BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Chief risk officers of
general insurance firms regulated by the PRA

Lisa Leaman
Head of Division,
London Market Insurance Supervision,
lisa.leaman@bankofengland.co.uk

Vishal Desai
Acting Head of Division,
General Insurance Risk Specialists,
vishal.desai@bankofengland.co.uk

13 November 2020

Dear CRO,

Insights from PRA review work on reserving and exposure management

We are writing to share insights from our recent supervision review work across the general insurance sector focusing on reserving and exposure management, including some observations on contract uncertainty in light of the Covid crisis. We trust this will be useful as your firm prepares for its year-end reserving exercise and plans for the 2021 underwriting year.

As the corporate executive responsible for identifying, assessing, and mitigating risks to the business and a source of independent challenge, we consider the chief risk officer (CRO) is particularly well placed to assess the extent to which the points raised below are relevant to your business and how they are being addressed.

Reserving

Our review work has identified a number of observations evident in reserving data prior to Covid. In turn, it highlights areas of additional complexity and uncertainty which Covid has given rise to. We expect the board and reserving committee to reflect these appropriately and explicitly, to the extent relevant for your business, as part of setting the year-end Solvency II and booked reserves.

Evidence of reserve weakening prior to Covid

Two of the areas of concern highlighted in our previous letter to chief actuaries in 2019[1] persist in our analysis of the latest Solvency II reporting as at year-end 2019 (see Figures 1 and 2 in the Appendix). Firstly, bias in reserve estimates (over-focus on favourable claims development potential, despite evidence of worsening incurred claims experience) and secondly, possible weakening in case reserve estimates. Our analysis indicates that reserving assumptions may have weakened over time, while data shows that the claims experience continues to deteriorate (see Figure 3 in the Appendix).

1 'Letter from James Orr: Feedback from recent PRA reserving reviews', November 2019: https://www.bankofengland.co.uk/prudential-regulation/letter/2019/letter-from-james-orr-feedback-from-recent-pra-reserving-reviews.

While not exclusive to financial lines (indeed similar trends are visible within General Liability as a whole), the observations are particularly noticeable for these classes of business. We recognise that in light of our feedback a number of firms have taken positive steps to revisit key assumptions and reserve estimates, and strengthen these where appropriate. However, others have either not done so or made insufficient allowance for uncertainty. In some cases, these same firms have then experienced continued reserve deterioration, particularly on financial lines. You can expect us to sharpen our focus on those firms that have material exposure to financial lines of business, if we consider that adequate measures have not been taken.

In particular, we encourage the board to satisfy itself that the key assumptions related to the rate of future claims development remain appropriate, that case reserving has not weakened over time, and that there is no unjustified anchoring to optimistic business plan loss ratios. You can expect us to seek evidence of the risk function's involvement in challenging reserving teams, and ensuring that the board is suitably well-informed about the uncertainty the above risks give rise to before it sets the reserves.

Allowance for additional uncertainty following Covid

In addition to the observations above, we note that Covid has given rise to additional complexity and uncertainty in estimating ultimate losses. We group these into four key areas that we encourage firms to consider as part of their year-end reserving exercise.

(i) **Data:** Our work has highlighted that a number of firms have not been able to accurately identify and track Covid exposed policies, leading to unexpected Covid losses. Firms should ensure that this uncertainty is reflected in the reserve estimates and that, where possible, appropriate procedures are put in place to identify and track exposed policies.

(ii) **Discontinuities in historical trends:** For some classes of business, due to the impacts of lockdown on claims reporting and settlement or delayed emergence of Covid losses, it is possible that the claims trends emerging during 2020 may not be reflective of future claims experience. Our thematic work suggests that a number of firms' estimates for Covid losses on casualty classes may be optimistic. Consequently, we encourage firms to make sufficient allowance for the uncertainty related to both the direct impact of Covid losses (where claims may not have yet materialised, or have been incurred but are yet to be reported, or where limited claims information exists currently), as well as the indirect impacts on claims arising from the downturn in the wider economy.

(iii) **Appropriateness of common reserving methodologies**: Given that the historical claims experience may not be a good guide for estimating future Covid losses, alternative approaches such as the use of benchmarking and exposure-based analyses will be particularly useful to consider alongside more common reserving methodologies.

(iv) **Reinsurance adequacy:** Where there is a material reliance on reinsurance to protect against losses, be it intragroup or third party, we encourage the board to satisfy itself that those arrangements are adequate. Our review work highlights that Covid has given rise to situations where coverage may not respond as envisaged, be it from an insurer or reinsurer perspective. This can add to the uncertainty in determining loss estimates and therefore the appropriate reserves to set aside. Consequently, it would be prudent to stress-test the assumptions related to reinsurance recoveries to understand the impact of reinsurance not responding as expected, and then to ensure sufficient allowance is made for this uncertainty when setting reserves.

Exposure management

Our letter to chief executives in 2019[2] highlighted the importance of continuing to develop exposure management frameworks in the light of the changing and evolving nature of risks from both natural and man-made perils. Recent review work has sought to compare and contrast exposure management frameworks across the market, covering property, casualty, cyber, and specialty lines of business. While we have identified a broad range in the quality of frameworks reviewed, a number of common themes emerge among the firms exhibiting better practice.

In general, we have observed that exposure management frameworks for non-property classes of business are less mature than for property classes (see Figure 4 in the Appendix). We have noted that the state of man-made catastrophe risk assessment remains significantly behind that of natural catastrophe risk assessment. Firms at the better practice end of the spectrum have shown a less marked difference between the two, and have been able to demonstrate a more consistent approach across the whole portfolio. In particular, these firms typically have stronger data governance in place, insisting on more consistent data capture across lines of business and setting clear data standards. These firms have also invested in tools and techniques (such as scenario testing) that better support forward-looking risk assessment, and have been quicker to incorporate the impact of emerging risks (eg social inflation, particularly for casualty lines). They have also considered the risk of clash across the portfolio more explicitly, including a more robust assessment of the interdependencies and accumulation of risks between geographies, perils, and lines of business. Finally, we have observed better practice where more considered thought has been given to setting risk appetites against which exposures can be monitored more meaningfully.

We have seen evidence of how these developments have led to an improvement in the overall timeliness, quality, and reliability of exposure management information provided to the board – information that more accurately reflects the interconnected nature of risk exposure and accumulation across the portfolio. In turn, this has supported more proactive decision making (eg portfolio rebalancing to remain within risk appetite).

As an important component of the firm's overall risk management framework, we trust these findings on exposure management will support you in challenging the areas that require further development to better assess risk accumulation across the firm's portfolio. Again, you can expect us to sharpen our focus on those firms which are materially exposed to man-made catastrophe risk and where progress towards better practice remains slow.

Contract uncertainty and unintended exposures

Covid has demonstrated that even those perils (eg pandemics) that are in many ways well identified can contain a severity potential that is not well understood. These events have the potential to expose insurers to unintended and unmonitored aggregations across several lines of business. They can give rise to disputes over interpretations of contract wordings, and in turn increase uncertainty to both insurer and policyholder.

We encourage firms to actively consider whether current risk and capital management frameworks – including current stress and scenario testing – sufficiently address the risks posed by contract uncertainty and unintended exposures. In particular, it may be useful to consider the identification, definition, and monitoring of all risk related to contract wording, including any key assumptions related to expected coverage. This includes the risk related to reinsurance contract wordings (both intragroup and third

---

2 'Letter from Gareth Truran: PRA current areas of focus for general insurance firms', November 2019: https://www.bankofengland.co.uk/prudential-regulation/letter/2019/letter-from-gareth-truran-pra-current-areas-of-focus-for-general-insurance-firms.

party) where coverage may not fully align with all assumed perils or events detailed in the underlying insurance contracts. As part of this assessment, it may also be important to reflect on whether the firm's current risk appetite framework makes allowance for these various risks, quantitatively and qualitatively.

We recognise that some firms have already taken steps to tackle the risks highlighted above, and that others are yet to consider how best to proceed. As part of our ongoing supervisory engagement, we will seek to better understand the issues and challenges you identify as you go through this process, and the approaches you are considering to manage the associated risks.

Next steps

In the coming months you can expect us to discuss with you how you have considered each of the points raised in this letter. In particular, we would expect a discussion of this letter (and the Appendix) at the board risk committee, alongside any further analysis you deem necessary to identify actions that you believe should be taken by your firm in response. We also recommend sharing this letter with the holder of the chief actuary function. In the meantime, please contact your supervisor in the first instance if you have any questions.

Yours faithfully,

Lisa Leaman
Head of Division,
London Market Insurance Supervision

Vishal Desai
Acting Head of Division,
General Insurance Risk Specialists

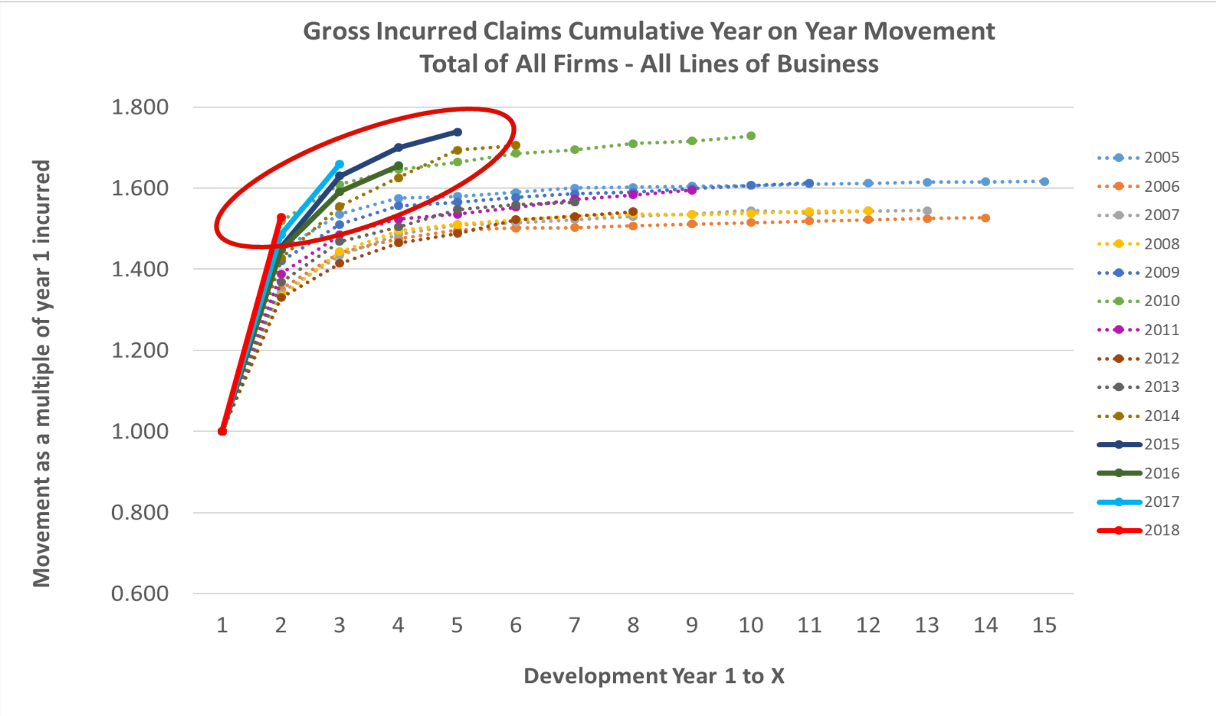
Appendix

Reserving

Figure 1: Deteriorating incurred claims experience for recent accident and underwriting years

The graph below indicates adverse reported incurred claims experience for accident and underwriting years 2015 onwards compared to 2014 and prior; the experience arises from both attritional and large claims. These observations are similar to those highlighted in our letter to chief actuaries in 2019. The graph shows the incurred movement after the first year of development.

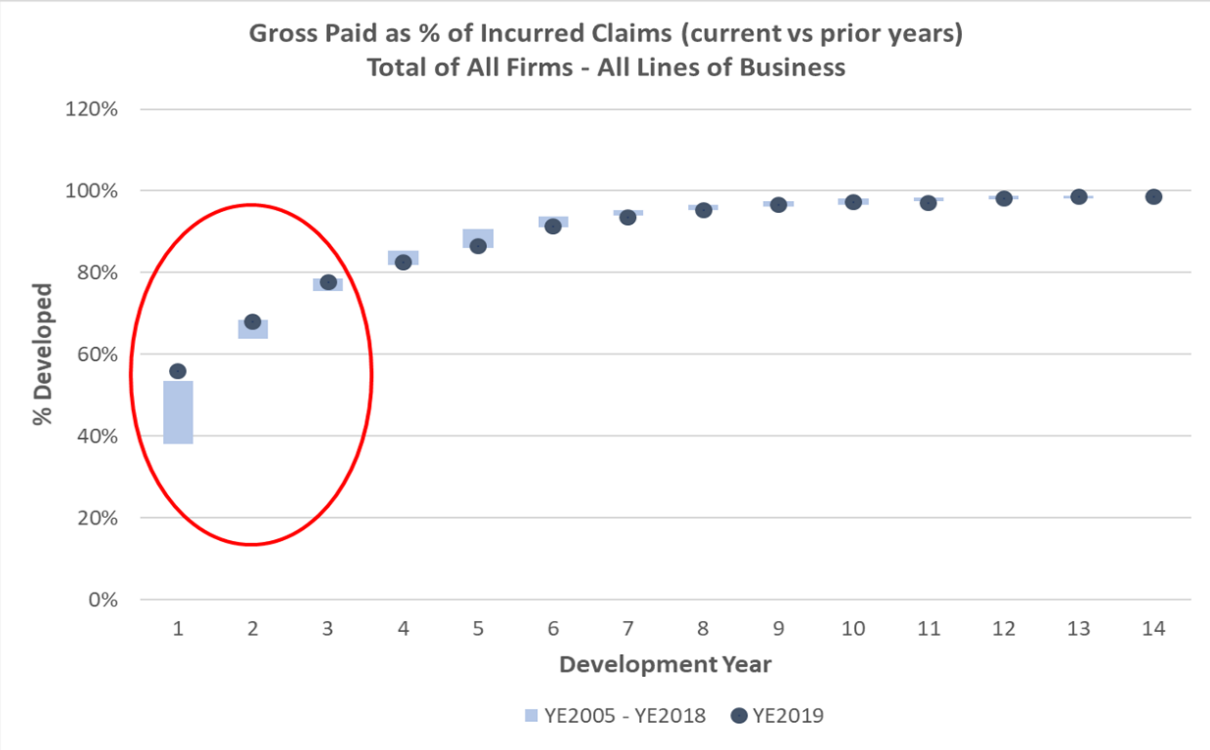
Note that year 2010 is distorted due to large events occurring in year 2 but not in year 1 for firms reporting on an underwriting year basis. The 2011 natural catastrophes (including Australia floods, New Zealand earthquakes, and Thai floods) occurred in 2011 but also impact underwriting year 2010 for some firms.



Source: PRA analysis of Solvency II triangles (form S.19.01) as at year-end 2019. 'Incurred claims' are cumulative paid claims plus reported but not settled (RBNS) claims.

Figure 2: Weakening of case reserves for outstanding claims

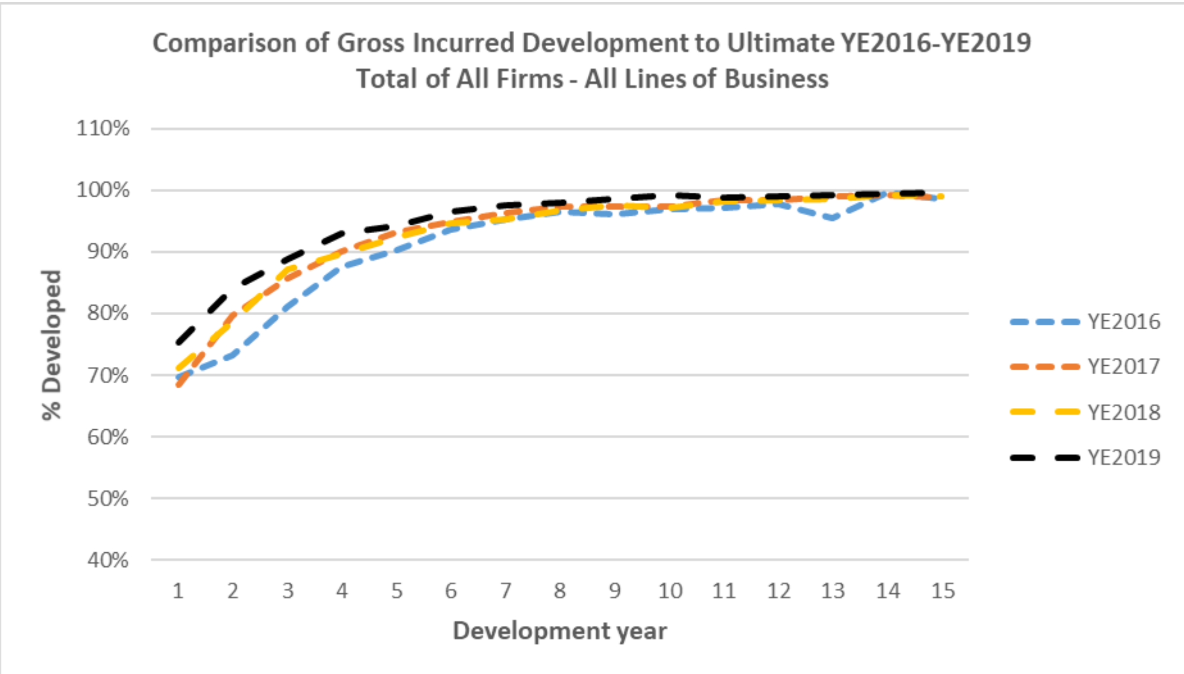
The graph below indicates potential weakening of market case reserve estimates for the more recent accident and underwriting years as at year-end 2019. Similar to our letter to chief actuaries in 2019, for the first few time periods the paid-to-incurred claims as at year-end 2019 are higher than the paid-to-incurred at previous year ends (shown by the dark blue circle being at the top of the bar).



Source: PRA analysis of Solvency II triangles (form S.19.01) as at year-end 2019. 'Incurred claims' are cumulative paid claims plus reported but not settled (RBNS) claims.

Figure 3: Weakening reserving assumptions

The graph below indicates potential weakening of claims trend assumptions as at year-end 2019 versus the assumptions used at previous year ends. The graph shows that the black line (year-end 2019), sits above the lines at previous years, indicating faster implied development to ultimate (which would result in lower implicit reserves, all else being equal).

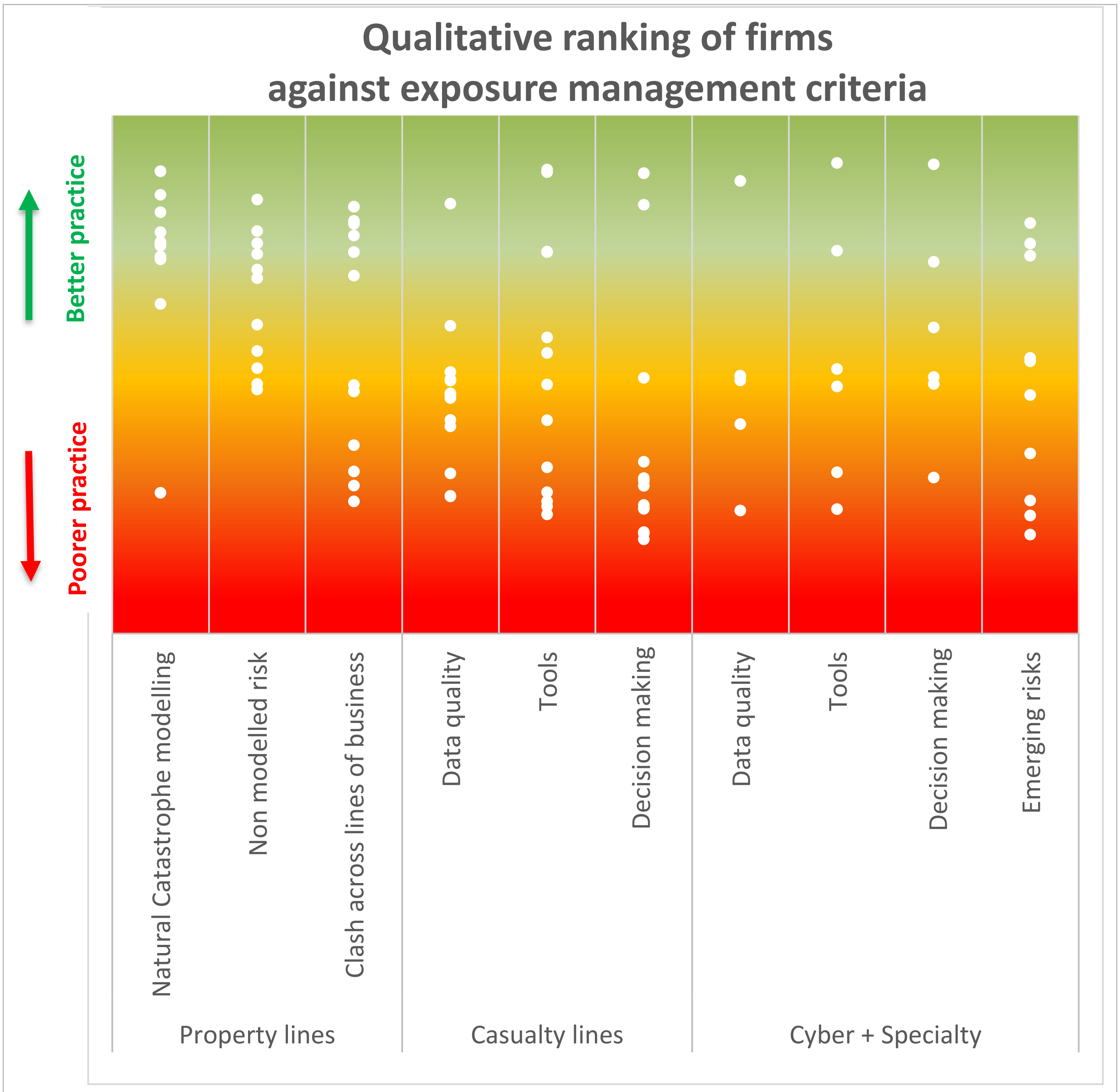


Source: PRA analysis of Solvency II triangles (form S.19.01) as at year-end 2016, 2017, 2018, and 2019. The 'ultimate' claims underlying the graph are based on the undiscounted Solvency II claims provisions triangulations plus the cumulative paid claims triangulations.

Exposure Management

Figure 4: Firms have less mature exposure management frameworks for non-property lines

The graph below indicates the variance, in our view, of the quality of firms' exposure management frameworks across different lines of business. Each dot represents the qualitative ranking of a firm against various exposure management criteria. The ranking indicates that most firms in our sample were less mature in capturing data, developing tools, and making decisions based on exposure management information for casualty lines compared to property, while the picture for cyber and specialty lines was more equally split. Those firms that have invested in developing better casualty data, tools, processes, and controls also exhibited improved quality of management information, which proved more useful to decision making. In contrast, our review identified that where firms lacked accurate and complete data or tools that permit risk accumulation assessment across the wider portfolio, it impaired the firm's ability to understand the potential exposures to risk. This observation was most acute for lines of business where the nature of risk is rapidly evolving, such as casualty.



Source: PRA exposure management review of 16 London Market firms. Qualitative rankings of firms against exposure management criteria.