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INSURANCE SECTOR — TECHNICAL NOTE

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TECHNICAL NOTE

INSURANCE SECTOR

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) in the United Kingdom in November 2015 and February 2016 led by Dimitri Demekas. It contains technical analysis and detailed information underpinning the FSAP findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx

CONTENTS

Glossary _____ 3

EXECUTIVE SUMMARY _____ 5

INTRODUCTION _____ 10

INSTITUTIONAL, REGULATORY, AND SUPERVISORY ISSUES _____ 10

A. Institutional Framework and Arrangements _____ 10

B. The Supervisor _____ 12

C. Supervision Approach _____ 14

D. Enforcement _____ 18

E. Group Supervision _____ 19

F. Market Entry and Exit _____ 22

G. Solvency II Implementation _____ 25

STABILITY OF THE INSURANCE SECTOR _____ 36

A. Market Structure and Performance _____ 36

B. Global Systemically Important Insurers _____ 45

C. Stress Testing _____ 46

D. Interlinkages and Spillovers to the Financial Sector _____ 47

FIGURES

1. General Insurers' Profits from Investment Activities _____ 42
2. Insurance Industry Assets by Sector _____ 42
3. Nonlife Underwriting Results _____ 43
4. Life Insurers' Bonds Investment Portfolio and Sterling Corporate Bonds Universe Rating _____ 44
5. Global—Alternative Reinsurance Capital _____ 45

TABLES

1. Recommendations for the Insurance Sector _____ 9
2. Global Share in Insurance Premium, Penetration, and Density, 2014 _____ 37
3. Insurance Premium and Total Assets _____ 37
4. Market Participants in Insurance 2014 _____ 38
5. Market Share of Top 10 Individual U.K. Authorized Insurers, 2014 _____ 39
6. Life Insurance Premium by Product _____ 40
7. Nonlife Insurance Premium by Product _____ 40
8. Life Insurance Investments _____ 41
9. Nonlife Insurance Investments _____ 41
10. Insurance Investments Classes _____ 47
11. Domestic and Global Insurance Investments Classes _____ 48

Glossary

APR	Approved Persons Regime
BCR	Backstop Capital Requirements
BMA	Business Model Analysis
BoE	Bank of England
CASS	Client Assets
CDS	Credit Default Swaps
CMG	Crisis Management Group
COAGs	Cross-border Cooperation Agreements
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
FC	Financial Crime Department
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Service
FPC	Financial Policy Committee
FSA12	Financial Services Act 2012
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act
FTE	Full Time Equivalent
GIRS	General Insurance Risk Specialists
G-SII	Global Systemically Important Insurers
HLA	High Loss Absorbency
HMT	Her Majesty's Treasury
IAIS	International Association of Insurance Supervisors
ICA	Individual Capital Assessment
ICP	IAIS Insurance Core Principle
IEO	Independent Evaluation Office
IT	Information Technology
ITS	Implementing Technical Standards
LIPRD	Life Insurance & Pensions Risk Department
LRMP	Liquidity Risk Management Plan
MA	Matching Adjustment
MCR	Minimum Capital Requirement
MoU	Memorandum of Understanding
NDFs	Nondirective Firms
NED	Nonexecutive Director
NTNI	Nontraditional Noninsurance
ORSA	Own Risk and Solvency Assessment
PIF	Proactive Intervention Framework
PRA	Prudential Regulation Authority
PSM	Periodic Summary Meeting

QRTs	Quarterly Quantitative Reporting Templates
RCP	Recovery Plan
RFR	Risk Free Rate
RLD	Retail Life Department
RSR	Regular Supervisory Reporting
SCR	Solvency Capital Requirement
SF	Standard Formula
SIMR	Senior Insurance Managers Regime
SFCR	Solvency and Financial Condition Report
SRMP	Systemic Risk Management Plan
SRPC	Supervision, Risk, and Policy Committee
SS	Supervisory Statement
U.K.	United Kingdom
U.K.LA	U.K. Listing Authority
UFR	Ultimate Forward Rate
VA	Volatility Adjustment

EXECUTIVE SUMMARY

The U.K. has one of the deepest, most developed insurance markets in the world. The U.K.'s life insurance premium accounts for almost 9 percent of the world's life insurance premium and 5.5 percent of the world nonlife premium. Insurance penetration is 50 percent higher than in the European Union (EU) or other advanced markets, and the expenditure per capita in insurance amounts to USD 5,429 as compared with USD 3,815 in the advanced markets. The U.K. insurance industry is the third largest in the world and the largest in Europe with around 600 insurers operating in the U.K.

The supervisory approach of both the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) are forward-looking and risk-based. Insurance supervision is shared between the PRA and the FCA under robust cooperation and coordination arrangements. The forward-looking supervisory approach is supported by comprehensive stress testing requirements that follow international best practices. Supervision has a strong focus on the companies that present the highest risk to the achievement of better outcomes for consumers or the integrity of the U.K. financial system. The smallest PRA-regulated firms and most FCA-regulated firms are supervised on a reactive approach, based on thematic methodologies and outlier analyses.

However, improved data availability and an enhanced risk appetite statement are required. Sufficient data provided with the necessary frequency and in the required level of granularity are not always available. The FCA's data needs will not be met by the Solvency II reporting regime, and the FCA is working on addressing the gaps. There are also some firms that use the U.K. "brand" to operate mainly offshore, like exclusive reinsurers' branches and brokers, but are not captured under the current supervisory risk appetite because they are not considered large in U.K. market terms. However, these firms could still represent reputational risk for the U.K. insurance market and the supervisors.

Notwithstanding the stronger enforcement on supervisory and enforcement actions, important challenges still need to be addressed by the FCA. The FCA has started a series of commendable thematic work, but policy revisions as a result of this work can be slow. Also, enforcement action can take up to a few years. The FCA should do everything possible to accelerate the timetable, while ensuring due process and fair treatment. Last but not least, the disruptive technological change in the digital sales of insurance, while increasing the outreach of insurance, creates new challenges for market conduct supervision, that have not yet been fully addressed.

Despite the progress made in group supervision, including the Memoranda of Understanding (MoUs) in effect, there is room for improvement. Apart from the substantial improvement achieved in the formation and functioning of colleges through the European Insurance and Occupational Pensions Authority (EIOPA) guidelines and several existing MoUs for international cooperation outside the EU, important challenges beyond the U.K.'s supervisors' direct authority remain to be addressed:

- The direct PRA powers over holding companies apply only to qualifying parent undertakings. Given the complexity and size of the groups active in the U.K., these powers should be exercised

with regard to the relationships of U.K. entities with others outside the U.K., including, appropriate measures to protect U.K. policyholders.

- Given that the possibility to designate the lead supervisor independently of the domicile of the insurer is not always given, for insurers with significant business outside the EEA, similar agreements to the EIOPA requirements for colleges in the EEA should be introduced for non-EEA jurisdictions. To be sure, this is not something the U.K. can achieve on its own and would require cooperation of international supervisory authorities.

- Continued efforts are required to establish a clear definition of responsibilities around joint decisions over group internal model applications and group model changes; ensure transferability of surplus capital across jurisdictions; and given the delegated supervision to the home supervisor, establish an appropriate level of cooperation, information-sharing and engagement within the colleges of supervisors, which should include consistent guarantee schemes for failing insurers and consistent cross-border resolution powers.

- At this early stage in the Solvency II regime, there has been little or no specific mention of conduct risk or its supervision on the agenda at colleges of supervisors, but the U.K. is well-placed to promote further harmonisation on this facet of supervision.

The focus on Solvency II implementation remains strong; however, supervisory arbitrage remains a risk that needs to be addressed at the EU level. The PRA maintains a strong focus on the implementation of the Solvency II Directive in the U.K. However, the maximum harmonization implementation of Solvency II, the complexity of Solvency II, and the onerous requirements that Solvency II imposes on the insurers could theoretically motivate the use of freedom of service in the EU to search for jurisdictions where the supervision uses a lighter version of Solvency II pillars two and three. Monitoring and acting to prevent such a potential deterioration in supervision standards on a cross-border basis will be important. The supervision of the Solvency Capital Requirement (SCR) (including those derived from internal models) and of the Own Risk and Solvency Assessment (ORSAs) are central for ensuring the resilience that Solvency II requires. It is important that the U.K. continues to contribute to EU-wide coordination mechanisms to monitor any potential arbitrage.

A sharp increase in interest rates could have material immediate and secondary effects. Overall, rising interest rates would benefit insurers' business models. However, if accompanied by rising default risk, substantial increases in credit spreads for corporate bonds could affect insurers adversely. Life insurers are generally well cash-flow matched and use a market-consistent based valuation method for their balance sheet. They are thus relatively insensitive to upward shifts to the risk-free yield curve—with the notable exception of the annuities written by life firms that generally have large corporate bond portfolios. Nonlife insurance firms are less vulnerable than life insurers, as their balance sheets are typically less exposed to interest rate risk. In the 2014 EIOPA stress test, U.K. insurers were most significantly impacted by the mass lapse, longevity, and provision deficiency stresses. The relatively positive results of the low-yield test on the U.K.-regulated solo insurance entities reflected the prevalence of sound asset-liability matching practices.

The U.K. insurance sector has remained resilient amidst the current hostile interest rate environment (for the life sector) and intense competition (in the nonlife sector). The low interest rate environment has eroded the investment returns but life insurers remain resilient—as is attested by stress test results. Life insurers have maintained to a large extent the rating of their investments with only a gradual, small shift to lower rated bonds from 2005 to Q3 2015. Regulation has also led insurers to tighten their asset-liability duration matching, lower the guarantees offered, and move into unit-linked products where the policyholder carries the return risk. Nonlife insurers facing strong competition appear to have preferred to forfeit growth to revert their underwriting losses by improving results in motor insurance to compensate for the diminished investment returns.

However, potential vulnerabilities remain and need close monitoring. As the attractiveness of some life products diminishes, leading to the search for new business, and given the delicate situation of insurers in the EU, contagion or reputational impact on U.K. insurers is possible. In this context, the growing longevity swaps activity and annuity block transactions requires close monitoring for counterparty risk—particularly when the ultimate risk carrier is located in a jurisdiction with light regulatory requirements or where there has been insufficient risk transfer. Profitability in the nonlife and reinsurance business has been artificially inflated by a below-average level of losses due to natural hazards over the last five years, which has limited claims on catastrophe insurance policies. Any further softening in the terms and conditions on insurance policies would have the potential to increase future losses, leading to reserve deterioration and impacts on capital.

While Solvency II will increase the risk sensitivity of the prudential framework, the effectiveness of Solvency II remains untested. In the life sector, the Volatility Adjustment (VA) involves a number of simplifications. Applied indiscriminately, the VA has the potential to allow insurers to operate beyond the recovery point and to create systemic risk. The Matching Adjustment provides a considerable benefit that makes its close monitoring central to effective supervision. In nonlife insurance, the one-year horizon of the Solvency II framework is also potentially insufficient for some of the long-tail risks that are insured in the London market. Steps the U.K. authorities should consider to mitigate these risks include:

- Multi-year stress testing as a tool to allow the PRA to take preventative measures to offset the effects of no longer having matching and volatility adjustments.
- Close monitoring of the Solvency II transitional measures and the development of a framework of actions that could be taken in case of non-compliance by firms.
- Additional consideration to address the long-tail nature of certain lines of business for firms using an internal model as well as in those firms using the standard formula, for example, through the PRA's stress testing exercises.
- Working with EIOPA and other member states to propose revision of the risk margin definition to incorporate prevailing economic conditions.
- Using macroprudential tools to manage macroeconomic risks instead of relying on adjustment measures in the Solvency II framework to address cyclical conditions.

- The geographic diversification of the insurers activities protects the insurance sector against a downturn of the U.K. economy, but could make them vulnerable to global economic shocks that need to be monitored and stress tested.

The U.K. supervision of systemic risk in the insurance sector is strong. As the home supervisor of two of the nine designated Global Systemically Important Insurers (G-SII), the U.K. has advanced its supervision in line with the Financial Stability Board (FSB) requirements. The U.K. G-SIIs are required to monitor their group-wide liquidity position on a continuous basis and provide monthly reports. G-SIIs have developed a Systemic Risk Management Plan (SRPM) and Recovery Plan (RCP) that the PRA is reviewing. The resolution plans for the two U.K. G-SIIs are under development. In addition to the stress testing carried out by individual insurers, several market-wide stress tests have been carried out, including the 2014 EIOPA stress test and the 2015 PRA stress test for nonlife companies. The FPC is monitoring the systemic risk that insurers, as investors, could create through a series of reporting and stress tests.

Table 1. United Kingdom: Recommendations for the Insurance Sector

Recommendation	Timing[1]	Authority
The PRA should consider introducing into the internal model approval process, where appropriate, complex business scenarios that cover long-term latent losses—i.e., supplementing the one-year horizon with complementary analysis including explicit stress testing.	Immediately	PRA
In case of a delay, the PRA should specify the supervisory measures to be taken by an insurer in meeting the technical provision transitional milestones.	Immediately	PRA
The authorities should introduce supervisory tools that include supervisory scrutiny of entities with a strong international focus independent of their size in the U.K.	Immediately	FCA
Consideration should be given to raising, along with the EU Commission, the merits of a non-objection rather than approval of the model, in order for the supervisor to avoid taking excessive legal risk.	Immediately	U.K. though the EU
The PRA should maintain the strong focus on internal model supervision as it has been doing for the approval phase. In particular, to monitor the model drift risk the PRA should develop an analytical tool kit, with a suite of measures such as ratios based on independent and external measures as well as the internal model SCR.	Immediately	PRA
The longevity swaps activity and annuity block transactions need to be monitored for counterparty risk.	Immediately	PRA
The authorities are recommended to develop the appropriate tools to exploit the data in a manner that enhances its supervision on the thematic and outlier approach.	Near Term	PRA, FCA
Given the complexity and size of the groups active in the U.K., the authorities should maintain oversight and if required take action with regard to relationships of U.K. firms with others beyond the U.K.	Near Term	PRA, FCA
For insurers with significant business outside the European Economic Area (EEA), similar agreements to the EIOPA requirements for colleges in the EEA should be introduced for non-EEA jurisdictions.	Near Term	PRA, FCA
The U.K. authorities should work with international partners to develop an integrated regime of resolution powers for insurance, with due regard to the insurance business model.	Near Term	U.K. with partners
When developing its stress testing strategy, the PRA should consider: • Multi-year stress testing as a tool to allow the PRA to take preventive measures to offset the effects of no longer having matching and volatility adjustments within the limits imposed by Solvency II. • Stress testing using the matching adjustment under spreads widening shocks in a persistent low interest rate environment beyond the one-year horizon on a regular basis. • Stress testing to assess resilience to overseas economic shocks.	Near Term	PRA
Working together with EIOPA and other relevant European bodies, the PRA is recommended to consider macroprudential tools to manage issues of a cyclical character in the Solvency II framework. Also the risk margin definition should be revised to incorporate economic conditions.	Near term	PRA

[1.] "Immediate" is within one year; "near-term" is one to three years; "medium-term" is three to five years.

INTRODUCTION[1]

1. This Technical Note covers the analysis carried out of the insurance sector as part of the 2015 United Kingdom Financial Sector Assessment Program (FSAP). The sector is supervised and regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The analysis was based on the regulatory framework in place, the supervisory practices employed, and other conditions, as they existed in November 2015. The note also refers to the regulations that came into force in January 2016 (Solvency II).

2. The Technical Note is not a full assessment on the observance of International Association of Insurance Supervisors (IAIS) insurance core principles (ICPs). The focus of the assessment was determined by the findings of the last FSAP carried out in 2011, the IAIS new supervision requirements and aspects relevant to the U.K. global center role for insurance. The Note looks into the following aspects of supervision, regulation, and financial stability:

- Elements supporting effectiveness and efficiency of the supervision of both authorities in the area of insurance supervision and regulation.
- Level of implementation of Solvency II. Including the internal model approval, group supervision and reporting requirements.
- An assessment of the resilience of the sector based on the available stress test results.

INSTITUTIONAL, REGULATORY, AND SUPERVISORY ISSUES

A. Institutional Framework and Arrangements

3. The U.K.'s legislative and regulatory landscape has changed significantly since the 2011 FSAP. The Financial Services Act 2012 (FSA12) established a new framework for financial regulation in the United Kingdom. Responsibility for financial stability was given to the newly established Financial Policy Committee (FPC) of the Bank of England (BoE). The Committee is charged with a primary objective of identifying, monitoring, and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the U.K. financial system. The FPC has a secondary objective to support the economic policy of the Government. It must also hold an annual, dedicated discussion on the appropriate boundaries around, and within, the regulatory perimeter. Her Majesty's Treasury (HMT) is required at least once a year to review the FPC's remit.

[1] This technical note was prepared by Rodolfo Wehrhahn, IMF external expert. The assessor is thankful to the staff of the PRA, FCA, HMT, Financial Services Compensation Scheme (FSCS), as well as to trade associations, professional bodies, market participants, and experts he met.

4. **The FSA12 also established new microprudential supervisors.** The PRA prudentially supervises banks, insurers, and the largest investment firms, a total of around 1,700 entities. The PRA is a subsidiary of the BoE. The FCA is responsible for the conduct supervision of all financial services firms and for the prudential supervision of those firms that are not prudentially supervised by the PRA. The FCA currently supervises around 56,000 firms. The FCA oversees primary and secondary market activity and is the U.K.'s Listing Authority (U.K.LA). In addition, since April 2014, the FCA has been responsible for the conduct-focused supervision of all consumer credit firms in the U.K. In April 2015, the independent Payment Systems Regulator was also established as a subsidiary of the FCA.

5. **The interaction among the supervisory authorities is set out in the FSA12.** Several MoUs have been entered into by the authorities responsible for supervision and regulation to support communication and coordination. The FSA12 requires the FCA, PRA, and BoE to coordinate their functions effectively; empowers the PRA to veto certain actions by the FCA if the PRA believes it would threaten the stability of the U.K. financial system; and provides for mechanisms that define the relationship between HMT, the BoE, the PRA and the FCA in the event of financial crisis. A number of MoUs between these agencies provide further detail on cooperation arrangements.

6. **Cooperation and communication between the PRA and the FCA is good.** All MoU are public documents available in the BoE web page. No major violations of the MoU have been reported in the established quarterly reports. Furthermore, there is frequent practical collaboration between the FCA and the PRA. For instance, the FCA General Insurance and Protection Supervision director and the heads of each department meet the PRA director of general insurance supervision and their department chiefs on a quarterly basis to discuss firm-specific issues, ongoing work, specific concerns, and risks relating to the market and other matters of mutual interest. And at the operational level, supervisors of both authorities share findings of firm assessments and each authority invites supervisors from the other to attend their 'Firm Evaluation Meeting' (FCA) or 'Periodic Summary Meeting' (PRA)—attendance then being based on the risk based resource allocation of the invited authority. There are also formal U.K. regulatory colleges between the two authorities on dual regulated firms and, for the largest firms, more frequent informal meetings between the supervisory teams.

7. **Policyholders are protected by a guarantee scheme.** The Financial Services Compensation Scheme (FSCS) protects insurance policies and insurance broking (for business conducted on or after January 14, 2005). For insurance business, there is no upper limit on the amount of protection. For firms declared in default after July 3, 2015, claims for long-term insurance, compulsory insurance, professional indemnity insurance, as well as certain claims for injury, sickness or infirmity of the policyholder are protected at 100 percent, while other types of insurance claims are protected at 90 percent. Before paying compensation for long-term insurance, the FSCS is required to seek to make arrangements to secure continuity of insurance and maintain benefits falling due. For general insurance, the FSCS may seek to secure or facilitate the transfer of the insurance business and secure the issue of policies by another firm.

8. **The Financial Ombudsman Service (FOS) was established by law as an independent public body to resolve individual disputes between consumers and financial sector businesses.**

Depending the complexity of the case, the FOS is able to sort out some complaints within just a few weeks—and over half of all cases within three months. However, many of the disputes involve complex financial and legal issues that require longer time for settlement. Over the years, the FOS has been involved in resolving PPI claims and other insurance small claims accelerating the settlement time and reducing costs. Thus, the FOS has contributed to increase the credibility in the financial sector.

B. The Supervisor

Structure

9. The Insurance Directorate in the PRA comprises two divisions (Life Insurance and General Insurance) and the Executive Director's Office (which includes the Solvency II project team). The Directorate is responsible for supervising PRA-authorized life and general insurance firms. The Insurance Directorate is supported by other parts of the PRA/BoE, including Prudential Policy, Regulatory Operations, and the Legal Directorate.

10. The General Insurance Division is comprised of two supervisory Departments and the General Insurance Risk Specialists (GIRS). The London Markets department supervises an estimated 80 firms that operate in the London wholesale insurance market. This includes Lloyd's of London and all of the firms that write business through Lloyd's; subsidiaries of Bermudian and North American insurance groups; and the P&I Clubs (marine mutuals that provide cover for ship owners). The Nonlife and International Composites Department supervises 160 firms that largely offer consumer products such as home, motor, and health cover and includes large firms, as well as a significant number of very small firms. The Department also supervises some 150 firms in runoff. GIRS comprises specialists (predominately actuaries) with deep understanding of the prudential risks posed to the PRA by nonlife insurance and reinsurance firms operating in the U.K. In addition, sectoral trends and analysis to assist in identifying risks and issues are led by the technical head of division. This analysis is refreshed every quarter using supervision resources to ensure quantitative and qualitative information is reflected in informing prioritization.

11. The Life Insurance Division comprises four departments: Groups, Retail Life (RLD), Life Insurance & Pensions Risk (LIPRD), and Business Model Analysis (BMA) departments. Groups supervises five of the largest life groups in the U.K., which together represent more than 70 percent of the U.K. life insurance market; RLD supervises 40 to 50 firms, comprising Category 1 to Category 4 firms and much of the mutual life insurance sector; LIPRD comprises specialists (predominately actuaries) with a broad and deep understanding of the prudential risks posed to the PRA by life insurers, reinsurers and pension schemes; and BMA, a small group (five to six) of specialists focusing on understanding firms business models and how they generate profits/capital; the threats they are exposed to; and the sustainability of those firms.

12. The FCA comprises nine divisions that operate with several executive and nonexecutive committees that oversee the operations. The organization includes the enforcement and market oversight division, the strategy and competition division, the markets policy and international

division, the risk and compliance oversight, two supervision divisions, and three divisions responsible for internal oversight and support. The two supervision divisions are divided according to market participants.

- **The Supervision—Investment, Wholesale, and Specialists (SIWS)** is responsible for supervision of the producers and distributors of financial products, including asset managers, life companies, retail distribution platforms, and investment banks. It is also the division responsible for the buy-side activities of investment managers and the sell-side and trading activities of investment banks and markets. It contains centers of excellence dedicated to Prudential, Client Assets, Financial Crime, and Event Supervision that serve both Supervision divisions. The SIWS is made up of three subdivisions: Wholesale Markets and Investment Management, Life Insurance and Financial Advice, and Specialist Supervision. The division spans five market sectors: Wholesale Banking, Capital Markets, Investment Management, Retail Investments, and Pensions and Retirement Income. It also houses the Central Support function covering operational and systems support, management information, quality assurance, and data. Central Support also operates across both Supervision Divisions.

- **The Supervision—Retail Banking and Authorizations** is responsible for supervision of the three sectors, which have the biggest mass market footprint—Retail Banking, Retail Lending, General Insurance and Protection. It also provides Authorizations and Contact Centre services—including a dedicated capability for authorizing consumer credit firms—as well as a center of excellence for conduct supervision. These services are provided across both Supervision divisions. This division consists of three sector teams: Retail Banking, Retail Lending, General Insurance and Protection, along with Authorizations and Credit Authorizations.

Resources

13. The human resources in both supervisory authorities have been increasing. At the PRA, resources for insurance supervision have been gradually increasing and the turnover is low. Resources at the FCA have also been increasing. At June of 2015 the full time equivalent (FTE) number at the FCA was two percent higher than at the end of 2014. The PRA's Insurance Directorate FTE at the end of June 2015 showed a 7 percent increase in headcount compared to the end of 2014.

14. Both the PRA and the FCA have the authority to levy fees from the industry to finance their operations. Fees are intended to recover from the industry all the costs of their operations. The FCA collects the fees on its own account and on behalf of the PRA as its collection agent. The process is transparent and equitable, as commented by the industry. The fee is based on the size of regulated business as a proxy for the impact risk on their statutory objectives. For some projects like Solvency II implementation, special project fees can be levied. Additionally, the PRA and the FCA have the ability to require individual firms to pay for experts' reports commissioned under Section 166 of FSMA. The fines imposed by the authorities are transferred to the HMT after recovering enforcement costs. The FCA fee has increased by 11 percent in the last three years amounting, for 2015/2016, to GBP 66 million. For the same year, the PRA fee amounted to GBP 227 million, also an increase from the previous year.

C. Supervision Approach

The PRA

15. **The PRA has three statutory objectives:** A general objective to promote the safety and soundness of the firms it regulates; an objective specific to insurance, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders; and a secondary objective to facilitate effective competition. The PRA advances its objectives through regulation, setting standards or policies that it expects firms to meet; and through supervision, assessing the risks that firms pose to the PRA's objectives and, where necessary, taking action to reduce them. The PRA does not seek to operate a "zero-failure" regime. Rather, it seeks to ensure that a financial firm which fails does so in an orderly way that avoids significant disruption to the supply of critical financial services.

16. **The PRA's secondary competition objective applies when the PRA is discharging its general functions in a way that advances its primary objectives.** The secondary objective came into force on March 1, 2014, and various actions have been taken to ensure it informs policy design and the PRA's supervisory approach. At the request of the BoE's Court of Directors, the Bank's Independent Evaluation Office (IEO) will be monitoring the PRA's approach to this new objective. An example where the secondary competition objective has influenced the PRA's policymaking is the Solvency II long-term guarantees package for insurers. The PRA consulted on transitional measures for insurance technical provisions (liabilities), as part of the introduction of the Solvency II regime. The transitional measures aim to avoid market disruption potentially associated with the move to a new regulatory regime and to limit interference with the existing availability of insurance products.

17. **The PRA's supervision approach is risk–based, having a forward view that allows for supervisory judgement within a structured framework.** The supervisors' actions are guided by the PRA's Risk Assessment Framework that captures (i) the potential impact of firm stress/failure on the financial system; (ii) how the macroeconomic and business risk context in which the firm operates affects its viability; (iii) mitigating facts that combine to determine the overall safety and soundness; and (iv) the extent to which a firm would be resolvable in the event it ceased to be viable as a going concern (resolvability). Accordingly, the intensity of the PRA's supervisory activity varies across firms. The firm's potential impact on the financial stability depends on its footprint in the entire financial sector. In addition, supervisory judgement is applied to take into account its complexity, business model, and interconnectedness with the rest of the system. The PRA divides each type of firm it supervises—deposit takers, investment firms and insurers—into five categories of potential impact.

18. **The organization and deployment of supervisory resources reflects the categorization of insurers.** The intensity of the PRA's supervisory activity varies across insurers. The level of supervision principally reflects the PRA's judgement of an insurer's potential impact on (i) policyholders; (ii) the stability of the financial system, (iii) its proximity to failure; (iv) its resolvability; and (v) the PRA's statutory obligations, if any. Other factors that play a part include the type of business carried out by the insurer and the complexity of the insurer's business and organization. The resources dedicated to supervision depend on the categorization of the firm, with

Category 1 firms having the largest number of supervisors. In addition to firm-specific teams, specialist support on a variety of topics is also provided.

19. A reduced intensity of supervision applies to firms in the lower categories. In accordance to the risk-based approach, the supervisory intensity that applies to each category diminishes as the impact to the financial sector weakens. At the low end, in Category 5, firms are the smaller insurers that have been assessed to have the lowest potential impact to the stability of the financial system. The PRA supervises these firms on a portfolio basis using automated tools to analyze regulatory returns. Supervision is mainly reactive, with no named supervisor. The PRA examines individual insurers when a risk crystallizes (for example, a visit to the insurer or an approach from the insurer itself), or in response to authorization requests from the insurer; conducts peer group analysis across sectors as a whole to develop a clear understanding of the risks posed by both small insurers in aggregate and by a typical insurer; and conducts annual assessments of these insurers in large peer groups.

20. Complementing the baseline supervisory activities, the PRA uses the Proactive Intervention Framework (PIF). Within each category of firm and with varying frequency, an assessment of each firm against seven risks is carried out.[2] Based on supervisory judgment, a PIF stage is assigned to the firm. The different PIF stages trigger a series of possible actions for the corresponding supervisor's consideration—such as putting a firm on the watch list—that requires continuous reporting in some cases up to the board level. The PIF stage list is updated on a monthly basis, and all firms up to Category 4 have been assigned a PIF stage. The PRA also maintains a watch list of firms posing heightened levels of supervisory concern that requires continuous reporting, in some cases up to the board level.

21. Supervision is supported by regular reporting. The PRA's approach to supervision is to undertake an ongoing program of continuous assessment. The Periodic Summary Meeting (PSM) reviews work conducted over the previous year, approves the proposed supervisory plan for the next 12 months, and assesses the supervisory strategy for the firm in the longer term (often several years into the future). For Category 1, 2, and 3 firms, PSMs are firm-specific meetings, whereas for Categories 4 and 5 the PSM considers firms in peer groups. For Category 1 firms, the PSM convenes at the Supervisory, Risk, and Policy Committee (SRPC) level and sends the outcome to the PRA Board, within a maximum period of four weeks after the PSMs, for it to then decide whether or not to discuss those firms. The PSMs for Category 2 to 5 firms are empowered to make decisions for the firms being considered but can also escalate decisions to a more senior supervision committee (i.e., the committee immediately above the PSM), if necessary.

22. The supervisory effectiveness and consistency of the actions taken is assessed by the Supervisory Oversight Function (SOF). The SOF provides independent assurance to the PRA Board and Executive as to the quality and effectiveness of supervision, and in doing so, promotes and supports the PRA's aim to deliver high quality, forward-looking, and judgment-led supervision. This

[2] These include external context, business risk, governance, risk management, capital, liquidity, and resolution.

is achieved by undertaking firm-specific and thematic supervisory effectiveness reviews and providing management information and analysis in the application of the supervisory approach. Both of these activities facilitate forward-looking recommendations and the identification of good practices to share designed to further improve the quality and effectiveness of supervision.

23. Decision-making at the PRA is a robust process. The governance framework of the PRA supports proportionate and practical decision making, ensuring senior management are involved in the most important decisions for the largest firms. Decisions that could have a material impact on the PRA's objectives and/or the firm's safety and soundness are escalated, with the seniority of the committee being dependent on the potential impact of the firm and the materiality of the decision. Detailed information on the escalation process for a series of decisions are indicated in the PRA Decision-Making Framework. There are certain decisions which fall outside this framework, and must always be taken by a certain committee—these are detailed in full in the Decision-Making Framework document, and include placing a firm into resolution. Different supervisory views are decided through different committees. For disputes about an individual firm, this will usually be the relevant PSM, but if necessary disputes can be escalated to the SRPC.

24. The risk appetite driving supervision should take into account the reputational risk of the U.K. as a global financial center. Entities that are authorized in the U.K. by the PRA and FCA to carry on insurance business or by the FCA to carry on insurance mediation business are subject to supervision. There are some brokers that use the U.K. "brand" to operate mainly offshore, like exclusive reinsurance branches and brokers, and are not captured under current risk appetite declarations (because they are not considered large in U.K. market terms). The authorities should consider a minimum level of supervisory scrutiny of entities with a strong international focus regardless of size.

The FCA

25. The FCA supervises the business conduct and prudential aspects where the PRA is not responsible of firms in the financial sector. The FCA makes risk-based judgments about whether (i) the firm's business model (and how its run) results in fair treatment for consumers; (ii) it upholds market integrity; and, (iii) for those firms that it regulates prudentially, they are financially sound. The FCA takes a forward-looking and judgment-based approach to regulation. As such, it looks closely at firms' business models and culture and uses its judgment to assess soundness and robustness. It focuses on the more substantial issues and the causes of problems, as well as ensuring when problems arise, that there are accountable individuals in the firm. The FCA therefore prioritizes its work on the areas and firms that pose a high risk to its objectives. While the PRA has prudential responsibility for all deposit takers, insurers, and certain designated investment firms, the FCA is the prudential supervisor for firms in other sectors across the financial services industry. Prudential supervision encompasses the establishment of financial resource requirements (either through making rules or individual review) and monitoring firms' compliance with applicable rules and requirements.

26. The FCA has reacted to the new responsibilities by restructuring its supervisory approach. The number total of entities that the FCA supervises is very large (56,000). The supervisory approach has therefore moved from a company focus to a sectoral focus. The overall risk appetite has been replaced by sectoral risk appetite declarations, including those of the cross sector departments, like the FC department, the authorization department, the enforcement department, etc. In August 2015, the FCA Board approved the new supervisory model. The new model places less emphasis on firm-specific supervisory activities and allows the FCA to respond flexibly to its most significant risks, so that it works on the areas that matter most to markets, firms, and consumers. The FCA approach to Prudential, CASS, and FC supervision remains unchanged.

27. The continuous supervision of firms is supported by a number of formal processes. The FCA's supervisory framework has a number of processes built-in to ensure it maintains an up-to-date view of risks in both firms and sectors. The largest (re)insurers will be subject to a continuous cycle of proactive supervision aimed at identifying and mitigating risks in these firms. A key element of this cycle is the Firm Evaluation meeting. This meeting uses all available intelligence to form an overall view of a firm and the risk it poses to FCA objectives and establishes a supervisory strategy to mitigate these risks. Firm Evaluation meetings are held at intervals of up to three years, depending on the risks posed by the firm, and are supplemented by interim reviews to refresh their view of the firm and to ensure the supervision strategy is on-target and remains appropriate; these take place at least annually.

28. Sectoral risk identification and consistency in the supervisory approach are being strengthened. At a sectoral level, the FCA is developing House Views, which provide a unified cross-FCA view of the sector and the risks and issues it faces. The House Views are a strategic approach to managing risk in a sector as a whole, and inform prioritization across the FCA. The first iteration of the House Views are expected to be completed by Q2 2016. The Views will be refreshed on a quarterly basis and rewritten on an annual basis. The House Views will be used to identify priority areas for market studies or thematic work, and will be used to identify where the FCA may want to carry out discrete investigatory work in firms. In addition to the House Views, the FCA also maintains ongoing oversight of the sector by continually identifying and assessing key risks in the sector, including emerging risks. This analysis allows the FCA to support their general supervision of (re)insurers by targeting work to mitigate priority risks impacting all (re)insurers.

29. The FCA's new approach to supervision does a good job of acknowledging the sectors' specificities, but access to the required centralized resources might be difficult. The supervisory approach has moved from a company to a sectoral focus. The overall risk appetite has been replaced by sectoral risk appetite declarations that better reflect the sector specificities. These declaration also apply to the cross-sector departments, like the FC department, the authorization department, and the enforcement department. But access to these centralized resources does not only depend on the risk appetite of the supervision but also on the priorities set by the centralized departments. The FCA

should consider a mechanism to allow any sector[3] to satisfy its urgent needs independently of the risk appetite of the centralized resources.

30. Notwithstanding the stronger focus on the sectoral issues, including insurance, supervisory and enforcement actions, important challenges need to be addressed:

- The FCA has started a series of commendable thematic work but time to action and policy revision (as a result of this thematic work) is relatively slow.
- The enforcement actions may sometimes take a few years to be effective and published if the cases cannot be settled. The FCA should do everything possible to accelerate the timetable, while ensuring due process and fair treatment.
- The disruptive technology in the digital sales of insurance is strong in the U.K. market and has brought greater competition and a better customer experience in some areas. However, it also creates new challenges to market conduct supervision. For instance, comparison price web pages disaggregating benefits without adequate explanation to consumers can lower the price to the extent that protection is either useless or inadequate. Ensuring consumer understanding will require enhanced regulatory requirements when providing web-based comparisons.

31. The FCA information technology (IT) system is not connected with the new reporting system of the PRA. At its creation, the FCA inherited the reporting regime of the FSA. The core insurance return is the exception to this as it was transferred to the PRA. The FCA is currently in the process of reviewing the degree to which the returns they receive provide the data necessary to support the FCA's new objectives and remit. The FCA over the next few years will be updating its reporting requirements and developing new returns for insurers and insurance intermediaries to allow for better monitoring consumer protection and market integrity.

D. Enforcement

32. The FCA and the PRA use enforcement actions to meet various objectives. These objectives include making their powers effective, providing redress to consumers, setting expectations on the behavior of authorized firms, and providing credible deterrence. Enforcement uses a wide range of enforcement powers—criminal, civil, and regulatory—to take action against firms or individuals. Final notices of the enforcement actions are published so as to ensure transparency and accountability, as well as inform the public in order to maximize the deterrent effect of the enforcement action. Also, issuing alerts about financial services firms and individuals, based both overseas and in the U.K., which are operating without FCA authorization supports the credibility of the supervision in the U.K.

[3] In the area of FC, such a mechanism exists and it has been used in the past. For example: (i) FC can apply override in exceptional cases (and have done) so it isn't absolute and rigid; and (ii)) just because an issue does not meet the FC threshold, it does not preclude action by supervisors—and in fact there is an expectation within the hybrid model that operates in FCA that supervisors can and should take FC cases forward where FC does not—and this has happened.

33. The authorities enjoy a high degree of operational independence when issuing enforcement measures, but are subject to numerous—and appropriate—accountability mechanisms. Enforcement actions have been issued in the form of fines, prohibitions, and withdrawal of permissions. Breaches in risk management systems leading to harm to consumers, as well as wrong remuneration incentives leading to inappropriate sales, have been penalized. The justification for the enforcement on the final notices makes reference to the Statements of Principles breached and the responsibility of the penalized person and are always linked to breach of rules. A firm can be penalized by each of the two authorities for the same action if the action breached the rules of both authorities. Fines have been applied to both firms and individuals. From the starting point to the publication of the fine it can take several years if the firm contests the ruling and the case is referred to courts. In parallel, however, supervisory corrective and protective measures may be taken.

34. The new regulators have already delivered strong enforcement action. The FCA imposed fines totaling GBP 425 million. By October of this year, more than GBP 20 billion had been paid under an FCA redress scheme to consumers who were mis-sold card and identity insurance and payment protection policies. In November, the FCA took action in response to attempted manipulation of the FX market, so far fining five banks GBP 1.1 billion, with potentially criminal misconduct by individuals being investigated by the Serious Fraud Office.[4]

35. HMT published a review of enforcement decision-making at the financial services regulators. The recommendations will enhance the enforcement processes and enforcement actions that are already high under international standards.[5]

E. Group Supervision

36. A large number of groups are supervised by the PRA and the FCA. A definitive list of all insurance groups supervised in the U.K. is not published by the PRA, but all individual legal entities are listed publicly on the Financial Services Register. However, for European insurance groups where a college has been established a list (the Helsinki List), is published by EIOPA and a similar list of financial conglomerates with head of group in the EU/EEA is published by the Joint Committee of European Supervisors. Twenty groups have been identified in the 2014 listings where the U.K. is the group supervisor.

37. The preparation for group supervision by PRA and the FCA under Solvency II has been ongoing for several years. Colleges of supervisors for the groups where the PRA is the lead supervisor have been created. These colleges have been active for a few years and are in compliance with the EIOPA requirements on colleges. In advance of the Solvency II Directive's implementation,

[4] http://www.fca.org.U.K./news/fca-fines-five-banks-for-fx-failings, http://www.sfo.gov.U.K./press-room/latest-press-releases/press-releases-2014/forexinvestigation.aspx.

[5] https://www.gov.U.K./government/uploads/system/uploads/attachment_data/file/389063/enforcement_review_response_final.pdf.

insurance colleges are subject to existing EIOPA and IAIS guidelines. In particular, procedures for internal model pre-applications were included in EIOPA guidelines that applied as of January 1, 2014. The final draft of EIOPA guidelines on the operational functioning of colleges were published in February 2015. These include guidance on the organization of the exchange of information among college members; communication with management of the firms and the voluntary sharing and delegation of tasks. The guidelines also include templates for coordination arrangements, emergency plans, and a suggested list of data to be exchanged within the college. Processes for joint decisions on group internal models under Article 231 can be found in Title II Chapter II Section 2 of the delegated acts. Directive requirements relating to the duties of supervisors in a group have been transposed by HMT in the FSMA—the 2015 Solvency 2 Regulations. The regulations set out different requirements that apply to the PRA, depending on whether the PRA is group supervisor or it is a member of a college of supervisors for a group but not the group supervisor. The PRA has published in its supervisory statements how it intends to comply with EIOPA guidelines and (where applicable) that it expects firms to comply with these guidelines. The PRA and FCA liaise closely on EIOPA colleges. PRA and FCA also run their own college meetings for U.K. groups for large (re)insurers and on a sector or sub-sector basis for some small entities.

38. The PRA has direct powers over the authorized companies within the group and indirect power over other entities of the group. Obligations to comply with group requirements are placed on the authorized entities within a group (i.e., the U.K. (re)insurers for an insurance group). These obligations include ensuring that the PRA is satisfied that the group is managing risks posed to (re)insurers adequately, and that any group reporting sufficiently covers the activities of noninsurance entities within the group.

39. The direct PRA powers over holding companies apply only to qualifying parent undertakings. A 'qualifying parent undertaking' under the FSMA (2012) encompasses financial holding companies, mixed financial holding companies, and insurance holding companies (as defined under the Capital Requirements Regulation (CRR), the Financial Conglomerates Directive, and Solvency II, respectively), provided their head office is in the U.K. Given that the intermediate holding company meets the definition of a qualifying parent undertaking, PRA's powers of direction also apply to these entities. The PRA powers of direction can only be used in two conditions—where a direction to a qualifying parent undertaking would further the supervisory objectives (the 'general condition'), or for the purpose of meeting consolidated group requirements (the 'consolidation condition').

40. Where the PRA supervises an entity within a broader multinational group, or is the group supervisor for a multinational group, a 'college of supervisors' is established. Prior to the full implementation of Solvency II, all colleges with at least two EEA members were required to have a coordination arrangement. The majority of coordination arrangements, which are in the process of being drafted or have been signed for colleges in which the PRA is the group supervisor, are based on the template found in the EIOPA guidelines on the operation of colleges. These coordination arrangements state the participants in the college, their status for certain Solvency II decisions, and the contact information for all relevant supervisors. The arrangements also outline the roles and

responsibilities of each member of the college and the group supervisor, the college work plan, the establishment of any specialized teams within the college, and the procedures for the sharing and delegation of tasks within the college. The FCA's experience with supervisory colleges has been limited so far. As conduct issues rise up the agenda, the FCA anticipates that early teething problems will be overcome, and that quality relationships with the relevant home supervisors will develop.

41. Under Solvency II, all EEA colleges should put in place a "College Coordination Agreement". The agreement would include an emergency plan for the college of supervisors. This emergency plan is intended to support the management of a crisis by the group supervisor and the college of supervisors. This emergency plan should define the means for crisis handling of the group and in an emergency situation provide a common understanding of the division of tasks such as communication to the public of measures taken.

42. During 2014–15, the PRA engaged in a range of activities in relation to groups. Firms and groups have engaged in significant restructuring and/or acquisition activity. These activities have led to review of specific transactions, including change in control and issuance of capital instruments. In preparation for Solvency II, firms also have been engaging with their supervisors on matters such as the scope of the group, the availability of own funds across the group, and the scope of internal models. There was considerable focus on the review of model development and the extent to which groups are making progress against their delivery plans. As part of the regular supervisory activity, periodic summary meetings addressed the supervisory strategy and conducted an assessment of the key risks facing the group—having regard to its compliance with threshold conditions, its impact score, and its PIF score. During 2014 and continuing into 2015, commitment panels were introduced in order to assess the extent of progress a group had made in its internal model preparations and whether the PRA was satisfied that the firm/group could proceed to the formal application phase. Chaired by senior management and comprising supervisory and specialist representation, these panels provided an opportunity for the supervision team and management to put forward for challenge and/or confirmation its assessment of the firm/group's readiness to proceed.

43. The FCA has performed a number of on-site assessments (as well as desk-based review work) on the U.K. operations of multiple financial conglomerates and insurance groups. Among other issues, the FCA reviewed entity governance, product design, outsourcing oversight, and sales. It also looked at group operations, where relevant to its objectives and the U.K. entities. For example, it required a report by a skilled person to review the governance of a major international insurance group where it was concerned that the U.K. firms had an inappropriately low level of control over their operations. It also required an on-site assessment of the centralized policy administration and claims payments operations of a multinational group.

44. Solvency II is introducing extensive improvements in group supervision requirements that will accelerate the progress already made by the authorities. The PRA has been creating the supervisory colleges for the most important groups, and has also been participating as a member in other colleges where it is not the group supervisor. The EIOPA requirements on the conduct of colleges have been implemented for the PRA-led groups. The FCA is in the process of structuring its group supervision for market conduct purposes by reallocating responsibilities to sector-specific

supervisors. This approach, while having the focus the sector-specific issues, will require strong coordination among the different group of supervisors looking at the group as a whole. The FCA should ensure a coordinated approach to group supervision when finalizing the new supervisory approach for groups.

45. Notwithstanding the progress made in the group supervision, the PRA should consider the following further improvements:

- A large number of groups are supervised by the PRA, but its current IT system does not allow the supervisors to map comprehensively individual legal entities to a group structure.
- The monitoring of contagion risk could benefit from a IT tool that maps the group structure together with all important intragroup transactions—like loans, reinsurance and guarantees. The tool should allow for stressing the different transactions to gain an overview of the contagion risk within the group and the transmission channels.
- Effective cooperation establishing a clear definition of responsibilities around joint decisions over group internal model applications and group model changes, in particular where the group internal model determines the solo SCR of more than one (re)insurance undertaking.
- Capital transferability across jurisdictions when diversification benefits are granted.
- Given that the possibility to designate the lead supervisor independently of the domicile of the insurer is not always given for insurers with significant business outside the EEA, similar agreements as those existing under the EIOPA requirements for colleges in the EEA should be introduced.

F. Market Entry and Exit

Licensing and entry controls

46. The licensing process, including fit and proper assessments, is strong. The good practices in the licensing process, including the approved person regime and the corresponding fit and proper assessments found in the last FSAP, continue to be in effect. The PRA is responsible for the licensing of the firms that are supervised by both authorities. However, the license can only be approved after the FCA has provided its consent. The PRA's Central Supervisory Support (CSS) covers a broad range of activities including routine authorizations (nonroutine authorizations case management and decisions are undertaken by supervision), firm enquiries, PRA communications and maintenance of the supervisory model (for example, training).

47. The EU's freedom of services rules allow insurers established anywhere in the EU to operate in the U.K. without an additional license. While the FCA has a limited market conduct responsibility for the branches of EEA-domiciled insurers, the prudential supervision and key elements of the conduct supervision of such branches are the sole responsibility of the home supervisor. Currently, the information on the prudential condition of the insurers is delayed and the level of granularity of the data does not allow for timely preventive market conduct actions. These

deficiencies are expected to be removed with the strong reporting requirements that Solvency II is imposing. However, for market conduct supervision, the FCA's data needs are likely to not be entirely met by the Solvency II reporting regime, and it is working on addressing the gaps.

Market exit

48. Two main options for dealing with insolvent insurers established in the legislation are administration and liquidation:

- A modified administration regime exists for insurers based on the corporate U.K. administration process. Under the insurer administration regime, the administrator has a duty to carry out the insurer's contracts of life insurance with a view to the business being transferred as a going concern to another insurer (the administrator may do similarly with general insurance business, but is not required to do so). The administrator is required to cooperate with the FSCS (the U.K. compensation scheme). The administrator is appointed by the court and may be suggested by the directors, or creditors of the firm, or by the regulatory authorities.
- A modified liquidation regime exists for insurers based on U.K. corporate liquidation process. The primary purpose, once the relevant tests have been met, is to allow the assets to be realized, and thereafter claims to be agreed and settled after payment of the cost of proceedings.

49. The winding-up of insurers is usually a long process, partly intended to protect policyholders by enabling more accurate calculation of long-tail claims liabilities. Insurers generally cannot cancel their authorization and liquidate promptly because they might still receive claims and need to ensure that all policyholders are paid what is due them (or an equitable percentage of that in the case of an insolvent insurer). This applies to insurers who enter run-off voluntarily or following regulatory action (e.g., due to insolvency). The last major insurer in the U.K. to go insolvent was in 2001. It entered a court-approved scheme under which claims were processed and agreed (but not paid). In 2015 (having received non-objection from both the PRA and FCA), it gained court sanction to amend this to an arrangement, whereby all known and projected future liabilities are calculated and creditors, including claimants, are to be paid a fixed percentage of the amounts due to them. This is currently ongoing. The company is expected to liquidate in 2016, following the court-agreed date for the amended scheme. Since the firm became insolvent, the FSCS has ensured that protected claims have been paid, and it will continue to pay any new protected claims going forward (including after the liquidation of the insurance company).

50. For transfers of insurance business of U.K. authorized insurers, the legal framework is set out in Part VII of the FSMA (2000). Essentially, Part VII of FSMA allows an (re)insurer to transfer insurance business to another (re)insurer without the consent of the policyholders. An (re)insurer is therefore able to utilize an insurance business transfer to facilitate its orderly exit from the marketplace. This process requires a willing recipient, and some sort of risk margin is expected to be built-in accordingly. Portfolio transfer is a statutory process that requires the sanction of a U.K. court. Under FSMA, the main requirements of a business transfer are a report by independent expert, policyholder notification, court approval, and non-objection by the PRA and the FCA or other regulators and interested parties.

51. Both the PRA and the FCA are involved in the transfer portfolio decision. Both authorities must be satisfied independently (taking account of their different objectives) that the independent expert is appropriate and that his or her report covers the right issues. The court is involved in the process at two points. The first is the "directions hearing," when the court is asked to grant leave to proceed with the transfer. The second is at the hearing to sanction the transfer, sometimes known as the "final hearing". Each regulator will produce a report to the court setting out its view of the transfer with regard to its respective objectives. In addition, an independent expert will opine on the impact of the transfer on the interests of different policyholder groups.

52. Any impact on policyholders' rights, fair treatment, and the effectiveness of the firm's policyholder communications strategy are particular areas of focus for the FCA. The FCA considers a wide range of factors, such as the transferee's ability to handle claims appropriately, as well as explicit statutory factors, to come to a view on whether the policyholders of either transferor or transferee will be in a worse position following the transfer. The FCA's approach also takes into account the sophistication of the policyholders involved.

53. For the PRA, the prudential aspects are more relevant. These include the impact of the transfer on the transferor and transferee firms' business models, capital position and fungibility, reinsurance arrangements, intragroup arrangements, and ongoing ability to meet threshold conditions. Sometimes a capital injection pre- or post-transfer may be required to ensure sufficient capital resources are available. Transfers also raise jurisdictional issues and, during 2015, a particular area of interest was whether the transfer impacted a firm's Solvency II position.

54. A number of portfolio transfers have been approved in the context of the winding up or restructuring a group. Part VII transfers are routinely used as part of a process of winding up an insurer, often to remove any remaining insurance business in an insurance company followed (swiftly) by a cancellation of authorization and liquidation of the company. They are commonly used either by insurers after a long run-off period or as part of group reorganizations. The volume of transfers from both these communities has risen markedly in the last few years as firms prepare for the implementation of Solvency II.

55. The protection afforded to insurance policyholders under EU member states' various insurance guarantee schemes (IGS) is uneven. Some EU member states have no such scheme at all. The Insurers' Winding-up Directive, which has been incorporated into Solvency II, ensures the mutual recognition of reorganization measures and winding-up legislation of the member states concerning insurance undertakings. For cross-border insurers with branches operating in the EEA, reorganization measures and modified insolvency proceedings will be determined by the home state regulator. Reorganization measures taken in accordance with the legislation of the home member state is fully effective throughout the community without any further formalities. That means that the U.K. FSCS, which is a comprehensive scheme, covers protected insurance policies, sold by both U.K. authorized insurers and U.K. branches of EEA insurers (whether the risk is a U.K. or EEA). Additionally, it covers U.K. risks insured with firms based in EEA countries and sold via freedom of services in the U.K. The FCA requires all covered insurers to pay the corresponding levy to the FSCS independently

of their domicile. The European Commission is considering whether to make a legislative proposal for a harmonized Insurance Guarantee Schemes Directive.

56. The PRA is preparing resolution plans for the two G-SIIs headquartered in the U.K. in the context of the FSB work on recovery and resolution planning for G-SIIs. G-SIIs are required to prepare recovery plans in the context of the FSB work on recovery and resolution planning for G-SIIs. There are no requirements for insurers that are not G-SIIs to prepare recovery plans. Under Solvency II, all insurers must submit a recovery plan within two months where the solvency capital requirement has been breached.

57. Resolution powers of the PRA have been strengthened but remain indirect, needing court approval for any restructuring. The PRA does not operate as a single resolution authority for insurers, even though it can use its supervisory powers to direct restructuring, including portfolio transfers. As a result, final enforcement of these actions relies on the courts. The ability to write down policyholder liabilities is exercised through the courts—not an administrative power available to the resolution authority, as is the case for banks. Insurance failures are generally protracted and complex, and need to consider a number of different interests, with certain policyholders already protected by the FSCS. The U.K. authorities should work with international partners to develop an integrated regime of resolution powers for insurance, with due regard to the insurance business model. Also, the U.K., in conjunction with EU authorities should consider whether the current arrangements in the case of a cross-border failure ensure adequate coordination and flexibility between the various resolution tools and authorities.

58. The delegated supervision to the home supervisor requires an increased level of cooperation, information sharing, and engagement within the colleges of supervisors. This level of cooperation goes beyond the current supervisory powers and should include consistent guarantee schemes for failing insurers, and consistent cross-border resolution powers.

G. Solvency II Implementation

Introduction

59. After seven years of preparation, Solvency II came into force on January 1, 2016. With over 30 percent of Executive Directors' time in recent years dedicated to the implementation of Solvency II, the PRA has prepared diligently for its implementation. This includes securing and maintaining skilled human resources that can be supplemented with external specialists; developing IT systems to facilitate the intense data reporting requirements under Solvency II, and also to be able to exploit the granularity of the data availability for the supervision of insurers and for monitoring systemic risk; and preparation of the approvals firms need to obtain prior to the commencement of Solvency II. Some of these relate to scrutiny of measures provided in Solvency II to help insurers manage the transition, while others are of ongoing relevance. Of the latter, the most significant is the need for firms to obtain approval should they wish to calculate their capital requirements using an internal model.

60. The transposition of the Solvency II Directive into national law was carried out without significant exceptions. All EIOPA guidelines have been incorporated into PRA rules as set out in various supervisory statements. The Directive has been fully transposed into national law, using an intelligent copy-out approach. Deviations to copy-out were exceptional and included, for example, changes where clarifications were needed; but care was taken to preserve the meaning of the directive requirement. The FCA has also amended its handbook to make appropriate changes as a consequence of Solvency II implementation.

61. Only a small part of the market is out of the Solvency II scope. About 20 percent of the insurers are out of scope of Solvency II. The majority of these firms are mutuals. This figure also includes approximately 60 partnership pension friendly societies, which are not required to submit regulatory returns and for whom detailed data is not available; 24 other friendly societies; and 20 or so other small (re)insurers (including branches of EEA firms that passport into the U.K.). The majority of these are in the life business, but there are a few writing GI. These life firms at end-2013 collectively had total assets of approximately GBP 232 million and gross written premium of approximately GBP 89 million. The 13 (re)insurance companies writing a variety of GI business at end-2013 had total assets of approximately GPP 5.26 billion, and gross written premium was GBP 310 million.[6]

62. Third-country pure reinsurance branches are also out of scope of Solvency II requirements. The PRA has recently reviewed the rules for third-country pure reinsurance branches and published a Supervisory Statement (SS44/15) setting out its approach to supervision. In summary, the PRA has followed Article 174 of the Solvency II directive and expects third-country branch undertakings to comply with the EIOPA Branch Guidelines.

63. The implementation costs of Solvency II for the PRA are estimated to be GBP 100–150 million. However, this does not include the allocated time of PRA staff that supported the implementation of Solvency II in course of their normal duties. A well-managed IT project that will allow for the intensive and extensive data reporting requirements under Solvency II contributed to the cost reduction from the original budget of GBP 150 million.

64. The PRA maintains a dedicated website on Solvency II. To keep the industry and public informed on the implementation of the Solvency II Directive in the U.K., pages of the BoE website provide the U.K. insurance industry with information on the implementation of the Solvency II Directive in the U.K. The publications include clarifications and expectations of different aspects of Solvency II by the PRA.

65. The effectiveness of Solvency II in the U.K. will depend on the forthcoming regulatory changes and supervisory action taken in the U.K. Implementation of Solvency II by the U.K. authorities will be tested in economic downturns. Under macroeconomic conditions affecting

[6] These data are from 2013 and are skewed by two firms that will be out of scope by virtue of Article 11 of the Directive in that they are guaranteed by the U.K. government.

insurers throughout the EU, the pressure on the U.K. to support a weakening of the market consistent valuation principle of Solvency II will be challenged. Consideration should be given to macroprudential tools to manage macroeconomic risks instead of relying on adjustment measures in the Solvency II framework to address cyclical conditions.

66. The maximum harmonization implementation of Solvency II creates vulnerabilities that need to be addressed at an EU level. The complexity of Solvency II, in particular when internal models are used, requires a significant amount of highly qualified resources for proper supervision. This condition presents an important challenge to several EU jurisdictions. The onerous requirements that Solvency II imposes on the insurers could theoretically motivate the use of freedom of service in the EU to search for jurisdictions where the supervision uses a lighter version of Solvency II pillars two and three. Monitoring and acting to prevent on an EU-wide level such a trend would be important.

Pillar one

67. Some risks are not covered in the Standard Formula (SF). EIOPA's document on the SF lists the assumptions and bases that were used when calibrating the SF, including in respect of sovereign risk, and as such it makes clear the SF's limitations and the fact that some risks are not covered by the SF.[7] It is for these reasons that Solvency II requires an assessment as to whether the SF may or may not be appropriate. Where the risk profile of a firm is not appropriately addressed by the SF, an internal model (full or partial) may be needed or capital add-ons may be required.

68. Consideration should be given to addressing the long-term exposure of certain lines of general insurance business. In nonlife insurance, the prudential buffers from the reserve requirements under Solvency I have been stripped off in favor of capital charges based on statistical distribution. This approach is particularly sensitive to the insurance of extreme infrequent events. The one-year horizon of the Solvency II framework is also potentially insufficient for some of the complex emerging risks that are insured in the London market, some of which may give rise to losses several years after the policy was underwritten (asbestos claims is just one example). It is precisely this type of risks that have the characteristic of intrinsic long-term latent liabilities, and for which the one-year horizon required under Solvency II for the calculation of the SCR may not be appropriate. While the one-year horizon is complemented by the required ORSA exercise that should consider multi-years exposure, the supervisor's powers to take action under pillar two requirements are weaker. Consideration should be given to supplementing the one-year horizon with complementary analysis for complex business, for example, explicit stress testing scenarios that addresses long-term latent losses.

[7] https://eiopa.europa.eu/Publications/Standards/EIOPA-14-322_Underlying_Assumptions.pdf percent23search=underlying percent20assumptions.
http://www.bankofengland.co.U.K./pra/Documents/publications/cp/2015/cp1415.pdf.

69. Use of the Matching Adjustment (MA) and Volatility Adjustment (VA). The MA and VA are important pieces of the Solvency II framework in order to better account for the long duration of the insurers' liabilities and to limit unwanted volatility stemming from a market consistent regime. Both adjustments are relevant for the U.K. life sector underwriting long-term annuity business.

- **The MA has an important benefit for U.K life insurers.** The MA gives insurers relief for holding certain long-term assets that match the cash-flows of a designated portfolio of life or annuity insurance and reinsurance obligations. Firms with long-term, fixed, and predictable liabilities, such as regular annuity payments, are able to match their obligations to policyholders with assets that have the same cash-flow characteristics. The MA enables firms that are cash-flow matched in this way to recognize the reduced level of spread risk that they encounter. Delivering advice on the calibrations of the measures is the responsibility of EIOPA, subject to the European Commission endorsement. Over 20 U.K. life insurers have applied (or have indicated to the PRA that they intend to apply) for approval to use the MA. Significant work has been done by the U.K. industry to ensure compliance with the requirements set out in the Directive. Given these requirements, the PRA does not expect any nonlife firms to make applications. The estimated benefit of applying the MA to the U.K. life insurance market would be a substantial increase in own funds, with some additional benefit arising from reduction in capital requirements. The precise impact will not be known until decisions on specific portfolios are made. The impact of the MA will be a public number in the annual reports of insurers applying such measure. The matching adjustment approval was announced to the companies individually during the FSAP.

- **The VA measure is expected to have a much smaller impact on the solvency position of U.K. firms than the MA.** This is a result of two related factors: the lower calibration of the VA compared to the MA, and, as a consequence, its lower uptake on eligible liability pools. (For a given liability pool, firms can apply either the MA or VA—not both). The main areas in which the calibration of the MA and VA differ are:

    - The VA allows for a smaller proportion (65 percent, compared to 100 percent for the MA) of the risk adjusted spread to be used in discounting the technical provisions.
    - The VA is based on a currency-specific reference portfolio that excludes assets held within MA portfolios and has a lower overall yield.
    - The PRA has not permitted firms to assume any change in the VA under stressed conditions. In contrast, the MA can increase and this can reduce the solvency capital requirement.

- **The impact of the MA and VA should be closely monitored.** The volatility adjustment involves a number of simplifications, such as the use of a model portfolio, that could distort the market consistent approach to capital determination as required by IAIS. Applied indiscriminately, the VA could allow weak insurers to continue operating beyond the point of recovery. The PRA has therefore made use of the option to require supervisory approval for firms to use the VA. In the MA, the eligibility of unrated assets will require close scrutiny of firms' internal ratings and so relies on strong expert judgment. The PRA should introduce a series of well-defined actions to be

taken to monitor the levels of the impact that both measures have on the solvency position of the insurers.

70. Sophisticated stress testing will be necessary to allow for appropriate preventive measures.

- Multi-year stress testing is a tool to allow the PRA to take preventive measures to offset the effects of no longer having matching and volatility adjustments. The legal risk of changes to the illiquidity of the liabilities underlying the use of the matching adjustment will, in most cases, not materialize in a one-year horizon. The risk of changes to the illiquidity of the liabilities underlying the use of the matching adjustment in most cases will not materialize in a one-year horizon. The volatility adjustment justification of transitory volatility in the market will also be challenged only in a multi-year stress scenario.
- Stress testing using the matching adjustment, under spreads and widening shocks in a persistent low interest rate environment beyond the one-year horizon, need to be used on a regular basis. And this, used as the possibility to match the long-term liabilities with unrated or below investment grade rating securities, can result in a dual hit to the SCR of companies that will be affected both by the credit risk and the loss of the matching adjustment simultaneously.

71. Measures have been taken to allow for a smooth transition into Solvency II. Other than the risk-free interest rate transitional measure, there is no a priori difference in the scope of application as they are available to life insurers, general insurers, and reinsurers. The measures phase in the impact of the move to a going concern regime, and as such, mitigate significantly the likelihood of significant wide restructuring of liabilities or capital structure in the short time between the settlement of the regulation and the implementation date. The estimated initial benefit for U.K. industry is important on day one and falls gradually over time. Without transitional measures, some U.K. life insurers would have a surplus deficit, mostly as a result of the introduction of the risk margin that has a fix cost of capital independent of prevailing economic conditions.

72. The long duration of the transitional measures needs to be closely monitored. The longest transition period is 16 years for the risk-free interest rate and technical provisions. The U.K. industry (mainly life insurers) is expected principally to make use of the technical provision transitional measure. While the transitional measures have been taken in a manner that does not allow insurers to have a weaker position under Solvency II, adverse macroeconomic conditions could increase the challenge of meeting this scheduled transition. The PRA should consider developing a framework of actions that could be taken in case of a delay in meeting the transitional milestones. This would support a no forbearance regime and would be particularly important given the intention of the PRA to allow dividend payments, taking the transitional measures into account for the SCR determination.

73. The regulation for non-Solvency II firms is also undergoing changes. The PRA has recently consulted on a recast Rulebook covering the prudential regime for firms out of scope of Solvency II (so called Nondirective firms (NDFs)). It takes the current sourcebooks that apply to all insurers and presents them in the new PRA Rulebook style specifically for NDFs. It seeks to

rationalize and remove obsolete rules that no longer apply to this population of firms. The recast Rulebook represents a coherent and simpler set of rules for NDFs, which maintains the current regulatory standards and does not increase the burden on these relatively small firms. The FCA has also instituted changes as needed to implement the NDF regime from a conduct perspective including a proportionate change to the Approved Persons Regime.

74. Solvency II internal model approvals have been ongoing for several years and benefited from the ICA regime since 2005. Introduced in 2005, the ICA solvency regime permits the use of internal models. This allowed companies to be in a good position for the internal model approval process under Solvency II. Initially, around 120 insurers intended to apply for an internal model approval. Ultimately, 19 internal models have been approved. The reduced number of insurers applying for the internal model is probably a result of the high expectations on the internal models as stated by the PRA[8] and also partly due to the improved calibration of the SF that reflects better the risk of more companies than was the case a few years ago.

75. The PRA (and before that the FSA) has extensively engaged with industry in the run up to Solvency II. In 2011, the FSA held an industry briefing for firms in the pre-application phase of internal model approval. In 2013, EIOPA built on this work and issued guidelines on the pre-application of Internal Models. The PRA also held an industry conference on Solvency II implementation in October 2014, supplemented by regular "Director's Letters". In addition, the PRA run a "Smaller Insurers Seminar," where a number of Solvency II and Non-Directive regime challenges are addressed.

76. The PRA engaged fully with EIOPA's guidelines and issued a supervisory statement outlining how it expected firms to engage with the pre-application process.[9] The culmination of the pre-application phase was a series of Commitment panels that enabled the PRA to form a view on firms' internal model progress. Feedback was then provided to firms on what needed to be addressed in formal application. The PRA has made available an extensive list of resources for firms intending to apply for internal model approval.[10]

77. The approval process is structured to encourage consistency. To ensure consistency of decision-making and avoid competitive advantages to any firm, the approvals process itself is well structured, with pre-defined templates for the approval "panel packs." The process to reach an 'approve' or 'reject' decision is as follows:

- A firm-specific "recommendation panel" is held to assess the individual internal model application and consider the recommendation of the reviewing team;

[8] http://www.bankofengland.co.U.K./pra/Documents/publications/ss/2015/ss1515.pdf.

[9] http://www.bankofengland.co.U.K./pra/Documents/publications/ss/2013/ss413.pdf.

[10] http://www.bankofengland.co.U.K./pra/Pages/solvency2/internalmodel.aspx.

- The recommendation from this initial panel is reviewed by an oversight panel of PRA senior management who will reach a "minded to" decision; and
- All "minded to" decisions are reviewed and final decisions taken. Final decisions are communicated simultaneously to all firms.

78. The Solvency II internal model approval process is thorough and carried out following the EIOPA guidelines. The PRA has a strong governance process for the internal model approval process which has benefited from the banking sector experience—specifically from the use of models for capital determination as well as of the ICA solvency regime (that has been in place for insurers since 2005). The PRA should maintain the strong focus on internal model supervision going forward, as it has during the approval phase. The PRA should develop an approach to monitor potential internal model drift as, following approval of an internal model, an insurer may make model changes that will impact SCRs calculated in the future. Although major changes would require prior supervisory approval, insurers may make business choices relating to model development, such as on which areas of the model to direct time and resource. There is a risk that models generating lower capital requirements would be favored over time, and solvency standards might deteriorate. To identify and monitor this "model drift" at the individual firm level, sector level, and the industry as a whole, the PRA should develop an analytical toolkit. The toolkit should have a suite of measures and ratios based on independent and external measures, as well as the internal model SCR. These measures should not be hard regulatory thresholds, but used to inform supervisory review work. Consideration should also be given to raising with the EU Commission the merits for the supervisor of a nonobjection rather than approval of the model, thus avoiding legal risk.

Pillar two

79. Compliance with Solvency II as of January 2016 requires the strengthening the—already strong—governance requirements. The new Solvency II Level 2 Delegated Act and EIOPA System of Governance (SoG) guidelines contain a number of relevant provisions relating to governance, the organization of functions, and risk management, within firms and groups (e.g., EIOPA GL 67). Firms and groups have already addressed these issues through their preparations for Solvency II—as envisaged in the EIOPA preparatory guidelines. The PRA rules have been updated to transpose the Directive provisions relating to conditions governing business covering both firms and groups respectively—see PRA PS2/15, Solvency II: a new regime for insurers (App 1.12 and App 1.14, sects. 15 &17). Also, the PRA has issued a policy statement [PS 22/15], and made final rules for the new Senior Insurance Managers' Regime (SIMR), as well as issuing [SS35/15 and SS41/15] that spell out the expectations of both authorities with respect to the Solvency II requirements on governance, risk management and internal controls.

80. The regulatory requirements regarding the functions and responsibilities of directors and senior management have been established. These are included in the Senior Management Arrangements (SYSC) 2, SYSC 3.2, and SYSC 14.1 of the PRA Handbook. These rules are designed to ensure that at Board level, there is an effective system of risk management within the firm. Individual directors currently need to be pre-approved (SUP 10B of the PRA Handbook) as being fit and proper.

And for this purpose, the skills, knowledge and experience of individuals, as well as the board as a whole, are assessed. All directors and senior managers are also subject to a set of conduct principles in APER of the PRA Handbook, which include due skill, care, diligence, ensuring that the business is organized so that it can be controlled effectively, and ensuring that the function/firm complies with the relevant regulatory requirements and standards. This has recently been supplemented by a proposed supervisory statement in CP 18/15, further describing PRA's expectations on board responsibilities. The PRA has also proposed the application of equivalent SIMR rules to non-Solvency II firms in CP12/15, Senior Insurance Managers Regime: a streamlined approach for non-Solvency II firms. The FCA has also consulted on proposals for revised Approved Persons Regimes, for both Solvency II firms and NDFs, to be implemented from March 7, 2016. Following an announcement by HMT on October 15, 2015, further changes to these regimes are expected to be made by March 2018 at the latest.

81. In addition, all authorized firms in the U.K., including (re)insurers, are subject to the FCA's Principles for Business. These are contained in the PRIN sourcebook and include a requirement that firms must deal with their regulators in an open and honest way. In practice, individual FCA firm supervisors will have established and communicated to the largest firms a schedule of meetings with a firm's senior managers and NEDs, including MI requirements, all of which is subject to ongoing review. In addition, there is an expectation that firms would inform supervisors on key issues arising or expected to arise in a timely manner. The underlying theme of these interactions is one of being open and cooperative with the regulators.

82. The PRA and the FCA have aligned their requirements on governance with Solvency II. Under the proposed new SIMR as set out in the PRA's PS 3/15 and PS22/15 and adopted in March 2016 (except for rules transposing Solvency II Directive requirements that came into force January 1, 2016), the PRA expectations on the compliance with Solvency II requirements on governance have been made explicit. The FCA has also introduced changes to its APRs as set out in FCA's PS 15/21 and PS 15/31 to reflect the changes introduced by PRA's SIMR. PRA rules will contain rules relating to conditions governing business—see PRA PS2/15, Solvency II: a new regime for insurers (App 1.12, rule 2.2(3)), and the EIOPA System of Governance Guideline 11 (Fit requirements) provides further clarity and context to Solvency II directive with which the PRA will comply.

83. Among other governance duties, each senior manager (and director) will need to have a set of clear responsibilities allocated to them under the SIMR. Firms will be required to establish a governance map showing the roles and responsibilities of key officers, along with their lines of reporting and accountability. In addition, there will be a prescribed responsibility to be allocated to a senior manager or director under the new SIMR of leading the development and monitoring effective implementation of policies and procedures for the induction, training, and professional development of all members of the firm's governing bodies. A set of (business) conduct rules and standards applied to senior managers (and directors) includes the need to ensure that the firm complies with the relevant requirements and standards of the regulatory system. The changes introduced by the FCA to their APR are intended to pick up Significant Influence Function holders (SIFs) that fall outside SIMR but the FCA wish to keep in scope because of the terms of their statutory

objectives (for example, the Chair of the With-Profits Committee). They have also retained some SIFs for NDFs that PRA has not included in their new regime.

84. The existing strong risk management requirements are strengthened further under Solvency II. Current regulatory requirements on risk assessment relating to firms and groups respectively are contained within SYSC 3, SYSC 12, SYSC 13 and SYSC 14 of the PRA Handbook. Implicitly covered as well through ICAS and stress tests required by GENPRU 1.2 and INSPRU 7.1; as well as by BMA work by supervisors (See paragraphs 65-70 in the PRA's Approach document). The FCA also has rules in this area within COBS and ICOBS Sourcebooks. The PRA rules contain rules on conditions governing business covering both firms and groups respectively—see PRA PS2/15, Solvency II: a new regime for insurers (Apps 1.12 & 14). The EIOPA System of Governance (Section 4: Risk Management) and EIOPA ORSA Guideline 13 cover the implicit need for firms to ensure robust risk management at all stages of the business.

85. The risk management system will be further enhanced under Solvency II through the introduction of the ORSA. U.K. companies have been required to produce the ICA for several years. This requirement has prepared insurers well for the development of their ORSA. All companies subject to Solvency II have submitted their ORSA to the PRA. There is no formal approval process for ORSAs, but firms are required to submit them to the PRA for review and the PRA has issued a series of recommendations on best practice and coverage of different risks. The FCA has the right to ask firms to submit ORSA reports to them as well, and is likely to do this for firms who are required to hold an Annual Strategy Meeting (ASM) with them, or as required for any other conduct supervision initiative for which they are relevant. The range of ORSAs varies with the complexity of the business model and size of the firms. The ORSA is forward-looking and should identify risks that pose a threat to the firms strategic goals, such as conduct risks relevant to the FCA, but that may not be covered under Solvency II pillar 1. At a national level, the PRA has issued a SS, "Solvency II: ORSA and the ultimate time horizon—nonlife firms," SS26/15 explaining the PRA's expectation that such firms should demonstrate that they have considered the ultimate time horizon in their ORSA supervisory report. The FCA is currently finalizing its approach to the review of ORSA reports, but has been active in reviewing elements of the ORSA process and procedures in its day-to-day supervision of firms.

86. Under Solvency II, insurers should prepare their ORSA at a minimum once a year and submit it as part of the supervisory report. The ORSA supervisory report is to comprise results of each regular ORSA performed and conclusions, both in qualitative and quantitative form, methods and main assumptions used, comparison of own solvency needs with regulatory capital requirement and own funds. See (Article 304 and 306 of the "Solvency II Delegated Acts"),[11] and the EIOPA guidelines on ORSA (GL 16).[12]

[11] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2015:012:TOC.

[12] https://eiopa.europa.eu/Pages/Consultations/Public-consultation-on-the-Set-1-of-the-Solvency-II-Guidelines.aspx.

87. Supervisory arbitrage remains a risk when key aspects of the solvency framework are not subject to equivalent or centralized supervision. While regulation under maximum harmonization is equivalent across all EU member countries, important differences remain in supervisory practices. Certain functions under a highly complex solvency regime will need strict quality control. The supervision of internal models and ORSAs at group level are subject to colleges of supervisors and coordination arrangements, under the direction of the group supervisor, to ensure appropriate level of review and assessment that Solvency II requires. The U.K. should consider supporting centralized (or subject to strict peer review) supervision of internal models and ORSAs for the largest insurance groups.

Pillar three

88. The PRA has designed and implemented a system for collecting the regulatory reporting data to support Solvency II reporting requirements. As the period for the first set of preparatory phase returns for in-scope firms approached (July 1–15, 2015), the PRA issued a number of communications on how to use the system and also provided online training. As a result of this preparation, the process is working smoothly. The PRA is now working to ensure that those firms who were not in-scope for the preparatory phase are aware of the process for submitting their first regulatory data returns in 2016. To facilitate Solvency II Pillar 3 reporting, PRA is implementing the BEEDS portal, a system that firms will use to submit the regulatory returns including group returns. As part of the 'on-boarding' of firms and groups to the BEEDS portal all those in scope will need to be enrolled on the system at which time a complete list of all groups within the scope of Solvency II, where the PRA is the group supervisor will be available.

89. Enhancing the levels of disclosure and regulatory reporting is a key objective of Solvency II. All firms and groups within the scope of Solvency II are required to publish a Solvency and Financial Condition Report (SFCR)[13] annually. In the narrative part of the SFCR, firms need to clearly explain key aspects of their approach to Solvency II, such as the use of an internal model (where applicable) and any noncompliance with regulatory solvency requirements. In this report, the insurer describes its activities and results, its risk profile, the principles used to value its assets, technical provisions and other liabilities, and the management of its capital. The SFCR report also includes a set of quantitative templates that provide information on the Solvency II balance sheet, including technical provisions; the firm's SCR and eligible own funds; the impact of using long-term guarantee measures and transitional adjustment for technical provisions; information on premiums, claims and expenses; details of own funds by tiers and solvency ratios; the SCR by risk modules or risk components (for internal model firms); and, for solo insurers only, the minimum capital requirement (MCR) and technical provisions. Groups will need to disclose the group structure.

90. All firms and groups within the scope of Solvency II, are required to produce a Regular Supervisory Report (RSR) (full or a summary) annually. Solvency II requires insurers to compile a

[13] https://eiopa.europa.eu/Pages/Consultations/Public-consultation-on-the-Set-2-of-the-Solvency-II-Implementing-Technical-Standards-(ITS)-and-Guidelines.aspx.

supervisory report for submission to the supervisor. The Full RSR[14] has to be submitted at least every three years. In any financial year, where there is no requirement to submit full RSR, firms nevertheless have to submit a summary report. Supervisors may require submission of full RSR every year.

91. The requirement for quantitative reporting templates (QRTs) applies to all firms. The PRA has not exercised its discretion with regard to granting exemptions for "item-by-item" reporting (listings of assets), as such all Solvency II firms will be required to submit the full QRTs package (as appropriate) on annual basis. The QRTs capture information on the balance sheet, off-balance sheet items, detailed listings of asset portfolios (including derivatives), SCR, MCR, technical provisions, variation analysis and reinsurance. Each form is to be completed as prescribed in the instructions (log files). There are also specific requirements for reporting including at a ring fenced fund level and the material matching portfolio level.

92. The PRA has decided that only Category 4 and Category 5 firms would be eligible for quarterly reporting exemptions. The PRA may grant exemptions from quarterly reporting and reporting on an item-by-item (assets listings) basis when certain criteria are met (subject to 20 percent of market share cap—i.e., the exemptions are to be targeted at small insurers). Under Article 35 (6) and (7) of the Directive. The PRA set out its approach to exemptions in SS11/15 "Solvency II regulatory reporting and exemptions." The statement lists the quarterly reporting requirements (templates) that are subject to exemptions; explains the steps firms need to take to apply for exemptions, and how the decision as to whether or not they have been given the exemption will be communicated to them. The PRA has decided not to exercise any discretion under Article 35 (7) regarding item-by-item reporting—i.e., all Solvency II firms and groups are required to submit a detailed list of assets reporting on annual basis. All Category 1 to 3 firms are required to report to the PRA on quarterly basis.

93. Day 1 reporting—Solvency II opening position. Article 314 "transitional information requirements" of the "Solvency II Delegated Acts" sets out the information required to be submitted by all Solvency II firms and groups at the first day of Solvency II application. The requirements will apply to all firms and groups, within the scope of Solvency II and is a once only submission. Firms are required to report their opening valuation of assets and liabilities (explaining differences in comparison with Solvency I), opening SCR, MCR and own funds. This requirement is to be met by submitting a set of templates as defined in Article 5 (solo) and Article 22 (groups) of the "Solvency II Supervisory Reporting ITS," together with a narrative report explaining valuation differences in comparison to the Solvency I regime.

94. Preparation for the new reporting regime under Solvency II has been carried out for several years. Under EIOPA Guidelines, the PRA is also required to "review and evaluate the quality of the information submitted and progress made by firms". The PRA's approach was to require all Category 1 to 3 firms to take part in the preparatory phase, reaching well over 80 percent market

[14] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2015:012:TOC.

coverage. Each firm is required to make one annual submission, based on December 31, 2014 year-end; and one quarterly submission, for 3rd quarter of 2015 year end (e.g., September 30, 2015).

95. Notwithstanding the long preparation for the new reporting regime, the large amount of detailed data will be a challenge. The PRA should develop over time the appropriate tools to exploit the data in a manner that enhances its the thematic and outlier approaches. In addition, it would be advisable to continue compiling time series for the currently reported statistics.

STABILITY OF THE INSURANCE SECTOR

A. Market Structure and Performance

96. The U.K. has a well-developed, global insurance sector. The life insurance premium in the U.K. accounts for almost 9 percent of the world's life insurance premium and 5.5 percent of the world nonlife premium. Insurance penetration is fifty percent higher than in the EU or other advanced markets, and the expenditure per capita in insurance amounts to USD 5,429 as compared with USD 3,815 in other advanced markets. However, given that a relatively high amount of premium underwritten by U.K. insurers corresponds to overseas risks, U.K. persons may not actually be spending significantly more each on insurance than their equivalents in other developed economies (Table 2).

97. There is a wide range of insurers. The U.K. insurance needs are covered by nonlife insurers, who provide services like motor and home insurance; life insurers, who provide long-term insurance including pensions fund management and annuities; and the London market that specializes in global complex risks. There are around 600 insurers operating in the U.K. (Table 3). Current annual premium amounts to GBP 233 billion (GBP 140 billion life and GBP 83 billion nonlife) (Table 4). The importance of the insurance sector for the economy is reflected in the large amount of assets held by the sector (GBP 2,161 trillion, of which GBP 1,882 billion correspond to life insurance and GBP 279 billion to nonlife business), the increasing transfer of risks from the estimated GBP 1.4 trillion occupational pension fund sector to the insurance sector, the extent to which the Lloyd's market provides overseas (re)insurance coverage for complex risks, and the fact that it provides more than a quarter of all U.K. financial services employment.

Table 2. United Kingdom: Global Share in Insurance Premium, Penetration, and Density, 2014

	Jurisdictions	Gross premiums		Penetration	Density
		in US$ mn	*% share*	*As % of GDP*	*US$ per capita*
Life	UK	235,321	*8.86*	7.99	3,637
	EU	944,311	*35.57*	5.13	1,878
	Advanced markets	2,232,490	*84.10*	4.81	2,162
	World	2,654,549	*100.00*		
General	UK	115,945	*5.46*	3.94	1,792
	EU	616,028	*29.01*	3.34	1,225
	Advanced markets	1,706,373	*80.35*	3.68	1,653
	World	2,123,699	*100.00*		
Total	UK	351,266	*7.51*	11.92	5,429
	EU	1,560,339	*33.35*	8.47	3,103
	Advanced markets	3,938,863	*84.20*	8.48	3,815
	World	4,678,248	*100.00*		

Source: Authorities. Based on Swiss Re Sigma 4/2015 (adjusted).

Note 1: Advanced markets include the U.S., Canada, Western Europe, Israel, Oceania, Japan and the other advanced Asian economies (Hong Kong, Singapore, South Korea and Taiwan).

Note 2: EU figures exclude Lithuania and Latvia as these countries are not included in the Swiss Re Sigma report.

Table 3. United Kingdom: Insurance Premium and Total Assets
(In million GBP, 2010-2014)

	2010	2011	2012	2013	2014
Life					
Gross premiums	144,703	140,895	161,635	149,371	139,785
Net premiums	128,170	126,927	145,269	132,106	114,807
Total Assets	1,716,853	1,635,956	1,714,351	1,784,213	1,882,131
Nonlife					
Gross premiums	76,393	78,220	81,287	84,561	82,951
Net premiums	57,472	59,802	61,453	64,622	62,575
Total Assets	252,548	280,343	286,169	281,332	278,874

Source: Authorities. PRA regulatory returns.

Note 1: Domestic risks relate to insurance business written in the U.K. and pertaining to risks based in the U.K. All other risks are considered as foreign risks.

Note 2: Data for the Society of Lloyd's are not included in life totals as not significant for life insurance premiums.

98. **The top 10 individual U.K. authorized insurers account for 60 percent of the life market but only 37 percent of the nonlife market.** The concentration in the life industry is moderate, with a dominant market leader with a 16 percent market share in terms of assets. The nonlife market is very competitive, with the top 10 insurers accounting for only 37 percent of the market in terms of premiums (Table 5).

Table 4. United Kingdom: Market Participants in Insurance 2014

(Re)Insurer		EEA authorised with branches in the UK		EEA authorised to provide Cross-border Services to UK consumers		Insurance intermediaries	
Life	177	Life	5	Life	141	Authorised Intermediaries	5423
Nonlife	321	Nonlife	37	Nonlife	472	Appointed Representatives	24196
Composite	14	Composite	1	Composite	12	EEA authorised with branches in the UK	58
Lloyd's Syndicates	99	Pure reinsurance	9	Pure reinsurance	1	EEA authorised to provide Cross-border Services to UK consumers	5693
Total	**611**		**52**		**626**		**35370**

Source: Authorities.

Note 1. Reinsurers and Captives are included in the other numbers of the '(Re) insurers' Table. Many U.K. authorized insurers and Lloyd's syndicates write both insurance and reinsurance. Captives are treated the same as other insurers in the U.K.

Note 2. Regulated intermediaries can operate in the U.K. in three ways: authorized by the FCA, Appointed Representatives (which are appointed by an authorized intermediary who accepts responsibility for all acts, error and omissions by the appointed representative), and intermediaries regulated in other EEA states who either establish branches in the U.K. or operate in the U.K. via cross-border services performed from their home country. The Intermediary and Appointed Representative numbers only include firms whose main regulated activity is insurance mediation. These numbers do not include firms that are Authorized to intermediate insurance and Authorized for another activity which is their main activity (for instance a mortgage broker, financial advisor or bank). Including these firms would increase the numbers by several thousand.

99. The life insurance premium, after strong growth in 2012, has declined. The main driver of this volatility were the changes in occupational pensions that now make up approximately 60 percent of the entire U.K. life business excluding unit link products, up from 50 percent in 2011. Fewer participating and nonparticipating policies have been sold, reflecting in a reduction in premium of 15 percent since 2011, while term life remains notable. This trend is in line with the strategy of insurers to reduce their interest risk exposure. The unit link premium reflects market conditions, with a high in 2012 (Table 6). The individual annuity and the impaired annuity business are declining but have been replaced by annuity block transactions. This reflects the changing policy environment in the U.K., notably the removal in 2014 of mandatory requirements for defined contribution (DC) pensioners to purchase an annuity at retirement, with the change effective as of April 2015.

100. The nonlife premium reflects a mature market with a balanced mixed of business. The nonlife premium in 2014 was lower than in 2013, but showed an increment of 7 percent since 2011. The liability insurance, mostly corresponding to the mandatory Motor Third Party Liability (MTPL) business, is the business that has seen growth. All other lines of business have either decreased or merely maintained their volume since 2011. Nonlife insurers see the U.K. as a saturated market and expect future growth coming mainly from overseas business (Table 7).

101. The total investments in 2014 of the U.K. insurance sector amounted to GBP 1.7 trillion or 92 percent of GDP. The majority of the investments, 71 percent, correspond to assets that support unit linked business (business where the investment risk is borne by the policyholder). This percentage has grown from 60 percent in 2010, reflecting the strategic decision of life insurers to reduce their market risk exposure by transferring it to policyholders and the growth of defined contribution pensions business. Of the 29 percent of other investments belonging to insurers, 72 percent is invested in bonds that provide for the matching of long-term liabilities through a steady cash flow. The percentage of investments in derivatives has grown since 2010, but remains at around one percent of investments. Nonlife insurers that have more liquid liabilities also have a higher share of investments in corporate bonds, cash, and equity compared to life insurers (Tables 8 and 9).

Table 5. United Kingdom: Market Share of Top 10 Individual U.K. Authorized Insurers, 2014

Life insurance - as percentage of total assets

	Total Assets GBP million	% of industry
Legal & General (Pensions Management)	260,944.76	16.0
Standard Life Assurance	137,119.82	8.4
Prudential	127,149.63	7.8
BlackRock Life	102,411.11	6.3
Aviva Life & Pensions UK	98,848.54	6.0
Royal London Mutual Insurance Society	62,191.79	3.8
Friends Life	62,014.51	3.8
Scottish Equitable	57,221.50	3.5
Legal & General Assurance Society	46,203.29	2.8
Managed Pension Funds	38,440.92	2.4

Nonlife insurance - as percentage of total premiums*

	Total Premiums GBP million	% of industry
AIG Europe	4,835.63	6.0
Aviva Ins	4,708.35	5.9
Royal&SA Ins	3,896.44	4.9
AXA Ins UK	3,292.92	4.1
UK Ins	3,099.01	3.9
ACE European Grp	2,322.94	2.9
BUPA Ins	2,217.13	2.8
Allianz Ins	2,088.14	2.6
Great Lakes UK	1,949.96	2.4
QBE Ins Europe	1,400.07	1.7

Source: Authorities. PRA regulatory returns.

* The Society of Lloyds had premiums of GBP 25,771 million and if included in the top 10 they would represent 32 percent of the nonlife market.

Note that because this is individual firms and not groups, Legal and General and Aviva each have two entries in the top 10 life firms.

Table 6. United Kingdom: Life Insurance Premium by Product

(In GBP million, 2011–2014)

Life	Gross Premiums written			
	2011	2012	2013	2014
Domestic risks				
Participating (or with-profits)	7,164.9	7,289.14	5,352.71	5,974.83
Non-participating	2,560.11	2,511.01	2,527.44	2,331.23
Term	4,175.37	4,257.51	4,206.59	4,311.1
Annuities	16,704.52	24,163.3	20,838.33	22,473.76
Unit-linked	105,387.1	118,060.35	110,701.33	101,439.99
Foreign risks				
Participating (or with-profits)	2,097.02	2,024.09	2,271.98	957.1
Non-participating	444.34	394.81	527.92	172.9
Term	274.76	659.79	524.93	227.8
Annuities	218.43	256.5	306.44	167.79
Unit-linked	1,868.68	2,018.07	2,113.07	1,728.71
TOTAL	140,895.23	161,634.58	149,370.74	139,785.2

Source: Authorities. PRA regulatory returns.

Note 1: Domestic risks relate to insurance business written in the U.K. and pertaining to risks based in the U.K. All other risks are considered as foreign risks.

Note 2: Data for the Society of Lloyd's are not included in life totals as not significant for life insurance premiums.

Table 7. United Kingdom: Nonlife Insurance Premium by Product

(In GBP million, 2011–2014)

Nonlife	Gross Premiums written			
	2011	2012	2013	2014
All risks				
Accident & health	7,223.6	7,648.45	8,205.02	7,934.46
Financial loss	4,972.54	4,964.84	5,045.39	4,750.01
Liabilities	10,933.02	11,428.47	13,171.77	13,665.11
MAT	8,674.35	9,182.83	9,423.36	8,551.08
Motor	13,524.54	13,344.77	12,860.46	12,594.93
Others	1,190.9	1,321.43	1,450.63	1,653.02
Property	19,050.05	20,079.5	20,884.11	20,145.49
Reinsurance	12,650.8	13,316.82	13,520.53	13,657.2
TOTAL	78,219.8	81,287.1	84,561.27	82,951.3

Source: Authorities. PRA regulatory returns.

These tables include data for the Society of Lloyd's. No split between domestic/foreign businesses is available.

Table 8. United Kingdom: Life Insurance Investments
(In GBP millions, 2010–2014)

	2010	2011	2012	2013	2014
Life					
Investments in GBP millions	1,388,628	1,383,219	1,442,940	1,501,008	1,559,076
of which: (in percent of total investments)					
Government securities	8.64	9.19	8.49	7.52	8.20
Corporate securities	11.79	12.13	13.43	12.97	12.96
Equities	6.81	5.90	5.43	5.34	5.36
Real estate and real-estate related	1.53	1.51	1.42	1.39	1.50
Cash and bank balances	2.05	1.99	2.00	2.12	2.24
Investments supporting unit-linked	59.96	58.92	62.63	68.40	71.18
Other Investment Assets	9.21	9.99	10.52	10.37	10.83
of which:					
Collective Investment Schemes	6.66	6.63	7.23	7.10	6.82
Derivatives	0.64	1.07	0.92	0.68	1.17
Loans	1.87	2.21	2.31	2.55	2.77
Other Investment Assets	0.04	0.08	0.06	0.04	0.07

Source: Based on information provided by the authorities from PRA regulatory returns.

Table 9. United Kingdom: Nonlife Insurance Investments
(In GBP millions, 2010–2014)

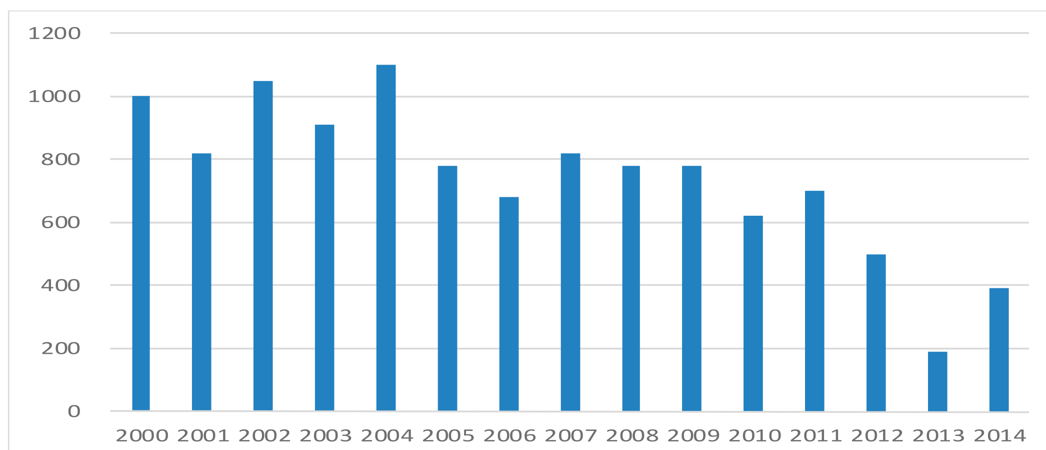
	2010	2011	2012	2013	2014
Nonlife					
Investments in GBP millions	147,537	155,310	161,030	162,730	164,844
of which: (in percent of total investments)					
Government securities	33.80	35.43	33.93	33.07	32.15
Corporate securities	32.59	35.60	39.75	42.24	46.31
Equities	13.44	13.42	15.83	15.18	13.27
Real estate and real-estate related	0.80	0.83	0.86	1.14	1.51
Cash and bank balances	10.63	10.26	10.04	9.74	8.77
Other Investment Assets	8.74	9.73	8.74	8.93	9.74
of which:					
Collective Investment Schemes	7.79	8.20	7.31	7.88	8.67
Derivatives	0.16	0.33	0.34	0.30	0.20
Loans	0.79	1.03	0.82	0.64	0.78
Other Investment Assets	0.01	0.17	0.26	0.11	0.09

Source: Based on information provided by authorities from PRA regulatory returns.

102. The low interest rate environment has eroded investment returns but U.K. insurers remain resilient. Persistently low interest rates have had a significant impact on the investment profits of insurers worldwide, as well as in the U.K. Figure 1 shows the investment returns of U.K. nonlife insurers. As a response, life insurers in the U.K. have tightened their asset-liability duration matching (the duration gap was less than one year in May 2014), lowered the guarantees offered (0.5 percent averaged weighted guaranteed rate), and moved into unit linked products where the policyholder carries the return risk (Figure 2). Nonlife insurers have managed to improve their underwriting losses, in particular the results in motor insurance (Figure 3). However, vulnerabilities remain as the attractiveness of the life products diminishes, leading to fewer new business, and given the delicate situation in the EU of insurers, which increases contagion and reputational risk for U.K. insurers.

Figure 1. United Kingdom: General Insurers' Profits from Investment Activities

(In GBP million, 2000–2014)



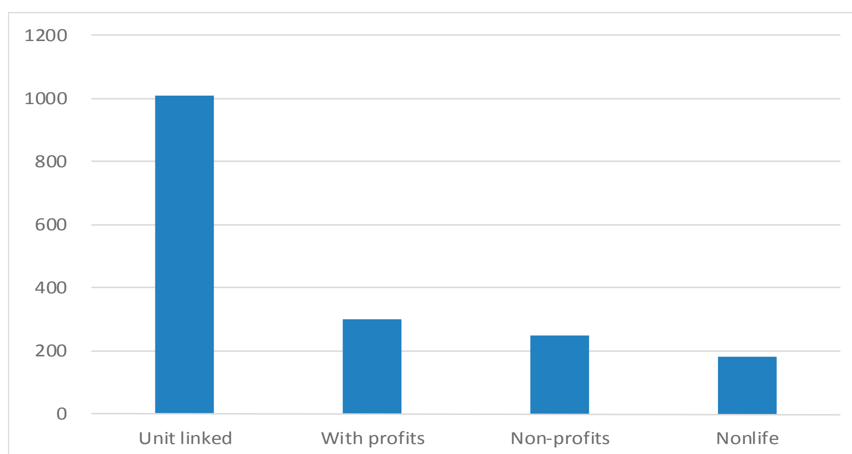
Source: Authorities. Financial Stability Report: December 2015 from the PRA regulatory returns.

(a) Data to end-2014.

(b) General insurers exclude Lloyd's of London.

Figure 2. United Kingdom: Insurance Industry Assets by Sector

(In GBP billion, 2014)

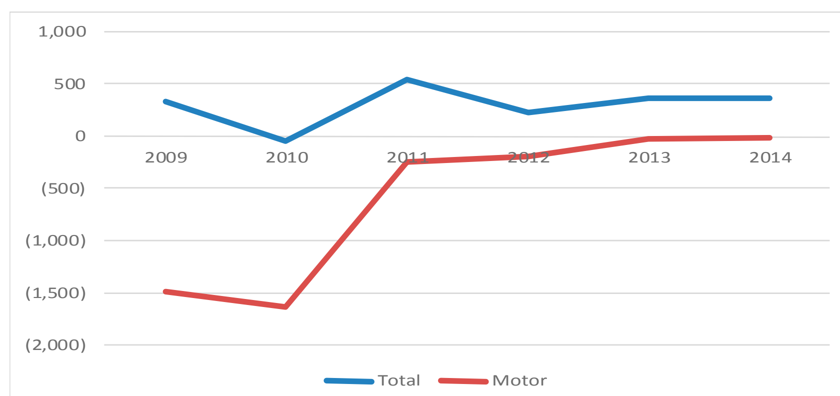


Source: Authorities. Financial Stability Report: December 2015 from the PRA regulatory returns.

(a) Data to end-2014.

(b) General insurers exclude Lloyd's of London.

Figure 3. United Kingdom: Nonlife Underwriting Results
(In GBP million, 2009–2014)



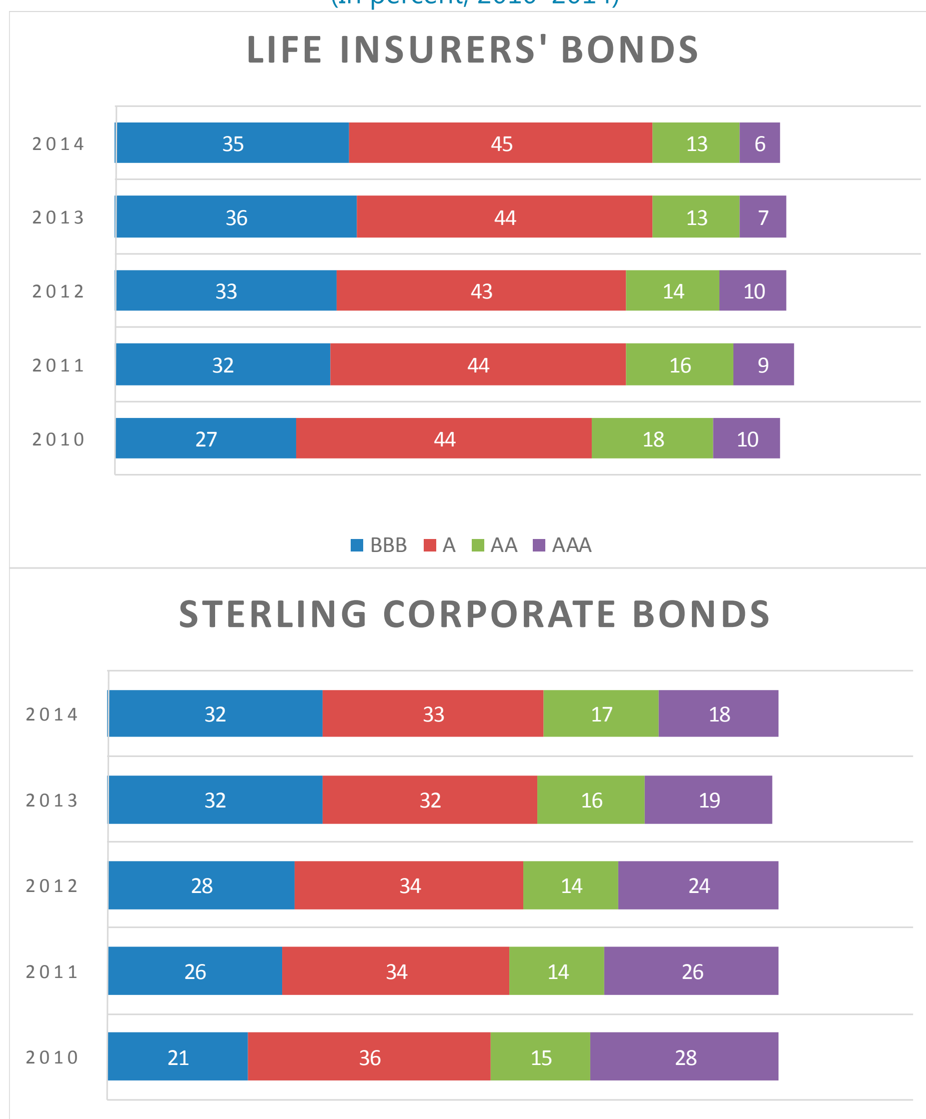
Source: Association of British Insurers.

103. Notwithstanding the low yield environment, insurers have, for the most part, maintained the rating of their investments. Although there has been a shift to lower-rated bonds from 2010 to 2015, this change was small and gradual, and may be a result of insurers retaining downgraded securities and a lack of supply of the highest investment grade securities, rather than a uncontrolled search for yield. From 2010 to 2014, the BBB rated sterling corporate bonds increased from 21 percent to 32 percent while the life investments in BBB corporate bonds increased almost in the same proportion from 27 percent to 35 percent (Figure 4).

104. The absence of large insured catastrophic events in the last few years has attracted alternative capital to the reinsurance and high exposure risks operations. The new available capital is putting pressure on the level of the technical premium. The U.K. insurance sector is a major risk carrier for global insurance. Traditionally, 25-30 percent of the premium is generated globally, with the Lloyd's market having as much as 80 percent of its premium generated from overseas business, consisting mostly of general insurance and reinsurance that predominantly underwrites high exposure risks. Profitability in these areas in recent years has been artificially inflated by the relative lack of insured natural hazards, which has limited claims on catastrophe insurance policies. Globally, alternative capital has also increased from USD 20 billion in 2010 to USD 60 billion in 2015—the available reinsurance capacity. This has intensified competition and created interlinkages between insurers and capital providers (Figure 5). Premium income rates written in the U.K. have fallen by 10 percent to 15 percent for property catastrophe insurance for the third consecutive year. Overall, risks are most evident for reinsurers; but as soft market conditions continue, the risks will likely also migrate to direct insurers, both commercial and retail. Any further softening in the terms and conditions on insurance policies will have the potential to increase future loss payments leading to reserve deterioration and impact on capital.

Figure 4. United Kingdom: Life Insurers' Bonds Investment Portfolio and Sterling Corporate Bonds Universe Rating

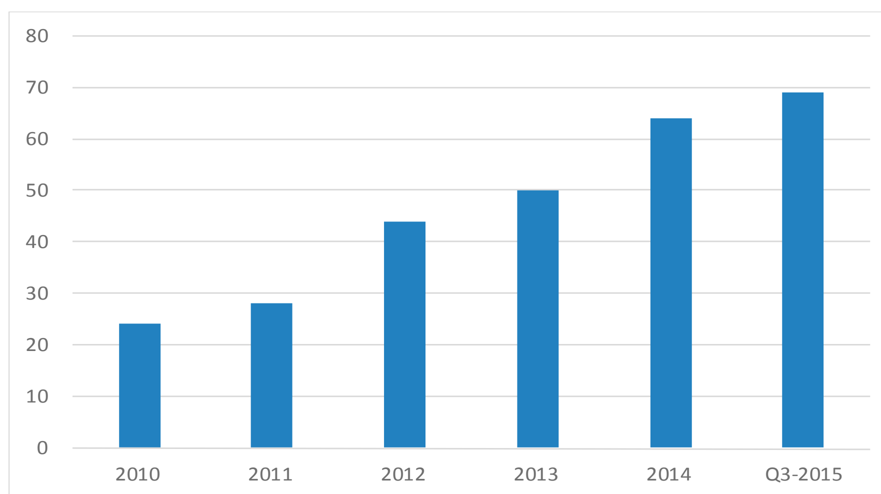
(In percent, 2010–2014)



Source: Authorities.

Due to rounding errors the total does not always add to 100 percent.

Figure 5. United Kingdom: Global—Alternative Reinsurance Capital
(In USD billion, 2010–2015)



Source: AON Securities Inc.

B. Global Systemically Important Insurers

105. The U.K. as the home supervisor of two of the nine designated G-SII has advanced its supervision in line with FSB guidance. The G-SII designation resulted in the development of a SRMP, a Liquidity Risk Management Plan (LRMP), and a RCP. The U.K. G-SIIs are required to monitor their group-wide liquidity position on a continuous basis and provide monthly reports, including a range of stress scenarios, to the PRA for review. The LRMPs summarize this approach and provide specific focus to the NTNI activities. The U.K. G-SIIs developed a SRMP and Recovery Plan (RCP) that the PRA is reviewing. The plans include (i) credible options to cope with a range of scenarios including both idiosyncratic and market-wide stress, (ii) scenarios that address capital shortfalls and liquidity pressures, and (iii) processes to ensure timely implementation of recovery options in a range of stress scenarios.

106. The PRA, in conjunction with the relevant CMGs, produced resolution strategies for U.K. G-SIIs. The purpose of the resolution plans is to ensure effective resolution of a firm without severe systemic disruption and without increasing U.K. taxpayers' exposures to loss. The plans should also identify and seek to remove any impediments to effective resolution. The PRA together with the corresponding CMG is scheduled to carry out the resolvability assessments by end-2016 in accordance with FSB timetable, and to develop institution-specific cross-border cooperation agreements (COAGs) among relevant resolution authorities.

107. The PRA's plan and timeline to implement the BCR and the Higher Loss Absorbency (HLA) for G-SIIs operating in the U.K. follows the FSB timetable. The PRA has been closely engaged with the IAIS in developing the timetable for the implementation of the BCR and the HLA:

- Confidential (voluntary) reporting of the BCR will commence as part of the IAIS field testing (2015–2018).
- BCR and HLA requirements to be applied to all G-SIIs designated in November 2017 and in future years (January 2019).

However, the ability of the PRA to implement BCR and HLA in line with this timetable will depend on developing the necessary EU-wide legislation in a timely manner.

108. G-SIIs, including Aviva and Prudential in the U.K., will be expected to hold capital resources at least equal to the sum of the BCR and HLA requirements. These will be applied to all activities at the group level. Under the HLA proposal, traditional insurance activities will face capital surcharges of between 6 percent and 13.5 percent, whereas nontraditional noninsurance activities will carry larger surcharges of between 8.5 percent and 27 percent, depending on systemic designation scores assigned to each G-SII and the type of business activity undertaken.

C. Stress Testing

109. In addition to the stress testing carried out by individual insurers, several market-wide stress test have been carried out. The forward-looking supervisory approach by the PRA is supported by comprehensive stress testing requirements that follow international best practice. Current regulatory requirements on stress testing for firms and groups respectively are set out in GENPRU 1.2.42 to 1.2. 59 and SYSC 20 (including SYSC 20.2.22) to be applied in the context of risk management covered by SYSC Sourcebook of PRA Handbook. A series of market-wide stress tests have been carried out recently, including the EIOPA stress test in 2014 and the PRA nonlife stress test in 2015.

110. A sharp increase in interest rates would have both direct and indirect effects. Overall, rising interest rates would benefit insurers' business models. However, substantial increases in credit spreads for corporate bonds could materially affect life insurers. This is in particular true for the annuities written by life firms that generally have large corporate bond portfolios. Life insurers are generally well cash-flow matched and use a market-consistent based valuation method for the balance sheet. They are thus relatively insensitive to upward shifts of the risk-free yield curve. Nonlife insurance firms are, in general, less vulnerable than life insurers, reflecting that their balance sheets are typically less exposed to interest rate risk. However, well-established insurers might lose new business to newcomers as they unhedged their positions to the new higher interest bearing instruments.

111. The U.K. participated in the 2014 EIOPA stress test. In 2014, EIOPA launched a stress test exercise (covering 19 different scenarios) to assess the resilience of European insurers.[15] The tests comprised of a core and low yield module. Some scenarios addressed financial market and insurance-specific stresses, while others addressed the impact of a prolonged period of low interest

[15] https://eiopa.europa.eu/Pages/Financial-stability-and-crisis-prevention/Stress-test-2014.aspx.

rates and a snapback in yield curves on particularly exposed business. All scenarios were undertaken on a 'best efforts' Solvency II standard formula basis.

112. In general, the results for U.K. participants were similar to or better than those of the wider European sample. Only in two of the 19 stress scenarios the aggregate capital fell below solvency requirements. U.K. insurers were most significantly impacted by the mass lapse, longevity, and provision deficiency stresses. On the other hand, the results of the tests exploring low yield environment on U.K.-regulated solo insurance entities were positive, reflecting progress in asset-liability matching practices.

D. Interlinkages and Spillovers to the Financial Sector

113. The U.K. insurance sector's critical role in the economy create interlinkages with the financial system that are closely monitored by the FPC and the PRA. First, insurance facilitates the transfer of risk, including financial guarantees; and second, the sector provides long-term investment to the economy. Insurers are liability-driven investors. Asset allocation must ensure duration matching of assets and liabilities, as well as adequate investment return to pay contractual policyholder obligations in time. A number of other factors, such as regulation, accounting and valuation methodologies, and structural changes also influence asset allocation behavior. As significant investors in financial instruments, such as bonds and equities, insurers have the potential to exacerbate asset price falls—for instance by fire sales of assets. The FPC is monitoring the systemic risk that insurers as investors could create, through a series of reporting and stress tests.

114. Investment assets are generally well diversified. The insurers' investments exposure to overseas has been growing and is now over 37 percent of all assets (Table 10). Also the largest U.K. groups have as much as 50 percent of their assets related to foreign operations (Table 11). This geographic diversification protects the insurance sector against a U.K. downturn of the economy, but could be vulnerable to overseas economic shocks that need to be monitored and stress tested.

Table 10. United Kingdom: Insurance Investments Classes
(In percent of Total Investments, 2005–2014)

	UK Public Sector Securities	Overseas Public Sector Securities	UK Ordinary Stocks and Shares	Other UK Company Stocks and Shares	Overseas Ordinary Stocks and Shares	Other Overseas Company Securities	Unit Trusts	Property	Cash and Other Investments	**TOTAL in GBP million**
2005	15	4	23	11	12	9	10	7	9	1,372
2006	14	3	23	10	13	10	12	7	9	1,481
2007	13	4	22	10	14	9	13	7	9	1,626
2008	13	5	14	10	14	15	12	7	10	1,494
2009	12	5	15	11	15	14	14	6	8	1,622
2010	13	5	14	10	16	14	15	6	6	1,708
2011	14	6	12	10	15	15	16	5	7	1,670
2012	12	6	11	10	18	15	14	5	9	1,691
2013	11	6	11	10	18	13	18	5	7	1,811
2014	12	6	10	10	19	12	19	5	8	1,930

Source: Association of British Insurers.

Table 11. United Kingdom: Domestic and Global Insurance Investments Classes
(In percent of Total Investments, 2014)

	Consolidated in GBP million	Domestic Operations %	Foreign Operations %
Aviva	285.72	56.28	43.72
Prudential	369.20	47.42	52.58
Standard Life	203.60	73.50	26.50

Source: Data provided by the authorities based on group annual report and accounts.

115. Insurers are also connected to the financial system through their NTNI activity. NTNI captures a range of activities that can involve maturity transformation, liquidity mismatch, or leverage. Examples include products involving liquid liabilities, where insurers engage in derivatives or securities lending for efficient portfolio management or yield enhancement, and where they undertake complex hedging. Such activities may increase insurers' fragility and inter-connectedness.

116. The longevity swaps activity and annuity block transactions also need to be monitored for counterparty risk. To offset loss in business from traditional annuities and with-profit products, life insurers have been entering block transactions to help some U.K. pension funds reduce their longevity exposure. These transactions take different forms, like buy-in/buy-out or swaps, and have grown from GBP 5.5 billion in 2010 to GBP 38.1 billion in 2014. Insurers may hedge the risk that policyholders live longer than expected by offloading longevity risk to investors. This includes offshore insurers, who receive an upfront sum in return for taking on the risk. The counterparty risk that these transactions create can be important—particularly when the ultimate risk carrier is located in a jurisdiction with light regulatory requirements, or where there has been insufficient risk transfer.