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22 June 2017

Dear CEO

Observations for your attention based on feedback from the monitoring-the-market questionnaire

This is the second year that we are sharing observations based on feedback from the recent questionnaire completed by London market insurers titled: 'monitoring-the-market', and the first year that we have included large UK commercial insurers. The headline findings are another year of continued softening in premium rates and some evidence of widening in terms and conditions. However, our analysis also highlights a contradiction. In aggregate, premium rates reduced, but overall premium adequacy, as estimated by firms, is marginally higher. While we recognise that not all business can be subject to robust technical price, this observation does raise the question whether some firms are taking an overly optimistic view of current pricing.

The remainder of this letter sets out further observations as well as PRA initiatives designed to understand better the impact on individual firms. I specifically draw your attention to the appendix that sets out the issues and considerations for you and your board in detail.

Background

The purpose, as in the previous year,[1] has been for the PRA to get a quantitative and qualitative sector-wide understanding of current market conditions and identify those insurers that are most affected by them. We combine questionnaire responses with other supervisory information to ensure a targeted and risk-based approach to our supervision.

This year, in addition to large commercial insurers outside the London market, we also had responses from a number of European insurers that write significant amounts of commercial or London market business in the United Kingdom through passporting. We thank all those who participated in providing feedback on current market conditions.

Headline observations

Overall, many of the statements made this year are consistent with those in the previous year. However, the underlying metrics have a compounding impact so that the issues mentioned below take on increasing importance.

1) Risk-adjusted rates continue to deteriorate, albeit reductions are moderating in most lines. Smaller insurers are experiencing higher rate reductions than their larger peers.
2) Terms and conditions are widening but views differ as to whether this is sufficiently material to raise risks overall.
3) Perceptions of rate adequacy suggest firms believe profitability is being maintained, but this highlights a potential disconnect between current views of pricing levels and assessments of Risk-Adjusted Rate Changes (RARC). Lines of business that are perceived as most favourable (with

[1] 'Analysis and observations from regulatory returns and monitoring-the-market questionnaire', July 2016; http://www.bankofengland.co.uk/pra/Documents/solvency2/cmoulderletter180716.pdf

regards to rate adequacy) are those that are harder to model and where the ultimate claims cost will not be known for a number of years eg casualty and financial and professional lines.

4) New business continues to be viewed more favourably than renewed business.

5) Smaller insurers generally have a more favourable view on rate adequacy, but they are also seeing greater rate reductions than their larger peers.

6) The majority of firms, but by no means all, had concerns about changing distribution channels. Higher commissions, difficulties in exposure management and the implications of moving from case to portfolio pricing were common themes.

7) In addition to changing distribution channels, cyber exposures, merger and acquisition (M&A) activity and the move to increasingly aggregate cross-class covers were the main structural issues commented on by firms.

Further details on each of these observations are set out in the Appendix.

Next steps

Current market conditions mean that firms are receiving lower premiums for the same level of exposure. Widening terms and conditions may result in increased claims, both in terms of what is payable in the event of a claim as well as new events that could result in a claim. In addition, weakening terms and conditions can also affect claim notification and settlement patterns, challenging firms' claims reserving.

It is important that firms explicitly assess and understand the extent and level to which changes in terms and conditions carry an internal cost (for instance, an increase in risk capital or an increase in the level of incurred-but-not-reported (IBNR) claims), and whether this cost is commensurate with the additional risks.

Given the findings in this review, we are concerned that some firms may have insufficiently captured current market conditions and the potential impact of broadening terms and conditions in their risk management. Over the course of 2017, we will carry out a number of supervisory initiatives to improve our understanding of how individual firms are being affected by current market conditions:

1) We are assessing underwriting and exposure management in detail for selected lines of business in a number of large corporate insurers with a view to understanding how changes in terms and conditions are reflected in the monitoring process and carried through to planning, reserving and capital assessment.

2) Where these firms participate in broker facilities, managing general agents (MGAs) or other delegated underwriting arrangements, we will be assessing how they ensure that they understand the impact of business written on their overall risk profile and their results.

3) Across a number of smaller Lloyd's managing agents, we are conducting a thematic review of distribution practices to understand trends in strategies employed by firms, how distribution channels are evolving and the quality and cost of obtaining this business. Firm-specific and thematic findings from this exercise will be communicated to the contributing firms towards the end of the year.

As already highlighted last year, we are increasing our use of analytics to support supervision. During 2017 we will be "joining-the-dots" by reviewing: Solvency II annual returns (identifying trends in growth and profitability), internal model output information (identifying potential outliers in the assessment of downside risk), results from the General Insurance Stress Test 2017 and analysis from the exercises described above in order to identify firms that warrant more detailed supervisory investigation. For instance, this analysis should allow us to identify firms that are planning to grow in specific lines on the basis of relatively optimistic views of premium adequacy and required risk capital.

Your supervisory contact will discuss the contents of this letter with you as part of our regular dialogue. Should you wish to provide feedback on the wider sectoral implications of the topics raised please contact Stefan Claus our Technical Head of Division (stefan.claus@bankofengland.co.uk).

We trust that this feedback is useful as your firm continues to navigate current market conditions.

Yours sincerely

Appendix

Observations based on the feedback from the monitoring-the-market questionnaire

The following observations are based on the feedback from the monitoring-the-market questionnaire, completed by most London market insurers, including all Lloyd's syndicates, and a number of the largest UK commercial insurers.

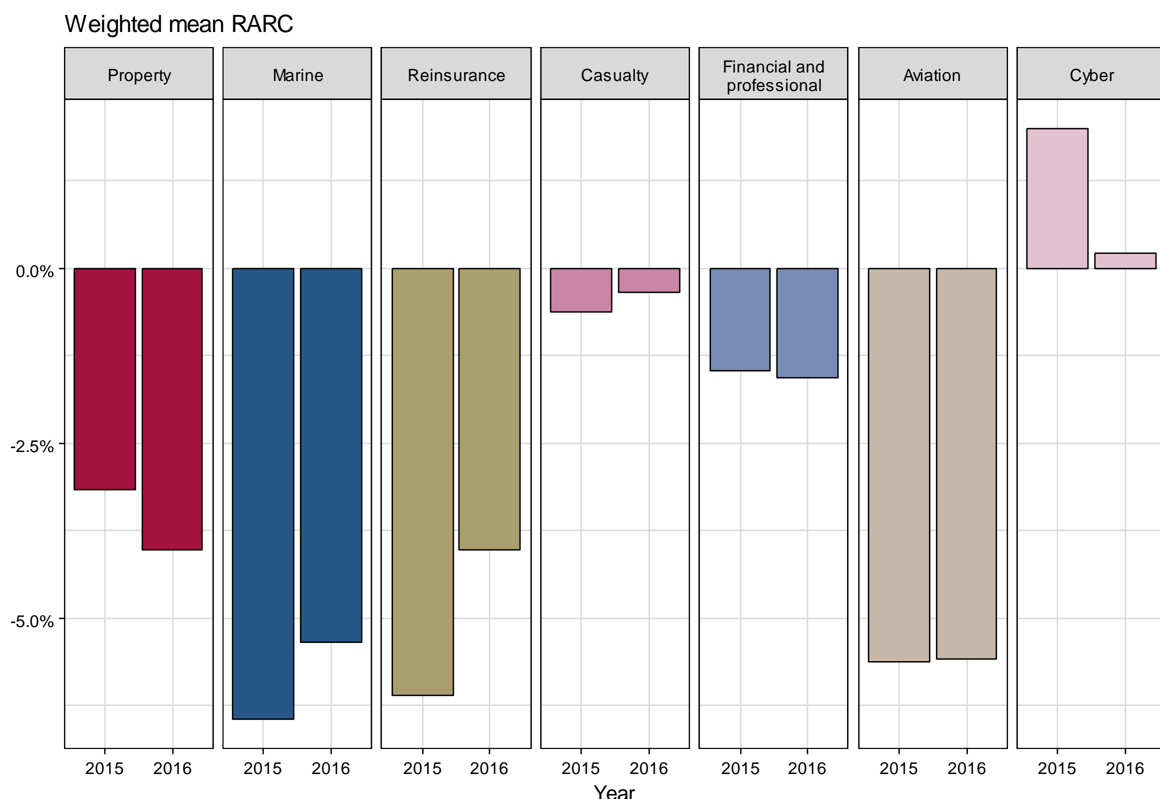
Observation 1: RARC continue to deteriorate, albeit the level of reductions appears to be moderating in most lines. Smaller insurers are experiencing higher rate reductions than their larger peers.

RARC continued to deteriorate for all lines except cyber and commercial motor during 2016. However, this reduction has started to moderate in most lines, with the exception of property direct and financial and professional lines (Chart 1a). The moderation in the rate reduction in the reinsurance lines is further supported by the RARC for the 1 January renewals (Chart 1b). Notably the property catastrophe reinsurance RARC was worse than in the previous year, suggesting continued competitive pressures from alternative markets.

Beyond these headline reductions, our data suggests that for a number of lines of business (including casualty and marine) smaller insurers are seeing a higher reduction in the RARC than their larger competitors.

We note that the assessment of RARC is not an exact science. It is important that when reporting the RARC the Board is aware of the different levels of credibility between lines of business and within the components that make up the RARC. For instance, the same terms on a reduced price is relatively straightforward, but allowing for a subtle change to terms or changing view on the underlying exposure is subject to greater expert judgement.

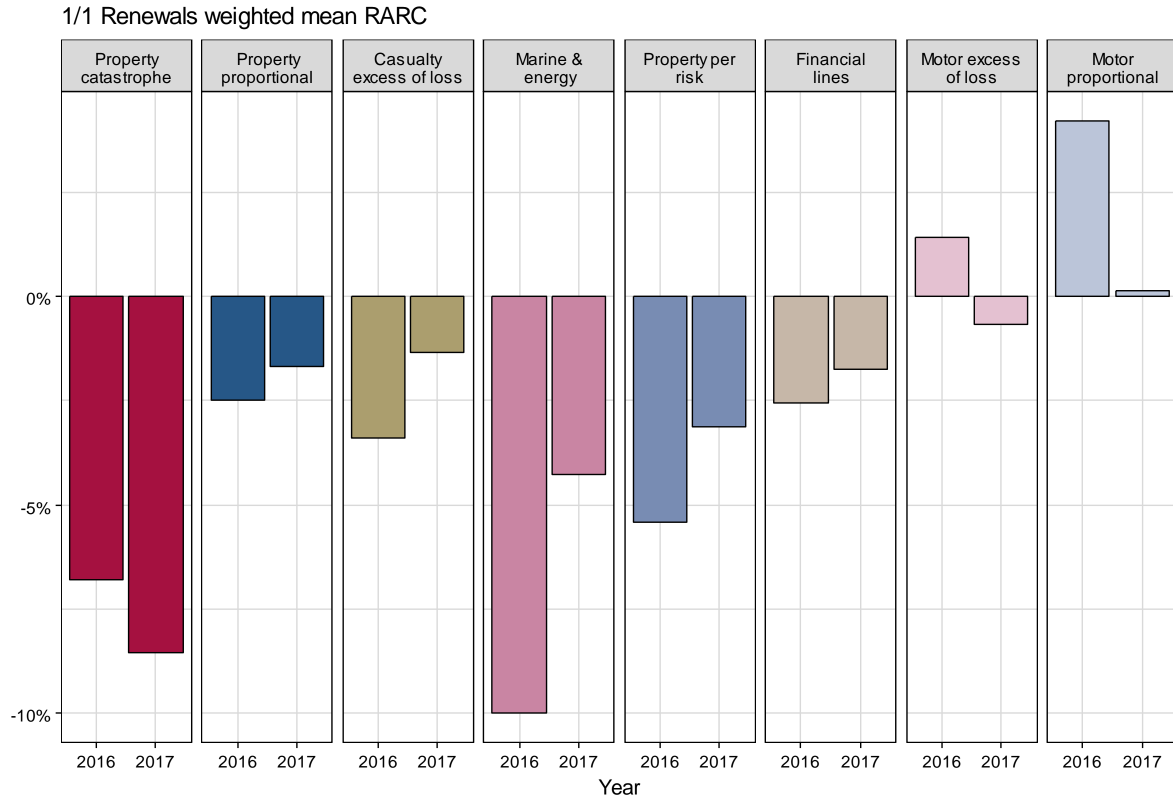
Chart 1a: Comparison of RARC by line of business between 2015 and 2016



Note:

1. *RARC is based on weighted average and is shown on a like-for-like basis (ie. only where we have firms that responded to the questionnaire this year and last year, hence figures for 2015 may differ slightly from those shown last year).*
2. *This is the first year that commercial motor and small and medium-sized enterprise (SME) data was requested so the year-on-year comparison is not included above. For these two classes the weighted average RARC in 2016 was +2% and -0.3% respectively.*

Chart 1b: Comparison of the RARC for inwards reinsurance business incepting on 1 January



Observation 2: Terms and conditions are widening, but views differ as to whether this is sufficiently material to increase risk overall.

The majority of firms commented on price reductions, but stated that there had not been any material widening of coverage. However, a significant minority stated the opposite and provided a number of examples where terms and conditions had expanded. Examples of the changes highlighted by firms were:

- *business interruption coverage expanded to include non-damage perils*
- *cyber inclusions or expansions of cover to include non-physical damage*
- *increase in years of discovery / extended reporting periods*
- *inclusion of contagious disease*
- *weaker definition of incidental coverage (e.g. the insured determines what constitutes incidental damage)*
- *increase in multi-year policies.*

We acknowledge that many of the changes above are difficult to capture on a quantitative basis (often due to the absence of any credible historical data) and hence will rely to a large extent on expert judgment. It is important that firms are transparent on the extent and level to which changes in terms and conditions carry an internal cost (for instance an increase in risk capital or an increase in the level of IBNR held), and whether this cost is commensurate with the additional risks.

Only a handful of insurers stated that terms and conditions had widened more than anticipated such that it resulted in an increase in their risk capital. In part, this reflected the benefits of improved terms on their outward reinsurance.

An increasing number of firms highlighted the use of dedicated wording teams to identify, monitor and assess any changes in terms and conditions. Many firms are looking to strengthen in this area.

Observation 3: Perceptions of rate adequacy suggest profitability is being maintained, but that highlights a potential disconnect between current views of pricing levels and the RARC. Lines of business that are perceived as most favourable (with regards to rate adequacy) are those that are harder to model and where the ultimate claims cost will not be known for a number of years eg casualty and financial and professional lines.

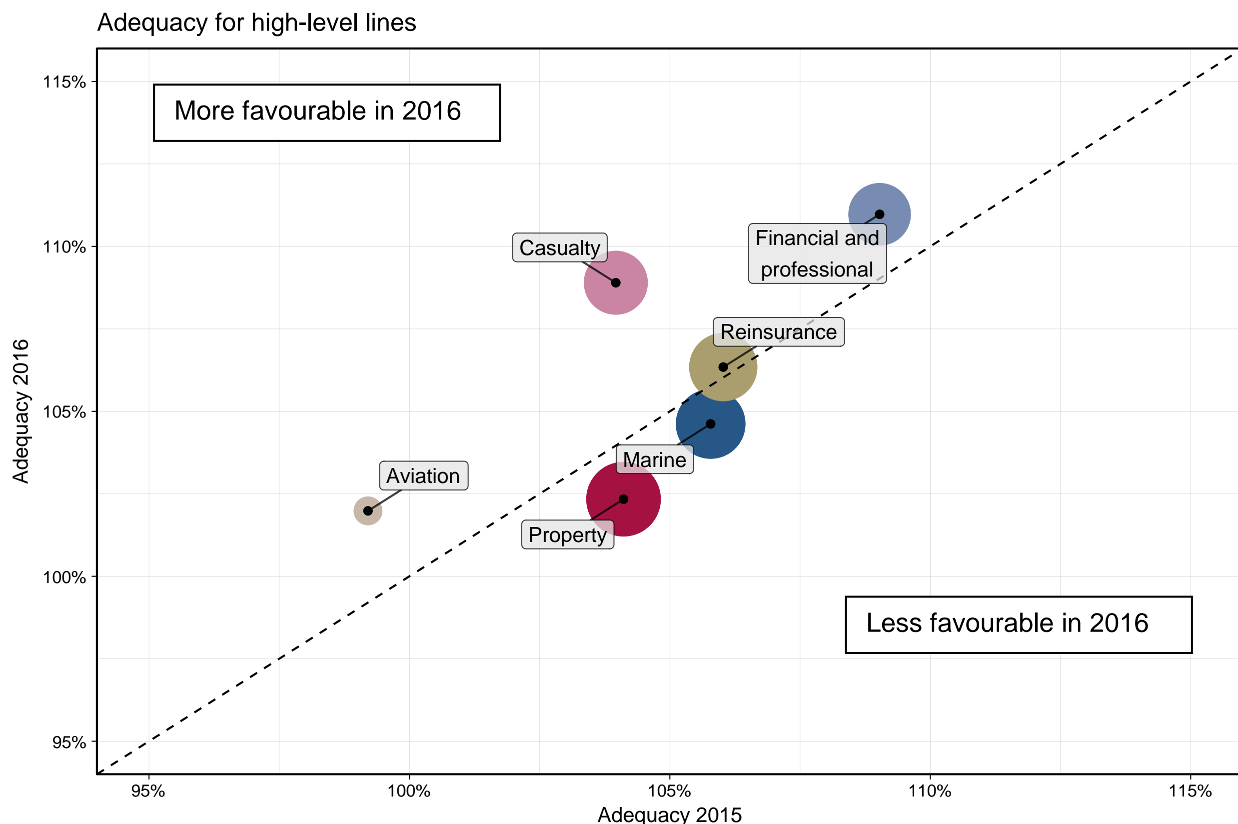
Questionnaire responses suggest that rates in all lines continue to be adequate, and in several cases more favourable than last year. For instance this is the case for aviation, casualty, reinsurance and financial and professional lines (see Chart 3a).

In part this is explained by the fact that new business continues to be viewed as more profitable than renewed business – see Observation 4. However, it also reflects a wider complexity in assessing rate adequacy based on technical price over time. There appears to be a disconnect between the risk-adjusted rates in Observation 1 and that shown below – in aggregate overall premium adequacy has not materially changed, yet the RARC has reduced by around 3.2% (see Chart 3b). Potential reasons for the apparent anomaly include (1) firms reducing their return on capital targets; (2) firms taking credit for re-underwriting the portfolio; (3) firms taking the view that the loss environment is improving, perhaps reflecting adverse years becoming a reducing component of their historical data used to project forwards; and (4) firms not adequately reflecting changes in RARC (which may reflect some of the softer factors discussed in Observation 2) within their assessment of technical price.

It is important that firms are transparent as to how they reconcile their view of price adequacy and the RARC from one year to the next, and whether the assessment of premium adequacy appropriately reflects changes in a firm's risk profile, particularly where firms have limited historic claims data and are reliant on market risk profile curves to assess the risk-reward trade off. In addition, the continued and increased attractiveness of the long-tail and difficult-to-model casualty and financial and professional lines should raise questions for boards as to whether undue credit is given to the recent benign environment.

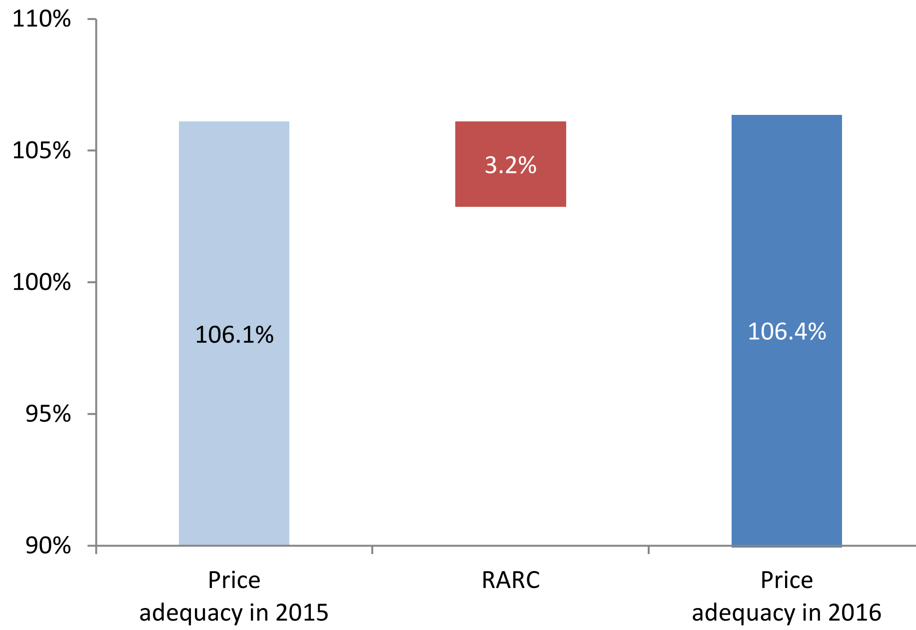
This is an area we will seek to understand in more depth as part of our ongoing reviews into the underwriting and exposure management of a number of firms in the London market.

Chart 3a: Comparison of premium rate adequacy by line of business between 2015 and 2016



Note: Adequacy is defined as actual premium as percentage of benchmark premium and shown on a like-for-like basis (ie only where we have data from firms this year and last year – hence figures for 2015 may differ marginally from those shown last year). The size of the bubble reflects 2016 gross written premium.

Chart 3b: Illustrating the potential disconnect between current view of pricing levels and the RARC



Note: Adequacy is defined as actual premium as percentage of benchmark premium and is shown on a like-for-like basis (ie only where we have data from firms this year and last year – hence figures for 2015 may differ marginally from those shown last year).

Observation 4: New business continues to be viewed more favourably than renewed business.

In many lines of business, new business continues to be viewed more favourably than renewed business.

This phenomenon was noted last year: "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."

It is noticeable that those lines that are harder to model are generally those where the deviation between new and renewed business is greatest eg casualty and financial and professional lines.

For most UK commercial lines the relationship between renewed and new business is in line with expectations; ie price adequacy on renewed business is above that of new business (Chart 4b).

With a desire to meet business plan premium volumes there is a risk that some firms may take an over-optimistic view on new business. This is an area we will seek to understand in more depth as part of our ongoing reviews into the underwriting and exposure management of a number of firms in the London market.

Chart 4a: Price adequacy for new and renewed business in 2016 (all geographic regions combined)

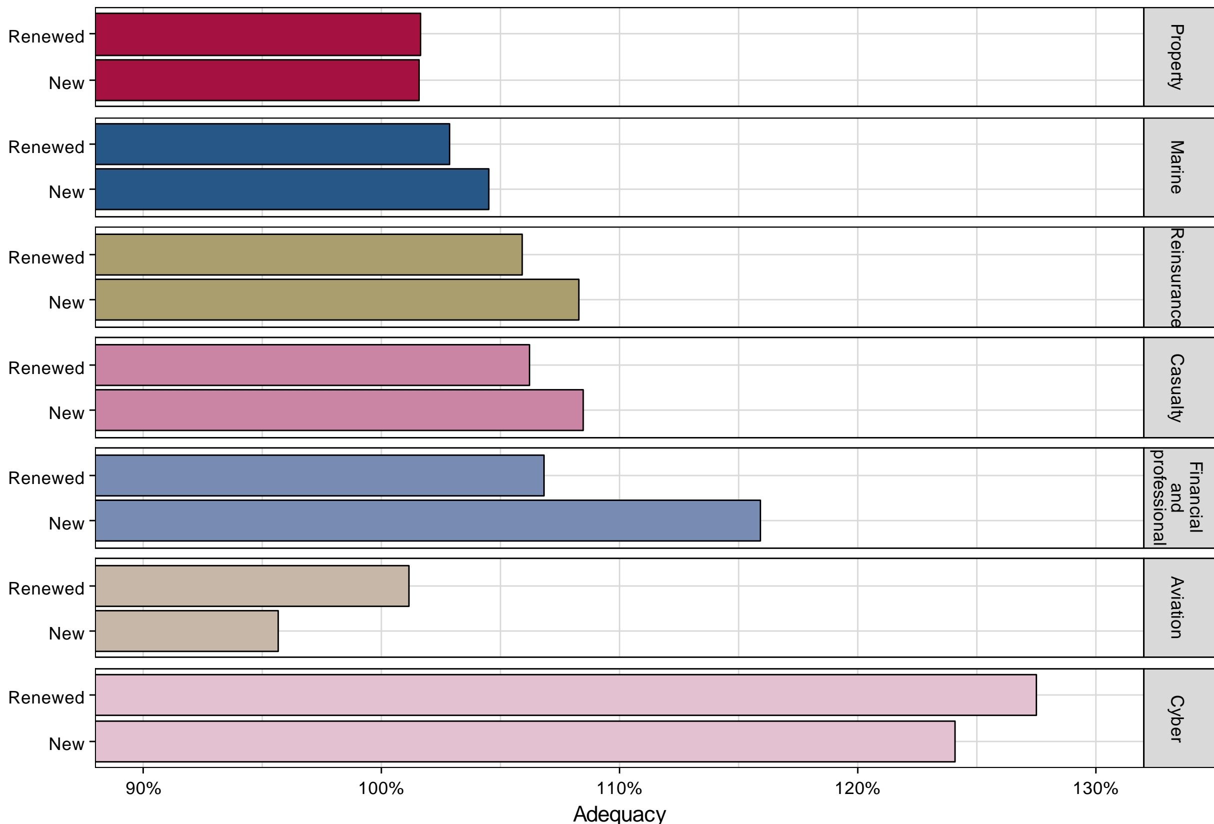
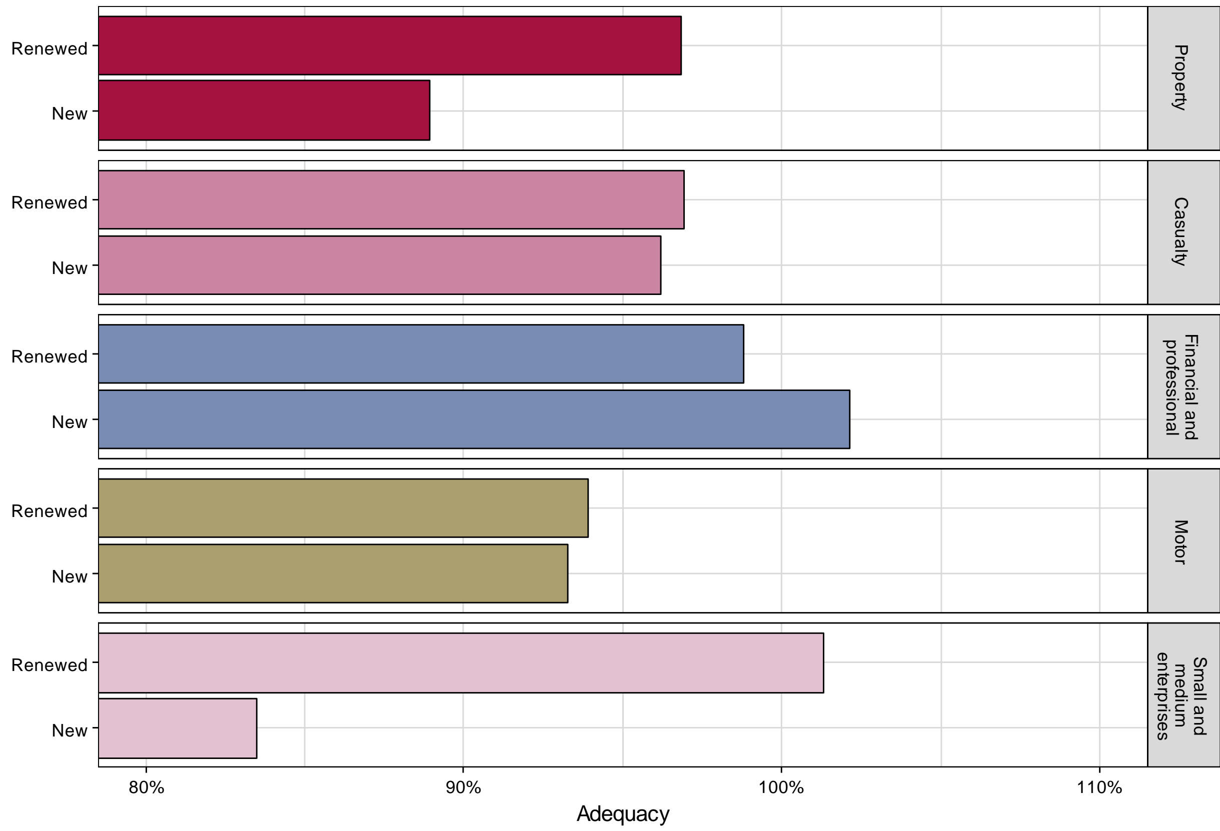


Chart 4b: Price adequacy for new and renewed business in 2016 (UK only, excluding syndicates)



Note: Motor refers to UK commercial motor only

Observation 5: Smaller insurers generally have a more favourable view on rate adequacy, but they are also seeing greater rate reductions than their larger peers.

Consistent with what we observed last year, larger insurers are generally more pessimistic about rates than their smaller peers.

Chart 5a: Price adequacy for property direct ranked by size of gross written premium

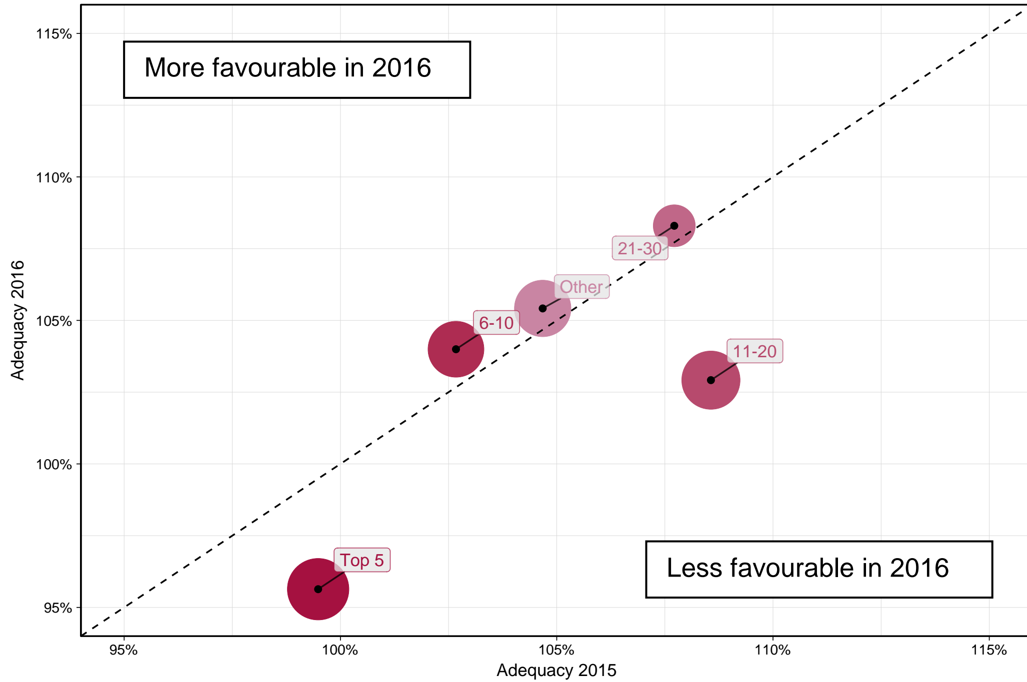
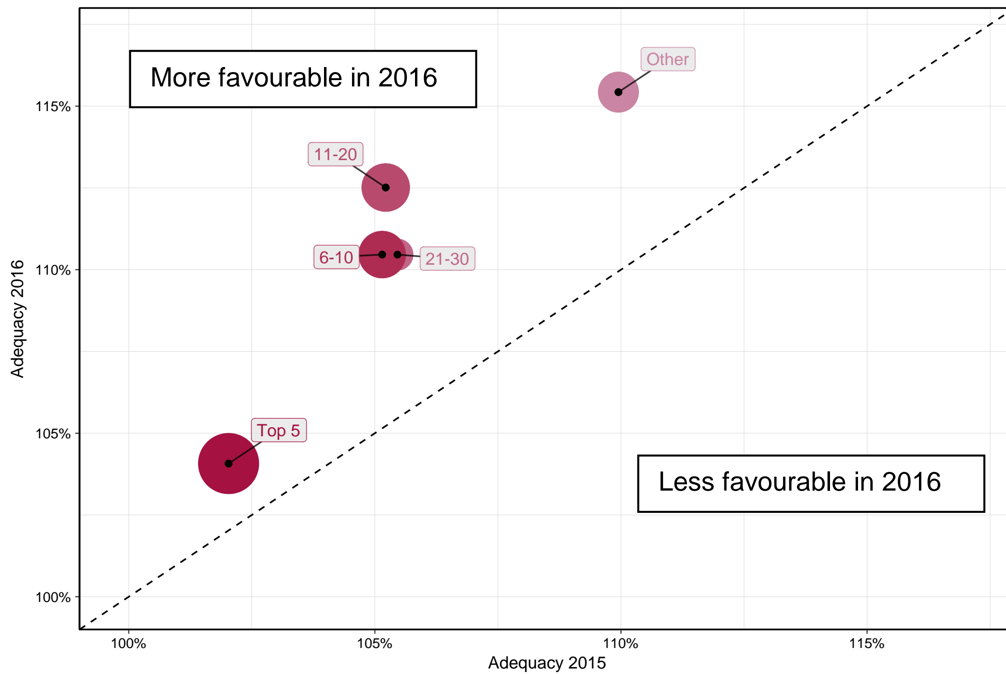


Chart 5b: Price adequacy for casualty direct ranked by size of gross written premium



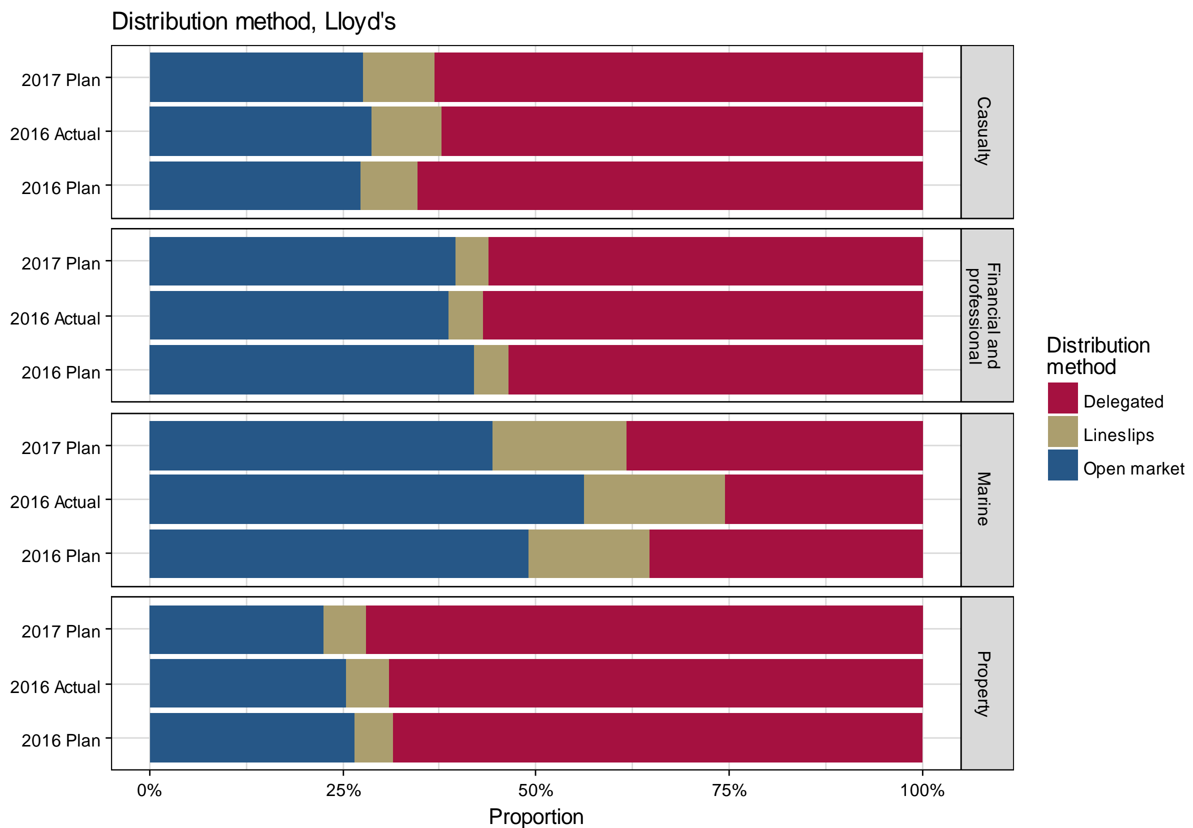
Observation 6: The majority of firms, but by no means all, had concerns with changing distribution channels. Higher commissions, difficulties in exposure management and the implications of moving from case to portfolio pricing were common themes.

Delegated underwriting and lineslips are increasing, but in many cases not as quickly as expected. Chart 6a shows the changing split of distribution channels for Lloyd's syndicates only (many firms outside Lloyd's were unable to provide this information in a consistent manner).

This chart illustrates that the market is expecting a continued decline in open market placement and a continued growth of delegated underwriting. Marine is an outlier in that far less was actually placed through delegated authorities during 2016 than was planned.

While lineslips form a relatively small percentage of business, they are increasing above plan in many lines.

Chart 6a: Breakdown of distribution channels for Lloyd's syndicates (as % of gross written premiums)



Note: Delegated distribution method does not distinguish between delegation to a group company and delegation to a third party

Qualitative feedback on the impact on underwriting standards and acquisition costs of broker-insurer facilities and other types of delegated underwriting was mixed. In part, this reflects the significant difference in scale and type of business of the firms that responded. Most (although not all) firms focused their feedback by considering the impact on underwriting and acquisition costs of broker-insurer facilities – including firms which have consciously decided not to participate in these. Most firms also acknowledged that the decision as to whether to participate depended on a number of potential benefits (eg access to new business, increased diversification) and potential disadvantages (eg higher commissions, reduced client connection).

Underwriting control

Two core themes emerged from the responses to the questionnaire:

1. *Increased delegation is resulting in a shift away from case underwriting towards portfolio pricing. As many insurers highlighted, this requires a changing skill set; for instance, increased emphasis on the need for robust operational controls, underwriting controls, conduct risk, credit control and regular audits.*
2. *A number of insurers are not participating on cross-class broker facilities due to a concern about their ability to monitor aggregate exposures, particularly for the following market. We will be following up with a number of insurers to understand the extent to which the ability to monitor aggregations of exposure is compromised when participating in broker facilities.*

Acquisition costs

Views differed as to whether broker-insurer facilities were significantly increasing acquisition costs. Some firms stated that increased commissions could be offset by a reduction in their own claims administration.

However, a common point of feedback was the importance of managing the potential for conflicts of interest and transparency of commission arrangements. Several firms mentioned increases in different types of commission and fee arrangements that could be perceived as going against the benefit of the insured.

A firm's distribution strategy is a commercial decision but may have an impact on a firm's ability to monitor, manage and assess risks. This is an area we will seek to understand in more depth as part of our ongoing reviews into the underwriting and exposure management of a number of firms in the London market.

Observation 7: Changing distribution channels, cyber exposures, M&A activity and the move to increasingly aggregate cross-class covers were the main structural issues commented on by firms.

The broad nature of the question resulted in firms highlighting a very wide range of topics including the United Kingdom's withdrawal from the European Union, the Insurance Act 2015, social and political changes, InsurTech and model-driven behaviours. We have restricted our feedback to the most common areas: distribution channels, cyber, M&A and increase in aggregate covers.

Distribution channels

The impact of distribution channels was the topic most extensively covered in the feedback. Firms offered most feedback in relation to broker facilities, which were covered under Observation 6. However, there were three additional trends that are worth highlighting:

1) *the increasing use of lineslips that several insurers felt were designed to achieve a similar result to broker facilities;*
2) *the increasing number of MGAs, digitisation (including where insurers are increasingly relying on third-party technology), M&A in both brokers and insurers and increasing capacity from start-ups were all highlighted as having an impact on the SME market; and*
3) *certain risks being written through local markets were changing the risk profile of risks written in the London market.*

Cyber exposures

Growth in cyber was mentioned both as additional coverage to existing classes and as a stand-alone class. Many insurers expressed the view that they were unable to obtain explicit exclusions for cyber on non-UK risks – in part blaming external market pressures.

Impact of mergers and acquisitions amongst insurers on the reinsurance market

The impact of recent M&A activity was seen in equal measure as both an opportunity for and presenting no material impact on the reinsurance market in the short term. In some cases this feedback was supported by the view that relationships would remain important in this market and insurance buyers would need to diversify their risks across multiple carriers.

Aggregate covers

A trend noted last year and which continued in 2016 was the move by insurance buyers towards cross-class aggregate covers. For reinsurers, this trend is expected to change the risk profile and requires sharp focus on appropriate correlations to ensure the assessment of risk is not compromised.