Chris Moulder
Director, General Insurance
Prudential Regulation Authority
T 020 3461 7885
chris.moulder@bankofengland.co.uk

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Dear CEO

Reserving

In advance of the financial year end for most firms, I am writing to remind PRA regulated general insurance firms and their board members of their responsibilities to set adequate technical provisions to comply with INSPRU 1.1.12R, and to set out the PRA's expectations of firms in so doing.

Background

Competitive pressure within many sectors of the general insurance market remains high, and many parts of the industry show signs of being in the soft part of the insurance cycle. In the face of increased pressure, some firms have chosen to lower their premium rates, extend the terms and scope of cover offered, or weaken their underwriting selection criteria to protect their market position.

The claims environment has also been challenging: claims inflation, claims frequency and severity, have seen an increase in some lines of business, and there has been continued development on some particular areas of reserving uncertainty such as periodic payment orders and asbestos claims. All these aspects have the potential to increase the risk of mispricing business and/or weakening the reserving basis beyond what is adequate.

At the same time that firms have experienced pressures with current underwriting conditions, many parts of the industry have reported high levels of prior year reserve releases in recent years. Where firms are using prior year reserve releases to support current financial results, such releases should not deplete overall technical provisions beyond a level which is adequate.

The PRA's expectations of firms

The PRA requires firms to set adequate technical provisions in order to comply with INSPRU 1.1.12R. In so doing, it expects general insurers to have a robust approach to the setting of reserves and to put in place appropriate and adequate oversight of reserving processes.

More specifically, the PRA expects general insurers, and their boards, to pay particular attention to the need to:

- understand the key issues and sources of material uncertainty in the reserve-setting process, and how these may impact the reserving basis, in order to make informed decisions on reserve levels;
- be able to demonstrate strong governance around the reserve-setting process. For example, firms are expected to be able to explain how they have sought to ensure an adequate degree of independent challenge or peer review of the key assumptions in the reserving basis, and to be able to articulate a clear rationale for the management booked reserve;
- ensure that the level of reserving strength is monitored and reported to the board over time, such that the board can take appropriate and timely action, if required;
- assess whether an unexpired risk provision needs to be established. This is particularly relevant under current market conditions;
- have regard to the underwriting, reserving and economic cycles when setting reserves;
- ensure clear feedback loops exist between underwriting, claims and reserving; and
- have regard to data quality and consider how any data limitations might impact firms' reserves.

This list is not exhaustive.

The PRA's approach to reviewing firms' reserving processes and reserve levels

Under the current regime, the PRA considers reserve adequacy at the firm level, and reserves from prior years have, in some cases, been used by firms to offset poor underwriting year / accident year results. However, the PRA will question the robustness of the underwriting practices at firms that rely unduly on prior year reserve releases to support ongoing underwriting activity for any substantial period of time.

Some of the ways the PRA seeks to assess the adequacy of reserving governance and reserve levels within general insurers include:

- monitoring reserve indicators across the market and for individual firms, based on analysis of data reported within PRA returns and firms' management information;
- holding discussions with external auditors and independent external actuaries involved in assessing individual firm reserves to understand their assessment of firms' reserving practices and reserve adequacy;
- reviewing firms' internal actuarial reports, or reports provided to firms by their independent reserving actuaries where relevant, to understand the basis of the booked reserves;
- assessing the robustness of firms' reserving governance arrangements, through reviews undertaken by PRA supervisors and specialists; and

- using skilled persons' reports commissioned by the PRA under section 166 of the Financial Services and Markets Act 2000, to provide the firm and the PRA with an independent assessment of the robustness of reserving governance arrangements and/or reserve levels.

Given the pressures on firms' performance caused by current market conditions, firms should be aware that the PRA is placing increased emphasis at present on gaining assurance over firms' reserving. As part of regular supervisory interactions, firms should stand ready to demonstrate the robustness of their reserving governance frameworks, and the adequacy of reserve levels. Firms should expect supervisors to make use of some or all of the tools outlined above to provide the PRA with assurance in this area.

Forthcoming Solvency II requirements

Finally, under the new Solvency II regime, firms will be required to set technical provisions for regulatory purposes in accordance with Articles 76 to 86 of the Solvency II Directive (as amended by Omnibus II). In April 2014, the PRA published Supervisory Statement 5/14,[1] which seeks to ensure that general insurers set an adequate level of technical provisions under the new basis required by Solvency II. Firms need to prepare for these new requirements and be able to demonstrate that they meet these by the implementation date of 1 January 2016.

On 16 October 2014 the PRA set out how it will gain assurance that a firm's Solvency II balance sheet is adequate for all internal model and some large standard formula firms when assessing the solvency capital requirement calculations.[2]

Please speak to your supervisor in the first instance if you have any questions on the PRA's expectations of firms in the areas covered by this letter.

Yours sincerely

Chris Moulder
Director, General Insurance

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[1] PRA SS5/14 'Solvency II: calculation of technical provisions and the use of internal models for general insurers', April 2014;
http://www.bankofengland.co.uk/pra/Pages/publications/solvency2generalinsurersss.aspx

[2] See
http://www.bankofengland.co.uk/pra/Documents/solvency2/insurancedirectorsupdateoctober2014.pdf