

ESG in 3D - March 2023 (Edition 1)

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Governance

A more personalised approach to insurer governance?

Key points from the [British Insurers Dinner speech by Sam Woods](#), Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority (“PRA”).

Headlines

- Insights into concerns about Solvency 2 (“S2”) reform, especially ‘fundamental spreads’ (“FS”)
- Insights into new powers over insurers, including increasing the personal accountability of individual senior managers.

Key background

- FS are “used in the calculation of the discount rate for certain types of insurance liabilities ... [They represent] an allowance for the credit risk of an asset [, which is the] ... probability that the income expected ... from [the] asset is not realised ...
- FS comprise “a key aspect” of the ‘matching adjustment’ (“MA”): “a countercyclical measure to ... immunise the balance sheet from fluctuations in credit spreads” ([IFOA FS research July 2022.pdf](#));
- “The current design of the FS means there is a risk insurers recognise profits upfront ... that may not actually be realised in the future ... [but] the current [approach to] the risk margin gives some mitigation of this ...” (see [The PRA’s statement on the ‘Review of \[S2\]’](#))
 1. (risk margin: “an amount added to ... [policyholder] liabilities ... [resulting in an overall] transfer value ... to a willing third party” – see PRA [Discussion Paper 2/22](#)).

The direction of travel

Despite its own views on FS reform, the PRA accepts that “if Parliament supports [\[the government’s proposed reforms\]](#) ... we need to move ... into implementation.”

The PRA’s “expectation is that we will publish a first consultation on some of the [relevant] topics in June [2023], followed by a second consultation, on those areas that will benefit from more time for industry engagement ... in September.”

S2 reform will give the PRA “additional tools” for supervision of insurers including:

- “senior manager [“SM”] attestations on the appropriateness of the levels of [MA] ...
- ... voluntary top-ups of [FS] ..., and
- publication of individual firm results in stress testing.”

Insurers “should expect [the PRA] to implement the new tools robustly ... focus[ing] hard on the adequacy of valuations ... for assets in [MA] portfolios ...”

According to the PRA, “the entirety of the rest of the [reform] package is about competitiveness and growth”, including changes to vital aspects of the S2 regime to which FS relate:

- **Internal models** (in short, methodologies for calculating that an insurer has sufficient capital to meet its obligations to policyholders in the face of all quantifiable risks): the PRA intends “to interpret sensibly a smaller number of principles-based requirements”

- **Eligible assets for the MA:** the PRA plans “to ... allow assets with prepayment options and construction phases ... [and] to find the best way to ... include assets with highly predictable cash flows, and to understand the consequential impacts of removing the MA cap on sub-investment grade assets.”

Why is this significant?

It seems that the PRA's approach to S2 and especially FS reform is to make matters more publicly specific for firms (eg for stress-testing outcomes as above) and personal for SMs.

For SMs, there has been an increasing trend since about 2013 for the PRA's and FCA's use of attestations, although with substantially less overt use by the PRA than the FCA. In the insurance market, the PRA publicly specified use of attestations on the effectiveness of the whistleblowing policies and procedures of the Society of Lloyd's in 2019.

Given the strategic importance for the PRA of whistleblowing as a risk management mechanism (see eg Policy Statement 24/15), an attestation can be seen as commensurately significant.

As such, the requirement of an attestation in relation to FS indicates how profound questions on FS are for the PRA.

Moreover, the FS-linked use of attestation indicates growing PRA appetite for increased personal liability of individual senior managers for policyholder protection.

Key contact



Jeremy Irving

Partner

jeremy.irving@brownejacobson.com

+44 (0)20 7337 1010

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