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Pro-cyclicality, current trends, issues and priorities for insurance mutuals.

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Agenda

- Pro-cyclicality of insurers
- PRA perspective on Current Trends and Issues
- Regulatory Priorities
- Questions

The Bank of England and the Discussion Paper on Pro-cyclicality

- The Bank of England is in charge of ensuring financial stability.

- The Bank is responsible for both macro and micro prudential regulation.

- The Bank recognises that financial stability requires coordination between macro-prudential oversight by the FPC and the micro-prudential supervision of individual firms undertaken by the PRA.

- This is the context for the July 2014 discussion paper on pro-cyclicality which considered whether investment decisions made by insurers and pension funds were pro-cyclical.

What is Pro-cyclicality?

- The Bank discussion paper defined pro-cyclicality in two ways:

  In the short term, pro-cyclicality is the tendency to invest in a way that exacerbates market movements and contributes to asset price volatility, which can in turn contribute to asset price feedback loops, with impacts on participants across financial markets, as well as longer-term macroeconomic effects;

  In the medium term, pro-cyclicality is as a tendency to invest in line with asset price and economic cycles, so that willingness to bear risk diminished in periods of stress and increases in upturns.

- If insurers and pension funds invest pro-cyclically this might deepen the troughs and exaggerate the peaks of asset price or economic cycles in a way that is potentially detrimental to financial stability and long term economic growth.

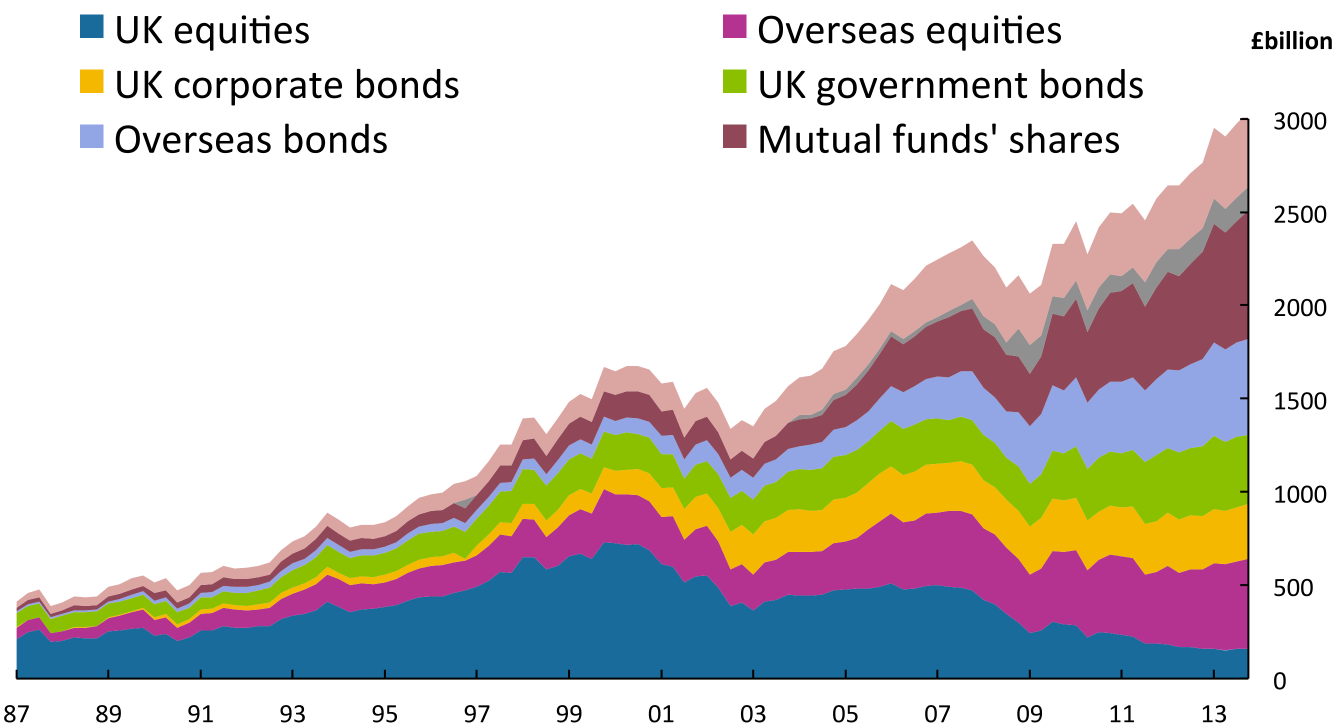
Evidence of Pro-cyclical investment behaviour

- The study did not find significant evidence of pro-cyclical effects from the investment activities of life insurers (including mutuals) or pension funds.
- Insurers and pension funds are long-term investors so should invest counter-cyclically but little evidence was found to support this.
- Industry practice can result in “herding”, so if incentives towards pro-cyclicality were to increase herding might amplify the impact.
- There was some pro-cyclical shifts in asset allocations following the dotcom crash, and to a lesser extent during the recent financial crisis. However the impact of these were hard to identify due to significant structural shifts in asset allocation occurring during that period.
- Following the 2014 Budget announcement PRA will monitor whether this results in any shifts in asset allocation for insurers.

Change in Asset Allocation

- In the longer-term there has been a structural trend away from holding equities by both insurers and pension funds. For pension funds, it appears that the strongest (i.e. most well-funded) have shown their strength through accepting lower returns rather than taking additional risk.

Asset allocation of UK insurance companies and pension funds (nominal)



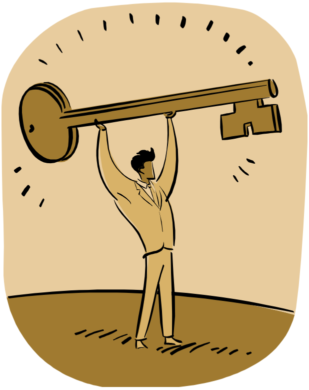
Current Trends and Issues

- Assets
  - Trend towards higher yielding illiquid assets particularly for annuity writers (infrastructure, CLOs, CRE, CTF etc.)
  - Important that these assets are understood and have appropriate oversight.
  - Is the additional yield really due to liquidity? Is the asset and the potential risks fully understood.
- Expenses
  - Need to keep expenses under control.
  - Leveraging off IT.
  - Changing nature of the market, an opportunity but at what expense?
  - Payback periods – is the investment really worth it?

Current Trends and Issues

- Strategic Changes
  - Move, in some areas, away from traditional investment and WP business.
  - A range of different products either being sold, or being considered by firms.
  - These changes can bring significant changes to business models, and the associated risks must be well understood.
    - Revised stress and scenario testing
    - Recognised in the ORSA
    - Appropriate appetites set
- Consolidation
  - Seeing increased amounts of consolidation.

Key to Success



- **Strong governance and risk management.**

- As a result, Governance and Risk management will remain a key area of work for us.

Priorities

- Chrysalis
  - Need to understand the outcomes from FCA Chrysalis work as and when available to feed in to current risk assessment of business, in particular the assessment of the firms business models.
- Solvency 2
  - ORSA
  - Internal model
  - Standard Formula appropriateness
  - Reporting
  - Interim Guidelines
- Business Model Analysis
  - Still ongoing, and for many firms moving into second phase.
  - Seeing changes in business models for some firms.

- Questions