BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Gareth Truran
Acting Director, Insurance Supervision

Chief Executives of general insurance firms
regulated by the PRA

5 November 2019

Dear CEO

PRA current areas of focus for general insurance firms

As we approach the year end, I am writing to set out our priorities for the general insurance sector in the months ahead, along with some feedback from our supervision activity across the sector over the last year. We are also writing today to holders of the chief actuary senior management function of UK general insurance firms to outline the results of some recent actuarial review work on reserving and claims handling[1], some of which I refer to in this letter.

Our priority areas of focus for general insurance firms over the coming year are as follows:

- Reserve adequacy and associated reserving governance and controls, particularly in the light of emerging risk developments including in the US;
- The extent to which firms are demonstrating discipline in underwriting strategies remediation activity and controls, notwithstanding recent rate rises in some specialty lines;
- Emerging risk trends and experience in firms' exposure management practices, including both natural catastrophe and man-made accumulations;
- Understanding UK retail general insurers' responses to the FCA's pricing practices review, once this review is finalised;
- Ensuring firms develop and maintain a culture where staff feel able to speak up and raise concerns, with effective mechanisms in place to support them in doing so (including mechanisms to ensure access for control functions to non-executive board members).

I cover some of these points in more detail below, and draw out some examples where we have seen weaknesses in firms' controls across the sector. You can expect our supervisory focus over the next year to include discussions with you, your boards and your management teams to understand how your firm is addressing these issues to the extent relevant to your business.

Reserving adequacy, governance and controls

There have been signs in recent months that the risk of reserving deficiencies may be increasing in some lines of business, particularly in specialty classes. Some firms have reported material reserve strengthening, and we see increasing areas of emerging risk particularly in some US casualty lines such as financial and professional lines, medical malpractice and general liability classes. Our Dear Chief Actuary letter also highlights some specific areas of concern relating to individual case reserve adequacy, future claims inflation and attritional loss deterioration on older years of business. Furthermore, we have heard some anecdotal concern that commercial pressure from management

[1] https://www.bankofengland.co.uk/prudential-regulation/letter/2019/letter-from-james-orr-feedback-from-recent-pra-reserving-reviews

to deliver improved results may sometimes translate into actuarial judgements being challenged disproportionately where there may be areas of potential prudence, with less focus on areas where there may be potential reserve inadequacy. Where relevant, we will expect management and boards to be especially vigilant on these issues as they consider the appropriateness of their reserves and solvency positions as we approach the year end.

Some of our work on reserving has also highlighted some broader areas which should be of more general interest to senior management teams and boards. These are set out in more detail in an annex to this letter. In particular we have seen examples where:

(i) reserve deterioration over recent years raises concerns about ongoing optimism within firms' reserving and business planning assumptions, and where firms may be taking credit too quickly for underwriting remediation activity;
(ii) there are underdeveloped links between internal business and control functions with the result that key underwriting, claims and reserving trends may not be being picked up and acted upon quickly;
(iii) there is insufficient MI and transparency at board level about the key judgements being made when setting reserves, to help boards understand and challenge where reserves are being set within a reasonable range; and
(iv) weaknesses in underlying data quality are limiting firms' ability to identify and act on trends relating to underwriting performance, reserving and exposure management.

Given this backdrop, you can expect reserving to be an important area of supervisory focus for us in the months ahead, particularly for firms with material exposures to longer-tail casualty lines, firms who show a poor track record of reserving developments compared with initial assumptions, and those who have shown rapid growth. You can expect the PRA to:

- challenge management and boards to justify material reserving assumptions particularly for classes of business where the risk of reserve inadequacy may be higher;
- work closely with Lloyd's on the adequacy of reserving positions for Lloyd's syndicates;
- consider use of skilled persons reviews commissioned under section 166 of the Financial Services and Markets Act to provide an independent view on the adequacy of individual firms' reserving governance, controls and reserving levels;
- challenge firms with approved internal models to ensure that allowance for reserving risk within models remains appropriate, bearing in mind these emerging reserving trends; and
- if necessary, consider use of further supervisory responses including use of our formal powers where we judge that a firm's technical provisions may be inadequate.

Underwriting conditions

In May 2018 we wrote to you setting out our observations of our recent work on underwriting controls and exposure management, particularly in the London Market. We asked firms to assess their controls against our letter, and we published an update on this work in December 2018 setting out some areas where we judged firms' responses to be weak.

Since last year, some further notable large losses have occurred – some with unexpected risk characteristics – and market conditions have evolved to include some signs of rate hardening. While some firms appear to have adapted their strategies and business plans, others are still struggling to achieve underwriting profitability and have not yet completed remediation work to deal with potential underpricing of risk. We will continue to challenge firms to justify their position where they lack credible plans. For Lloyd's managing agents, we will continue to work closely with Lloyd's, taking into account in particular the work of Lloyd's Performance Management Directorate in approving and monitoring syndicate business plans.

Our supervisory work also continues to highlight underwriting control weaknesses which affect firms' ability to understand profitability and exposures at a sufficiently granular level. In such cases we will expect firms to be able to demonstrate how they are adjusting their underwriting strategies, risk appetites and business plans accordingly and how they are taking action to address material control weaknesses.

Exposure management

Recent natural catastrophe experience reinforces the need for firms to assess the adequacy of their exposure management data and controls, and their risk mitigation strategies. Some key perils may be changing in their nature, frequency or severity, may involve greater loss development than previously assumed, and may be accompanied by new or changing secondary perils, aggravated by the change in underlying exposure at risk. Examples include recent wildfire losses, tropical storm-induced flooding, and non-property lines impacted by natural catastrophe events. We encourage firms to consider whether their historical information and models continue to represent current hazard and exposure trends.

Over the last year we have undertaken a series of exposure management reviews and we see a number of areas for improvement. We expect firms with material catastrophe risk exposures – or those planning to expand their exposure materially – to take these potential weaknesses into account when reviewing the appropriateness of their risk appetites and exposure management controls. For example, although firms are aware of the potential for changing and emerging catastrophe risks, many still stop short of assessing those appropriately despite the existence of relevant tools (e.g. flood, wildfire, casualty cat models). Equally, we remain concerned that some firms place excessive reliance on estimates of exposure which have been derived from complex models, especially when setting their exposure tolerances and reinsurance strategies. Such firms may experience losses which are much larger than expected if these model assumptions prove misplaced (e.g. through inadequate post-loss amplification or contingent business interruption allowance). We encourage firms to consider back-testing actual and near-miss losses against modelled estimates, which can highlight firms' potential for model error when assessing current hazard and exposure trends.

In the coming months, we intend to undertake a sample review of firms' exposure management approaches to assess the adequacy of firms' aggregated risk quantification against the changing characteristics of natural and man-made perils. Firms' responses to our recent Insurance Stress Test exercise should also help give insights into these issues, as should the Bank's planned future work on climate stress testing.

More broadly, we continue to encourage work across the industry to develop more robust approaches to assessing man-made catastrophe risk, which we believe is an underdeveloped area given the changing nature of risk and firms' portfolios. On cyber risk, we have asked firms to develop action plans to address residual 'silent' or 'non-affirmative' cyber exposures, in the expectation that firms who have not yet acted will be able to show demonstrable progress in the months ahead. On casualty catastrophe risk, we welcome industry-wide initiatives to improve data standards and undertake forward-looking exposure-based assessments challenging historic loss information, especially for lines of business where losses may be scarce or non-existent.

Culture and support for control functions

Recent public reports relating to sexual harassment and bullying within the London market are of deep concern and it is clear that some firms have more work to do to improve aspects of corporate culture and individual behaviour. As indicated in Anna Sweeney's speech[2] in June, instances of non-financial misconduct could speak to personal integrity and may have implications for our view of the fitness and propriety of individuals within our Senior Managers and Certification Regime. We are encouraged by some of the important initiatives that are now under way within the market to improve this position. We will also continue to work closely with the Financial Conduct Authority to assess instances where inappropriate culture and behaviour within firms may impact compliance with regulatory expectations, standards and our statutory objectives.

Beyond the specific examples highlighted, these issues also raise broader questions about whether firms are promoting a culture where staff feel able to speak up about poor practices or unidentified risks within their organisations, including issues relating to a firm's financial soundness. We remind Boards that they have a collective responsibility for articulating and maintaining a culture of risk awareness and prudent management of risk for their organisation. These questions may be more acute at a time of challenging market conditions, when commercial pressures may be high. For example, key prudential judgements such as reserving assumptions may attract particular management scrutiny given the potential impact on reported results. Senior management should be careful to ensure that commercial pressure to deliver results does not translate into inappropriate pressure on individuals within control functions to weaken assumptions. Boards should be alert to this risk and ensure that the effectiveness of the risk control framework is supported by the organisation's culture.

Management and boards have clear responsibilities to ensure a culture of prudent management of their firms and they should consider how best to foster an environment where control functions can best assist management and boards in exercising this responsibility. As well as formal channels such as whistleblowing, we encourage boards to consider what other internal mechanisms may be useful in supporting key function holders and allowing board members to understand directly their views and perspectives. For example, some heads of control functions such as Chief Actuaries have told us that they do not have routine opportunities to meet non-executives outside formal board meetings. We would encourage firms to put in place such mechanisms where they do not already exist.

Conclusions and next steps

The issues in this letter will be priority areas of focus for us across the sector in the coming year. We would encourage firms to assess these points and consider whether the issues we raise are relevant to them. In the first instance, we would expect a discussion of this letter at the board, supported by more detailed analysis of the specific issues highlighted in our Dear Chief Actuary letter, in order to identify actions that you believe should be taken for your firm.

In our supervisory interactions with you in the coming months, you can expect us to discuss these issues further with you and to understand what actions you have decided to take. In the meantime, please contact your supervisor in the first instance if you have any questions.

Yours faithfully

Gareth Truran

Gareth Truran
Acting Director, Insurance Supervision

[2] www.bankofengland.co.uk/-/media/boe/files/speech/2019/making-impactful-change-speech-by-anna-sweeney

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Annex - Examples from recent PRA supervisory work on reserving

Optimism within business plan and reserving assumptions

We see a number of firms who have demonstrated a poor track record of reserve deterioration. In some cases this appears to reflect undue optimism in original business plan loss ratios (where business plan loss ratios are a significant input into reserves at early stages of development). In other cases, firms appear to be taking credit for the potential benefit from recent underwriting remediation actions when setting loss ratio assumptions, before evidence has emerged to confirm that these actions have had the desired effect. In such cases further work may be needed by firms to justify the level of reserves and business plan loss ratios being set. We would expect management and boards to pay particular attention to this when challenging reserve assumptions and future business plans.

Key risk trends may not be being picked up quickly, due to weak links between control functions

We see examples where regular information-sharing between relevant key functions such as pricing, claims, reserving, exposure management and actuarial is underdeveloped. This raises a clear risk that important emerging developments identified in one area are not recognised sufficiently quickly in the assumptions being made by other functions. We encourage firms to consider how they can ensure that key trends are communicated quickly and more effectively across functions.

Insufficient transparency when setting material reserve assumptions

Our review work has highlighted examples where board and management committees do not appear to receive sufficient information to assess the adequacy of the most material reserving assumptions, and understand potential areas of key uncertainty. Firms should consider how they can support actuarial functions, relevant boards and reserving committees to make fully balanced reserving judgements, including understanding clearly where key reserving assumptions are being set within plausible ranges. We have also heard examples where management challenge of actuarial reserving assumptions seems to focus disproportionately on areas of potential reserving surplus, with less focus given to areas where there may be a case for reserve strengthening. Management and boards should consider the potential adverse consequences of such an approach given their responsibilities for the prudent management of their firm's financial position.

Data quality issues

A number of firms are struggling with the consequences of poor-quality underlying data. Causes include inflexible legacy systems, insufficient controls over initial data capture, and data being stored in formats which prevent effective analysis. In a number of cases we have observed actuarial teams and other control functions having to spend significant proportions of time and resource cleaning data for analysis rather than using the data to inform high-quality decisions. This limits firms' ability to identify and respond to trends quickly. Responsibility for ensuring satisfactory firm-wide data quality goes beyond any single control function such as the actuarial function. Management would therefore benefit from considering their data quality management strategy both at the level of individual control functions and across the business as a whole.

The PRA also makes extensive use of Solvency II quantitative reporting relating to technical provisions. We have identified a number of data quality issues in these reports as part of our review work this year. We plan to increase our plausibility checks on this data and your teams can expect follow up enquiries from us when regulatory reporting data appears to us to be inaccurate.