's 'Dear CEO' letter[4], published a few months ago, set out nine areas where our supervisory review work had suggested weaknesses, including:

- Formulating business plans based on loss ratio (and future reserving assumptions) which appear optimistic given current market conditions and historical performance. In particular, we have seen a number of examples of insurers expecting improvements in claims experience due to portfolios changes, leading them to exclude historical years of poor performance from reserving benchmarks without good supporting evidence.
- Insufficient use of technical pricing models, even for lines of business where such models are generally considered to be more developed and reliable.
- Slow reaction to emerging loss development, with insurers taking false comfort from reserving benchmarks which appear to show business as still profitable despite emerging underwriting results.
- Diversifying into new lines of business (for example, casualty classes) despite insufficient underwriting expertise or oversight.

Aggregate analysis for a sample of London Market insurers suggests that initial estimates of reserves were inadequate for more recent years of account, with insurers needing to strengthen reserves over the past couple of years.

[3] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/new-insurer/new-insurer-start-up-unit-guide.pdf?la=en&hash=310E7B09C241113F97CDDCC36F339DAF90911057
[4] https://www.bankofengland.co.uk/prudential-regulation/letter/2018/market-conditions-facing-specialist-general-insurers-feedback-from-recent-pra-review-work

Chart 3: Progression of claims by accident or underwriting year



Source: Analysis of gross ultimate claim triangulations from publicly available annual report and accounts as at year end 2017 for a sample of firms included within our review. Initial values ignored to minimise distortion caused by increase in earnings from end of year 0 to end of year 1 where public information was presented on an underwriting year basis.

Responses to Anna's letter have acknowledged almost universally the concerns raised about the wider market. The quality of insurer's individual responses has, however, been more variable. Where we have concerns over a firm's response to our Dear CEO letter, we will follow these up, including with the Board where appropriate. Insurers must have effective controls to assess and monitor pricing and reserving adequacy. We also expect boards to consider seriously the sustainability of their business plans.

Capital management, market risk sensitivities and disclosure

A further concern for prudential regulators is that insurers will take more risks with capital, seeking to improve 'return on equity' by lowering equity if they cannot boost returns. Of course, that can be perfectly legitimate if insurers genuinely reduce risks. But amber lights flash when I read stories about brokers setting up teams to help insurers 'optimise' capital, including through 'innovative' use of reinsurance. We will also be alert to insurers seeking to reduce capital requirements through aggressive changes to internal models or over-optimistic business plans. This includes using our internal model output data to compare across insurers and monitoring model 'drift' indicators, such as the ratio of internal model to standard formula capital requirements.

The PRA also expects insurers to set a risk appetite for the levels of capital that are to be maintained in reasonably foreseeable market conditions: for example, as assessed through stress and scenario tests, or through some suitable alternative approach, to provide no more than a 1 in X probability that Solvency Capital Requirement (SCR) coverage might fall below 100%.[5] We published Supervisory Statement 4/18 on Financial Management and Planning by Insurers earlier this year. It explained that if an insurer's capital management policies are calibrated such that frequent or foreseeable breaches of SCR are likely to occur, the PRA may consider whether the insurer is meeting the requirement to have in place an effective system of governance. Similarly, if the level of capital of an insurer regularly or persistently falls outside of its risk appetite, or an insurer makes frequent changes to its risk appetite for its planned levels of capital, the PRA may consider whether this indicates failings in the governance process by which the insurer sets its risk appetite.

That Supervisory Statement also set out some of the factors we expect boards to take into account in setting a risk appetite for capital, including: the quality of capital resources; the results of stress and scenario testing; levels of uncertainty in forecast earnings; inherent uncertainty in the technical provisions; credit ratings and market reputation; any non-linearities and discontinuities that may arise due to combinations of adverse events; recovery options available; and the potential impact of firm failure on policyholders.

Central to setting capital risk appetite is the sensitivity of the balance sheet to changes in key risk drivers, including changes in market and underwriting conditions, and the emergence of large claims. Since the introduction of Solvency II, the PRA has been collecting data from large UK life insurers on the sensitivity of their capital positions to movements in key UK market variables, including interest rates, credit spreads, credit rating downgrades and property prices.[6] Chart 4 below shows the averages of these sensitivities across firms at year-ends 2016 and 2017.[7] Individual insurers' positions fall in a range around these averages.

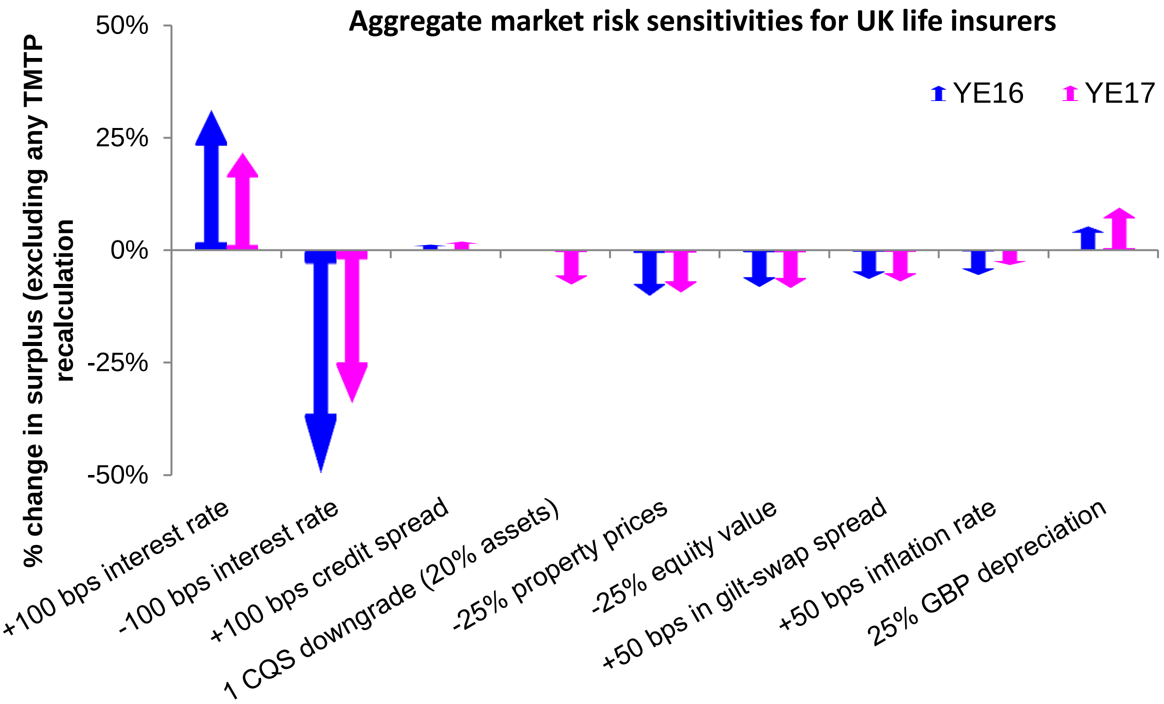
The most material sensitivity is to changes in interest rates. A large fall in interest rates would lead to a reduction in capital surplus over the SCR. Other significant market movements leading capital positions to deteriorate include a fall UK property prices, downgrades in credit ratings of corporate bonds[8], a fall in UK equity markets and widening in the spread between sterling interest rate swap and gilt yields. But life insurers' capital positions are not especially exposed to a widening of credit spreads, partly because of the insulating effect of the Solvency II Matching Adjustment.

The interest rate sensitivity is primarily due to the risk margin. Risk margins for annuity writers increase by 40%-50% for a 100bps fall in interest rates, which the PRA believes to be excessive. Insurers do not

[5] https://www.bankofengland.co.uk/prudential-regulation/publication/2018/financial-management-and-planning-by-insurers-ss
[6] https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-data-collection-of-market-risk-sensitivities-ss
[7] The aggregate solvency ratio (defined as aggregate Own Funds of the firms in this survey as a percentage of aggregate SCR) was 150% as at YE2016 and 156% as at YE2017. For definitions of the market variables, see https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/insurance/market-risk-sensitivities-instructions.pdf.
[8] More specifically, the impact of 20% of assets by market value downgrading from the current Credit Quality Step (CQS) to the next CQS. A CQS refers to rating agency ratings.

typically hedge the risk margin. For insurance liabilities written before the introduction of Solvency II, the risk margin can however be offset by Transitional Measures on Technical Provisions (TMTP), which allow any increases in reserves due to the introduction of new Solvency II requirements, such as the risk margin, to be phased in over sixteen years. Insurers can therefore partially reverse any deterioration in their capital position due to a higher risk margin if interest rates fall by applying to the PRA to recalculate their TMTP upwards. For example, TMTP recalculation would have reduced the decrease in aggregate capital surplus following a 100bps fall in interest rates by about two thirds as at end-2017. Conversely, if the risk margin falls because of an increase in interest rates, the PRA may require recalculation so that TMTP is not overstated.

Chart 4: Aggregate market risk sensitivities for UK life insurers



Source: Aggregated UK life insurers market risk sensitivity submissions

Some individual insurers have published many of these market risk sensitivities. But the pattern is inconsistent across firms. I held a roundtable with insurance analysts and investors on disclosure around a year ago.[9] I took away that they find Solvency II disclosures more useful than accounting disclosures, at least in the current state of insurance accounting. And a consistent set of such sensitivities was near the top of their disclosure wish list. I hope insurers and industry groups will work towards an industry standard in this area, perhaps drawing on what they report to us.

[9] https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-solvency-and-financial-condition-report-roundtables

Another key area where investors and analysts want better and more consistent disclosure is the drivers of the change in insurer's SCR coverage ratio from one reporting date to another. I think of this as the 'Solvency II P&L'. But Solvency II itself does not address measurement of changes in capital position over time. There is a reporting gap and insurers are closing it with their own content, leading to a mixed picture across the sector. Again, this is an area where insurers and industry groups could usefully develop some template approaches.

As supervisors, we are also keenly interested in understanding how insurers generate capital, now and in the future. This is at the core of our analysis of the sustainability of an insurer's business model. In particular, we want see the change in the SCR coverage ratio due to the risks and returns in the business split out from the effects of changes in broader market and economic variables and changes in modelling approach or assumptions or management actions. I have set out more detail in the Appendix.

I have mentioned two areas – market risk sensitivities and a Solvency II 'P&L' – where insurers could improve the quality and consistency of disclosures. It is a concern that we still see evidence of analysts and investors not fully understanding insurers' Solvency II balance sheets. In more stressed market conditions complexity and lack of transparency might lead investors to turn away from regulatory measures of risk and rely on simpler but cruder approaches. Progress towards an International Capital Standard should help. More generally, it is vital that insurers maintain discipline in underwriting, reserving and capital management, notwithstanding tough trading conditions in some parts of global insurance markets.

Appendix: Breakdown of insurer capital generation used for PRA business model analysis

This Appendix sets out a generic break-down of the change in an insurer's capital surplus over the Solvency Capital Requirement (SCR) from one reporting date to the next, used by the PRA to understand how an insurer generates Solvency II capital. The example shown is for a life insurer.

Separate reporting of capital generated from new business as opposed to existing business is key. Supervisors also find it valuable to see this split by material product line.

Separating out the effect of the Risk Margin and Transitional Measures on Technical (TMTP) provisions means supervisors can see the underlying business returns.

Experience variations and changes in operating assumptions are combined into one line item, alongside the line for economic variance. Each combines several possible items to show the result of market factors or those items under management control. Here this also includes the insurance assumptions built into the pricing of business and feeds into the assessment of management forecasting. This item could sensibly be split further at the cost of simplicity.

The position of the interest expense line is a deliberate choice to split the returns from business and the outflows to capital providers. This could be included in other lines to reflect the business funding model in order to support understanding of individual business lines economic returns however this tends to obscure our analysis and therefore supervisors prefer this approach.

Item#	Description	Calculation
I001	Existing business Own Funds generation, excluding Risk Margin and TMTP from current back book	
I002	TMTP run-off	
I003	Existing business Risk Margin run off from current back book	
I004	Existing business SCR run off from current back book	
I005	Total Existing Business Excess Capital Generation from current back book	= Sum I001 to I004
I006	Existing business Own Funds generation excluding Risk Margin and TMTP from planned new business	
I007	Existing business Risk Margin run off from planned new business	
I008	Existing business SCR run off from planned new business	
I009	Total Existing Business Excess Capital Generation from planned new business	= I006+I007+I008
I010	New business Own Funds generation, excluding risk margin	
I011	New business risk margin	
I012	New business SCR	
I013	Total New Business Excess Capital Generation	= I010+I011+I012
I015	Experience variance and change in operating assumptions	
I016	Economic variance	
I017	Other	
I018	Total organic excess capital generation	= I005+I009 + Sum I013 to I017
I019	Excess capital generation arising from model changes	
I020	Excess capital generation arising from other management actions	
I021	Portfolio and business transfers	
I021	Shareholder transfers from with-profit funds	
I022	Debt raise	
I023	Debt repayment	
I024	Net equity issuance	
I025	Interest expense	
I027	Dividends	
I028	Total change in excess capital	= Sum I018 to I028