BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Dear CEO

Analysis and observations from regulatory returns and monitoring-the-market questionnaire

Last December, in light of the continuing soft market conditions in the general insurance commercial sector, we set out the PRA's expectations in relation to underwriting, reserving, reinsurance and the setting of capital requirements in meeting the System of Governance requirements under Solvency II.[1][2]

With continuation of soft market conditions in the commercial sector we have decided to share some observations based on our analysis of the PRA returns as well as analysis from a recent questionnaire completed by London market insurers titled 'monitoring-the-market'. While much of our analysis is focussed on the commercial sectors, we start with observations based on an analysis of reserves that is relevant to all insurers.

Headline observations

Reserving trends relevant to all general insurers based on analysis of the PRA returns (Solvency I basis):

- We observe that reserve releases in 2015 as measured by the percentage of reserves brought-forward have been the highest for over 30 years. Inevitably this raises the question as to whether these reserve releases are sustainable. We have not identified a single trend to explain the increase; however, this will be an area of continued interest as we move to analysing technical provisions under a Solvency II basis.
- While we did not identify a universal trend across all lines, our analysis identified a number of classes that either indicated a weakening of reserves or a speeding up of claim notification and payments. A number of possible reasons might explain this trend including:
    - One-off exercises to clear out any excess in reserves left in older years of account.
    - A movement more towards a (Solvency II technical provisions) best estimate basis.
    - Pressure to maintain a certain level of profitability.
    - A speeding up in the reporting and settlement of claims, reflecting improvements in claims processes.

  We acknowledge that these factors and trends can speed up claims settlements, and might help to explain in part some of the trends identified. Nevertheless, we would also expect insurers to understand how much credit is being taken for these trends – noting that not all of these may yield the benefits anticipated.
- Our analysis of claims development data includes estimating the calendar year claims inflation inherent in the historic data as well as estimating the future claims inflation assumption implied by

[1] 'Continued soft market conditions in the UK general insurance sector', December 2015: www.bankofengland.co.uk/pra/Documents/about/insuranceletter041215.pdf.
[2] 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.

an insurer's booked reserves. In several cases, our estimate of implied future claims inflation was lower than that implied by the claims inflation inherent in the historic data. In an extreme case, as illustrated in the Annex, we estimate the historic claims inflation to be 5% per annum, whereas to obtain the insurer's booked reserves would imply a claims inflation assumption of -2%. For this particular class, this would suggest that if the future trend is in fact in line with past inflation, booked reserves would need to be 25% higher than currently assumed.
Given the current low inflation environment, the potential inflationary risks associated with currency fluctuations and the potential for long term inflation rates to be higher than recent experience, we expect insurers to consider the impact of a range of inflationary assumptions so that boards are able to understand the sensitivities in this area.

Lloyd's syndicates

In addition to the above analysis and observations which were based on the PRA returns, we also conducted similar analysis using Lloyd's syndicate claims development data. This identified some common trends for specific lines – notably potential weakening in case estimates for certain long tail liability lines. Following discussion with Lloyd's we understand that they are going to initiate their own review in this area. Hence, to avoid duplication we will, where practical and possible to do so, be using Lloyd's' analysis and observations to assist our supervision of individual syndicates.

Pricing trends for London Market insurers based on analysis of the 'monitoring-the-market' questionnaire:

(Note: these findings may also be of interest to those insurers with significant commercial portfolios.)

- While premium rates have fallen across nearly all commercial lines of business, most insurers appear to believe that current market rates are still adequate (in the sense that they exceed internal technical rate). Consequently, in the absence of a significant loss event, it is possible that rates will continue to fall in 2016.
- Firms appear to expect that the most profitable lines, as measured by the difference between market and technical price, are long tail casualty and financial lines. Historically we note that these lines have been susceptible to unexpected adverse deterioration impacting multiple underwriting years through a changing legal or economic environment. The PRA is not a pricing regulator, but we expect insurers to consider these risks both in their pricing/underwriting and exposure management – and to consider whether too much credence is being given to the more recent benign environment in determining their view of risk.
- We note that, at a market level, there is an apparent disconnect between year–on-year trends in the booked loss ratio for commercial liability lines and the overall view on market pricing. Whilst firms report that the commercial liability booked loss ratios between 2014 and 2015 have been broadly static the risk adjusted rate changes have been negative. We observe that this may indicate an insufficient feedback loop between pricing, reserving and business planning.
- At a market level our analysis indicates that insurers seem to be shedding business that no longer meets technical rate, yet most expect new business to be more profitable than their existing business despite the fact they are likely to have a deeper understanding of their existing portfolio compared to new risks. While aggregate data will inherently contain issues of comparability (for instance definition of technical rate or definition of renewal) the underlying concern is that some insurers are taking an overly optimistic view on new risks, possibly to enable top line targets to be met in an increasingly competitive market.
- We also note that smaller insurers or those entering new markets with typically less information seem to have a more optimistic view of current pricing than their larger competitors. Some of this difference might be explained by smaller firms having expertise in niche markets, but it might also simply reflect a more optimistic view, based on the relatively benign loss environment in several lines of business.

Looking forward to Solvency II analytics within supervision

We hope the above observations and the analysis we provide in the annex is of interest, and allows you to better understand how we use the information submitted. We will continue to use this type of analysis to track broad trends across the insurance industry as well as to inform and assist our individual firm supervision. In the latter case we are well aware that much of this report is based on market averages – as a result, this information is used to support rather than drive a supervisor's knowledge and view of the key risks.

Looking ahead we are already receiving a significant increase in firm level information under the new Solvency II reporting requirements. We are responding by continuing to invest in our analytical capabilities to maximise the value of this new data.

Over the coming years, you can expect the PRA to increase its use of analytics to support its forward-looking, judgement-based supervision – both for prioritising activities and assessing the risks faced by, and business models of, individual insurers. We recognise that at a class of business level, the quality of data supporting the Solvency I PRA returns was not always consistent. Over time, that reduced some of its value. With the new Solvency II information, we are focussing on understanding trends from the introduction of the new regime on 1 January 2016, including developing and maintaining a sector-level view that is grounded in firm-level intelligence. To do that, we need to ensure that data quality is front of mind from the outset. Insurers can therefore expect us to ask questions based on this new data, particularly if our analysis highlights anomalies in a given firm's data relative to the past and/or other firms.[3]

This is the first letter providing feedback on market trends in the general insurance sector. As such we welcome any feedback, please contact Stefan Claus (stefan.claus@bankofengland.co.uk).

Yours sincerely

Chris Moulder
Director, General Insurance

[3] Since 2013, PRA staff have convened roughly once per quarter an Industry Working Group to discuss and help resolve data reporting issues under Solvency II. Further details can be found on the Bank of England's website: www.bankofengland.co.uk/pra/Pages/regulatorydata/insurance/riworkgroup.aspx.

Annex

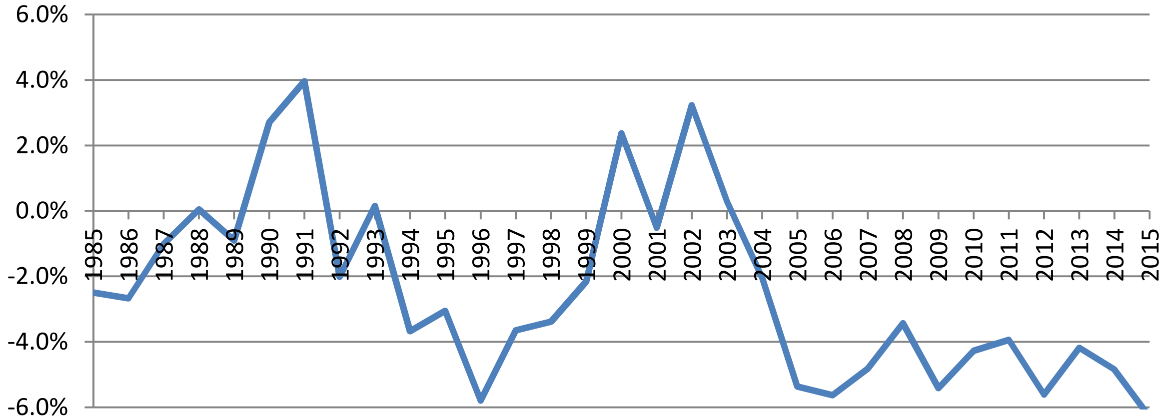
Reserving: Analysis and observations

The following analysis and observations are based on an analysis of the PRA returns data. Note this excludes Lloyd's syndicates.

Observation 1

We observe that reserve releases in 2015 as measured by the percentage of reserves brought forward have been the highest for over 30 years (see Chart 1). Inevitably this raises the question as to whether these reserve releases are sustainable. We have not identified a single trend to explain the increase; however, this will be an area of continued interest as we move to analysing technical provisions under a Solvency II basis.

Chart 1: Net reserve movements in each calendar year



Notes:

- *A positive result shows a strengthening in reserves a negative result shows a release in reserves.*
- *The data is based on a total of all firms reporting in the PRA returns on an accident year basis.*
- *Calculation: [Form 20,Line 22, Column 1] / [Form 22, Line 13, Column 1].*
- *Outliers have been removed from years 2006, 2010 & 2015, to better reflect the trend for the majority of firms.*

Observation 2

While we did not identify a universal trend across all lines, our analysis identified a number of classes that either indicated a weakening of reserves or a speeding up of claim notification and payments. A number of possible reasons might explain this trend including:

- *One-off exercises to clear out any excess in reserves left in older years of account.*
- *A movement more towards a (Solvency II technical provisions) best estimate basis.*
- *Pressure to maintain a certain level of profitability.*
- *A speeding up in the reporting and settlement of claims, reflecting improvements in claims processes.*

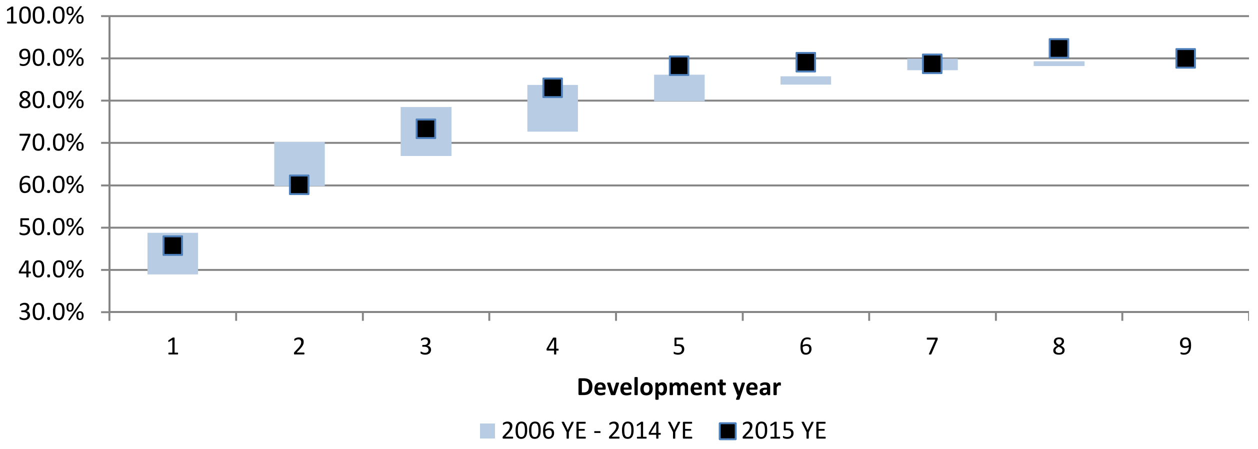
We acknowledge that these factors and trends can speed up claims settlements, and might help to explain in part some of the trends identified. Nevertheless, we would also expect insurers to understand how much credit is being taken for these trends – noting that not all of these may yield the benefits anticipated.

To illustrate we have provided details of the implied reserving assumptions at a market level for personal motor both in 2015 as well as that assumed during the previous nine years, see *Charts 2 and 3*.

Chart 2 provides details of the assumed percentage paid from the estimated ultimate claims – the dot represents the latest view (ie in 2015), and the bars represent the range of estimates based on the experience of the last 10 years. Where the dot is above or at the higher end of the bars then this indicates that the insurer is estimating that more of the ultimate claims have been paid than would have been in the past – ie weaker reserves or faster claims payment. *Chart 3* provides identical analysis, except that instead of considering only claim payments it also considers the number and amount of claims notifications (ie the incurred claims).

Assuming that the settlement of claims reverts back to that implied by the historic average would result in a deficit of approximately 9% to the current held reserves.

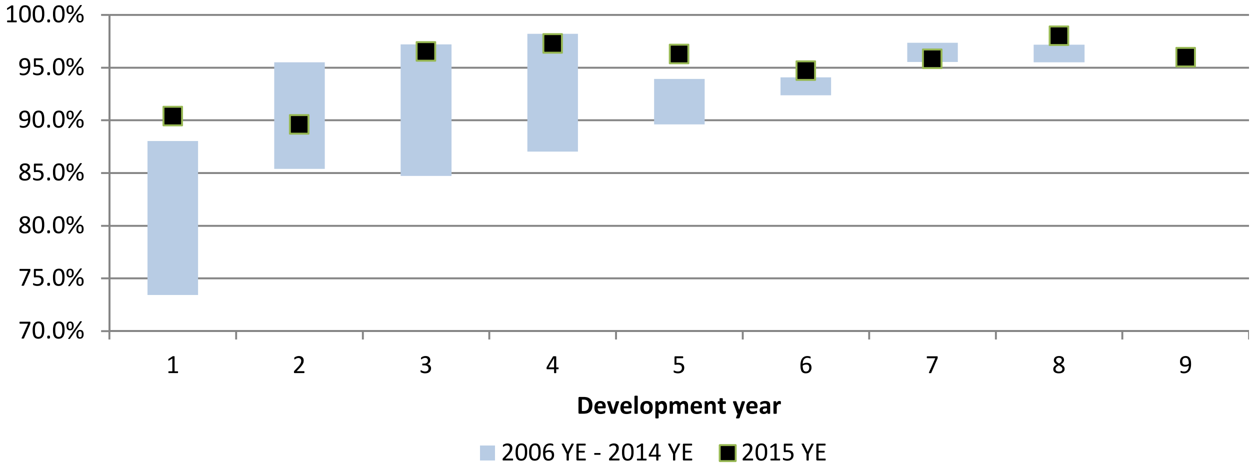
Chart 2: Paid as percentage of ultimate claims for each development year, personal motor



Notes:

- *Analysis based on a selection of the most prominent motor underwriters that report on an accident year basis.*
- *Data is taken from the PRA returns [Form 32, Column 4, Line 11]; [Form 32, Column 5, Line 14]; and [Form 32, Column 6, Line 13] for category 121: Primary direct & fac. personal private motor – comprehensive.*

Chart 3: Incurred as percentage of ultimate claims for each development year, personal motor



Notes:

- *Analysis based on a selection of the most prominent motor underwriters that report on an accident year basis.*
- *Data is taken from the PRA returns [Form 32, Column 4, Line 11]; [Form 32, Column 5, Line 14]; and [Form 32, Column 6, Line 13] for category 121: Primary direct & fac. personal private motor – comprehensive.*

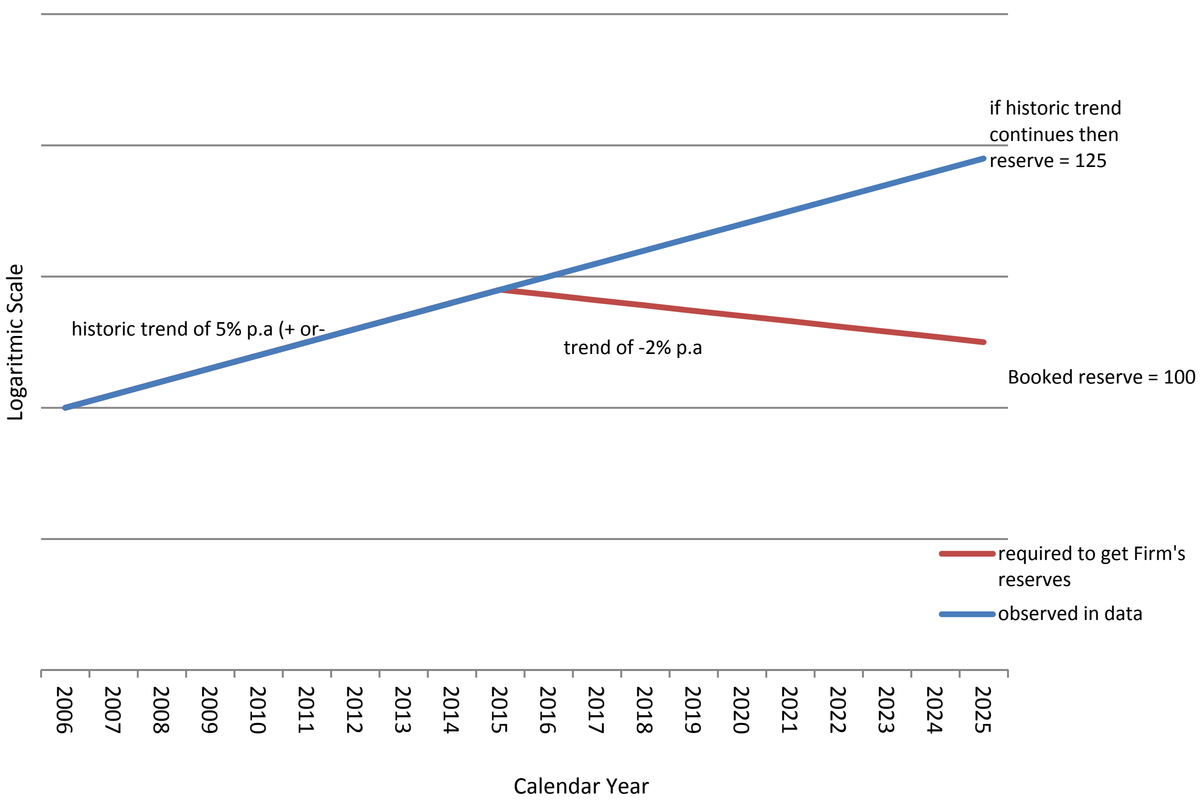
Observation 3

Our analysis of claims development data includes estimating the calendar year claims inflation inherent in the historic data as well as estimating the future claims inflation assumption implied by an insurer's booked reserves. In several cases, our estimate of implied future claims inflation was lower than that implied by the claims inflation inherent in the historic data. In an extreme case, as illustrated in the Annex, we estimate the historic claims inflation to be 5% per annum, whereas to obtain the insurer's booked reserves would imply a claims inflation assumption of -2%. For this particular class, this would suggest that if the future trend is in fact in line with past inflation, booked reserves would need to be 25% higher than currently assumed.

Given the current low inflation environment, the potential inflationary risks associated with currency fluctuations and the potential for long term inflation rates to be higher than recent experience, we expect insurers to consider the impact of a range of inflationary assumptions so that boards are able to understand the sensitivities in this area.

Chart 4 provides a graphical illustration of the example provided above and has been taken from an insurer writing a long tail line of business. In this case we were only able to derive the booked reserves when we assume a negative inflation rate. Should inflation increase to 5%, in line with that implied by the historic data, this would result in an underestimation of reserves by around 25%.

Chart 4: Analysis of calendar year trends: historic implied inflation vs. assumed future inflation



Underwriting: Analysis and observations

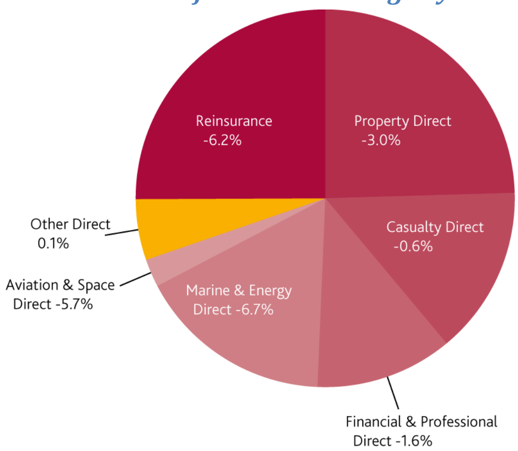
The following observations are primarily based on the feedback from the monitoring-the-market questionnaire, completed by most London market insurers, including all Lloyd's syndicates.

Observation 1

While premium rates have fallen across nearly all commercial lines of business, most insurers appear to believe that current market rates are still adequate (in the sense that they exceed internal technical rate). Consequently, in the absence of a significant loss event, it is possible that rates will continue to fall in 2016.

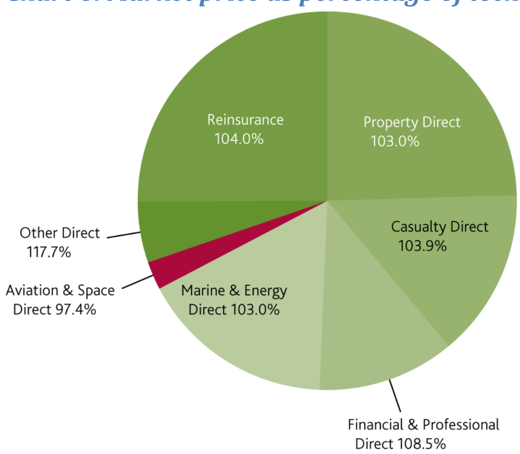
As shown in *Chart 5* rate reductions impacted almost all commercial lines in 2015. However, *Chart 6* indicates that while premium rates are lower, insurers believe they are still in excess of internal targets; note: above 100% implies market prices are above the technical premiums. We expect robust internal and external challenge of insurers' view of technical pricing and for any insurer relying on premium rate increases within commercial lines to meet their business plan profit targets in the current challenging market environment.

Chart 5: Risk adjusted rate change by line of business



Source: PRA monitoring-the-market survey, March 2016

Chart 6: Market price as percentage of technical price by line of business

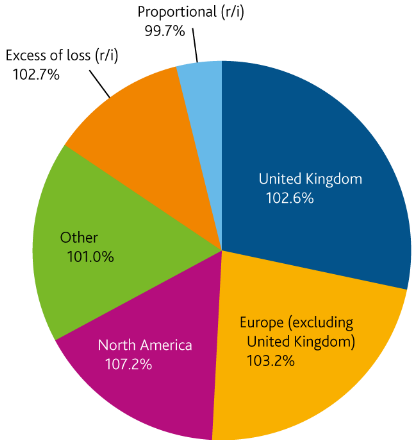


Source: PRA monitoring-the-market survey, March 2016

Observation 2

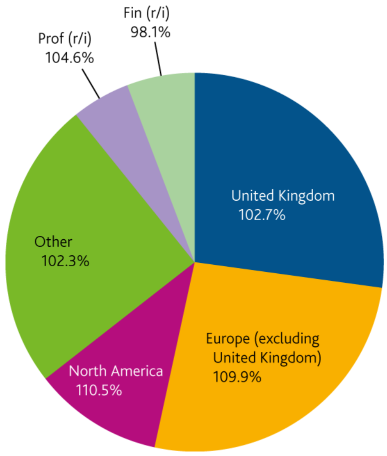
Firms appear to expect that the most profitable lines, as measured by the difference between market and technical price, are long tail casualty and financial lines. Historically we note that these lines have been susceptible to unexpected adverse deterioration impacting multiple underwriting years through a changing legal or economic environment. The PRA is not a pricing regulator, but we expect insurers to consider these risks both in their pricing/underwriting and exposure management – and to consider whether too much credence is being given to the more recent benign environment in determining their view of risk.

Chart 7: Market price as percentage of technical price by region for casualty



Source: PRA monitoring-the-market survey, March 2016

Chart 8: Market price as percentage of technical price by region for financial lines

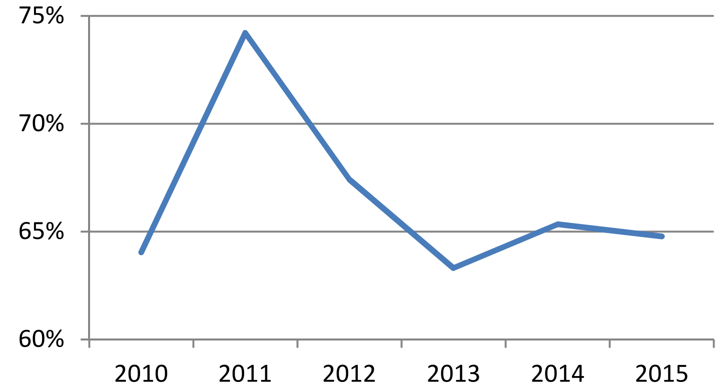


Source: PRA monitoring-the-market survey, March 2016

Observation 3

We note that, at a market level, there is an apparent disconnect between year–on-year trends in the booked loss ratio for commercial liability lines and the overall view on market pricing. Whilst firms report that the commercial liability booked loss ratios between 2014 and 2015 have been broadly static (see Chart 9 below) the risk adjusted rate changes have been negative (previous Chart 5). We observe that this may indicate an insufficient feedback loop between pricing, reserving and business planning.

Chart 9: Net loss ratio trend for commercial liability

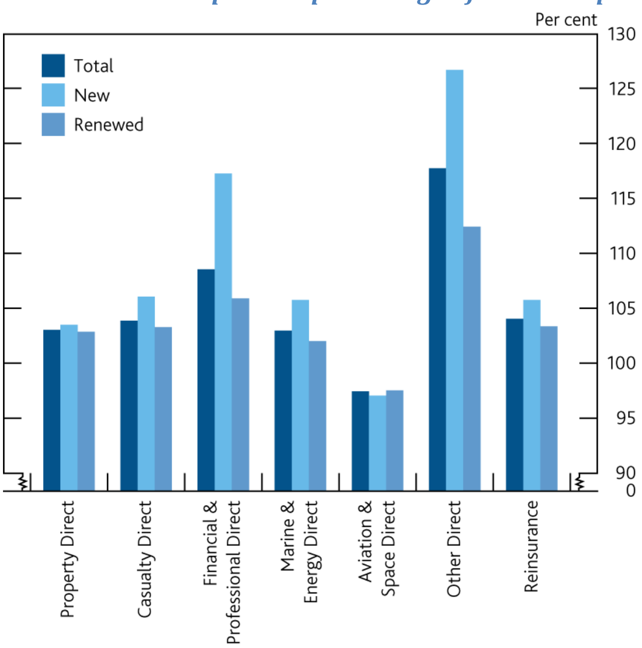


Source: PRA Returns Data, Form 23

Observation 4

At a market level our analysis indicates that insurers seem to be shedding business that no longer meets technical rate, yet most expect new business to be more profitable than their existing business (see Chart 10) despite the fact they are likely to have a deeper understanding of their existing portfolio compared to new risks. While aggregate data will inherently contain issues of comparability (for instance definition of technical rate or definition of renewal) the underlying concern is that some insurers are taking an overly optimistic view on new risks, possibly to enable top line targets to be met in an increasingly competitive market.

Chart 10: Market price as percentage of technical price for new and renewed business

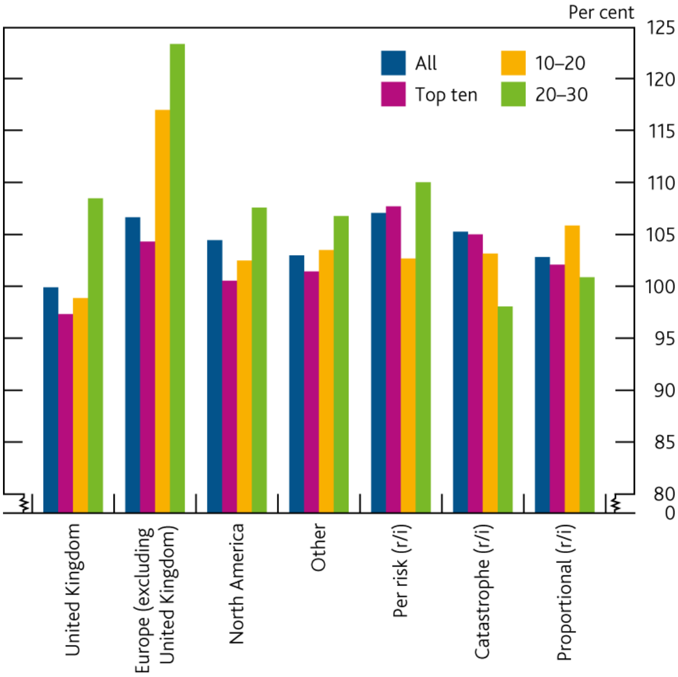


Source: PRA monitoring-the-market survey, March 2016

Observation 5

We also note that smaller insurers or those entering new markets with typically less information seem to have a more optimistic view of current pricing than their larger competitors (Chart 11). Some of this difference might be explained by smaller firms having expertise in niche markets, but it might also simply reflect a more optimistic view, based on the relatively benign loss environment in several lines of business.

Chart 11: Market price as percentage of technical price on new business for property direct



Source: PRA monitoring-the-market survey, March 2016