BANK OF ENGLAND

Speech

Dealing with a market-turning event in the general insurance sector

Speech given by

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Thank you for inviting me to speak today.

My brief was to talk about the PRA's supervisory priorities for the general insurance sector. You will have seen from my letter over the summer and David Rule's speech last week at GIRO that soft market conditions, particularly in the London Market, are the matter that exercises us most and we believe presents the most material risk to our objectives of safety and soundness and policyholder protection for GI firms. The robustness of firms' oversight of technical pricing, exposure management, and reserving levels, remain core areas we are focusing on in our supervision. We have already set out on a number of occasions our views on the issues we see in these areas.

Alongside our work on understanding firms' responses to soft market conditions, we have also been doing some preparatory thinking on what might happen in the event of a large general insurance market loss. Such an event might affect firms' financial positions significantly and might also change conditions in the market in a number of ways. We published a consultation paper on this last week, and so I'd like to focus today on the background to this work and to highlight what we have been doing to take forward our thinking on this issue.

Background and context for work on MTEs

History shows that at the time of a large general insurance loss, a number of things can happen. First, given the nature of these events, it can take some time for firms to fully understand their position and to come up with reliable estimates of losses. Secondly, premium rates can rise in the aftermath of an event as surplus capital falls, firms take stock of their exposures, and capacity withdraws from the market. Thirdly, some firms are likely to want to respond to higher premium rates by writing more business. All of these raise important issues for firms and the PRA as we work collectively to understand the impact of the loss and to decide how to respond.

It has been over a decade since the last such event occurred on a scale which had a significant impact on insurers' balance sheets. The sector has also changed in a number of ways in recent years. The systems, models and data available to firms have evolved, and the market has become even more global in nature. Regulatory standards, structures and cooperation arrangements have also moved on; within the UK, firms now operate under Solvency II which includes revised capital and risk management standards, and specific provisions relating to the actions required by firms in difficulty. Given these changes, we think it is sensible to devote some time now to planning for how we might collectively respond if such an event happens.

We are aware that views differ in the market about the likelihood of an event being able to cause a significant impact in current conditions, given the levels of capital in the market, and a belief that further capital may be sitting on the sidelines waiting for an opportunity.

These extreme events are – by their nature – hard to foresee. We have avoided trying to speculate about what type of event it might take, or the probability of it happening. Rather, we think it is prudent to assume that at some point, an unexpected or very large event will occur that causes significant losses to firms and possibly cause market conditions to change. We have focused on the issues which might arise in such a scenario – both for regulators, and for firms, and how we can ensure we are as well prepared as possible for such an event.

What are the issues the market and regulators are likely to face?

In the event of a large insurance loss on the scale we are assuming, firms and regulators are likely to have a number of important judgements to make.

First, firms will need to form as accurate a picture as possible of the impact of the event on their financial position, in conditions of great uncertainty. Some firms might be affected significantly and might have to consider whether they can continue to trade. They would need to consider what steps they might need to take to recover – for example, in the event of a breach of their solvency requirements. Other firms might be more confident about their future position and keen to act quickly, including by responding to higher rates by writing more business. In either case, firms might look to seek access to further capital to rebuild their position or to facilitate writing more business.

Faced with such a scenario, a firm's board would need to consider carefully what judgements to make on these issues given their various legal obligations, and the likely incomplete nature of the information available to them at the time. Firms might also need to notify or seek regulatory approval for some of the steps they intend to take.

At the same time, we at the PRA would also obviously be keen to understand as quickly as possible the impact of such an event on the general insurers we regulate. In the initial stages after an event, we are likely to be in close and regular contact with firms to understand their assessment of the event's impact, and we would expect firms to be discussing with us proactively any significant issues they are facing or significant changes they plan to make in response. We will expect firms to be able to explain to us the judgements that firms' boards have made on these issues, including the assumptions they have made when coming up with their initial loss estimates, and the information available to underpin their judgements.

In circumstances like this there are likely to be a number of important regulatory judgements for the PRA to make in discharging our objectives of policyholder protection and financial stability.

Whatever the event, we will clearly wish to assess the ability of individual firms to continue to operate in line with their solvency requirements and other minimum standards, and to assess what actions should be taken if a firm cannot identify or implement steps to recover within the timescales required by our rules.

At the same time, there might also be circumstances in which firms' responses to an event could impact more broadly the availability of certain insurance coverage to policyholders, which would be relevant to the PRA and the rest of the Bank given our wider financial stability remit. Provided firms have the necessary financial and non-financial resources to support their commitments, firms might argue that the ability to write further business at higher rates could help the sector rebuild profitability and capital, and facilitate the continued provision of insurance to those who need it.

Whilst we can all recognise that there might be trade-offs to make here, it is not possible to identify fully in advance what specific judgements might be required in weighing up these issues. We do not expect firms to have a crystal ball in this respect, and nor can I prejudge the decisions the PRA might need to take in response to a particular event. These decisions will inevitably depend on factors which can only be assessed at the time – for example, the precise circumstances of the event, its impact on firms, the quality of the information available on which to base decisions, the extent to which firms can source additional funding to support future business, and an assessment of any broader adverse consequences on the market. Recognising that speed is of the essence, the PRA will take the decisions it believes appropriate at the time to discharge its statutory objectives of policyholder protection and financial stability, working closely as necessary with colleagues in the wider Bank of England and other authorities to consider any wider impacts on the market. Part of our own planning is about how we can respond as quickly as we can whilst meeting these objectives.

Whilst we cannot predetermine the precise decisions we will face in a real scenario, we think that there are still things we can all be doing to consider in advance what information we are likely to want in such circumstances – to help us prepare for the type of issues we might face.

Specific issues for PRA and firms

Within the PRA, we have thought about the information we are likely to seek from firms to help us understand the initial impact of the event, how it might develop over time and to understand firms' judgements on their financial position. We have considered what internal management arrangements we would put in place to coordinate our response to the event, to enable us to take decisions and to manage flows of information with other key stakeholders. We have also thought about what notifications or applications we might receive from firms.

We also believe there are a number of things that firms can do in advance to think through the decisions they themselves might face and to improve their level of preparedness. For example, what kind of information would a firm's board want to see after an event in order to inform its own judgements about the position of their firm and its ability to continue to trade? How quickly could a firm pull together the relevant information on exposures and possible losses needed to inform these decisions? What information might a firm's parent wish to see to meet its wider group information requirements? What assumptions are being made (about the availability of further capital from a parent company or other shareholders), and have these assumptions been tested? What notifications or applications might a firm need make to the PRA or other bodies and can some preparatory work be done in advance?

To explore firms' existing thinking on these issues, we held a number of discussions earlier in the year with insurers operating in the London Market, and we also commissioned an external survey of a focused sample of firms. This work highlighted some notable differences as to the level of detailed planning firms had undertaken on these issues, and also revealed some possible misconceptions about how events might unfold or what actions might be required, including what notifications and/or approvals firms might be required to obtain from the PRA or what contact firms should expect to have with us.

We have used the findings of this research to inform our own on-going work in this area and help shape our thinking. The paper we published last week sets out some factors we believe firms should be considering on this topic. For example, we think there are things firms can do in advance to consider what data they would be able to gather, and what information their boards would want to see. Where firms plan to write significantly more business after such an event, we highlight in the paper a number of factors we would expect firms to have considered in reaching their decision, and to be able to justify their analysis if asked. This is likely to be easier if firms give this some thought in advance and consider how they would be able to address these issues at the time.

The paper also highlights some data we believe we are likely to want to collect from firms to help understand firms' positions and to help us make early judgements on the most appropriate supervisory response. We would consider how this request might need to be tailored at the time to reflect an actual event, but we are sharing this now to help firms consider in advance how they might be able to deal with such a request if and when the time comes.

The paper also highlights some of the uncertainties that will inevitably exist in a scenario like this, that we will all have to bear in mind when considering how to respond. Losses from such events often develop over time, so however good a firm's systems and data, it may take some time for a settled view of the impact of the event and its longer-term consequences to become clear. This has implications for firms' future planning and it is important that allowance is made for the likely uncertainties in these initial loss estimates when a firm is projecting its future position.

Our work earlier in the year also revealed that firms were particularly keen to understand our expectations in relation to internal models immediately after a major event. Alongside our paper on market-turning events, we also published last week a statement on our expectations of firms in relation to model changes. In summary, whilst we would expect internal model firms to consider the impact an event might have on their models and assessing how these might need to be updated, we recognise that it might take some time for this to be done properly as information emerges about the event, and as firms assess whether the event should change any of the key assumptions in their model. Given this might take some time, we would expect to discuss with firms what other steps might be needed in the interim to compensate for any weaknesses revealed by the event.

Interactions with other stakeholders, including Lloyd's

In considering such an event, it is also important to recognise that there are a number of other key stakeholders in both the public and private sector who are likely to play an important role.

For example, for participants in the Lloyd's market, we would expect that after an event there would be close coordination of activity between managing agents, the Society of Lloyd's and the PRA in gathering information on the impact of the event and how managing agents might plan to respond.

As supervisor of the Society, the PRA will wish to understand the impact of the event on the Lloyd's market as a whole, and to assess the ability of the Society to meet its own regulatory requirements at a market level. We would also plan to work closely with Lloyd's to understand the impact of the event on individual agents and what actions the Society planned to take across the market. In line with our general co-operation agreement with Lloyd's, we would hope to minimise duplication in information requests. We know from our discussions with Lloyd's that the Society plans to say more to managing agents in the near future about how it would intend to work with the market after such an event to gather information and deal with possible requests from managing agents.

Although the precise details would need to be agreed at the time, in many cases we would envisage that Lloyd's might well take the lead on many of the discussions required with individual managing agents to understand the financial impact of the event and to assess any proposals from agents to amend syndicate business plans. We would also envisage that in many cases the PRA might well be able to obtain much of the information it is likely to need from the Lloyd's market by using data collected by the Society, rather than the PRA having to make separate requests to individual managing agents.

That said, there might, of course, be cases when the PRA would wish to enter into its own dialogue with individual managing agents on the impact of an event or an agent's proposed response, based on our assessment of the issues at the time.

As well as Lloyd's, there will be a number of other stakeholders which will have an interest in a response to a significant event. For example, firms might have a variety of obligations they would need to fulfil including to shareholders, other investors, and to their staff. For our part, we would be liaising closely as appropriate with Treasury, other regulators such as the FCA and fellow overseas prudential regulators where we supervise different entities within groups and where we are members of supervisory colleges.

Industry dry-run scenario

Before I close, I should also mention that alongside our own work, we have also been discussing with a number of firms their plans to test the market's own response to an extreme event of this nature, through a dry-run scenario exercise planned for November. This exercise involves a number of market participants including firms, industry bodies, and brokers, and we are also providing input. We welcome industry initiatives of this nature as a useful complement to our own work in this area, and will continue to engage with them as appropriate to ensure that we understand any lessons which emerge of relevance to us as regulators.

Conclusion

Let me finish by saying that we regard this as an area in which we can all look to work collaboratively to improve our collective ability to deal with such events. In our consultation paper and in my accompanying remarks today, we are trying to be as transparent as possible in highlighting some of the issues we think are relevant for firms and the PRA's own response to an event of this nature. I would invite firms who could be affected by such an event to read and respond to our consultation paper, and to consider what actions they could usefully be taking now to ensure they are as well prepared as possible for such an event when it occurs.

Inevitably, any planning we do will not anticipate all the issues we will have to face in a real event, and none of us can prejudge what precise decisions or actions will be required if and when the time comes. But better planning now should hopefully enable us all to have a more efficient and effective dialogue at the time. All other things being equal, we would hope that time invested in planning now should improve our collective ability to respond appropriately to the challenging circumstances we might face, so that we can protect policyholders and minimise any disruption to the wider market. We welcome feedback on the consultation, and stand ready to discuss these issues with firms in more detail.

Thank you. I am now happy to take questions on this or any other topic.