

Industry in Focus

Recent market events: implications for the UK insurance sector

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Three US banks entered voluntary or government ordered resolution between 8 and 12 March. All three banks faced liquidity challenges due to severe deposit outflows and reduced capacity to generate new liquidity.

In this paper we discuss the events that led to the collapse of the US banks. We also provide initial views on the responses we are likely to see from regulators, as well as the steps insurers should consider taking to strengthen their resilience in the face of market stress.

Several drivers led to the resolution of the US banks, including a loss of market confidence and balance sheet mismatches that collectively led to a depletion of the banks' liquidity and capital position. Contributing factors included:

- a significant proportion of excess liquidity invested in long-term bonds
- the subsequent rises in interest rates leading to a fall in the value of these bonds
- customers reducing their deposits post-pandemic due to increased spending and more attractive investment alternatives
- capital-eroding losses being crystallised when investment portfolios are sold down to fund those withdrawals, and
- digitally networked and enabled customer bases that then lose confidence and start withdrawing their money at pace which further depletes capital and liquidity.

While the UK subsidiary of one of the US banks was acquired, several questions have been raised about contagion risk. And whether the bank's collapse, along with the Swiss government's arranged acquisition of a global bank headquartered in Switzerland, could impact other financial services sectors, such as insurance. In the 2008 global financial crisis, we saw that insurers were negatively impacted along with the banks. This was primarily due to the interconnectedness of banks with the wider economy including insurers, as well as poor investment decisions taken by insurers.

Following the financial crisis, European and US regulators tightened their rules to reduce the chances of such a financial crisis from occurring again. While there was significant banking reform, we also saw Solvency II significantly reform the European insurance regulatory landscape.

As such, the European / UK banking and insurance sectors are more financially and operationally resilient than they were in the lead up to the financial crisis. Nonetheless, while key institutional structures and regulations differ by jurisdiction, the past few weeks have served as a stark reminder that many of the risks present in the US, are equally present in Europe and the UK. Risks are clearly heightened by current macroeconomic conditions, which include the Russian invasion of Ukraine which is closely linked to supply chain disruption, and high inflation followed by interest rate rises.

It will also be interesting to see what impact, if any, the above-mentioned events have on the UK Insurtech sector. Established banks have historically been less likely to lend to high-growth technology start-ups, and at this stage it is unclear if their appetite will change. This is important given that up until now it has primarily been specialised lenders, such as the collapsed US banks, that have provided access to funding for the Insurtech sector.



Recent events will no doubt make the regulator sharpen its focus on systemically important insurers. This, with the backdrop of the Solvency UK package, which, among other things, is expected to result in a release of capital, will be an interesting set of priorities for the regulator to navigate.

The regulator recognises that the insurance sector plays a critical role in supporting significant areas of economic activity through risk pooling, long term investment, and the provision of retirement income. Recent events shine a light on the importance of insurers being sufficiently agile to be able to weather macroeconomic risks to their business models. Effective governance and risk management to drive prudent balance sheets, liquidity and interest rate risk management become even more critical during challenging and uncertain economic times.

So what questions should insurance boards and executive teams be asking themselves?

- Does the insurer understand how it is materially dependent on the wider financial ecosystem?
- What risks are inherent in the insurer's critical third-party ecosystem?
- Has the insurer's approach to governance and risk management evolved to be sufficiently sophisticated and provide the necessary resilience required to navigate today's increasingly uncertain times?
- How resilient is the insurer's business model and growth strategy given the current changing geopolitical and macroeconomic dynamics?
- How is the potential impact (both in terms of quantum and speed) of public and market scrutiny managed, given the risk of contagion spreading in a digital world?
- Is the insurer prepared for the increased scrutiny by the regulator?

How might recent events increase regulatory focus?

Areas	Impact
Governance	<p>Regulators will want to understand whether boards have a sufficient understanding and oversight of the adequacy of reserving, how management is performing scenario analysis, and the risks associated from increased concentration and operational risks in an uncertain economic climate. They will also want to understand if board members have sufficient expertise to challenge their businesses on these matters.</p>
Financial resilience	<p>Current economic conditions are likely to lead to continued regulatory interest in how life insurers in particular are managing their exposure to credit and concentration risk. In particular, the current interest rate environment which contributed to the recent bank failures, will naturally result in more scrutiny from the regulator. This includes scrutiny of exposures to certain assets, particularly those impacted by the higher interest rate environment. The regulator has already made it clear that it expects life insurers to robustly stress test their capital planning against prolonged adverse credit scenarios.</p> <p>With respect to property and casualty insurers, the regulator is likely to further increase its focus on how underlying pricing, reserving, business planning and capital modelling are being managed given inflationary pressures.</p>
Risk management	<p>Insurers will be expected to proactively manage their risk management and control frameworks. There is likely to be greater scrutiny on how insurers are assessing their credit and counterparty credit risk management capabilities. The regulator will also be interested in insurers' capital models to understand if they remain fit for purpose. Further, insurers can expect to have their liquidity sources scrutinised to ensure there is sufficient liquidity, particularly where derivatives have been used to hedge risks.</p>
Reinsurance risk	<p>The regulator has already made clear that insurers should consider the resilience of their reinsurers for the full duration of their exposures. Given reinsurance is increasingly taking place with offshore reinsurers, and the increasing interconnectedness of different world economies, the regulator may want to see evidence from insurers regarding the due diligence they performed and continue to perform with the ceding of risk to other jurisdictions.</p> <p>In addition to how insurers have examined their reinsurers ahead of a transaction and as part of the continued relationship, the regulator may want to see the structures and limit frameworks that insurers have put in place to manage their counterparty and concentration risks.</p>



Stress and scenario testing capabilities	Stress and scenario testing is a core risk management tool, as well as planning for severe but plausible risk events. The regulator may increase its scrutiny of the stress and scenario testing that insurers deploy, including the scale and severity of the scenarios.
Solvency UK reform	Given minimal changes to the fundamental spread, and a significant reduction in the risk margin, the regulator is likely to increase its focus on the new powers due to be given to it to hold senior managers to account. The regulator will be able to require senior managers to attest to the appropriateness of the level of matching adjustment benefit being taken, and there will be scope for firms to top-up the fundamental spread where this is deemed insufficient. The regulator will also be able to publish individual insurer results of stress testing, which no doubt will help focus insurers to carry out meaningful stress testing.
Recovery and resolution	The regulator will consult this year on detailed requirements for insurers to prepare exit plans. The requirements will be set on the basis of proportionality and so will be commensurate to the size and impact of the insurer. Recent events are likely to significantly influence how the regulator shapes its consultation on this topic.
Operational resilience	Regulators issued rules on operational resilience in 2021. By now, insurers should have identified and mapped their important business services and set impact tolerances. Moving forward, under the rules regulators expect insurers to demonstrate their ability to operate within those impact tolerances, this includes when relying upon third party providers. Regulators are likely to remain close to how insurers evidence their ability to operate within their impact tolerances.
Group risks	The regulator already expects to receive information on group wide risks, which could impact UK-based subsidiaries of overseas headquartered insurers. Recent incidents highlight the spill-over effects that can result from some of those group risks and this will reinforce the regulatory focus and likely challenge in this area.

Questions insurers should be considering to manage their resilience in light of the challenging market conditions

Areas	Impact
Governance	<ul style="list-style-type: none"> • Does the board have the requisite skills and knowledge in relation to, and are they sufficiently engaged in, the oversight of the insurer's risk management of asset / liability strategies, liquidity management, reserving strategy, credit and concentration risks etc.? • Does the board receive the requisite information regarding these risks and how they are being managed on an appropriate frequency?
Strategy and business model	<p>Has the board reconsidered the robustness and viability of its strategy and business model in light of recent bank failures, taking into account contagion risk, current market pressures as well as the geopolitical and macroeconomic outlook?</p>
Financial resilience	<ul style="list-style-type: none"> • Has the insurer re-evaluated its interest rate risk appetite and risk management strategies, including its approach to hedging and enhancing interest rate risk modelling, to include scenario tests that evaluate different balance sheet trajectories? • Recent market events have created a degree of uncertainty on the trajectory of future interest rates in the US and globally. Has the insurer considered a variety of scenarios and the implications for the insurer's risk exposures, capital, liquidity and counterparties? Has this been built appropriately into existing stress tests? • Has the insurer robustly stress tested its capital planning against prolonged adverse credit scenarios? • Has the insurer considered which of the products that it uses could be impacted by a banking crisis? For example, derivatives, letters of credit, trust funds?
Reserving	<p>For property and casualty insurers in particular, current economic conditions mean there will be pressures and uncertainty with respect to claims inflation. Has management considered how recent market events will impact how they account for inflation in their reserving and pricing strategies?</p>



Risk management and stress testing	<ul style="list-style-type: none">• Is management and the board proactively evaluating the adequacy of risk management and control frameworks?• Has consideration been given to whether enhancements are required to the insurer's stress testing capabilities, including how to incorporate 'Black Swan' type events into those stress tests, as well as the interrelationship and interdependencies between liquidity and capital stress tests?• Has the insurer revisited its contingent funding plans for liquidity stresses in light of recent market events? For example:<ul style="list-style-type: none">– does the insurer have cash pooling arrangements that could be impacted?– has management re-evaluated potential liquidity demands created by the use of derivatives for risk management?• Has management considered and reassured itself of the continued validity of the insurer's models, in particular capital modelling?
Recovery and resolution	Ahead of the regulator's consultation on detailed requirements for insurers to prepare exit plans, as per the regulator's expectations, is the insurer considering how it might exit the market if the need arose, what the obstacles might be, and how they might be overcome?
Third parties and the distribution chain	<ul style="list-style-type: none">• Has the insurer considered how it could be impacted if, for example, a third-party administrator was adversely impacted in a banking crisis? Would the insurer still be able to service its customers and continue business as usual?• Has management considered how key players in the insurance distribution chain might be adversely impacted where there is bank failure? For example, how will the insurer ensure there will be continued access to client money accounts of significant managing general agents / coverholders?• Where the insurer utilises the 'bancassurance' model, has the insurer considered how the administration of policies will continue where there is bank failure?
Group risks	Have management and the board fully considered any group risks from outside the UK, and how those could and should be managed and mitigated?
Communication strategy and plans	Has the insurer re-evaluated its shareholder and other key stakeholder communication plans in the event of market disruption / crystallisation of contagion risk? Do the scenarios considered adequately cover recent market events, including the impact of social media?

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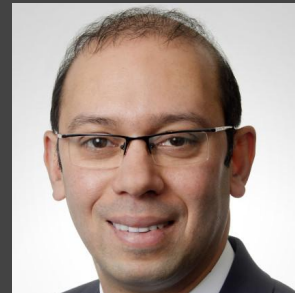
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