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The UK PRA's Priorities for Insurance Supervision in 2023

The UK Prudential Regulation Authority (PRA) laid out its priorities for insurance supervision this year in a 10 January 2023 Priorities Letter. In this newsletter, we summarise the broad themes emerging from the Priorities Letter and the earlier PRA Business Plan for 2022/23, together with our take on what might lie behind the PRA's occasionally indirect references.

Financial Resilience

The PRA has updated on the business plan to flag a number of additional insurance market-wide risks, ranging from the impacts of the forecast UK recession, elevated inflation and risks arising from climate change, both to underwriting risk and asset values.

Credit and concentration risk (life insurance)

For the life insurance industry, the PRA refers specifically to the increased exposure to credit and concentration risk (especially for insurers using internal models) as a result of widening credit spreads, rating downgrades and increased level of defaults. It notes that robust modelling will be required in prolonged adverse credit scenarios.

Claims inflation (general insurance)

For general insurers, the PRA notes elevated levels of claims inflation. This is compounded by uncertainty about the severity and duration of this inflation, and also the potential lag before claims come through. In the PRA's October 2022 letter on the topic, it identified a number of drivers (wages, parts, court settlements, medical as well as 'social' inflation), noting variations across different businesses and geographies. The profit warning and subsequent dividend cancellation by UK-listed motor general insurance group Direct Line Insurance Group PLC in January 2023, attributed to adverse weather conditions in Q4, is a high-profile example of the issues faced by the market.

Risk Management

General

The PRA notes that market and credit risks are now different than those that prevailed until recently. It expects firms to be sure of the continued validity of their models, and invites firms to look to the PRA's model risk management principles for the banking sector, which has been a PRA focus since the collapse of Archegos Capital Management in 2021. These draft banking principles, contained in a consultation paper released in July 2022, include proposals for allocation of responsibility for risk management to a senior management function holder, enhanced reporting to the audit committee, and identifying and assessing risks involved in the use of artificial intelligence (AI) in modelling.

Bulk purchase annuity deals

For the life insurance industry it flags a specific risk with the booming UK market for bulk purchase annuity (BPA) deals, where UK defined-benefit pension schemes offload risk, typically to specialized divisions of life insurance groups. In 2023, the PRA will conduct a thematic review around its (thinly veiled) concern that successful bidders (*i.e.*, risk-takers) on such deals are not acting in a disciplined fashion. The pricing offered by risk-takers (and hence the risk-taker's ongoing exposure over the lifetime of the book) will likely be scrutinized.

Liquidity risk/liability-driven investment funds

The PRA also flags specific concerns around insurers' liquidity risk frameworks, with explicit reference to the turbulence in the UK financial markets in October 2022, and the manner in which liability-driven investment (LDI) funds used by pension funds struggled to source collateral to cover widening spreads. Generally, the PRA will focus on the use by insurers of derivatives for risk management, and the scope for this to generate further liquidity risks.

The PRA subsequently released the results of its 2022 stress test of 54 firms in the general and life market. Whilst this confirms that the UK insurance sector is resilient to the PRA-specified scenarios, concerns remain about the ability of firms to sell assets following a market-wide stress where there may be few willing buyers.

Solvency UK

Edinburgh Reforms

We have already reported on the UK government's proposals for substantive changes to Solvency II (changes referred to as Solvency UK) as part of wider reforms to the UK financial services regime, which are known as the Edinburgh Reforms. *See* "The Edinburgh Reforms: Big Bang 2.0 or Thoughtful Change?" and "From Solvency II to Solvency UK: The UK Government Announces Its Post-Brexit Solvency II Reforms". Although HM Treasury-led, these processes will of course require significant PRA engagement with the industry.

Temporary permission regime and third-country branches

The PRA intends to complete in 2023 its assessment of UK branches of European Economic Area (EEA) insurers, with a view to whether such branches should obtain standalone UK authorisation or go into run-off. The UK policy of 'responsible openness' with regard to the EEA extends to all third-country branches, where, as part of the Edinburgh Reforms, it is removing requirements for third-country branches to calculate branch capital requirements and hold local assets to cover them. Post-Brexit, EEA third-country branches operate in the UK under the extended grace period referred to as the Temporary Permission Regime (TPR). It remains important for TPR firms to follow the PRA's requirements and timetables, given the regulatory willingness to enforce against infractions.

This is somewhat in contrast to the approach of the European Insurance and Occupational Pensions Authority (EIOPA), which in July 2022 reinforced efforts to restrict the activities of third-country branches in the EEA, both carriers and intermediaries.

Reinsurance Risk

Longevity and 'funded' reinsurance

The PRA also flags risks to UK policyholders in the life market arising from carriers' reinsurance arrangements In particular, it mentions (i) the increasing reliance of parts of the industry on longevity reinsurance (linked in part to the continuing popularity of the BPA deals discussed above), often offshoring risk to US and Bermuda reinsurers with lower or different capital requirements. and (ii) the emergence of more complex 'funded reinsurance'.

It will be interesting to see whether and how these concerns feed into the PRA's efforts to encourage an insurance-linked securities (ILS) market and collateralised reinsurance in the general insurance sector. It may well be that the only way to bring such risks back onshore may be to create a UK regime for reinsurers that is broadly similar to what Bermuda offers.

Concentration risk

The above concerns centre around concentration risk, with the PRA noting that use of specialized fully funded reinsurers may in fact increase a carrier's overall risk profile as compared to a more conventional cession to a range of diversified reinsurers due to the reliance on the integrity and suitability of a discrete pot of collateral. As it says, 'funded reinsurance also appears to be a long way from the traditional purpose of reinsurance, which is to access wider diversification of liabilities'. The PRA has particular concerns over the ability of a carrier to reassume risk in the event of reinsurer default (recapture risk), noting that recaptured assets may not be Solvency II-compliant, terms governing the collateral are not standardised and sometimes opaque, and there is a danger of 'wrong way risk' (*i.e.*, where the same issues affecting the reinsurer also impact the collateral pot).

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Operational Resilience

The PRA's concerns over general market conditions inform an increased attention to its rules about operational risk and resilience. The PRA currently expects insurers to identify and map key business services and set impact tolerances. Over the next three years, the PRA will expect insurers to demonstrate their ability to operate in a range of 'severe but plausible' scenarios, including cyber attacks. This will, of course, extend to arrangements where a firm relies on a third-party outsourced provider.

Exit Plans

Perhaps also linked to the concerns above, the PRA continues to make it a priority to improve 'ease of exit' — no doubt a euphemism for the lengthy and complex processes that typically result from a firm going into run-off or failing. The largest and systemically most important global (re)insurers have been required for some time now to develop and maintain 'living wills'. Now the PRA is turning to smaller firms. Although all firms are already required under the PRA's Fundamental Rule 8 to prepare for resolution to exit in orderly fashion, the PRA will consult in 2023 on whether this should be toughened up into a requirement for all insurers to produce exit plans.

This links again with continuing initiatives at EU level, where in September 2021, the European Commission adopted a legislative proposal for a Insurance Recovery and Resolution Directive (IRRD), with possible adoption in 2023.

In Summary

The contents of the Priorities Letter are perhaps unsurprising given the macro challenges that both the broader economy and insurers face. What will be interesting to observe is how the PRA adapts those priorities in real time to the further economic shocks and bumps we will no doubt experience in the coming year.