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Dear CEO

Market conditions facing specialist general insurers: Feedback from recent PRA review work

I am writing to you as conditions in the general insurance market, particularly for specialist risks underwritten within the London Market, remain challenging. There are signs that some of the longer-term prudential risks associated with a soft market, about which the PRA has been warning for a number of years, are now feeding through more demonstrably into firms' reported results. We believe boards of many firms may now benefit from reassessing whether their business models remain sustainable absent further action, and whether controls over underwriting and reserving in specialist lines are adequate in the light of some of the issues we highlight in this letter.

Over the last year, the PRA has prioritised in-depth review work with relevant insurers to assess the adequacy of firms' oversight of underwriting and associated risks given these market trends. This work has included reviews of underwriting controls, exposure management, reserving, and trends in distribution such as the growth in delegated underwriting arrangements and specifically broker facilities. Of course, in 2017 the market also experienced a more active natural catastrophe season, in particular from Hurricanes Harvey, Irma and Maria (HIM), from which we believe some lessons should be learned. We have also recently repeated our regular 'Monitoring the Market' survey the results of which we believe provide further support to our view of market conditions. Further detail on our review work is provided in Appendix 1, and the high-level feedback from our 'Monitoring the Market' survey is covered in Appendix 2.

We wanted to share with you a number of areas where our work has identified weaknesses in firms' oversight of underwriting and associated controls. In some cases, these issues have contributed to underwriting losses and/or to deteriorations in firms' solvency positions which have required remedial action by firms. We believe all relevant insurers would benefit from reassessing whether their operations might exhibit similar weaknesses (and from discussing the actions they might take if so).

Key findings

In summary, our recent supervisory work has shown that:

1. Some firms are now reporting underwriting performance consistently below the levels required to achieve sustained profitability, even in years of low natural catastrophe activity. Although firms are taking some remedial action to improve performance, it not yet clear whether this will be sufficient to ensure future profitability.
2. Some firms are formulating business plans based on loss ratio (and future reserving assumptions) which appear optimistic given current market conditions and firms' historical performance. Firms often justify their views by an apparent belief that they have superior underwriting talent and processes to the rest of the market. Self-evidently, these firms cannot all be correct in their judgement about their relative underwriting strength. Our latest 'Monitoring the Market' survey also highlights a continued

disconnect between firms' perceptions of current price adequacy and their views on recent risk-adjusted rate changes, and a continuing belief that new business pricing is more profitable than on renewal business. Finally, where firms take action to address past underwriting issues, we often see firms take credit too quickly for the expected positive impact of re-underwriting a portfolio before this is justified by results.

3. As well as over-optimism in business planning, some firms appear optimistic in the level of assumed future profitability used when calculating their regulatory solvency position. If so, these firms may be understating the actual capital needed to support business being written. We expect firms to pay close attention to whether business plan assumptions used in regulatory solvency may be optimistic, for example when setting premium provisions and internal model assumptions, and to be prepared to justify their position.¹ Firms with internal models approved for use by the PRA may also benefit from asking independent model validators to pay particular attention to these areas. This will also be an area of focus for the PRA in its supervision in the coming months.
4. In some firms, insufficient use is being made by underwriters of technical pricing models, even for lines of business where such models are generally considered to be more developed and reliable. Some firms are not collecting sufficient data to allow effective monitoring of model performance, there is insufficient monitoring of model use, and in some cases significant overrides of model output are being made regularly without this prompting challenge or review of the underlying models. This suggests such models are not well-embedded in firms' underwriting processes or management information, or that they are not regarded within the firm as credible tools.
5. Some firms have reacted slowly to emerging loss development and are too reliant on managing by business plan loss ratios. These firms are at risk of taking false comfort from pricing models which appear to show business as still profitable despite emerging underwriting results. We have also seen examples of increasing divergence between underwriter and actuarial views on key assumptions, and ineffective feedback loops between pricing, claims and reserving functions which has hampered firms' ability to identify and act promptly on deteriorating trends.
6. In recent years, many firms have diversified from areas of traditional underwriting expertise into new lines of business (for example, casualty classes). In some cases it has since become apparent that these new lines have not been subject to sufficient underwriting expertise or oversight, and we have seen examples where firms have suffered underwriting losses on these portfolios as a result.
7. Firms may be taking false comfort from the fact that their natural catastrophe losses in 2017 were largely manageable from a financial perspective, and specifically that the losses did not cause a significant deterioration in their capital positions. In some cases, although modelled loss numbers were apparently in line with expectations, the composition of the losses contained significant non-modelled elements. This implies that the composition of losses, if not the total, was different from expectation. In some cases, the events also highlighted deficiencies in exposure management approaches. For example, some firms were not able to produce high-level estimates of aggregate exposures within reasonable time periods following HIM for important geographical areas. Other firms appeared to have risk appetites that were set too high to influence exposure management with no clear linkage to underlying underwriting limits. Firms would benefit from considering scenarios in which the 2017 catastrophe losses were even more severe than occurred, to identify opportunities to strengthen their underwriting controls and risk management.

¹ Article 77(2) of the Directive requires technical provisions to be calculated using 'realistic assumptions and adequate methods'. In Supervisory Statement 5/14 we state '(m)any firms use business plan loss ratios to set the level of premium provisions. Using optimistic business plan loss ratios for this purpose is not realistic, and will not produce a best estimate as required by Article 77 of the Directive.' For firms with approved internal models, SS4/15 also makes clear that 'Firms should not assume an improvement in performance relative to that seen in the past unless such an improvement has been clearly justified, in line with the expected Delegated Acts. For example, it would not be realistic to base the internal model on a business plan which assumes improved underwriting results unless the measures taken have been shown to be effective'.

8. In some cases, firms involved in corporate restructuring activity in recent years appear to have suffered losses which may be traced in part to insufficient oversight during the period of transition. Examples include gaps in oversight caused by changes in underwriting management or broader management responsibilities, delays in being able to produce consistent financial information across a wider set of activities, and overall senior management distraction during such a period.
9. Some firms appear to lack management information to allow them to monitor effectively the use or performance of material delegated underwriting arrangements, including broker facilities. Furthermore, some firms may be paying insufficient attention to the adequacy of aggregate exposure data available through some of these arrangements.

Given these issues, we have also looked at how recent underwriting experience has informed the assumptions driving firms' reserving best estimates and, in turn, the level at which reserves are booked. Reserving data highlight that reserve releases have been flattening out and we have seen instances where firms' reserves have required significant strengthening. There is also some emerging evidence to suggest potential weakening of case reserves, particularly on casualty lines, which could point to potential future reserve deterioration. We are undertaking some further work on reserving, and we are planning a follow-up communication later in the summer to feed back our findings in more detail.

Next steps

If current market conditions persist, losses arising from weaknesses in underwriting oversight could pose a risk to the viability or sustainability of some insurers' business models, and ultimately to their prudential soundness. Firms therefore would benefit from considering how they intend to adapt their strategies to ongoing market conditions and from reviewing whether their underwriting and reserving assumptions reflect current market realities. For the PRA, firms who continue to exhibit some of the weaknesses outlined in this letter are more likely to find themselves under increasing supervisory scrutiny.

Although firms individually often take comfort from their own actions to manage these risks while highlighting concerns about the discipline being shown by others, we judge that these risks remain at a heightened level for the market as a whole. I know that most of you have discussed your response to current conditions with your boards on a number of occasions in recent years. But we would like you to arrange a further specific board discussion on the contents of this letter, to ensure that your board: (i) is aware of our feedback; (ii) has considered whether the specific issues highlighted might exist within your firm; and (iii) assesses whether your firm needs to adjust its strategy or business model further, or strengthen oversight and scrutiny of key underwriting controls.

If your firm is classified as a Category 1, 2 or 3 firm by the PRA, we would be grateful for a summary of your firm's response on the issues we have raised, and specifically points 1 to 9 above, by Friday 27 July 2018. We may also look to discuss your response to the issues raised in this letter in our regular meetings with your board members and senior executive management.

Please contact your usual supervisor, in the first instance, if you wish to discuss any aspect of this letter.

Yours faithfully

A handwritten signature in black ink, appearing to be 'Andy', written in a cursive style.

APPENDIX 1 – ADDITIONAL FEEDBACK FROM RECENT PRA REVIEW WORK

Market conditions

Soft market conditions have been a recurring theme of our recent letters to CEOs. Judging by recent reported results, these conditions look set to continue. Results across the market at year-end 2017 suggest that, in many instances, business had reached the point where, in an average natural catastrophe year, it was unprofitable at the prices being charged. The series of catastrophes that occurred in the latter half of 2017 appear to have had limited impact on pricing despite generating material losses for the industry.

This perception is reinforced by the findings of our latest 'Monitoring the Market' survey, which looked at the impact of January 2018 renewals as reported to us by participating firms. The survey responses suggested that, while property rates improved somewhat, such increases were lower than anticipated and largely restricted to loss-affected business. Rates in other, longer tail lines, such as general liability, professional indemnity and directors & officers insurance, were reported to be either flat or down. Further details are included in Appendix 2.

More fundamentally however, results at year-end 2017 suggest that, across the market as a whole, core lines of business have reached an inflection point where, in certain circumstances, they appear unsustainable in the long term. If, as looks likely, market developments during 2018 do little to correct this overall position, firms must actively consider whether further changes are needed to their business models to ensure their long-term viability and sustainability.

Furthermore, there are emerging signs that the longer-term risks associated with soft market conditions are beginning to crystallise. In our recent supervisory review work, we have seen increasing evidence that some firms have paid insufficient attention to technical pricing and have used pricing models inconsistently, as well as moving into new lines of business (in search of higher returns) where they did not have sufficient underwriting expertise (losing money as a result). Some firms also appear to have reacted too slowly to emerging loss development and have been too reliant on managing by business plan loss ratios and not challenging themselves on the realism of these original assumptions. These concerns, if unaddressed, could indicate a heightened risk of ongoing reserve deterioration.

Given these concerns, boards would benefit from paying close attention to any emerging reserve trends and from actively challenging the assumptions being made by the underwriting and reserving functions. Firms can expect us to seek increasing assurance over reserve adequacy over the course of 2018 (through an extension of the Financial Risk Framework (FRF) review work we began last year and/or through the use of skilled person reports commissioned under section 166 of the Financial Services and Markets Act).

Lessons from 2017 natural catastrophe activity

2017 was clearly a more active natural catastrophe year than the market has seen for a number of years. These events – notably Hurricanes Harvey, Irma and Maria ('HIM') caused considerable human suffering in a number of countries. For its part, the global insurance industry was able to pay significant claims to affected parties without threatening aggregate solvency levels. The ongoing payment and settlement of claims from these events show the important role that insurance can play in helping individuals, governments and the private sector to mitigate their financial losses, and to help communities to recover.

However, notwithstanding the impact of the events seen in 2017, it is important that the insurance industry does not take false comfort from its resilience and ability to respond to HIM. Instead, we encourage firms to consider what lessons can be learned from these events including some of the more adverse scenarios which could have arisen.

For example, we are aware of anecdotal reports of material Probable Maximum Loss exceedance (PML bust) on some accounts, and other firms having been significantly concerned by the potential level of financial losses or the adequacy of reinsurance coverage should Irma have struck Miami as a Category 5 hurricane. It would be a lost opportunity if the market failed to learn lessons to correct 'near-miss' losses which would have occurred had the 2017 catastrophe events been more extreme.

In 2017 the industry coordinated an industry scenario planning exercise on dealing with large insurance events, and we published a statement of our expectations of firms (Supervisory Statement SS5/17).² During the HIM events the PRA acted consistently with the approach it had set out in SS5/17, even though the events turned out not to be sufficiently severe to be 'market turning'. We sought early high-level indications of potential losses from UK insurance companies, and worked with Lloyd's to avoid duplication in the collection of information on the emerging impact of the events on Lloyd's syndicates.

The HIM experience showed that firms varied in their ability to provide early estimates of HIM losses to their boards and to regulators in line with our expectations. Some firms were able to provide high-level exposure estimates very quickly (in some cases, in advance of the hurricanes making landfall), based on high-level indicators such as total insured values in the affected areas, assumptions on damage ratios and likely reinsurance recoveries. In contrast, other firms were unable (or unwilling) to provide us with an indication of potential exposures within the affected areas quickly, let alone produce early loss estimates. This underlines the PRA's wider comments about firms' ability to identify and monitor aggregate exposures made in our Dear CEO letter on general insurance stress testing in December 2017. Some firms were also reluctant to provide quantitative loss estimates for some time after the events, citing the uncertainty attached with compiling specific bottom-up estimates of actual losses.

We recognise the difficulties firms would face in compiling bottom-up loss estimates or estimates of solvency impact in the immediate weeks following an event (for example, given difficulties in assessing actual damage in affected areas, and given complexities in assessing how complex reinsurance programmes might respond). We acknowledge this point in our supervisory statement on responding to market-turning events (SS5/17). However, notwithstanding these difficulties we believe that some firms could do more to ensure they can provide their boards (and where necessary, regulators) with potential indicators of aggregate exposure and potential loss in a timely manner in similar future situations. This belief was reinforced by the findings from recent work conducted by the PRA into firms' approaches to exposure management. With regard to property (and in particular natural catastrophe risks) there was a range of approaches, from heavily model-dependent to more traditional underwriting methodologies (eg monitoring TIVs in a particular zone and applying rule-of-thumb damage ratios). Our perception was that the 'better' firms utilised both methodologies as a way of mitigating model limitations and these firms were generally able to provide their boards with a high-level indication of potential losses more quickly following an event.

Finally, we believe there are other lessons which firms should consider from the HIM losses when considering future potential large loss events. There are some indications that the pattern of claims payments may have been accelerated following HIM compared to similar previous events. This could be attributable to factors such as changes in technology (eg drones allowing earlier assessment of damage), or to reputational pressures for insurers to demonstrate prompt payment in the affected areas. Regardless of cause, we believe firms should consider what implications such potential changes in claims development or payment patterns might have for their future reserving positions or liquidity needs (for example, potential mismatches of claims and reinsurance recoveries) or for the timescales in which liquidity or capital resources might need to be transferred intragroup.

Readers are also referred to an article on hurricane clustering, available on the Bank Underground blog.³

² 'Dealing with a market turning event in the general insurance sector', July 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/dealing-with-a-market-turning-event-in-the-general-insurance-sector-ss.

³ "US Hurricane Clustering: A New Reality", May 2018: <https://bankunderground.co.uk/2018/05/22/us-hurricane-clustering-a-new-reality/>.

Exposure management

Throughout 2018, we have conducted a number of exposure management reviews. As well as the specific points mentioned in relation to natural catastrophe risk above, one consistent finding was that, in many cases, firms' approaches to managing property exposures were significantly more developed (for most) than for liability risk. Whether by building on current approaches (eg developing more bespoke deterministic scenarios), or by considering how to address current limitations (eg availability of data), our perception is that many firms could do more to think about casualty accumulations. In the second half of 2018, we will look for ways to work with the market to advance these views.

Impact of market consolidation on underwriting controls

Recent announcements show that corporate restructuring seen within the sector over the past few years will continue to be a trend in 2018. Such activity can leave the senior management of affected firms vulnerable to the risk of distraction (due, for example, to unclear management responsibilities, delays in firms' ability to produce comprehensive management information across the entirety of its combined operations, and incomplete data), which can hamper a firm's ability to monitor and control its underwriting results. During such periods, boards would benefit from ensuring that senior management teams are focused on the core disciplines of running a sustainable insurance business, particularly during highly challenging trading conditions.

Risks within delegated underwriting arrangements

In our recent letters to CEOs, we have also highlighted our plans to assess the prudential risks that might arise for insurers that participate to a significant extent in delegated underwriting arrangements, including broker facilities. Our prudential interest in such arrangements is to ensure that firms are able to assess the performance of business taken on, and to ensure data is sufficient to monitor aggregate underwriting exposures. In the examples we assessed, firms were able to monitor the performance of facility business (although in some cases it was too early for them to draw definitive conclusions on the performance of some broker facilities compared to a firm's overall portfolio). Firms in our review were generally also able to evidence how they were able to obtain sufficient data to monitor aggregate exposures.

Beyond the specific areas we examined in our review, we are also aware of broader concerns that some arrangements of this nature may have a dilutive effect on the overall quality of underwriting in the market and/or prolong soft market conditions (as 'unplaced' risk can be automatically covered rather than having to be renegotiated at revised terms). We noted that firms' perceptions of the quality of data provided varied by arrangement, and it is important that individual firms have a clear understanding of the risks written on their balance sheet. Some firms were able to provide examples where they had declined to participate on certain facilities where they judged the data to be insufficient. However, we are aware that other firms have been willing to sign up for these same arrangements. Boards and senior management teams would benefit from a careful consideration of the quality of the data available to them to ensure that they are able to obtain sufficient information to enable them to manage the underwriting risks associated with delegated underwriting business, including facilities.

APPENDIX 2: 2018 'MONITORING THE MARKET' SURVEY FEEDBACK

Key messages from 2017 survey⁴ and 2018 update

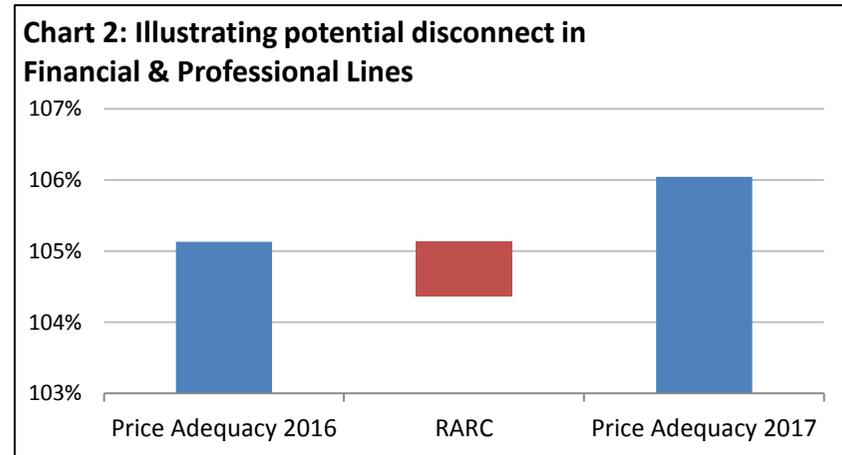
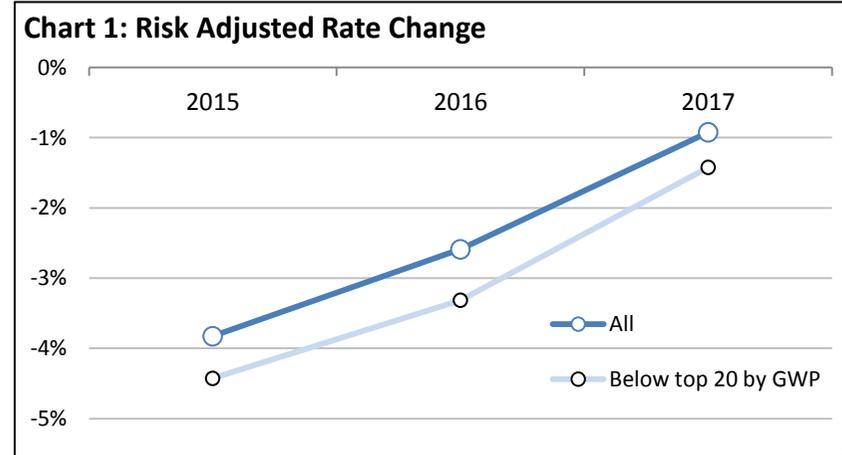
- 1 **2017:** Risk-adjusted rates continue to deteriorate, albeit reductions are moderating in most lines. Smaller insurers are experiencing higher rate reductions than their larger peers.

2018: No change in the overall message; Risk Adjusted Rate Changes continued to deteriorate in 2017, but to a lesser degree than the previous year (Chart 1). Note: the risk adjusted rate change in 2017 will reflect a mixture of pre and post-hurricane rate movements.

- 2 **2017:** Terms and conditions are widening but views differ as to whether this is sufficiently material to raise risks overall.

2018: Similar message to previous year. Some specific examples are listed below:

- Broader terms accepted on new business vs. renewed.
- Cyber: exclusions applied explicitly on Property, less so on Marine / Energy risks.
- Cyber / Property: Business Interruption increasingly provided for nonproperty damage.
- Increasing sub-limits, coverage extensions, write backs or exclusion removals (such as Cyber and Contagious diseases) with no additional premium.

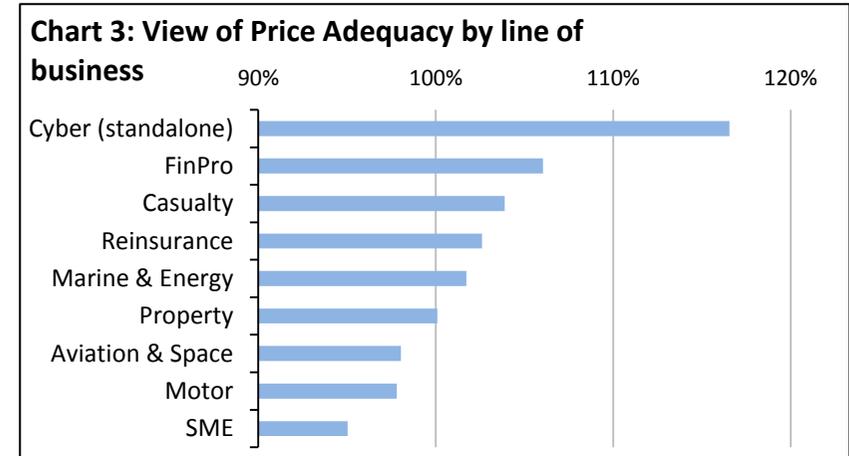


⁴ See 'Letter from David Rule: Analysis and observations from monitoring-the-market questionnaire', June 2017: <https://www.bankofengland.co.uk/prudential-regulation/letter/2017/letter-from-david-rule-analysis-and-observations-from-monitoring-the-market-questionnaire>.

- 3 2017:** 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 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.

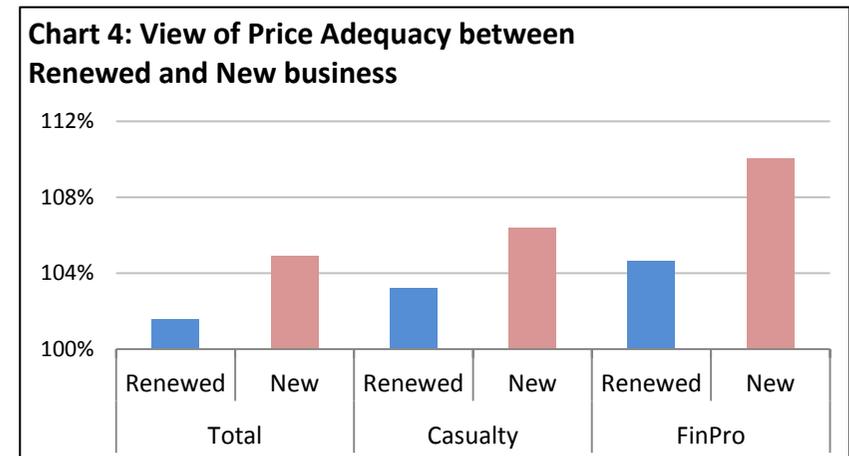
2018: For many lines (albeit not all) Price Adequacy is improving while RARC continues to fall. Chart 2 illustrates the aggregate view for Financial & Professional lines.

Furthermore, as Chart 3 illustrates, longer tail lines continue to be perceived as most favourable with regards to rate adequacy.



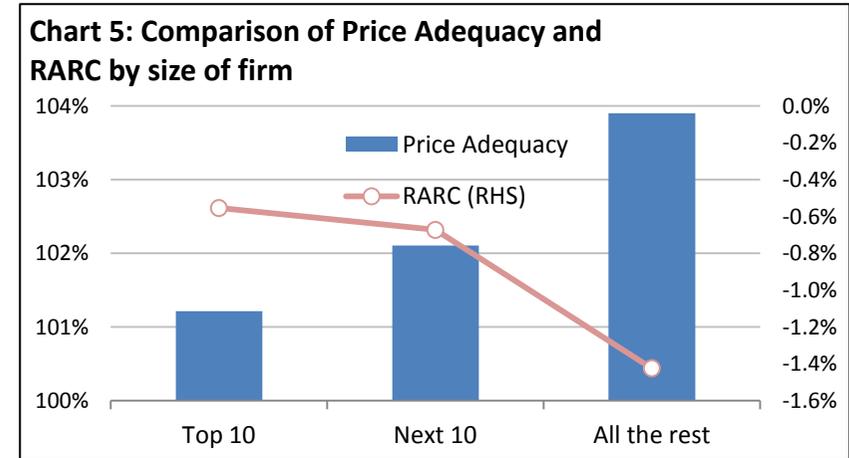
- 4 2017:** New business continues to be viewed more favourably than renewed business.

2018: Again this continues to be the case; both in aggregate as well as for the longer tail lines that are harder to model (Chart 4). This is a potential area for concern specifically combined with the comment from some firms that 'Broader terms accepted on new business vs. renewed'.



- 5 **2017:** Smaller insurers generally have a more favourable view on rate adequacy, but they are also seeing greater rate reductions than their larger peers.

2018: In aggregate smaller insurers continue to have a more favourable view of price adequacy; And as in 2017 these smaller firms continue to experience greater rate reductions than their larger peers. (Chart 5)



- 6 **2017:** 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.

2018: No new trends highlighted in the survey.

- 7 **2017:** In addition to changing distribution channels, cyber exposures, merger and acquisition activity, and the move to increasingly aggregate cross-class covers were the main structural issues commented on by firms.

2018: This year a number of firms commented on the influence of technology on the insurance industry. Generally, most firms acknowledged that longer term this would change business models. However, there was also general agreement that there was minimal impact to date; even for those firms actively engaged in supporting InsurTechs.

We will be following up individually with a number of firms identified as outliers to understand the potential prudential risks this may identify.

If we do not contact you, but you wish to receive further detailed feedback please contact your usual supervisor.