BANK OF ENGLAND

FSA®

The Bank of England, Prudential Regulation Authority

Our approach to insurance supervision

June 2011

Contents

I	Introduction and overview	3
II	Scope	8
III	Risk assessment framework	9
IV	Supervision	11
V	Policy making	18
VI	Authorisation of firms and approval of individuals	20
VII	Next steps	21

I Introduction and overview

Introduction

1. This publication has been produced jointly by the Bank of England and the Financial Services Authority (FSA). Its aim is to set out how the Prudential Regulation Authority (PRA), currently expected to be created by the end of 2012 as a subsidiary of the Bank of England, will approach the supervision of insurers.(1) The document complements HM Treasury's February 2011 consultation document *A new approach to financial regulation: building a stronger system* and HM Treasury's June 2011 White Paper *A new approach to financial regulation: the blueprint for reform*, which lay out the proposed legislative framework. It is intended that this document will inform public debate and facilitate engagement with relevant stakeholders as the PRA's approach is further refined and the details of its supervisory approach are put into place.

2. The PRA will be responsible for supervising insurers, deposit-takers and a small number of investment firms that could present significant risks to the stability of the financial system. Recognising that the risks posed by insurers are different to the risks posed by other firms the PRA will supervise, this paper focuses on the PRA's approach to supervising insurers. A separate publication sets out the PRA's intended approach to banking supervision.(2)

Overview

3. Insurance companies enable policyholders to pool and transfer risk, providing a variety of policies for doing so. The objective of insurance policies is to protect policyholders against the financial consequences of uncertain future events (for example, damage to or loss of property or ill health), and some policies also enable the accumulation of wealth. Usually, policyholders pay premiums in advance in return for payment if and when the insured event happens. **Insurers' liabilities are thus fundamentally different to those of banks.** They are, in general, inherently uncertain, both to the individual policyholder and in aggregate. That is in contrast to the certain commitment that banks make to depositors to return their deposit on demand in full. Insurers are less leveraged than banks and in general are therefore much less vulnerable to a run resulting from a sudden loss of confidence.

4. As with any service where payment is made in advance, policyholders are exposed to the risk that the insurer may fail, and to the fact that the incentives of management and policyholders may not be aligned, particularly in times of stress. The fundamental uncertainty associated with insurers' liabilities, combined with imbalances in information, means it is difficult in practice for many policyholders to monitor the financial health of their firm and to make reasonably informed judgements about the level of risk to which they are exposed. Added to this, for many products (such as annuities), policyholders are constrained in their ability to switch insurer over the period during which the contract is being fulfilled. And for some types of insurance, it will be many years until policyholders receive payment in return.

5. **The nature of insurers' business models exposes them to a different set of risks than banks. It also means they fail in different ways compared with banks, usually for different reasons and with different impact on the stability of the system. Recognising the particular nature of insurance contracts and insurers' business models, the PRA's supervision of insurers will be framed in a different way to its supervision of banks.**

6. **The PRA will have two, complementary, objectives for insurance supervision. It will seek both to secure an appropriate degree of protection for policyholders and, as needed, to minimise the adverse impact that the failure of an insurer or the way it carries out its business could have on the stability of the system.**

Securing appropriate policyholder protection

7. Policyholders will be protected both by the PRA as prudential regulator and by the Financial Conduct Authority (FCA) as conduct regulator. The two roles are distinct. **The PRA's role will be to ensure there is a reasonably high probability that an insurer is able to meet claims from, and material obligations to, policyholders as they fall due. And to make sure that where an insurer is unable to meet such claims and obligations, the adverse consequences for policyholders are minimised by ensuring that the insurer fails in an orderly manner.** At the heart of this will be ensuring that an insurer is likely to have sufficient financial resources to meet its obligations to policyholders as they fall due. This will include assessing an insurer's governance processes and whether these involve management making informed, forward-looking assessments of the firm's financial strength, including risks both to the assets and liabilities on its balance sheet. The PRA will use a combination of regulatory standards, arrangements for dealing with failing insurers (resolution arrangements) and supervisory interventions to deliver these elements.

(1) The PRA will supervise companies specialising in life insurance, general insurance and wholesale insurance (including reinsurance), and companies that undertake a composite of these activities. The approach to supervision set out in this document will be tailored as necessary according to the activities undertaken by insurers.
(2) *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision*, May 2011.

8. The FCA's role as conduct regulator will be to ensure that consumers are treated fairly in all engagements with insurance firms. This will involve reviewing a firm's sales and advice processes, as well as the appropriateness of new insurance products entering the market.

9. As set out in HM Treasury's White Paper, arrangements will be put in place so there is close co-operation between the PRA and the FCA. The co-operation arrangements between the PRA and the FCA will take particular account of the nature of insurers' liabilities arising from with-profits policies. A with-profits insurance contract contains both a defined and a discretionary benefit based on investment performance. **As prudential regulator, the PRA will have sole responsibility for matters relating to the interests of policyholders which could have an effect on the financial position of the firm.** To deliver this responsibility, in respect of material issues the PRA will consult the FCA. Arrangements between the PRA and the FCA in relation to with-profits will be set out publicly.

10. Firm failure is always possible and, as recognised in its statutory objectives, **the PRA's role will not be to guarantee that policyholders are protected in all circumstances. Nor will the PRA seek to ensure that no insurer fails**. The primary responsibility for financial soundness must lie with each insurer's management, board of directors and shareholders, not with the regulator. Recognising the important role played by a firm's management, board, auditor and actuary in the prudential soundness of a firm, the PRA will seek constructive dialogue with each of these groups. Beyond the role played by firms themselves, policyholders will be protected through a combination of: the PRA's supervisory approach; mechanisms by which insurers can exit the market in an orderly manner; and the existence of the Financial Services Compensation Scheme's (FSCS') insurance compensation scheme, which protects policyholders, up to certain limits, in the event that an insurer fails.

11. There is a range of statutory mechanisms by which an insurer may exit the market. Those existing mechanisms vary in the extent to which they have been used in practice, and may need to be adapted given international regulatory change. **Given the PRA's objectives, it will be important that there are mechanisms by which all types of insurer supervised by the PRA can exit the market in an orderly manner.** This will include ensuring that the FSCS has sufficient understanding of a firm's systems to maintain payments to policyholders in the case of insolvency.

The contribution of insurers to the stability of the system

12. **The PRA's insurance objective, to secure an appropriate degree of protection for policyholders, will complement its general role to contribute to the promotion of the stability of the UK financial system.** This will encompass both direct impact on the real economy arising from the withdrawal of insurance services and indirect impact via other financial institutions.

13. In general, firms carrying out traditional insurance activities do not pose risk to the system in the same way as banks. They do not typically undertake maturity transformation and the nature of their liabilities means they are considerably less vulnerable to sudden losses of confidence. Nor, on the whole, do they become leveraged to the same extent as banks. In addition, with the exception of reinsurers, insurers' interconnectedness is very considerably less than that of banks.

14. While insurers are not systemic in the same way as banks, their behaviour or failure nevertheless has the potential to pose risk to the stability of the financial system. When insurance is combined with banking in a single group (as is the case for many of the largest UK banks) that may give rise to system-wide risk if the failure of the insurer threatens the financial condition of the bank. And more broadly, insurance companies are significant providers of funds to the banking system both through outright holdings of debt and as effective providers of funds through financing operations such as securities lending. The ability and willingness of insurance companies to provide such financing is an important part of understanding banks' financial soundness, and this in turn is an important aspect of insurers' financial soundness.

15. The investment strategy of insurance companies can also have consequences for the rest of the system: given the scale of assets held by the insurance sector, their investment decisions can accentuate movements in asset prices. Further, where insurers provide reinsurance or financial guarantees, they will be interconnected with other financial firms and so their failure may affect the rest of the system, in a similar manner to the impact of the failure of, for example, an investment bank. And interruptions to the provision of certain classes of insurance (marine, aviation or trade credit insurance for example) will directly affect the ability to undertake real economic activity.

16. As seen with AIG, groups containing an insurer may undertake non-insurance activities, including through non-insurance subsidiaries that bring risk to the system (see Box 1). In such a scenario, the PRA will seek to tackle such risks via the powers it has in relation to the insurer, and, where appropriate, its group. In addition to co-ordinating with regulatory authorities in other jurisdictions to ensure effective management of such risks across groups, the PRA will also

Box 1
Lessons from previous episodes of insurance distress

In setting out the PRA's approach to insurance supervision, the Bank and the FSA have looked closely at the lessons arising from previous episodes of insurance company distress. Those cases included the problems in the London insurance market in the 1970s and 1980s; those culminating in Equitable Life's closure to new business in 2000; the insolvencies of HIH Group and Independent Insurance Limited in 2001; and the bailout of AIG Group during the recent financial crisis.

Although some lessons are bespoke to individual cases, a number of themes recur. Some of the key lessons for prudential regulators are summarised below.

- The importance of the *adequacy of reserves* to guard against shocks in a variety of scenarios, and the ability of firms to reassess their reserves or technical provisions in the light of new information. Inadequacy of reserves was an underlying issue in the majority of cases reviewed, including the London insurance market, which struggled to meet claims from asbestos and catastrophes such as Piper Alpha and Hurricane Andrew; and Equitable Life, which did not have adequate reserves to meet terminal bonuses to policyholders.
- The importance of *scrutinising firms' business models*, with particular attention to areas growing unusually quickly, as in the case of HIH Group and Independent Insurance. Both attracted business through aggressive pricing in order to compete for market share, but they had not set aside sufficient reserves to meet future claims. The case of Equitable Life also underlined the importance of ensuring that a firm's business model does not run ahead of its capital-raising potential, and highlighted the importance of understanding a firm's scope to raise further capital.
- The importance of *strong corporate governance* and, particularly, a board that provides adequate challenge to management.
- A *full understanding by firms of the risks created by their own products and by their exposures* to other areas such as reinsurance and non-insurance business (such as securities lending), including risks arising out of the activities of other group companies.
- The importance of *consolidated supervision*, and specifically, the importance of taking account of all the risk-carrying financial activities in a regulated firm and the group of which it is a part, when considering the risks posed by a firm. This was a lesson highlighted most acutely in the case of AIG Group which had become involved in activities more typically undertaken by banks (the sale of CDS and the investment of proceeds from securities lending).

ensure the Financial Policy Committee (FPC) is made aware, so that it might make recommendations to HM Treasury in relation to the regulatory perimeter.

17. The PRA's supervision of insurers will seek to contribute to the stability of the system. In particular, **the PRA will seek to identify those insurance companies likely individually to pose risk to the stability of the system and to supervise those firms in a way that reduces that risk**. Assessment of system-wide risks, such as risks arising because insurers are providers of funds to the banking system, will be the responsibility of the FPC of the Bank of England. The FPC will have responsibility for reducing risks to the financial system as a whole and will, among other things, be able to direct or recommend changes to PRA policies and rules on a 'comply or explain' basis. **The insurance supervisors of the PRA will work closely with the FPC in support of the FPC's macroprudential remit.**

Judgement-based supervision

18. The PRA will supervise a wide range of insurance firms, of which around one fifth are life insurers, with the rest being general, composite or wholesale insurers. **The PRA's supervisory approach will recognise the different risks inherent in the business models of life and general insurers**, reflecting the different maturities of their assets and liabilities and the different risks to which they are exposed.

19. **Across its entire portfolio of firms, the PRA's style of supervision will be judgement-based.** Key features of this for insurance supervision will include:

- **The nature and intensity of the PRA's supervisory approach will be commensurate with the level of risk a firm poses to policyholders and to the stability of the system.** Through this risk-based allocation of resources, the PRA will seek to deliver the same degree of policyholder protection across all insurers. There will be a baseline level of monitoring for all firms. But resources will be focused on those institutions and issues which will have the greatest impact on the PRA's objectives. Reflecting this, supervision will be tailored to different firms and sectors: it will not be driven by a one-size-fits-all approach but will vary according to risk.

- **Supervisors will focus on understanding where the main risks to policyholders and the stability of the system lie.** The PRA's test of materiality for points raised with firms in respect of their safety and soundness will be high. But where necessary, in order to protect appropriately policyholders, supervisors may need to undertake detailed assessment of firms' actions. All supervisory interventions will be clearly and directly linked to reducing risk to policyholders and, where appropriate, the stability of the system.

- **The PRA will be forward-looking, seeking to assess whether, on the balance of risks, there are vulnerabilities in firms' business models, reserving, solvency position, governance, risk management and controls that cast into doubt their ability to deliver on policyholder obligations.** Reflecting the uncertain nature of insurers' liabilities, analytical models will be an important part of assessing safety and soundness, both for management and supervisors. Supervisors will recognise the importance of understanding risks to a firm, including the limitations of the outputs of firms' models, when forming their judgements.

- **Where potential threats to the safety and soundness of an institution are identified, the PRA will take supervisory action at an early stage to reduce risk to its statutory objectives.** A Proactive Intervention Framework will be introduced. This will clearly set out both the recovery actions expected to be taken by a firm as its financial position deteriorates, and the actions expected to be taken to prepare for firm failure, should that become necessary.

20. The PRA will aim to build and develop highly qualified supervisory teams and robust analytical frameworks based on high-quality data. Actuarial, quantitative and other specialists will work closely with firms' supervisors, recognising the importance of taking a prospective (rather than retrospective) view of a firm's financial soundness. The PRA's approach will require clear decision-making procedures and constructive but challenging relationships with the firms that it regulates.

21. The PRA will seek to make clear to firms what it expects of them through straightforward, clear communication of its policies and rules. Firms will be expected to consider the underlying purpose of PRA rules — the spirit — when managing their businesses. The PRA will expect the firms it regulates not to engage in 'creative' compliance with its rules and policies and not to engage in regulatory arbitrage designed to mask the riskiness of their activities or financial exposures.

Delivering the PRA's approach

22. The PRA's policies and supervisory actions will take place within an international context. **The PRA will play an active and constructive role in shaping the development of the common framework for regulation and supervision at a global level and in the EU.** And its supervisory approach will be consistent with international obligations.

23. Much of the PRA's proposed approach will be achieved in practice through the application of Solvency II (see Box 2), the new European framework for insurance supervision. Solvency II will: introduce a new forward-looking Own Risk and Solvency Assessment (ORSA) for firms; place greater emphasis on the importance of disclosure; introduce a 'ladder of intervention' to support early action; and strengthen co-operation arrangements between national regulators, particularly with regards to international groups. All of these are consistent with the PRA's approach. The detail to support the Solvency II framework is still being finalised. The Bank and the FSA consider it to be important that the technical detail of Solvency II leaves scope for supervisors of individual firms to make informed judgements about risks posed, and action to be taken, within a clear overall EU-wide policy framework.

24. **At its core, the PRA's approach involves its staff making judgements, when needed, about current and future risks to an institution's safety and soundness and about the action the PRA should take to address these risks.** It is recognised that this will mean that, at times, the supervisor's judgement will be at variance with that of the institution. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong. This is inherent in a forward-looking system and does not necessarily point to regulatory errors. In order to reduce this possibility, **the PRA will ensure that major judgements involve its most senior and experienced individuals, using a process that is both rigorous and well-documented**.

25. Many international insurers operate in the United Kingdom. While recognising its more limited powers in relation to non-UK firms, the PRA will expect all insurers operating in the United Kingdom to operate to an equivalent

Box 2
The FSA's implementation of Solvency II

For the majority of insurers, a new regulatory framework is being introduced via the Solvency II Directive. This is currently expected to come into force on 1 January 2013. Implementing the Directive is a challenge for the FSA and firms, in part reflecting the current absence of complete clarity about the full requirements of the regime. The FSA's intended approach to the implementation of Solvency II was explained at a conference in April, which set out a programme of work to be delivered before 1 January 2013.(1)

(1) See www.fsa.gov.uk/solvency2 for further details.

standard. Collaboration with other regulators, engagement with the European Insurance and Occupational Pensions Authority (EIOPA) for EU firms, and engagement with the International Association of Insurance Supervisors (IAIS) for other international firms, will all be important in ensuring the PRA is able to address risks that non-UK insurers may pose to its statutory objectives. The PRA will support IAIS initiatives to strengthen the supervisory framework for internationally active insurers. It is also the Bank and the FSA's view that for internationally active firms, the group supervisor should be ready and able to conduct effective consolidated supervision of all activities (regulated and unregulated) within a group.

26. **Across all its activities, the PRA will recognise that accountability to the public is of the utmost importance.** It will therefore be fully committed to being transparent and accountable in delivering its public policy objectives set by Parliament, and in delivering its objectives in a cost-effective manner.

Structure of this paper

27. Section II provides background on insurers operating in the United Kingdom. Section III describes the PRA's proposed risk assessment framework. Section IV sets out how the PRA plans to put its judgement-led approach into practice through the supervision of firms. Section V articulates the PRA's approach to policy making, designed to support a judgement-led approach to supervision, while Section VI defines the PRA's approach to authorising firms and approving individuals. The paper concludes with next steps.

II Scope

28. The United Kingdom has the largest insurance industry in Europe and the third largest insurance industry in the world. In 2009, UK firms wrote £45.9 billion of non-life insurance premiums and £131 billion of life insurance premiums. In addition, UK firms provided policyholders with investment services totalling around £1.4 trillion of invested assets, of which almost £800 billion related to unit-linked or pension management investments where investment risk is borne mainly by the policyholder.(1)

29. Of the over 2,000 firms for which the PRA will be home or host supervisor, on current data more than half will be insurers (**Table 1**). Of those firms, just under two thirds provide general insurance services — typically commercial, public liability, motor and home insurance (with some of those also providing life insurance services) — while just under one fifth are life insurance companies.

Table 1 Insurers operating in the United Kingdom

	UK Authorised	EEA Authorised	Total
General insurer (including composites)	335	301	636
Life insurer	123	70	193
Friendly society	133		133
Wholesale/commercial insurer/reinsurer	64		64
Lloyd's and Lloyd's managing agents	68		68
Total number of insurers	**723**	**371**	**1,094**

Notes: Firms dealing in both life and general insurance (composite insurers) are classified as general insurers. Mutual insurers that are not friendly societies are included within figures for general, life of wholesale insurers, as appropriate.

Source: FSA data as at 31 March 2011.

30. The majority of the firms the PRA will supervise are incorporated and authorised in the United Kingdom, but there are also over 350 EEA insurers operating in the United Kingdom by means of branches (**Table 1**). Although some of these branches are significant, the majority have small operations in the United Kingdom.

31. Around one in ten insurers operating in the United Kingdom are involved in the London Market. The 'London Market' is a collective term used to describe a particular set of, largely wholesale, insurance activities centred around London. London Market organisations provide a specialised subset of general insurance and include both syndicates operating under the franchise of Lloyd's (whose managing agents are authorised firms) and wholesale insurance firms which will be regulated directly by the PRA.

32. The PRA will be the group supervisor for a number of large insurance groups headquartered in the United Kingdom. As **Table 2** shows, these groups individually and collectively undertake large volumes of insurance activity in the United Kingdom and worldwide.

Table 2 Gross consolidated written premiums and consolidated assets of large UK insurance groups

	Total consolidated assets at 31 Dec. 2010 (£ millions)	Total consolidated gross written premiums 2010 (£ millions)
Aviva plc	370,107	36,274
Legal & General plc	323,873	5,348
Prudential plc	260,806	24,568
Old Mutual plc(a)	193,552	3,582
Standard Life plc	154,116	3,244
Lloyds Banking Group (insurance)	144,540	8,358
Resolution Ltd(a)	122,365	1,288
Phoenix	83,564	1,534
Lloyd's of London	70,610	22,592
Royal London Group(a)	34,244	1,057
RSA Insurance Group plc	23,104	8,448
Co-operative Insurance Services(a)(b)	22,503	484
RBS Insurance Group	12,555	4,298
NFU Mutual	12,202	1,321
BUPA	9,544	6,049
Sum	**1,837,685**	**128,445**

Source: Insurers' 2010 *Annual Reports*.

(a) Gross earned premiums used where gross written premiums are not available in published accounts.
(b) Figures correspond to long-term business only. Co-operative Financial Services also wrote £495.9 million general insurance gross earned premiums.

33. The population of firms that will be supervised by the PRA spans a variety of different ownership structures, including privately owned, joint stock companies and mutual organisations.

(1) Source: FSA returns for 2009.

III Risk assessment framework

34. **The PRA will concentrate its resources and actions on those insurance firms and issues that pose the greatest risk to policyholders and those that pose the greatest risk to the stability of the UK financial system. The risk assessment framework for insurers will operate in a different way to banks, reflecting the PRA's additional objective to protect policyholders, the different risks to which insurers are exposed, and the different way in which insurers fail.**

35. As illustrated in **Figure 1**, the framework will capture three key elements:

- **potential impact** on policyholders and the financial system of a firm coming under stress or failing — for example, would the failure of a firm disrupt the income flow of policyholders, and might it (directly or indirectly) disrupt the provision of financial services to the economy as a whole;
- how the macroeconomic and business **risk context** in which a firm operates might affect the viability of its business model — for example, its vulnerability to changes in mortality; and
- mitigating factors, including risk management and governance (operational mitigation), a firm's financial strength, including its solvency position (financial mitigation), and resolvability (structural mitigation) — which together determine the **safety and soundness** of a firm — that may reduce the potential risk a firm poses to policyholders and to the stability of the financial system.

36. This risk assessment framework contains material, important innovations, notably the focus on potential impact as well as probability of failure, and on resolvability.

Potential impact on policyholders and the system

37. **Considerable emphasis will be placed on assessing the channels for a firm's potential impact on policyholders and the stability of the system, including in times of wider stress.**

38. The **potential impact of a firm on policyholders** will take account of its size (the number of policyholders) and the nature of the services it provides, thus capturing the disruption to policyholders were they no longer to be covered by existing policies and were there to be no substitute policies available. The assessment of impact on policyholders will differ across the different types of insurers regulated by the PRA. For example, for insurers offering annuities products, disruption to policyholders caused by any delay in receipt of, or absence of, annuity income will be taken into account. For insurers offering products such as motor or aviation insurance, the measure of impact would need to incorporate the potential disruption to motorists/air travel if they were unable to operate as usual.

39. The assessment of **potential impact on the stability of the system** will capture impairment to the capacity of the financial system as a whole to carry out activities important to the functioning of the economy, in particular the provision of payment services (including access to funds), credit and risk transfer.(1) Thus it will cover not just the impact arising from the provision of insurance services themselves, but also that arising from activities related to their insurance business (such as stock lending) and from the role that insurers play in channelling funds within the financial system. Impact will reflect an institution's size, substitutability of services and interconnectedness with other parts of the system, and in assessing impact the PRA will draw on the analysis of systemic risk undertaken in the rest of the Bank, including for the FPC.

Figure 1 The 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

(1) Consistent with the definition of financial stability described in Bank of England *Annual Reports*.

Risk context: external and business risks

40. Risk context will be assessed for insurers in a similar manner to banks. **The PRA will consider whether and how the wider external macroeconomic and business context may affect the execution of a firm's business model in a variety of different scenarios.** This will draw on the FPC's view of the macroprudential environment, on market intelligence and other external sources, and on actions being taken by the FCA with the potential materially to affect prudential soundness. For firms operating in the Lloyd's market, the Society of Lloyd's will be an additional source of information.

41. In reaching this assessment, the PRA will require a clear understanding of a firm's business model, including the key drivers of, and threats to, its viability. The PRA will, for example, wish to understand whether the firm has expanded into innovative, non-traditional insurance activities that pose particular risk to the PRA's objectives.

Mitigating factors: safety and soundness

42. The PRA will assess factors that have the potential to mitigate the adverse impact a firm may have on policyholders and the stability of the financial system.

43. Assessing a firm's **financial strength** will be central to this. This will include assessing the level of capital held and the firm's ability to raise more; the reserving of general insurers and the adequacy of technical provisions for life insurers; profitability of underwriting (eg by scrutinising the claims and other performance ratios of general insurance firms); whether the firm is exposed to particular concentrations of risk (including to particular loss events or large/clustered exposures); the approach to liquidity management (including contingency planning); and the adequacy of key assumptions (for example, discount rates being applied to technical provisions and life insurance firms' longevity assumptions). In assessing financial strength, the PRA will also seek to consider whether the firm has plausible recovery actions that it could take, including in times of general market stress.

44. The quality of a firm's **risk management and governance** will also be evaluated. This will include an assessment of the adequacy, effectiveness and integrity of risk management, systems and controls, culture, governance and the competence of senior management. In reaching this assessment, the PRA will consider how the board operates and the effect that incentive and remuneration structures may have on regulatory outcomes. For insurers operating with-profits funds, consideration will be given to the firm's governance in determining distributions to policyholders, and how these are balanced with the firm's solvency.

45. To assess **resolvability**, the PRA, working with the FSCS as appropriate, will assess whether an insurer could be resolved or wound up in an orderly manner. Such an assessment would depend on the insurer's structure and activities and would take account of the consequences both for the stability of the system and for policyholder protection.

IV Supervision

46. The PRA's supervision will be delivered within an international context. Its supervisory approach will be consistent with international obligations, particularly those to be set out under Solvency II.

Approach to supervision

47. **The PRA's approach to supervision will be based on forward-looking judgements, with early supervisory interventions taken, aimed at ensuring that its objectives are met.** A key element of the PRA's supervisory approach will be to recognise the important role played by a firm's management, internal audit, board, shareholders, creditors and external auditor and actuary in ensuring firms are run prudently. To support that, the PRA will seek to engage in constructive dialogue with a firm's management, board, auditor and actuary. The PRA will also seek to enhance the information available to shareholders and creditors to enable them to provide an effective source of discipline over firms. The PRA's interventions will not, however, be designed to reduce risks to shareholders.

48. Across all insurers, the PRA will seek to ensure there is a reasonably high probability that policyholder claims and obligations can be met as they fall due. This will require different levels of supervisory activity across different firms.

49. **All firms will be subject to a baseline level of supervisory monitoring**, which will involve ensuring compliance with prudential standards for capital, liquidity, asset valuation, provisioning and reserving. At least annually, there will be a review of the risks to the PRA's objectives from a firm or its sector. The PRA will also seek to assess a firm's planned recovery actions and how it might exit the market in a way consistent with its objectives. Where appropriate, early interventions driven by the Proactive Intervention Framework (PIF) will be taken (see Box 3).

50. **Beyond baseline monitoring, the nature and intensity of the PRA's supervisory approach will be commensurate with the level of risk an insurer poses to the PRA's statutory objectives.** Some insurers will, due to their very size, complexity and nature of business, pose only limited risks. For such firms, the PRA's approach will be proportionate: for example, it is likely that business model analysis would be largely undertaken at the level of the sector, supported by additional work on individual firms in the event that risk crystallised. The PRA's approach will also be tailored to recognise the different risks that arise across the varied set of insurance companies it supervises, particularly taking account of the differences across life and general insurance companies.

51. **For those insurers posing greatest risk to the PRA's objectives, the supervisory approach will be more intensive but still focused.** This will include: evaluation of a firm's business model in order to assess the key risks in the short and medium term; desk-based analysis of a firm's financial strength; and stress testing against a range of possible future states of the world, including extreme scenarios. Supervisors will assess a firm's governance arrangements; its risk management policies and procedures; and its possible recovery options and exit strategies. There will be regular contact between a firm's senior management and senior PRA management, and early and proactive supervisory interventions under the PIF designed to reduce risks to policyholders and the stability of the system.

52. To enable the PRA to form an independent judgement of the key risks posed by a firm, its **supervisors will need to have access to accurate information**. The PRA will therefore periodically verify firms' data and risk management systems, either on-site or using third parties such as external auditors. It will, of course, remain insurers' own responsibility to ensure that they have appropriate systems in place to run their business prudently.

53. The work of firms' supervisors will be supported by in-house risk specialists (including actuaries) to deliver robust analysis, focused on key risks to the business. Senior management will oversee risk assessments and supervisory interventions for insurers, with key decisions subject to review by insurance specialists. For those firms posing the largest risk to the PRA's objectives, formal meetings between PRA senior management and CEOs will form part of this process. The results of supervisory assessments, as well as proposed remedial actions, will be subject to rigorous and independent challenge within the PRA before communication to firms.

Supervisory assessment

54. For UK firms, the PRA's assessment will cover all relevant entities within the consolidated group. To support this role, the PRA will seek to maintain effective working relationships and information flows with other relevant regulators, including the FCA and local regulators of the overseas businesses. This will be supported through Memoranda of Understanding and supervisory college arrangements.

55. The PRA's approach to the supervision of international insurers is covered in paragraphs 81 to 85.

Business risk

56. Business risks will be assessed at sectoral level and at the level of the individual firm. Supervisors will need to understand a firm's **business model** and assess its viability. To

do that, they will need to understand key vulnerabilities to the business model, across a range of future scenarios. Assessing low probability risks will play a key role within this, given the nature of insurance business, and the potential for such risks to have high impact.

57. Peer analysis will form a key part of the PRA's assessment approach, highlighting where business strategies and risks may differ from those of peers in specific sectors. This will be supported by analysis of sectoral/macro risks, as highlighted by and to the FPC.

Financial strength

58. The PRA will assess a firm's financial strength to analyse the adequacy of its **solvency** position on a forward-looking basis, including in times of stress when asset valuations may become strained and the adequacy of reserves is in consequence strained. Particular emphasis will be placed on reviewing a firm's approach to **reserving**. The PRA will ensure that insurers have a robust approach to the setting of reserves and that there is appropriate and adequate oversight of reserving processes. **Underwriting** concentrations and performance will also be considered, including reviewing longevity and discount rate assumptions. Supervisors will assess whether insurers are properly funded and whether they are able to meet their obligations as they fall due.

59. **Forward-looking stress testing** may be undertaken to assess a firm's financial strength in the event of different scenarios, including extreme events. As well as reviewing the outputs of stress tests undertaken by a firm as part of its own risk management, the PRA will seek, where appropriate, to undertake its own idiosyncratic stress tests, drawing on macro scenarios provided by the Bank of England and on event-based scenarios. The PRA will also participate in sector stress tests co-ordinated by EIOPA and the IMF.

60. In addition, as part of the assessment of the viability of a firm's business model, senior management of firms will be expected to understand the potential scenarios that could put their firm's business model at risk. The PRA will seek to require firms to undertake **reverse stress testing** aimed at identifying which risks pose a real threat to the firm's business, with the firm's senior management able to explain the actions they would take to mitigate the potential impact of those risks should they crystallise.

61. A key input to the PRA's proposed assessment of financial strength will be the **mitigating actions** that firms would take when under stress. In reviewing these, consideration would need to be given to how such actions would affect policyholders' interests.

Risk management and governance

62. The PRA will pay close attention to how risks are managed within the firm. That will involve assessment of the quality of a firm's **risk management systems and controls**, including senior management oversight of capital and provisions management, the adequacy of underwriting and reserving processes, and the setting of the firm's risk appetite. Supervisors will assess to what extent risks are diversified, both in terms of assets and lines of insurance business. They will also review whether the firm has adequate **governance** and audit processes to be alert to risks to the firm or group as a whole, and the effectiveness and independence of the actuarial function. Fit and proper assessments of individuals appointed to certain functions will also be important (discussed further in Section VI).

63. The PRA will require firms to have robust **risk management policies** and will expect firms' senior management to consider the risks to their business when formulating assumptions used in risk assessment and quantification techniques.

64. The PRA will also take account of a firm's **culture**, given the underlying role it plays in influencing strategy. Firms' governing bodies will be expected to embed and maintain a firm-wide culture that supports safety and soundness, and that is consistent with protecting the interests of policyholders. Beyond that, supervisors will not have any specific 'right culture' in mind when making assessments, but they will focus on whether a firm is achieving the right regulatory outcomes. Where those are not being achieved, however, the PRA will expect the governing body to reconsider culture and, where necessary, to make changes to improve regulatory outcomes.

Resolvability and resolution

65. While the PRA will seek to ensure the safety and soundness of the firms it supervises, its role will not be to ensure that no insurer fails. Insurance supervisors will therefore assess how a firm might exit the system should it fail.

66. There are a range of resolution arrangements available to insurers, including modifications to standard corporate insolvency arrangements which take account of the particular nature of insurers and their liabilities. Resolution arrangements for insurers vary in the extent to which they have been put into practice. (For example, no significantly sized life insurance firm has necessitated compensation from the FSCS.)

67. Given the PRA's objectives, an early priority will be to consider whether there are arrangements in place which would

allow all types of firms supervised by the PRA to exit while minimising the impact on policyholders. This will include ensuring the FSCS has sufficient understanding of insurers' systems so that it can maintain payments to policyholders in an insolvency, should that be needed. The PRA will consider whether and how Recovery and Resolution Plans might be introduced for insurers.

Supervisory assessment: supporting tools

68. The PRA will have a range of tools that it can draw on in order to undertake its supervisory assessment.

69. **Auditors** and **actuaries** can and should play a role in supporting prudential supervision. In particular, auditors can identify and flag to the regulator potential weaknesses in: a firm's controls and in the quality of the financial data which form the basis of management and board decisions; the prudential information used to supervise firms; and the data upon which market discipline is built. And actuaries play an important role in determining the financial soundness of firms. Full, regular and timely dialogue between auditors, actuaries and supervisors forms an essential part of supervision.

70. The PRA will draw on external auditors and actuaries, building as appropriate on the current relationship between such firms and the regulator (for example, the involvement of external parties in the pre-application process for internal models, ahead of Solvency II). In addition, the PRA will expect firm's actuarial, internal audit and risk functions to play a greater role in monitoring implementation of corrective actions required by the regulator.

71. The PRA will operate in accordance with, and seek further to develop, the Code of Practice for the relationship between the external auditor and the supervisor, which was jointly produced by the Bank of England and the FSA. The Code aims both to improve audit effectiveness and to ensure that supervisors are better informed about, and able to challenge, the firms they regulate, in order that auditors provide more robust mitigation against prudential risk in firms. The PRA will increase the level of formal and informal dialogue with auditors, at senior and working level, in an open and collaborative way. It will share relevant information, for example where it views a firm's valuations of less liquid assets or its approach to provisioning to be significantly out of line with peers, and it will encourage auditors to increase their disclosure to regulators of emerging concerns within firms. A genuine bilateral dialogue between a firm's auditors and supervisors, covering current and potential risks, will strengthen both the audit process and the supervision of firms.

72. The PRA will seek to maintain a constructive relationship with actuaries, individually and as a profession, so that the PRA understands and can critically challenge actuarial judgements. Engagement with the Board for Actuarial Standards and the Institute and Faculty of Actuaries will be an important part of this.

Use of data to inform judgements

73. Supervisory judgements will be informed by quantitative and qualitative reporting which, for firms subject to Solvency II, will include some quarterly reporting in addition to fuller annual reporting. Supervisory judgements will further be informed by firms' management information (including that within the ORSA, for those firms subject to Solvency II), financial accounting data, and market information.

74. Given their key role in peer analysis and within the PRA's information set, **regulatory data submitted by firms to the PRA should be of the highest quality, given they will be a key input to the PRA's approach and will form a key input to analysis for the FPC**. The PRA will put in place appropriate quality assurance mechanisms covering data submitted to it.

Particular applications of the supervisory approach and supervisory assessment

75. The application of the PRA's supervisory approach will be tailored to take account of the varied nature of the firms it supervises.

Lloyd's

76. The PRA will be the prudential supervisor of the Society of Lloyd's and managing agents that operate within the Lloyd's market. In supervising the Lloyd's market, the PRA will have regard to two principles. First, that the Lloyd's market should be supervised to the same standards as the non-Lloyd's insurance market. This means that Lloyd's policyholders should benefit from the same level of protection as non-Lloyd's policyholders. Second, that the practice of supervision and the application of rules over the various entities that make up the Lloyd's market should take place primarily at the level in the market where risk is managed.

77. To achieve this, the PRA will supervise the Lloyd's market at two levels — the Society of Lloyd's itself (which provides central functions, including the maintenance of the New Central Fund) and the managing agents (which carry out, *inter alia*, the underwriting, risk management and strategic business functions for Lloyd's members).

78. In due course, the PRA, FCA and the Society of Lloyd's will enter into new co-operation arrangements to ensure that the new regulators' interfaces with Lloyd's market discipline

functions and its oversight of the market as franchisor are suitably clear. The PRA-FCA Memorandum of Understanding will cover issues relating to the supervision of Lloyd's.

Mutual insurance companies and friendly societies

79. The PRA will regulate a number of retail mutual insurance companies, friendly societies and firms with a mutual structure operating in the London Market. The vast majority of these firms are small and, in line with its general approach, the PRA will take a proportionate and risk-based approach to the supervision of these firms. This will also be aligned with the PRA's obligations to apply Solvency II requirements consistent with the nature, scale and complexity of individual firms.

80. The PRA will locate all retail mutual insurers and friendly societies within a single department within the Insurance Division so that firms' supervisors have the appropriate and relevant supervisory expertise to facilitate a consistent approach to the application of regulation and to further support the development of relationships with relevant bodies. Sectoral analysis will be undertaken so that issues and risks that are specific to the business models of mutual sector firms are identified — for example, the PRA's approach will take account of mutual insurers' ability to raise capital.

International insurers operating in the United Kingdom

81. A significant number of international insurers operate in the United Kingdom, as highlighted in Section II. **The PRA's supervisory approach will be based on the principle that all insurers operating in the United Kingdom should be subject to equivalent prudential requirements.** The PRA will focus on the adverse impact that an insurer might have on policyholders and the stability of the system.

82. **Supervisors will therefore seek to understand the safety and soundness of entities active in the United Kingdom as well as of their ultimate parents**, with a view to judging the impact on policyholders and financial stability if one or both fail. To achieve this, it will be necessary to understand the UK firm in isolation and as part of the global group across a range of issues including: the nature and scale of the firm's operations in the United Kingdom; the substitutability of its services; its solvency position and asset-liability management; barriers to resolvability; and intra-group operational and financial dependencies. The PRA will be supportive of the IAIS' ComFrame initiative to have a strengthened supervisory framework for internationally active insurance groups including improved co-operation among supervisors.

83. In the case of **UK subsidiaries of overseas insurers**, the PRA's approach will mirror that for UK insurers. The PRA will, however, seek to assess a firm's links with, and the viability of, its group as a whole. It will also seek to ensure that the subsidiary has effective local governance arrangements. Throughout its supervision of subsidiaries, the PRA will consider how much reliance it should place on the group supervision exercised by the group supervisor.

84. Approximately one third of firms operating in the United Kingdom are **branches of EEA insurers** (**Table 1**). The PRA will have very limited prudential powers over such firms, but it will, proportionate to its assessment of the potential impact of each firm on its objectives, seek to understand those firms. Where appropriate the PRA will then seek to influence, through collaboration and in a supportive manner, the supervisory approach of the home state. In the case of significant UK branches of firms within a group, the PRA will engage in the relevant supervisory college. The PRA will seek to assess regularly the scale of activities undertaken by EEA branches so that it is aware of the potential impact of these branches on its statutory objectives, and it will seek to act to assure itself that those risks are being actively managed. Active participation in EIOPA and, where appropriate, supervisory colleges will be important in this regard. Where the PRA considers that the prudential risk from a branch is too great, or where it is unable to assess the risk satisfactorily, it will make that understood publicly so that it is clear that policyholders are protected by the home state regime.

85. In relation to **UK branches of non-EEA insurers**, the PRA will have broader (although still limited) prudential powers. The PRA will concentrate on ensuring adequate protection via the setting of capital and governance requirements and focused information sharing. It may also seek to require firms to ring-fence capital.

Reinsurance

86. The PRA's approach to supervising reinsurers will be founded on the same principles as its supervision of primary insurers. However, reinsurance may give rise to a greater degree of connectivity with other parts of the financial system than is usually seen with primary insurance business. Undertaking an appropriate degree of supervision of the reinsurance business transacted in the United Kingdom will therefore be an important element in meeting the PRA's statutory objectives.

87. Reinsurance is transacted through UK-regulated vehicles (both inside and outside the Lloyd's market) and through incoming EEA branches. The PRA will seek to understand to the greatest extent feasible the activities of reinsurers operating in the United Kingdom and their potential impact on its objectives.

Box 3
Proactive Intervention Framework

The PRA will establish a Proactive Intervention Framework (PIF) to encompass all the institutions it regulates.[1] This framework will have two key purposes. First, it will support early identification of risks to a firm's viability and ensure that firms take appropriate remedial action to reduce the probability of failure. Second, it will flag actions that the authorities will need to take in advance to prepare for the resolution of a firm. This will include co-ordination with the FSCS as operator of the insurance compensation scheme. To guard against regulatory forbearance, where actions expected in a particular stage had not been taken, supervisors would report to PRA senior management.

The PIF is expected to have five clearly demarcated stages. The judgement on where to place a firm within a particular stage will be based on an assessment of the firm's viability in both current and future states of the world. There will not be a mechanical reliance on backwards-looking indicators.

The assessment of where a firm sits in the PIF will be undertaken as part of the ongoing supervisory process and will reflect, among other things, a firm's expected financial strength in stressed circumstances. It will be revisited in response to specific concerns arising in the external environment in which a firm operates — for example, in response to a sectoral risk identified by the FPC. Firms will, as a matter of routine, be made aware of where they sit in the framework.

If the PRA judges risks to a firm's viability to be low, the firm will be in Stage 1 of the PIF. This implies a normal level of supervisory monitoring and actions. As a firm moves through each stage of the PIF, the intensity of supervisory monitoring and the intrusiveness of supervisory actions will increase, and contingency planning will be stepped up.

The table below describes how a firm might move through the PIF and the presumed actions that might be taken at each stage. The PRA's approach will be consistent with European and other international regulatory requirements, including Solvency II's 'ladder of intervention'.

(1) The approach taken will need to reflect whether actions are required at holding company level and, where the PRA is host regulator, its more limited powers.

Table A Stages in the PIF

Stage	Presumed actions
Stage 1 – Low risk to viability of firm	— Firm subject to the normal supervisory risk assessment process and required to plan for stressed conditions and identify appropriate recovery actions or exit strategies. — The PRA to assess firm resolvability.
Stage 2 – Moderate risk to viability of firm Supervisors may have identified vulnerabilities in a firm's financial position or deficiencies in its risk management and/or governance practices.	*Recovery* — The intensity of supervision would increase and the firm would be required to reassess the appropriateness of recovery actions and exit strategies. — The PRA might set additional reporting requirements, and make use of information gathering and investigatory powers. — The PRA would review the firm's risk profile and the regulatory capital requirements and consider realigning the latter, as well as setting restrictions on the firm's activities until remedial actions have been completed. *Resolution* — The PRA would identify and instigate any initial contingency planning needed, potentially including information gathering and liaison with the FSCS.

Stage 3 – Material risk to viability of firm Significant threats to a firm's financial safety or soundness may have been identified.	*Recovery* — The firm would be required to submit a realistic recovery plan designed to address specific current problems and to initiate recovery actions in a timely manner to address the vulnerabilities identified. Actions may include: capital raising; asset disposal; business transfer or sale of the firm; and reduction of contracts. — Other actions the PRA might require may include: changes to management and/or composition of the board; limits on asset disposal/acquisition or capital distribution; restrictions on existing or planned activities; a limit on balance sheet growth; and an assessment of the effectiveness of risk transfer arrangements such as reinsurance. — At firm or PRA initiative, a firm's authorisation to carry out new business might be removed. *Resolution* — The PRA would intensify contingency planning for resolution. — The PRA would co-ordinate with FSCS to ensure it obtained the information necessary (including on data quality and payment systems) to evaluate continuity of cover or payout options (this will include an assessment of the potential exposure of the FSCS).
Stage 4 – Imminent risk to viability of firm The position of a firm may have deteriorated such that the PRA assesses there is a real risk the firm will fail to meet requirements for ongoing authorisation.	*Recovery* — In most cases, the PRA would remove the firm's authorisation to write new business. — Firm to accelerate and complete recovery actions in short-order, demonstrating to the PRA that these have mitigated the imminent risk to the viability of the firm. *Resolution* — The PRA, working with the FSCS, would complete all necessary actions for resolution of the firm including planning for commencement of orderly liquidation or administration and with the assistance of the insolvency practitioner in waiting.
Stage 5 – Resolution / winding-up under way	*Resolution* — As necessary, the PRA would trigger the appropriate insolvency process and the insolvency practitioner would work with the FSCS and PRA to effect continuity of cover and/or compensation to eligible claimants. — As appropriate, the PRA would monitor firms exiting the system.

Supervisory interventions

88. Subsequent to risk assessment, the PRA will identify those areas where further action is required by the firm given the potential risk to the PRA's objectives. In respect of safety and soundness, the test of materiality for raising points with firms will be high. Any less significant issues that have arisen — and of which the PRA feels the firm should be aware — will be conveyed to the firm, but with the onus on the firm itself to address these, with self-certification (by the Chief Financial Officer, internal auditor or chair of the Audit Committee) that issues have been closed.

89. **There will be a clear link between the PRA's assessment of risks to its objectives and the actions it will expect the firm to take in consequence.** Actions will be communicated clearly, and at a senior level, to the firm. The Proactive Intervention Framework will be designed to ensure that, if a firm's position deteriorates, concerns are escalated and recovery actions and necessary contingency planning undertaken promptly (see Box 3).

Supervisory powers

90. The PRA will have a range of powers available to it under statute to help it deliver its objectives. **The PRA's preference will be to use its statutory powers to secure action *ex ante*** (for example, through imposing requirements on a firm). Successful application of the PRA's supervisory approach should mean that enforcement actions will be relatively rare.

91. However, if a firm does not act on the PRA's request or recommendation, and in order to pre-empt risks before they crystallise, the PRA will, where necessary, look to use its statutory powers to compel firms to take certain actions to address the emergence of risk. It will stand ready to direct a firm to follow a certain course of action, in cases where it judges that the firm's failure to do so could

compromise the PRA's statutory objectives. Where necessary, the PRA will remove or restrict a firm's permission to operate.

92. There may also be occasions where prosecution via the courts or through fining firms or individuals (for example for consistently late or inaccurate reporting) is required either to ensure necessary remedial actions are undertaken or to provide an incentive against such behaviour in future.

93. The PRA will consult on its regulatory decision-making and legal intervention procedures in due course. It will aim to adopt procedures which are straightforward and transparent to firms, and are robust, fair and reflect the judgement-based nature of prudential supervision. To ensure transparency and fairness, prior notice will be given of proposed formal decisions and representations will be considered (although as now there may be cases where it will be necessary for the PRA's decision to take effect pending representations). Legal interventions will be subject to appeal to an independent tribunal.

Co-ordination with the Financial Conduct Authority (FCA)

94. Policyholders are protected by the PRA as prudential regulator and by the FCA as conduct regulator. **Effective delivery of the PRA's intended supervisory framework will require co-ordination with the FCA.** The principal focus of this co-ordination will be at the firm-specific level where an overarching Memorandum of Understanding (MoU) and colleges will be put into place to ensure that the statutory duty to co-ordinate is made effective in practice and that information relevant to both authorities' objectives is shared. In addition, consideration will need to be given to common standards and rules for risks which are directly relevant to both authorities' responsibilities; for example, governance and systems and controls.

95. **Co-ordination arrangements between the PRA and the FCA will take particular account of the nature of liabilities arising where insurers have written with-profits policies.** Such policies (of which there are around 25 million outstanding in the United Kingdom) contain both a defined and a discretionary benefit based on investment performance. As prudential regulator, the PRA will have sole responsibility for matters relating to the interests of policyholders which could have an effect on the financial position of the firm. To deliver this responsibility, in respect of material issues the PRA will consult the FCA. Arrangements between the PRA and the FCA in relation to with-profits will be set out publicly.

96. The FSA will shortly publish a document on the FCA's prospective supervisory approach. Further details of how the two authorities will co-ordinate will also be published in due course.

97. Careful consideration will also be given to interaction with other UK regulatory institutions such as the Financial Reporting Council and the Pensions Regulator.

The PRA's role in macroprudential supervision

98. **A key premise of the regulatory reform programme under way in the United Kingdom is that firm-specific supervision alone is not sufficient to deliver financial stability and that it must be complemented by an effective macroprudential regime.**

99. In the new UK regulatory regime, macroprudential policy and decisions will be the responsibility of the Financial Policy Committee (FPC). With both the FPC and PRA being part of the Bank of England, there will be frequent two-way flow of information and exchange of views between them. Although the PRA is charged with making firm-specific decisions, it is inevitable that there will be overlap between such judgements and those which the FPC is making. This will be addressed through some common membership of the PRA board and the FPC: the Governor, the Deputy Governor for Financial Stability and the CEO of the PRA. In addition, the PRA will provide firm-specific information to feed into the FPC's assessment of the macroprudential outlook; and the FPC's analysis of potential systemic risks will help inform the PRA's judgements on specific types of institutions, sectors and asset classes, including its approach to stress testing and its assessments of future vulnerabilities.

100. The FPC will give recommendations and directions to the PRA (and the FCA) on the regulatory tools that should be deployed for macroprudential purposes, including the formulation of those tools. The PRA will be responsible for implementing relevant FPC recommendations on a 'comply or explain' basis, and the FPC's directions in relation to the use of specific macro-tools, and for reporting on delivery.

V Policy making

101. The PRA's prudential policies will set out the high-level framework and expectations against which a firm is to be judged, and its prudential rules will set the minimum standards by which firms must abide. **Prudential policy will support judgement-based supervision by ensuring that supervisory judgements are made within a clear and coherent framework.** The PRA's approach to policy making will take full account of recommendations from the FPC given its remit for macroprudential policy, insofar as those relate to insurers; and it will implement any directions from the FPC. It will also take full account of international developments. The PRA's approach to the transposition of EU Directives, including Solvency II, will be to make maximum use of copy-out where available and appropriate, and to ensure that supplementary policy required for UK-specific issues delivers the same degree of policyholder protection as envisaged in the Directive itself.

102. **The PRA will seek to ensure that its policies and rules are straightforward, clear in intent, robust and support timely interventions.** The PRA's policy documents will explain the underlying purpose of its policies and rules. And the PRA will, wherever possible, include clear statements of purpose when setting rules to ensure that firms and the market more generally understand the reasons behind the policy.

103. **The PRA will expect firms to comply with the spirit as well as the letter of its rules** so that firms implement rules and policies consistent with their underlying purpose.

104. Alongside the rulebook, the PRA will publish a single easily navigable reference document that clearly sets out the PRA's approach to regulation and supervision.

The international dimension

105. **The PRA will operate within a global and European institutional framework.** In consequence, together with the rest of the Bank, the PRA will be an active participant in both international and European institutional structures. The United Kingdom is represented in a large number of international financial regulatory bodies, including the Financial Stability Board (FSB), which co-ordinates the work of national financial authorities and international standard setting bodies, and the International Association of Insurance Supervisors (IAIS). Such engagement will remain very important.

106. The introduction of the Solvency II framework, due at the start of 2013, is an important policy development. Solvency II is a predominantly maximum harmonising policy initiative, meaning that it will set out minimum standards for firms and that Member States cannot set higher standards. It will deliver a harmonised standard of solvency across the European Union, implemented through a framework of risk-based supervision. The more detailed EU-wide implementing measures and technical standards are under development. In this process, it is important that supervisors retain scope to make informed judgements about risks posed, and action to be applied, within a clear overall policy framework. Such an approach is essential to ensure appropriate risk assessment and mitigation and is thus necessary to ensure effective international action to preserve financial stability. In this process and more widely, **the PRA will play an active and constructive role in shaping the development of international regulatory standards, with the aim of ensuring that broader international developments support its judgement-based supervisory approach**. This will include involvement in discussions on the European Commission's White Paper on Insurance Guarantee Schemes.

Consultation on policy and rule changes

107. **The PRA will recognise the importance of appropriate engagement and consultation with the firms it will regulate. It will not, however, be accountable to regulated firms for delivery of its public policy objectives. It will be accountable to Parliament and, within the Bank, to Court. Nor should there be any perception of regulatory capture.**

108. The PRA's general approach to consultation will be to give industry, other market participants and commentators the opportunity to express views and to ensure that the PRA's policy making is based on as accurate analysis as possible. The PRA will communicate proposed policy and/or rule changes in a clear and straightforward manner, setting out the underlying rationale. A summary analysis of consultation responses will be published, including whether there is a justification for progressing policy proposals.

109. The PRA will take a flexible approach to consulting practitioners. Advice and representations may be sought via a full public consultation or a narrower consultation with experts and relevant stakeholders. The PRA is likely to set up specific expert working groups to advise on particular issues.

110. The PRA will not consult if consultation might be prejudicial to financial stability, for example if policies might otherwise not be introduced in good time.

111. The PRA will continue to analyse the costs and benefits of proposed regulation as an integral part of the policy

development process. Quantitative estimates of costs and benefits will not be included in its published documents where they cannot reasonably be estimated.

112. An increasing amount of detailed regulation will be determined by Europe, which will be subject to consultation and cost/benefit analysis at the European level. The PRA will seek to ensure that, in implementing EU Directives, its approach to assessing costs and benefits is as proportionate as possible, while recognising the United Kingdom's legal obligations. It is also recognised that the most effective point of intervention is in the early stage of the policy development process. The PRA, together with the rest of the Bank and HM Treasury, will therefore attach particular importance to effective engagement at that stage. Engagement will also be undertaken at later stages of the policy development process in order to influence the detailed articulation and implementation of EU regulation.

VI Authorisation of firms and approval of individuals

113. In line with its approach to supervision, the PRA's forward-looking and judgement-based approach will carry over into its role in authorising firms and approving specific individuals as 'fit and proper' to perform certain functions. As far as possible, the PRA's approach to authorising insurers and approving relevant individuals will mirror its approach to deposit-takers. The requirements of Solvency II will, of course, be a key factor shaping the PRA's approach.

114. The allocation of responsibilities for authorisation will follow from the split between prudential and conduct of business responsibilities, reflecting the twin peaks approach to regulation. Making these decisions will require close co-operation between the PRA and the FCA.

Authorisation of firms

115. Firms must apply to the PRA for authorisation if they wish to undertake an activity, deposit-taking or insurance, that requires them to be regulated by the PRA. **The PRA will administer the application and be responsible for granting authorisation.** Authorisation to carry out regulated activities will not be granted unless both the PRA, as prudential regulator, and the FCA, as conduct regulator, are satisfied that it should be.

116. Before granting authorisation, the PRA will assess whether the firm satisfies relevant statutory threshold conditions. In making this assessment, the PRA will judge whether a firm can meet those threshold conditions in current and future states of the world.

117. Given that the prudential soundness of a firm could be affected by any aspect of a firm's operation, the decision on whether the PRA authorises a firm will be made on a 'whole firm' basis. The PRA will approve applications from a firm only where it is satisfied that the firm will be prudently managed and has a viable business model in relation to all its material activities, and that there are effective controls for risk identification and mitigation. Additionally, as part of the authorisation process the PRA will seek to assess the impact on policyholders and the system should an insurer need to be wound up in the event of failure.

118. The PRA will lead on the authorisation process for dual-regulated firms. The PRA and the FCA will seek to minimise the administrative burden on firms of the new authorisation procedures. There will be a single administrative process with a single application form and a single timetable for decisions. The importance of ensuring the authorisation process is both clear to applicants and handled efficiently is fully recognised.

119. If a firm was already regulated by the PRA but it wished to vary its permission to undertake an additional regulated activity it would need to apply to the PRA.

Approval of individuals

120. It is the responsibility of an institution's board of directors to ensure that individuals appointed to senior management positions are competent to fill such roles. **Given the risks that poor management can pose to the financial soundness of a firm, the PRA will wish to satisfy itself that key individuals running the firm are 'fit and proper' to do so.** It is intended that the PRA's assessment will cover not only probity and integrity, but also competence. Assessing probity and integrity will reduce the risk of deliberate non-compliance with PRA policies and rules; assessing competence is necessary given management's prime role in ensuring a firm's safety and soundness.

121. The PRA will lead on the process for approving individuals to roles with a bearing on the safety and soundness of the firm, in close co-ordination with the FCA. The FCA will be responsible for approving individuals to conduct-focused roles. A full list detailing which functions will be approved by each authority will be published in due course. **The PRA and the FCA will design a simple and transparent process for approving individuals to significant influence functions which minimises the administrative burden on individuals and firms.**

VII Next steps

122. The new supervisory approach for insurers laid out in this document, including changes stemming from the implementation of Solvency II, will represent a significant change to the way in which regulation is conducted in the United Kingdom.

123. The Government currently envisages putting the new regulatory architecture in place by the end of 2012. In the interim period, the Bank and the FSA will continue with the detailed design of the PRA's new operating framework and will publish further detail on the PRA's regulatory and supervisory processes, its strategic priorities and its business plan ahead of the formal transfer of responsibilities.

Printed by Park Communications Limited