The release of PRA Policy Statement and Supervisory Statement on financial management and planning by insurers PS10/18 & SS4/18

June 2018

INTRODUCTION

On 17th May 2018, the Prudential Regulation Authority (**PRA**) issued two complementary publications in response to its November 2017 consultation paper (**CP**) CP23/17 "Financial management and planning by insurers". Milliman consultants published a paper[1] in December 2017 in relation to this consultation paper.

The policy statement[2] (**PS**) and supervisory statement[3] (**SS**), PS10/18 and SS4/18 respectively, issue further guidance and feedback based on industry responses to CP23/17 which set out the PRA's expectations on effective financial management and planning by insurance firms and groups.

This paper provides an updated summary of the SS.

SUPERVISORY STATEMENT (SS4/18)

The SS is effective from the date of publication, 17th May 2018, and is broadly structured into three areas:

- Risk Appetite statement;
- Business and financial plans; and
- Dividend suitability and sustainability

The updated SS closely resembles CP23/17 however it has been altered to reflect the proportionality of the PRAs expectations. In the PRA's view, the amendments to the draft policy set out in CP23/17 will 'lessen the burden on firms'. This update focuses on the key areas of SS4/18.

RISK APPETITE STATEMENTS

Governance and use of the risk appetite statement

The SS reminds insurers that the PRA would expect an insurer's risk appetite statement (the description of the amount and type of risk that an insurer is willing to take in order to meet its strategic objectives) to be approved by the board.

Any revisions to the risk appetite statement should also be approved by the board following an overall discussion on the risks and capital requirements of the business. The PRA acknowledges that most insurers review their risk appetite annually (in the context of reviewing their strategy and business plans) and that a review may also be required after 'some major external event'. The PRA does not expect a firm's risk appetite to be changed in order to justify the assumption of a new risk, a change in investment policy or dividend policy.

The PRA continues to place a strong emphasis on ensuring that firms are making decisions within the context of their existing risk appetite and that firms do not change their risk appetite solely to accommodate a business decision.

The PRA also expects that the risk appetite statement should be communicated appropriately across the firm so that individuals performing key functions can clearly understand the framework for management and reporting of relevant risks.

Insurers should also clearly document how the risk appetite has been determined and the rationale for the way the risk appetite is expressed.

The PRA also expects insurers' communication with external stakeholders to be in line with their risk appetite statements.

Contents of the risk appetite statement

The PRA has stated that they expect the risk appetite statement to specify the level of capital that will be maintained in reasonably foreseeable market conditions (e.g. assessed through stress and scenario tests or other appropriate alternatives so that there is only a 1 in X probability that the Solvency Capital Requirement (SCR) coverage will fall to below 100% over a certain time horizon). The SS also lists the following areas that should be considered when determining the risk appetite.

[1] Milliman Paper – "The release of PRA Consultation Paper on financial management and planning by insurers CP 23/17 ", December 2017

[2] PRA – "PS10/18 Financial management and planning by insurers", May 2018

[3] PRA – "SS4/18 Financial management and planning by insurers", May 2018

Sensitivity of the balance sheet to changes in the key risk drivers, including changes in market and underwriting conditions and the emergence of large claims.
Non-linearities and discontinuities that may arise in the balance sheet due to combinations of adverse events including the potential loss of matching adjustment (MA) or volatility adjustment (VA) approvals.
Quality of capital resources.
Inherent uncertainty in regular solvency monitoring due to approximations in modelling with respect to technical provisions (including risk margin, MA, VA and transitional measures), illiquid asset values and SCR.
Levels of uncertainty in forecasting earnings.
Results of stress and scenario testing.
Capital levels that are considered to be required to maintain credit ratings and market reputation.
Potential impact of the failure of the firm on policyholders.
Recovery options that may be available and consideration of circumstances when they may not be available.

Some firms will already implicitly consider some or all of these areas when setting their risk appetite statement. However, for many firms, demonstrating that the factors have explicitly contributed to determining the risk appetite will be a challenge. In particular, those firms which currently use a more 'top down' approach to setting their risk appetite whereby they make an overall assessment of how much 'comfort' they want to have in relation to not breaching the SCR.

The PRA also highlighted that, in a proportionate manner, they expected the risk appetite statement to include, among other things, the insurer's appetite with respect to the level and volatility of future dividend payments in the context of business plans, capital levels and volatility of earnings.

Some firms may not currently articulate the desired level and volatility of dividend payments explicitly within their risk appetite statement. Some firms do set a minimum SCR coverage above which dividends will then be considered, however the SS would suggest that further detail and clarity should be provided in relation to dividends.

The PRA also reminds firms that the risk appetite statement should encompass all material risks that are relevant to the insurer and it should also include risk tolerance limits that have been set for various types of risk. Many of these limits should be expressed quantitatively though for some types of risk (e.g. reputational risk) the limits may be expressed qualitatively.

Some smaller or less complex firms currently set only qualitative limits in respect to individual risk exposures and so may find it challenging (initially) to move to quantitative metrics, such as the percentage contribution to total SCR.

This can be particularly difficult where the firm is seeking to set individual risk limits that are consistent with and work alongside the insurer's overall risk appetite.

The SS also states that the risk appetite statement should identify the reasonably foreseeable circumstances under which the statement might be reviewed.

It is unclear how specific or detailed the PRA is expecting firms to be when considering the circumstances under which the risk appetite statement may need to be reviewed. In our experience, many firms currently make high level statements such as after a 'material change in risk profile' rather than stating specific events that would trigger whether a revision is needed.

BUSINESS AND FINANCIAL PLANS

The SS sets out the PRA expectations of an insurer's business plan:

- It should be consistent with the firm's risk appetite and risk tolerance limits;
- It should show how the insurer intends to generate revenue and earnings each year; and
- It should reflect achievable capital generation and a capacity for dividend payouts in accordance with their risk appetite.

We have found it can be particularly useful to consider areas such as revenue generation and the development of risk profile under a range of business planning scenarios e.g. pessimistic, central, optimistic etc.

Where internal analysis shows that the business plan will put stress on the firm's solvency position or put it outside of the risk appetite, the business plan should be revised. The feedback loop between business planning and financial and risk planning is a critical part of the Own Risk and Solvency Assessment (ORSA).

In addition, the PRA expects insurers to identify and understand the drivers of their profitability and potential balance sheet volatility, together with the significant risks relating to their business plans, and consider reasonably foreseeable adverse scenarios.

Insurers should also have plans for the maintenance of capital resources in line with their risk appetite, that take account of each of these factors, as well as the insurer's intended levels and mix of business growth.

The SS also includes guidance on the use of management information (**MI**). Regular MI should be produced at a frequency commensurate with the volatility of drivers of capital surplus. Calculations included within the MI may be approximate but they should reflect the main drivers well enough to provide useful information for management.

The PRA expects MI to include information about any deviation from the business plan and state whether it breaches, or could breach, the insurer's risk appetite or risk tolerances. The PRA reminds firms that any deviations that are not within the risk appetite should result in timely action to limit the insurer's exposure to these risks, as well as a potential change to business plans to bring these in line with the risk appetite.

This is a positive clarification from the PRA. In our view, good business MI should give the board and senior management insight into the company's current position, how it got there and where it is heading from a forward looking perspective. This might include views as to whether future deviations from the plan are expected to continue going forward as well as an updated forecast of the balance sheet to reflect the current position and any update to the business plan.

The PRA expects insurers and groups to identify and analyse planned management actions which might be implemented in response to stress scenarios. These management actions should be credible, consistent with regulatory expectations and achievable. Consideration should also be given to whether the identified actions should be taken in advance as precautionary measures or only in the event the scenario occurs to reduce or manage the impact.

It is also expected that firms understand any dependencies for implementation of the planned management actions on third parties or external market conditions, and actively monitor these dependencies so that the effectiveness of those actions is not undermined. In addition insurers are expected to consider the conditions their identified management actions could be applied and establish suitable trigger points for these identified management actions. This should be taken into account in the calculation of their technical provisions and SCR.

It is important to consider the uncertainty in relation to the efficacy or availability of management actions in all scenarios. Understanding the dependencies of management actions could be difficult for firms to reliably anticipate, especially if the conditions have not been experienced before.

In addition, to be effective this cannot be a static exercise, firms ideally need to review any issues affecting management actions on an ongoing basis. Firms may also find it difficult to reliably anticipate whether their planned management actions are in line with regulatory expectations.

The PRA have also stated that any planned reliance by an insurer on support from its group should be assessed carefully, after consultation with the group board, to consider whether such support would be readily available. This should take account of:

- The potential effect of any stressed conditions on the group as a whole;
- The groups likely appetite to provide such support; and
- Any other potential barriers to the provision of support (e.g. legal or regulatory) and any practical barriers such as transferring funds between countries.

The PRA expects insurers to consider how they will address the risks and vulnerabilities to their business plans consistently with their risk appetite, including through an appropriate allocation of capital and through their risk management framework and controls.

The SS also reminds firms that an insurer's ORSA should help to ensure there are effective links between an insurer's business plan, risk appetite and capital management plan.

DIVIDEND SUITABILITY AND SUSTAINABILITY

The SS, states that the PRA would not normally expect insurers (other than those in run-off) to seek the PRA's pre-approval of planned dividends provided the insurer is within risk appetite, and is likely remain so, and the insurer's SCR coverage is above 100%.

However, as part of regular supervision, the PRA may review the sustainability of insurer's capital management and dividend policies. The PRA would also expect to be informed in advance if a firm was close to its risk appetite limit or if this could occur as a result of a proposed dividend. The SS states that the PRA may take a particular interest in insurers whose capital levels are close to the SCR or which fluctuate unexpectedly.

Prior to the release of the CP, we were aware that the PRA had disclosed their intention to non-longer pre-approve dividends to firms individually, but it is helpful that the SS seeks to formally publicise this more widely.

This section of the SS serves as a reminder that the PRA will continue to place a strong emphasis on firms having a robust framework for planning, setting and assessing the sustainability of dividends. Accordingly, the rest of the section on dividend suitability and sustainability in the SS describes the expectations the PRA has on how firms manage and plan their dividends.

The PRA expects firms to demonstrate that planned dividends are appropriate in relation to actual and projected business performance as well as future and current capital positions.

We would therefore expect firms to project their balance sheets on a forward-looking basis with and without dividend payouts in order to assess the appropriateness of the dividends under both best-estimate and alternative scenario conditions. Firms should consider how their balance sheet might be expected to vary after planned dividends have been paid under a variety of scenarios to assess post-dividend resilience. Firms should also consider the impact on the level of planned or potential future dividends when considering alternative scenarios in order to ensure the level of dividend payouts assessed are realistic for the scenario being considered.

We would also expect firms to consider market expectations in relation to their dividend and capital management policies, considering analysts, credit rating agencies, reinsurance counterparties as well as policyholders.

The PRA also states that insurers will need to consider the level, timing and source of capital generation. Therefore, insurers should consider the longer term implications of their dividend policy and how any future dividends will vary with future capital generation.

Firms will therefore want to assess areas both where future capital is likely to be generated as well the availability of sources of additional capital if the solvency position deteriorates.

Also, in this section, the PRA reminds firms of the importance of governance in relation to capital management and dividend policies. The SS states the PRA may consider whether an insurer is meeting the requirement in Conditions Governing Business 2.1 to have in place an 'effective system of governance which provides for sound and prudent management of its business' if frequent or foreseeable breaches of SCR occur or are likely to occur, or if the insurer frequently falls outside of its risk appetite or makes frequent changes to its risk appetite.

In respect of the latter point, a firm's risk appetite is not necessarily static or fixed and firms may have very valid reasons for changing their risk appetite. However, firms will need to provide appropriate justification for the change and, as commented earlier, any significant changes will have to be approved by the board and under a robust decision framework.

EXISTING GUIDANCE

The SS is not designed to set out new expectations but to complement existing guidance. Specifically, the SS sits alongside:

- The PRA's approach to insurance supervision'[4]
- SS41/15 'Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines'[5]
- SS5/16 'Corporate Governance: Board responsibilities'[6]
- SS19/16 'Solvency II: ORSA'
- SS5/17 'Dealing with a market turning event in the general insurance sector'[7]

POLICY STATEMENT (PS10/18)

The PRA received 7 responses to CP23/17. Feedback from respondents is summarised and considered in the policy statement.

Overall, the responses supported the PRA in making its expectations clear with respect to the financial management and planning for insurers. In particular, respondents welcomed the clarification that the PRA provided on the importance of a robust risk appetite framework and agreed that the proposals generally complemented existing policy material on financial management rather than setting out new requirements.

The policy statement makes it clear that the main changes between CP23/17 and SS4/18 are designed to clarify the PRA's expectations and, in particular, highlight the proportionate nature of the PRA's expectations.

HOW MILLIMAN CAN HELP

Milliman has supported a wide variety of insurers in developing and enhancing their financial planning processes, capital management frameworks, and enterprise risk management.

We are therefore well placed to assist firms address the areas covered by this SS, including:

- risk appetite and risk limit setting;
- capital planning;
- management action review;
- stress and scenario testing; and
- ORSA review.

If you have any questions or comments on this paper or any other aspect of risk or capital management (including the ORSA) please contact the consultants listed below or your usual Milliman consultant.

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[4] March 2016: www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
[5] October 2015: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss4115.aspx
[6] March 2016: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss516.aspx.
[7] July 2017: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss517.aspx.