



BANK OF ENGLAND

Speech

Managing risk in a soft market

Speech given by

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Good morning.

This is my first speech as the Bank's Executive Director for Insurance Supervision. Since I took on this role in July, I have been trying to meet with as many chief executives and chairmen of UK insurers as possible. I have been struck by the variety of business models and strategies but one theme has dominated discussions of the risks facing insurers: the current low rate environment. For life insurers, this can create direct solvency pressures to the extent that they are not fully matched against the increasing value of their future liabilities as discount rates fall. That can also be an issue for some general insurers with long tail liabilities. More generally, low investment returns mean earnings on the 'float' can no longer cushion a poor underwriting performance. The margin for error in the running of general insurance firms has reduced – firms have to underwrite profitably. On the positive side, this emphasises the importance of underwriting discipline.

The soft market

But of course the current soft market makes profitable underwriting more difficult to achieve. I am going to focus my remarks today on the wholesale London markets. Although I have been told of some tentative signs of premium rates stabilising recently, they have been falling across most wholesale lines for around a decade now. For example, Guy Carpenter's Global Property Catastrophe Rate-On-Line Index has reduced by more than a third since its peak in 2006. Our market survey earlier this year found further year-on-year declines (Chart 1).

Looking at the possible causes of the current soft market, it is surely in part just another manifestation of the wider low return environment. The most obvious evidence is the inflow of capital to the market from institutional investors. Perhaps to a greater extent than historically, insurance is interconnected with wider capital markets and market forces have driven expected returns more into line with other investment opportunities.

These wider pressures may explain a squeeze on profits. But insurers should still be pricing to cover their view of risk. At the beginning of 2016 we carried out a survey that captured views on the rate adequacy of new and renewed business. The results suggested that the estimated rate adequacy of new business is, in most cases, higher than renewed business. Whist this may reflect what many insurers tell us – that they only want to grow in segments that they believe are adequately priced; another interpretation is that some insurers are being overly optimistic on risks for which they have no or limited historical claims data and which previous risk carriers have declined as they no longer believe them to be adequately priced.

Despite falling premium rates, general insurer profits in the past few years have been sustained by both benign catastrophe experience and levels of prior year reserve releases that are now the highest for thirty years (Chart 2).

Natural catastrophes are a major component of many GI firms' risk profiles. Catastrophe losses returned to more normal levels by historical standards in the first half of this year. But the low incidence of catastrophic events in recent years may have given support to the idea that this component has in some way diminished, whether due to trends in nature or more effective management of risks by policyholders and insurers. I have also heard speculation that some man-made risks may have decreased: for example, if planes and ships are built better than previously, or if companies are better at managing their risks. Mindful of both the impact and the uncertainty involved in considering this, we would expect firms to seek the best available evidence and to take a prudent and comprehensive view to the assessment of risks. Put simply, we would not expect a handful of recent data points to lead to a marked reduction in a firm's assessment of its best estimate of liabilities nor its '1 in 200' risk.

Turning to reserve releases, our obvious concern is that these should reflect genuine reserve redundancy with the decisions taken by risk managers and actuaries using their best professional judgement and not in any way influenced by a desire to sustain reported profits. For long tail lines, such as casualty, a key assumption in setting reserves is the expectation of future claims inflation. In most cases this assumption is derived implicitly using the recent actual data and trending this forward. Given that the recent past has seen falling inflation in many sectors the obvious question is - is it reasonable to assume that these trends will continue? It does seem plausible that claims inflation has often been lower than expected against the background of the current low inflation environment. But our calculations suggest reserve releases have in some cases got to a point where implied future claims inflation looks very low. In an extreme case, we estimated past claims inflation for the class of business to be 5% per annum, whereas to obtain the particular insurer's booked reserves would imply a future claims inflation assumption of -2%. If the future trend is in fact in line with past inflation, booked reserves would need to be 25% higher than currently assumed. Insurers that have sought to diversify and grow their business into longer-tail liability insurance classes have critical questions to answer about the future direction of claims inflation.

Managing risk in a soft market

Speaking to firms about their approach to the market, they often talk about prioritising margins over growth, focusing on more profitable lines of business – for example, where they have established strong market positions or a particular niche, and making more active use of reinsurance. These all seem sensible approaches for an individual firm but, in aggregate, the risk must end up with someone. One indicator of the competitive pressure on insurers to source new business in the wholesale markets is that brokerage commissions have been increasing as a share of gross written premiums despite the common desire to lower costs in line with lower premium rates.

Looking forward, the key challenge for insurers is how they preserve or even grow their activities while avoiding the 'Winner's Curse' of under-pricing in order to get the business. The PRA is not a price-regulator. But we are concerned to see that firms are adequately managing their exposures –

that they can identify and quantify the risks being covered, manage and control overall exposures, and estimate likely claims costs under different loss scenarios.

Against this background, I make no apology for repeating the points made earlier this year by my colleague Chris Moulder, our Director of General Insurance, in a Dear CEO letter and subsequent speech.

First, *underwriting*: we expect Boards to be relentlessly inquisitive in understanding and challenging the effectiveness of underwriting controls, pricing trends, exposure changes and rate adequacy in order to make informed decisions, and provide meaningful challenge, to the business. Fundamentally, the Board should seek evidence that underwriters are maintaining appropriate discipline.

Second, *reserving*: a robust approach to the setting of reserves and appropriate and adequate oversight of the reserving process is vital. We expect Boards to demonstrate independent challenge of key issues, material uncertainties and significant assumptions in the reserves and the rationale for their choice of booked reserves.

Third, *reinsurance*: we expect Boards to ensure that the economic impact of the reinsurance transaction is appropriately reflected in business plans, capital setting and reserving; and to be alive to the wider risks to which reinsurance placements can give rise. This includes ensuring the total risk and uncertainty over the claims run off has been captured in your risk management system and considered within your ORSA.

Fourth, *capital*: we expect Boards to ensure that firms assessment of risk and capital requirements remain valid in this challenging trading environment.

The new System of Governance requirements under Solvency II and the Senior Insurance Managers Regime are timely additions to the insurance regulatory regime, ensuring that clear expectations are being set as to the strength of systems and controls, and that there is clarity as to the roles and responsibilities of senior managers in firms.

Possible market-turning events

Previous soft phases of the insurance cycle have ended, sometime quite dramatically, with a major loss. Examples include Hurricane Andrew in the early 90s, Asbestos, Pollution and Health losses in the mid-90s and '9/11' in 2001. Whilst it is understandable that some in the industry talk of the need to have naïve capital and capacity cleared out of the market, restricting supply and supporting premium above the technical price level, there is a sense that, this time, things may be different. Many believe that further capital is 'waiting in the wings' to invest in the sector in the event that prices rise.

Nonetheless, it is sensible to plan on the basis that a significant, market-turning event might occur at some point. Taking this as the starting point, we think there is an opportunity for firms to think through what issues

might then arise and to consider what steps can be taken now to plan for these events, not least because we know some firms will be very keen to respond to any improvements in market conditions which might arise after a large loss event. We are publishing today a consultation paper setting out our expectations of firms in planning for these types of extreme insurance loss events; focussing on some of the governance, risk management, capital management and reporting capabilities that we think firms need to consider. The guidance also sets out an indicative template containing the type of information we think we will request from firms following a loss, and also expectations of firms with approved internal models.

We note that this is an area where the Industry itself is keen to ensure that it is well prepared and we welcome working with it on this topic. None of us will have a crystal ball to plan perfectly for such an event, and as decision makers we will only be able to make final judgements on how to respond at the time, once we have the facts as best as we can gather them. However, we still think there is more that can be done to think through how firms would go about gathering initial loss information, what information their boards are likely to need to see to inform their response, and some of the practical challenges which might arise for firms.

Capital and Model Drift

Given the challenging market conditions I have referred to earlier, and the uncertainties I have just discussed, it is all the more important that firms hold adequate and appropriate capital against the risks they face. As you will also be well aware, your and our work in the run up to January this year included significant work on internal models, and it would be unsurprising if there was not some collective sigh of relief within the industry after January given the work involved to get to that point.

But we all know that running an internal model is not just a one-off task, and there is a need for firms to continue to refine the models in the light of experience and as new data becomes available. As regulators, we need to be alive to the risk that when firms select the areas where change is required, and as internal models are updated, there is not some inherent bias towards changes which reduce the firm's capital requirement, at the expense of areas of the model which might be insufficient. We are publishing today our supervisory statement on changes to internal models, setting out our expectations in respect of firms applying for approval for a major change to their approved internal models or an extension of scope to an approved internal model (e.g. to cover new business units or risks). In May 2016, the PRA consulted on its proposed approach to monitoring 'model drift' for firms with an internal model, where model drift is defined as the risk that the capital level generated by an internal model moves gradually over time. Even acting in good faith, business pressures may create the risk that model changes generating lower capital requirements are favoured over time, and therefore that solvency standards might deteriorate.

The PRA's proposed approach includes monitoring the internal model SCR against a number of objective measures such as premium levels, technical provisions, MCR and the standard formula SCR. None are

perfect but all are independent of the internal model, and therefore can help provide us with a different view on the evolution of risk exposures and a safeguard against model drift.

All risk measures have their limitations. So we plan to use a range of measures alongside other supervisory review process initiatives, such as the analysis of internal model outputs.

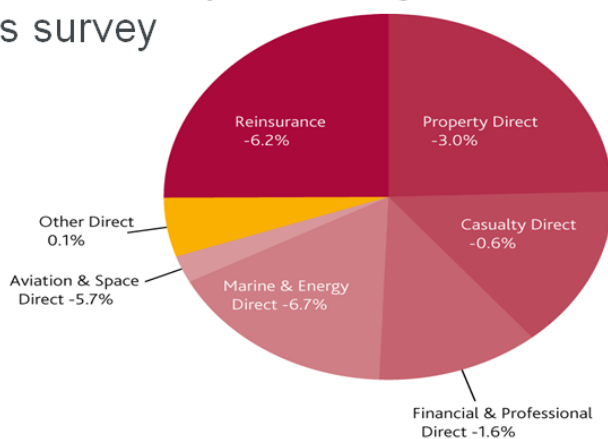
Conclusion

In conclusion, given today's audience, I want to stress the critical professional role of actuaries in current soft market conditions, where there may be a greater tension between on the one hand underwriting discipline and appropriate reserving and on the other hand business growth and current-year profits. Actuaries are responsible for providing assurance on reserves and opinions on both the underwriting and reinsurance strategies of firms, implying strong engagement with the risk function, as well as independence and objectivity in their assessments. Events like today's, where actuaries come together to share knowledge, with the aim of raising professional standards, are particularly important and welcome.

Chart 1

Monitoring-the-market: Underwriting

- Risk-adjusted one-year change in rates from 1/1/2016 renewals survey



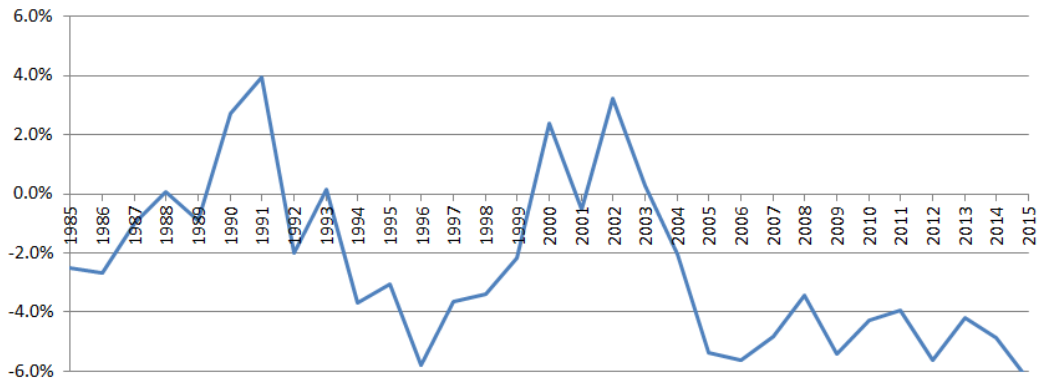
Source: PRA monitoring-the-market survey, March 2016. 1/1/2016 renewals



Chart 2

Monitoring-the-market: Reserving

- Net Reserve Movements in each calendar year



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.



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