BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

The Change in UK Financial Regulation and What This Means for GI Actuaries

James Orr and Kathryn Morgan
GIRO, Edinburgh
October 2013

Agenda

- Trends over time
- Previous structure of UK regulation
- Reasons for change
- New regulatory landscape
- Three dimensions of changes
- Conclusions

Objectives of the session

Explaining…

- Why and how the UK's regulatory system has changed
- The way the PRA supervises insurance firms
- The context of the European timeline on implementation of Solvency II
- How the PRA is working towards the implementation of Solvency II and the challenges we face
- The way the PRA approaches the use of models in insurance

Trends over time

Key Dates until 2012

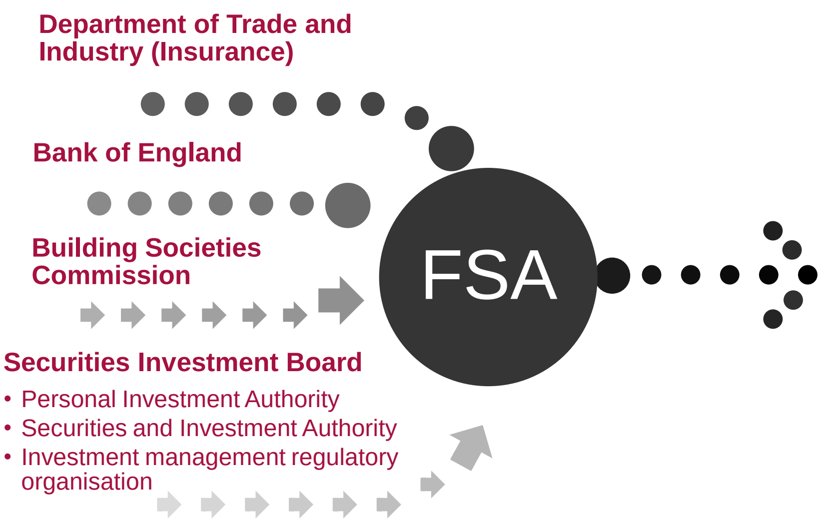
- Assurance Company Act 1909 (“freedom with publicity”)
- Insurance Company Act 1973 (Appointed Actuary)
- Insurance Companies Act 1982 (Minimum harmonisation)
- Financial Services and Markets Act 2000
- 2003 introduction of ICAS
- Solvency II Directive 2009
- Financial Services Act 2012

Three trends in regulation

- Increasing risk sensitivity
- Increasing transparency
- Increasing cross-border regulation (harmonisation)

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Previous structure of UK regulation



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Reasons for change

Pre-2008 (FSA)…

- **Politics**
  - **"New Labour" Government**
- **Conduct Failures**
  - **Financial Scandals**
    - Blue Arrow
    - Guinness
  - **Mis-Selling**
    - Personal pensions
    - Endowments
    - Home income bonds
- **Prudential Failures**
  - **BCCI/Barings**

Post-2008 (PRA/FCA)…

- **Politics**
  - **New Coalition Government**
- **Conduct Failures**
  - **Payment Protection Insurance**
- **Prudential Failures**
  - **Northern Rock/ Bradford & Bingley**
  - **RBS/ Lloyds TSB & HBOS**
  - **Failure to recognise systemic risk**

The changing architecture of UK regulation

The financial crisis exposed the limitations of regulatory systems across major financial markets.

UK tripartite regulatory system established in 2001

Bank of England

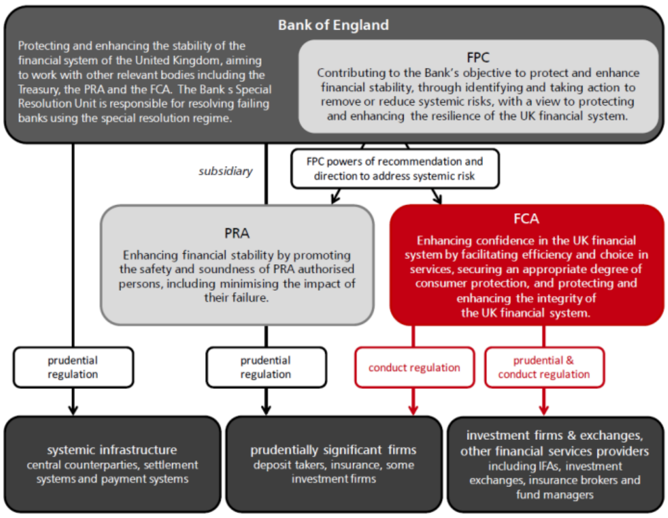
Treasury

FSA

Problems of the tripartite structure stemmed from limitations in each of the constituent authorities.

Entire supervisory ethos and approach, as characterised on various occasions by the FSA's last Chairman, Lord Turner, was too reliant on **'a static, backward looking compliance approach'**.

The new regulatory structure in the UK



The PRA approach to insurance supervision (1/2)

The PRA's regulatory approach has three distinctive characteristics:

Judgement based

- Forward-looking evidence and analysis to determine if
  - firms are safely and soundly managed;
  - if policyholders are properly protected;
  - If Threshold Conditions are met.

Forward looking

- Will put firms' risk profiles 'into perspective' and assess current risks as well as potential risks.
- An increasingly important part of our supervisory work will be Business Model Analysis.

Focussed

- Concentrate effort and attention on fundamental issues and risks faced by each firm.
- Will avoid looking at all the risks faced by a firm without regard to their impact and probability.

The PRA approach to insurance supervision (2/2)

1. The PRA has two statutory objectives:
   - To promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system.
   - A specific objective to insurance firms, to contribute to ensuring that policyholders are appropriately protected.
2. The PRA has a risk assessment framework

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

- Approach will be to focus on issues of the most importance
- Particular attention to reducing the impact of firm failure
- Assessment backed by proactive intervention framework which provides a ‘ladder of intervention’ (PIF).

1st dimension of change: 2 authorities
PRA/FCA – Two set of Objectives

PRA

Two complementary objectives:

1. *General objective*
   Promote the safety and soundness of the firms it regulates
2. *Insurance Objective*
   Contribute to the securing of an appropriate degree of protection for policyholders

FCA

Single Strategic Objective:

Protect and enhance confidence in the UK financial system

Three operational objectives:

1. *Secure an appropriate degree of protection for consumers*
2. *Promote efficiency and choice in the market for financial services*
3. *Protect and enhance the integrity of the UK financial system*

1st dimension of change: 2 authorities PRA/FCA – Impact on reserving actuaries

- FCA activities could have prudential implications
  - Sustainability of business models
  - Financial penalties

- Since the organisations have differing objectives, there is a potential for a **conflict of interest between prudential and conduct objectives**.

- But, the **Memorandum of Understanding** between the PRA and FCA ensures that

  "the FCA and the PRA will consult each other at an early stage in relation to policy deliberations which might have a material effect on the other's objectives."

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

2nd dimension of change: New regulatory framework Glide path to Solvency II

ICAS+

- Realistic balance sheet and Solvency II internal model
- Reconciliation and validation
- Review of the in-development ORSA

Solvency II

- Actuarial Function
- The way to calculate TPs

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Implementation of Solvency II – the European context

- EIOPA published its report on the long-term guarantees assessment on 14 June 2013.
  - European Commission report
  - Omnibus II
- EIOPA consultations on preparatory guidelines closed on 19 June 2013
  - The PRA will continue to supervise against Solvency I
  - Final guidelines published
  - The PRA will have two months to respond on whether they comply/intend to comply/explain

Uncertainty on the European timeline will continue until the autumn.

The PRA's approach to the implementation of Solvency II

Given policy uncertainty the PRA considers the formal implementation date for Solvency II of **1 January 2014 unrealistic**.

- In October 2012 we set a **new planning horizon** of 31 December 2015 for UK firms
- In January 2012 we set out our intention to enable firms in our internal model approval process (IMAP) to **leverage the investment in their Solvency II internal models to meet current regulatory requirements**
- Given the complexity inherent in modelled approaches **we continue to believe in the importance of non-modelled cross checks**

Principles of ICAS+

The PRA will continue to supervise against the individual capital adequacy standards (ICAS) until the implementation of Solvency II.

- ICAS+ is voluntary for firms in the internal model approval process (IMAP)
- Reviews will follow ICAS / PRA principles
- Submission expected from firms will be a combination of the information traditionally required for individual capital assessment (ICA) review and that needed to provide IMAP feedback
- ICAS+ will dovetail IMAP and ICAS reviews

Principles of early warning indicators

The PRA intends to **monitor the on-going appropriateness** of Solvency II internal models post approval through the use of early warning indicators (EWIs).

- The EWIs have been based on analysis of the data returned by firms in response to our request in Q3 2012 and feedback from the industry in 2012
- We propose to use the period before formal implementation of Solvency II to trial the use of EWIs in the ICAS regime for all firms using an internal model for regulatory capital assessment
- Separate indicators have been developed for life (excluding with-profits), with-profits funds, and general insurance business
- From September 2013 onwards we expect firms to be aware of the performance of their internal model against the EWIs and to be prepared to discuss it with their supervisor

The PRA's work on internal models (1/3)

As part of our ongoing commitment to giving feedback we published early findings from our review work of firms' internal models in May 2012.

- Methodology and assumptions
- Aggregation
- **Validation**
- Use test
- Documentation
- Model change policy
- Un-modelled risk (general insurance specific)
- **Expert judgement**
- Data risk

NB: We are sharing the PRA's current thinking on internal models. Please note, however, that the approach is still under development and that the information provided should not be regarded as PRA guidance. The current thinking reflected here will be superseded by further policy text on Solvency II from Europe, and any rules and guidance that we make in future to transpose the Solvency II Directive, which will be subject to our usual consultation process.

The PRA's work on internal models (2/3)

We reviewed a number of firms' **validation** policies and offered our feedback in five areas in May 2012.

Evidence of meeting the requirements

Materiality and granularity

Independence and expert judgement

Governance

Tools
(stress and scenario testing and sensitivity testing

NB: We are sharing the PRA's current thinking on internal models. Please note, however, that the approach is still under development and that the information provided should not be regarded as PRA guidance. The current thinking reflected here will be superseded by further policy text on Solvency II from Europe, and any rules and guidance that we make in future to transpose the Solvency II Directive, which will be subject to our usual consultation process.

The PRA's work on internal models (3/3)

Expert judgement is important and necessary in many aspects of internal models and should be viewed as a process. We offered further feedback in July 2012 having found some instances where expert judgement was being used without the corresponding governance around it.

Examples included:

- Inability of some firms to articulate the materiality of the assumptions derived from expert judgements.
- The reasons for coming to a decision not being clearly documented.
- No explicit links to the validation of the internal model, e.g. identifying triggers that would result in additional validation

NB: We are sharing the PRA's current thinking on internal models. Please note, however, that the approach is still under development and that the information provided should not be regarded as PRA guidance. The current thinking reflected here will be superseded by further policy text on Solvency II from Europe, and any rules and guidance that we make in future to transpose the Solvency II Directive, which will be subject to our usual consultation process.

PRA data collection exercises

We assess models and model output on an ongoing basis using techniques and tools that are informative, cost effective and straightforward to implement for us and firms.

- In 2013 we are conducting a data collection exercise for life insurance firms and for general insurance firms and have asked for data as at 31 December 2012
- We have asked for results by the end of July 2013. All responses will be collated and our analysis will be performed in Q3 and Q4 2013
- The results will assist our discussions with firms during ICAS and ICAS+ reviews, including individual capital guidance (ICG) assessments, and both the pre-application and submission phases of IMAP

3rd dimension of change: new supervisory approach

Two complementary objectives:

- **General objective -** Promote the safety and soundness of the firms it regulates;
- **Insurance Objective -** Contribute to the securing of an appropriate degree of protection for policyholders.

Key concepts

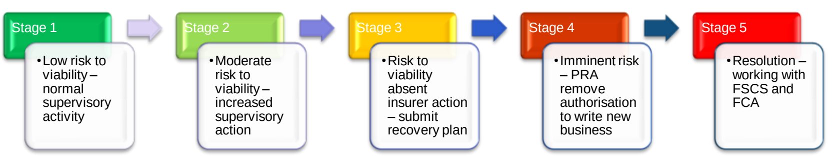
- Judgement driven
- Forward looking
- Strong focus on resolution
- BUT **not zero-failure** regime

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

3rd dimension of change
PRA approach to supervision

New proactive intervention framework which provides a 'ladder of intervention' (PIF)

Categorisation of firms a function of **potential impact if failing** and **size**.



The PRA threshold conditions are a continuous requirement on firms

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

3rd dimension of change – PRA approach to Actuaries

Disclosure of actuarial judgements (para. 75 of the **PRA's approach to insurance supervision**).

That the head of the actuarial function should be part of the **Significant Influence Functions (SIF) regime** (para. 98). [to be determined for GI]

Firms should have an actuarial function (AF) that will **support and challenge management** about risk management and governance, and financial and other controls (para. 117).

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

3rd dimension of change – PRA approach to Actuaries

Expecting AF to engage with all aspects of risk management (para. 120).

Insurers not relying on **aggressive interpretations** of actuarial standards when assessing capital adequacy (para. 135).

Potentially using firms' AFs to **identify and measure risks for the PRA** (para. 180).

PRA engaging with individual actuaries (para. 182).

Chief actuaries may be required to self-certify that PRA issues have been addressed (para. 198).

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Conclusions

New supervisory structure

- Potential conflicts of interest between PRA and FCA could occur more frequently than in the past, BUT the **impact should be limited** due to clear rule of engagements.

New supervisory framework

- Solvency II will bring forward some changes through the introduction of the AF;
- The AF will have an important role and responsibilities to the firm, the profession, and the regulators.

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Questions and further information

www.bankofengland.co.uk/solvency2

http://www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1304.pdf