



Newsletter Pru 22 – the PRA

The launch of the PRA

The FSA and the Bank of England launched the Prudential Regulation Authority in June 2011 with a day meeting for the insurance industry and with a document outlining the PRA's approach to insurance supervision.

European context

The PRA admits that most of the rules and most of the standards for insurance prudential supervision will now be set at the EU level. Solvency 2 will not allow "gold plating" of the rules and standards and there will be effective controls placed on national supervisors from the European Insurance and Occupational Pensions Authority (EIOPA). The PRA states that it will take a pro-active approach and constructive role in the development of a common EU framework.

The PRA will rely heavily on the new Solvency 2 framework to generate most if not all of the information on which it will act.

Risk assessment framework

The PRA states that it will concentrate resources on those insurance firms that pose the greatest risk to policyholders and to the stability of the UK financial system.

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3 key elements will be looked at:

1. The potential impact on policyholders of the firm "coming under stress" or failing. Could the firm's failure disrupt the income flow to policyholders for example;
2. Vulnerability of the firm and its business model to risks;
3. Mitigators including risk management, governance, financial strength and resolvability of a firm (see below).

Potential impact

The potential impact will take account the firm's size and nature of services provided. Annuities will be a higher rating than some other forms of insurance. For general insurance, motor and aviation insurance will affect transport.

Systemic impact will borrow from the Bank of England including the FPC.

Risk vulnerability

The PRA will draw on the FPC's view of the macroeconomic environment and interpret this against the individual firm.

Mitigating factors

The three items considered will be: (1) the financial strength of the firm including the strength of the technical provisions, the approach to liquidity management; (2) the quality of the risk management and governance which will include assessments of culture and competence of senior management; (3) resolvability which determines whether the firm can be wound up in an orderly way.

Supervision

There are going to be 5 stages of supervision.

The baseline stage will be for all firms and will involve a forward looking assessment of the solvency of the firm including in times of stress. Reserve strength will be analysed. Forward looking stress tests on the firm's business plan will be required and reverse stress tests will be examined.

Auditors and actuaries will be required to play a role in supervision. The PRA will build relationships with the actuarial function and the auditor. It will also ask firm's actuarial function, its external and internal auditors and its risk function to monitor implementation of any corrective actions required by PRA. The auditors will be told when the valuation of less liquid assets is out of line with other firms and will be expected to be in dialogue with the PRA on any questionable areas. The PRA will critically challenge actuarial judgements.

The Solvency 2 reporting framework will give enough information for the PRA to be able to carry out this work including the ORSA (especially the long term stress part).

Mutual insurers will be grouped in one department irrespective of size headed by a person responsible for all mutual insurance prudential regulation. The PRA promises to remember proportionality.

For branches, the PRA will require certain information. For branches of non-EEA insurers, they will require more information and may require firms to properly ring fence their UK capital.

Higher levels of supervision

Stage 2

If there is a moderate risk to the firm's viability, the FSA will put the firm into Stage 2 of the Pro-Active Intervention Framework (PIF).

Stage 2 shows a greater intensity to the supervision and there may be additional reporting requirements over and above Solvency 2 reporting. The PRA may use its information gathering and investigation powers. The PRA may require the firm to increase the capital held until remedial actions are taken. There may be initial contingency planning by PRA acting in concert with FSCS.

Stage 3

A material risk to viability would move the firm to Stage 3. Realistic recovery plans will be required including capital raising, asset disposal, business transfer or sale of the firm and reduction of contracts in force. Changes to management may be forced onto the firm by PRA and restrictions on business activity.

PRA will co-ordinate with FSCS to consider all information necessary to allow it to evaluate the eventual payout options.

Stage 4

Imminent risk to viability would cause the firm to be raised to Stage 4. The PRA will remove authorisation to write new business and require immediate action to remedy the position. The FSCS and PRA would now start action on the firm.

Stage 5

Stage 5 is when resolution or winding up is under way. The insolvency process will be triggered and FSCS and PRA will effect continuity of cover or compensation to claimants.

Ex-ante powers

The PRA will try to exercise its powers prior to things going wrong. The PRA would want to set requirements on firms prior to the position deteriorating.

Prosecution through the Courts may be required.

The PRA promise to make sure that it communicates its actions to senior management clearly and any issues it may have. It accepts that firms may disagree with its interpretation of the position and its risk assessment. However, it will rely on its own assessment.

Financial Conduct Authority

The PRA states that it will try to co-ordinate with the FCA.

Rulebook

There will be a new rulebook for prudential supervision. It will be based on a copy-out of the Solvency 2 rules wherever possible. Any divergence will be entirely in accordance with Solvency 2's targets and its level of prudential supervision.

All new rules will be subject to consultation. However, most will now come from the EU and the PRA does remind people to engage properly with the EU's decision and consultation process.

Authorisation of firms and individuals.

Firms and relevant individuals will need authorisation from PRA. The PRA accept the fact that this may mean that firms and individuals may need to be authorised both by themselves and the FCA.

With Profits

The lead for with-profits regulation will be the PRA rather than the FCA. We suspect this is to keep all the actuaries in one place.

Our analysis

Prudential regulation will become far more intrusive. We are not sure how PRA will carry out its supervision of non-directive firms especially as they will not be generating model office type business plan stresses or reverse stress tests. Many non-directive friendly societies find it difficult to afford annual valuations let alone annual stress reporting. Maybe this will drive further consolidation.

S. Dixon

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