Institute and Faculty of Actuaries

CP23/17: Financial Management and Planning by Insurers

IFoA response to Prudential Regulation Authority

9 February 2018

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

CP23/17
William Hewitson
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

9 February 2018

Dear William,

IFoA response to Consultation Paper CP23/17: Financial Management and Planning by Insurers

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's consultation paper (CP) on financial management and planning by insurers. We find the CP helpful in setting out the PRA's expectations of insurers in these areas.

2. Our CRO Forum, Life/ General Insurance Standards and Consultations sub-Committees (LSCC/ GISCC), and Life/ General Insurance and Risk Management Boards have all been involved in the drafting of this response. Members of the Forum, LSCC/ GISSC and Boards are heavily involved in insurers' financial management/ planning, working either in a consultancy capacity, or directly for the insurers themselves.

Comments on draft Supervisory Statement (SS)

3. The introduction to section 2.3 of the draft SS refers to risk appetite for levels of capital, but we think additional clarity should be added in relation to the reference to 'reasonably foreseeable market conditions'. We suggest replacing the following text in brackets with:

   'e.g. the desired level of SCR coverage after an earnings event or a tail event, maybe expressed as a 1 in x probability, and whether the probability is before or after mitigation'.

4. We interpret the drafting of section 2.3 as being consistent with the (common) situation where there is alignment between the management of an insurance entity, and capital provision.

5. However, in the specific case of Lloyd's syndicates, this may not be the case. The structure with such syndicates separates insurance management (through managing agencies and syndicates) and capital (through members). It may be the case that the managing agency to whom this requirement would apply would not know the details of the capital backing their syndicates; this would be a matter dealt with between Lloyd's and the member providing the capital. In this situation, the managing agent may know no more than that Lloyd's is satisfied with the capital provided to match an agreed SCR - and so would not have the 'balance sheet' view of the insurer that is consistent with the drafting of this section.

6. It is also the case that Lloyd's syndicates are structured as annual ventures. Capital is provided for a single year of underwriting, and subsequent years are subject to fresh capitalisation, based on subsequent underwriting plans. Whilst this does not mean the concepts in section 2.3 are not relevant, there may be a different interpretation.

7. Given this, we suggest adding a further section after the last bullet point in this section:

   'Syndicates at Lloyd's may have mixed capital, and will share in the Lloyd's Central Fund. In addition, they are structured as annual ventures. As a result, alternative considerations may be more relevant, but they should reflect the spirit of the above issues as appropriate. This section is drafted for the (common) situation where there is alignment between the management of an insurance entity and capital provision'.

8. It would be helpful if the PRA could provide guidance around how it envisages firms should be bringing together all the aspects given in paragraph 2.4 within the risk appetite statement. There are a number of different dimensions, and firms need to balance against the risk of an overly-complex risk appetite statement which the Board may struggle to use/ buy into, to manage the risks of the firm.

9. We believe paragraph 2.6 may exaggerate how much a Board should feel bound by a specific wording of the risk appetite statement. The risk appetite statement expresses, rather than defines, the Board's appetite for risk-taking; thus it does not constrain the Board from adapting to changed circumstances, risks, or opportunities.

10. It is important though that the Board controls the risk appetite, rather than setting it reactively. Thus, we agree that there are circumstances where changes are not appropriate, particularly where the purpose is to accommodate a particular proposed or completed action.

11. There is however a wide range of examples where regular changes to appetite may be appropriate as the external world changes; for example, changes in future risk preferences due to coverage/ pricing trends, following large events as in the hurricanes of 2017. We believe that the SS should refer to such examples, for balance.

12. In addition, most firms review their strategy and business plans on an annual basis, a process which inherently includes reviewing the risk appetite. Indeed Lloyd's syndicates are annual ventures and re-capitalise themselves every November: it is quite natural to make adjustments to the overall risk profile of the syndicate with this frequency.

13. We therefore suggest inserting the wording '..or regularise particular actions, such as after…' between 'justify' and 'the assumption' in the current draft paragraph 2.6.

14. Paragraph 2.8 notes the need to communicate risk appetite internally, but does not mention external communication. Consistency between the risk behaviour of the firm (as codified in the risk appetite statement) and the expectations of external stakeholders (which would be derived from the insurer's external communications) is an important goal for an effective risk appetite statement. Whilst it would not be expected that the detail of a risk appetite statement should be publically disclosed, some note about the consistency with external stakeholders (e.g. shareholders / capital providers, customers and their agents, rating agencies, regulators) seems appropriate.

15. We therefore suggest the following additional paragraph:

    'The PRA expects communication to external stakeholders, such as shareholders/ capital providers, customers and their agents, rating agencies and regulators to be appropriately consistent with the risk appetite statement'.

16. We interpret paragraphs 3.7/3.8 to relate to stress scenarios that would take the firm outside its risk appetite (maybe specifically for capital or liquidity), i.e. reverse stress testing and recovery planning. The wording should clarify this if appropriate.

17. We believe 'planned management actions' is too definite for what is, in effect, a set of contingency options. Firms will identify and assess the feasibility of potential recovery actions. However, when a stress actually takes place, the Board will choose the appropriate recovery actions in the light of the actual circumstances. It would be neither proportionate nor effective,

in unstressed conditions, to plan recovery actions down to an executable level of detail; those detailed plans would be made when a stress is developing, again taking into account the actual circumstances.

18. Similarly, Boards should approve the identification and feasibility analysis, not an action plan. The latter may inappropriately bind a future Board when faced with choosing recovery actions.

19. We also note that the Financial Stability Board's 'Guidance on Recovery Triggers and Stress Scenarios' explains that Boards should decide actions in the light of a stress, not in advance. In particular, it notes that[1]:

    'Whereas there should be a presumption that the firm needs to act when a trigger is breached, there should be no automaticity. Although a triggering event usually results in the firm taking a recovery action, an action may not be required in every case. Firms should retain flexibility to implement a discretionary response in accordance with the specificities of the situation and avoid market reactions that could be counterproductive in a stress scenario.'

20. To monitor market conditions or counterparty availability on an active basis could suggest regular test trades or counterparty discussions; these are not proportionate actions in unstressed conditions. Active monitoring would be appropriate when a stress is developing; otherwise monitoring will be part of the periodic refresh of the analysis.

21. Given this, we suggest paragraphs 3.7 and 3.8 in the draft SS are revised as follows:

    'The PRA expects insurers and groups to identify and analyse potential management actions in response to stress scenarios that could take the firm outside its risk appetite. Those actions should be realistic, credible, consistent with regulatory expectations, and achievable. The analysis should be approved by their boards. Firms should also consider whether any of the actions identified should be taken in advance as precautionary measures, or whether they would be relevant or desirable only in the stress scenario.'

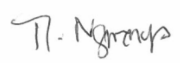
    'The PRA expects insurers to understand any dependencies for the implementation of the potential management actions on counterparties or external market conditions, and monitor those dependencies so that the effectiveness of those actions is not undermined.'

22. The requirements described in paragraph 4.3 are clearly helpful in ensuring robustness of dividend policies and plans. However, determining sources of capital generation (in particular changes in capital requirements) is a very time and resource intensive process. This may be disproportionate for small insurers, so we suggest softening the wording here slightly (e.g. the second line of this paragraph could replace 'including' with 'for example').

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely

Marjorie Ngwenya



President, Institute and Faculty of Actuaries

[1] See http://www.fsb.org/2013/07/r_130716c/, page 8.