25 November 2016: This letter has been archived. Appendix 8 of Policy Statement 33/16 lists the supervisory statements in which the PRA's expectations, where relevant, are available.
See http://www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps3316.aspx

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Dear CEO

Continued soft market conditions in the UK general insurance sector

Whilst the PRA and the industry prepares for the implementation of Solvency II on 1 January 2016, we are mindful that several sectors in the general insurance market are continuing to experience soft market conditions. Continued low interest rates and another year absent of significant natural catastrophes are increasing the competitive pressures in many areas. For instance, in several lines premium rates are continuing to fall, and extended terms and conditions are being accepted. There is also an abundance of (re)insurance capacity, which in part is driven by capital market structures that allow a wider range of investors easy access to specific insurable risks.

In the current environment, some insurers may be tempted to increase their reserve releases, rely on top-line growth, reduce their reinsurance spend and/or purchase alternative forms of reinsurance to meet business plan and market expectations of profitability. As regulator, the PRA has responsibility to ensure firms continue to have an adequate level of resilience to meet current and future policyholder obligations. As such, we expect boards to challenge where a firm's strategy either threatens this objective, or where the strategy compromises the ability for adequate oversight.

In this letter, I draw out the PRA's expectations in relation to: i) underwriting; ii) reserving; iii) reinsurance; and iv) the assessment of capital requirements in current market conditions. This is not an exhaustive list, and firms are reminded of their responsibilities to ensure the appropriateness of their business strategy, and the role of boards in providing oversight and challenge. Please note that the PRA's expectations are designed to assist firms in identifying areas of particular relevance given the soft market conditions that should be considered in meeting the System of Governance[1] requirements under Solvency II; they are not intended to represent additional requirements.

i. Underwriting

Underwriting, and specifically underwriting controls, are the first line of defence in identifying the extent, and the potential impact, of the continuing soft market conditions. The following examples illustrate areas in which we expect comprehensive board engagement:

- the extent to which the board receives adequate information to be able to understand pricing trends; for instance, consideration of whether the information received is adequate to assess risk-adjusted rate changes, rate adequacy relative to technical and/or benchmark prices, exposure changes, claims inflation as well as changes in terms and conditions;
- the effective management of the conflict between business plan objectives of growth, profitability and adequate pricing;

[1] Article 41, Directive 2009/138/EC consolidated at 23 May 2014 and Articles 258-260, 272 Delegated Regulation (EU) 2015/35 of 10 October 2014

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- the ability to monitor and report on exposure accumulations at an appropriate level of granularity to reflect the materiality of the risk, for instance, ability to report and track accumulations by geography, product or industry level; and
- the robustness of governance around expansion into new products and markets, as well as transparency around the ability to manage and monitor aggregate exposure. This is especially relevant where (re)insurers are expanding policy coverage to provide cover for more than one line of business, offering extended coverage periods, or for those (re)insurers providing covers in new areas such as cyber (whether explicit or implicit through existing products).

ii. Reserving

As highlighted in my letter last year[2], we continue to require firms to set adequate technical provisions in order to comply with INSPRU 1.1.12R for this year end, and Solvency II requirements on technical provisions thereafter. In so doing, we expect general insurers to have a robust approach to the setting of reserves and to put in place appropriate and adequate oversight of reserving processes.

We expect general insurers, and their boards, to pay particular attention to the need to:

- Be able to demonstrate strong governance around the reserve-setting process. As part of this firms should be able to demonstrate independent challenge of key issues, material uncertainties and significant assumptions in the reserves and the rationale for their choice of booked reserves;
- Have regard to the underwriting, reserving and economic cycles when setting reserves. This should include consideration as to whether an unexpired risk provision needs to be established (albeit that for future accounting dates under Solvency II, this item will be included within the technical provisions); and
- Ensure clear feedback loops exist between underwriting, claims and reserving. For example, regular monitoring and reporting of actual compared to expected and clear key performance or risk indicators that flag the need for more detailed assessment and allow boards to take appropriate and timely action if required. For internal model firms we also expect profit and loss attribution under Solvency II to be a valuable tool in providing information for, and supporting, the feedback loops.

iii. Reinsurance

We recognise that reinsurance is an integral part of risk management, assisting firms to manage capital requirements, and other aspects surrounding their insurance risk. As firms decide on appropriate reinsurance to place, we expect boards to:

- understand the risk transfer taking place;
- ensure that the economic impact is adequately reflected in business planning, capital setting and reserving; and
- appreciate the wider associated risks to which reinsurance placements can give rise.

We are aware that more complex reinsurance arrangements appear to be re-emerging in the market. For these, as for all reinsurance contracts, the PRA expects appropriate treatment, both with respect to preparing financial and regulatory statements, and with regards to ensuring appropriate treatment, when considering capital requirements. We expect boards to ensure reductions in capital requirements (whether arising from standard formula or internal model calculations) properly reflect the extent of risk transfer by the reinsurance arrangement. The PRA has and will continue to challenge firms to demonstrate that reductions in the solvency capital requirement (SCR) calculations that arise from such arrangements are commensurate with the real risk transfer taking place under the reinsurance contract. Boards should satisfy themselves that the methodology chosen to calculate the SCR – standard formula or internal model – continues to remain appropriate for the firm's risk profile.

Additionally, firms' risk management systems need to be sufficiently robust to ensure the risk transfer arising is not only adequately captured within their SCR requirements, but also that the total uncertainty

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[2] http://www.bankofengland.co.uk/pra/Documents/about/praletter131114.pdf

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and risk over the time horizon of the run-off of a firm's obligations has been considered within the Own Risk and Solvency Assessment (ORSA).[3]

Some of these topics were recently covered in two recent Solvency II Directors' letters, and they continue to remain relevant: 'Recognition of outwards reinsurance' (14 July 2015) and 'Reinsurance counterparty credit risk' (6 November 2015).

iv. Assessment of capital requirements

As the market for certain lines of business continues to deteriorate we expect general insurers and their boards to consider whether the assessment of risk continues to be valid. This is particularly important for underwriting risk, which includes risks on policies yet to be written, and which in the current market, are likely to be written on less favourable terms and conditions, as well as premium rates, than in the past. Two examples that highlight the issue are as follows:

a. As the market continues to soften, the difference between the projected business plan and expected (modelled) underwriting results will tend to increase. Monitoring, ensuring transparency and providing a clear bridging analysis around these differences can assist boards in understanding the likelihood of achieving plan, as well as potentially highlighting additional risks; and

b. Soft market conditions reduce the level of premium as a percentage of exposure. All else being equal we expect that as premium rates reduce, the level of capital relative to exposure (or premiums as a proxy for exposure) should increase.

We also note that a number of general insurers are increasing their risk appetite resulting in increased risk retentions, both at an account and line of business level. While we acknowledge that this in part reflects increased geographic, product and industry diversification, we expect boards to be given sufficient information to satisfy themselves that the assessment of risk remains robust. In particular, we expect boards to understand and challenge the extent to which changes in limits, geographic (or other additional) diversification and the soft market contribute to changes in their firm's assessment of capital requirements.

Supervisory approach

Finally, as part of our supervisory approach, we continue to develop and enhance our capabilities to monitor the insurance market, leveraging quarterly and annual submissions, and the new information available under Solvency II. This analysis is likely to result in additional discussions particularly (but not limited to) where insurers are outliers – either on a simple trend analysis, or relative to peers. As in previous years, we will continue to supplement this analysis with firms' management information, discussions with firms and their external auditors and actuaries, internal reports, and, where appropriate, skilled persons' reports commissioned under section 166 of the Financial Services and Markets Act 2000.

Given the pressures on firms' performance caused by current market conditions, we will increase our emphasis on gaining assurance over firms' underwriting and reserving controls using the tools available. As part of regular supervisory interactions, firms should stand ready to demonstrate the robustness of their underwriting and reserving governance frameworks, and the adequacy of reserve levels.

If you have any queries, please get in touch with your usual supervisory contact in the first instance.

Yours sincerely

Chris Moulder
Director, General Insurance

[3] See Supervisory Statement 26/15 'Solvency II: ORSA and the ultimate time horizon – non-life firms', June 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss2615.aspx.