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Chief Actuary, General Insurance
Prudential Regulation Authority

Chief Actuaries of general insurance firms
regulated in the UK

5 November 2019

Dear Chief Actuary

Feedback from recent PRA reserving reviews

Following our first two letters to Chief Actuaries in 2018[1,2], we are writing to share insights from our further reviews of firms' reserving during 2019. This has included work on casualty lines for London Market firms, reserving in the UK motor market and a thematic review of case (outstanding claims) reserves in the retail and wholesale markets. Our conclusions have also been informed by wider supervisory interactions with firms and other stakeholders, such as Chief Actuaries, Lloyd's and signing actuaries.

We are also writing today to CEOs of UK general insurance firms with some more general observations of recent supervisory work[3], and that letter also refers to some of the main findings discussed here.

Key issues

Some of the key issues to emerge from our recent actuarial work are set out below. You can expect the PRA to challenge these areas where we see weaknesses within firms or inadequate justification.

1. **Bias in reserve assessment:** Some firms have focussed heavily on favourable development potential in claims development, extending to optimism in the selection of Initial Expected Loss Ratios. Whilst this issue was referenced in our September 2018 letter, we continue to see firms taking early and/or what we view as excessive credit for underwriting remediation activity in setting initial estimates. Given that incurred claim experience appears to be worsening (see Appendix, Figure 1), when setting reserves on a best estimate basis firms would benefit from giving further consideration not only to upside but also to downside risks.

2. **Weakening of case reserving basis:** We illustrated the weakening in case reserving in our September 2018 letter. We continue to see evidence of weakening case reserves (see Appendix Figure 2) and would encourage firms to review the adequacy of case reserving across their portfolio. We draw particular attention to Casualty Financial & Professional Liability, Medical Malpractice and US General Liability classes, where analysis we have seen points to higher paid-to-incurred claims ratios on more recent years. This indicates a possible weakening in the case reserving basis.

   We have also observed firms who have been slow to react to bad news in their reserving, increasing the risk of subsequent reserve deterioration.

[1] www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2018/review-of-actuarial-function-reports-in-general-insurance-firms
[2] www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2018/joining-the-dots-the-actuarial-function-underwriting-capital-and-reserving
[3] www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/letter-from-gareth-truran-pra-current-areas-of-focus-for-general-insurance-firms.pdf

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3. **Inadequate claims inflation allowance:** We have seen insufficient consideration being given to how inflation could impact long-tailed classes of business. Allowance for inflation is often implicit only and poorly substantiated. Portfolios with significant casualty line exposures are particularly vulnerable to the underestimation of reserves.

   Our case reserving thematic work has found examples where there are significant differences between the claims inflation observed by claims teams and the claims inflation assumptions used by other areas. Some claims teams' views of annual claims inflation were 5-10% higher than allowed for within the loss ratio assumptions used in reserving, pricing and business planning, without adequate justification for these lower assumptions. A failure to recognise claims inflation experience could undermine the adequacy of both reserving and pricing within firms.

   Firms would benefit from better articulation on how they have gained comfort over their allowance for claims inflation in their reserve assessments, including an explicit consideration of the different views held by different teams. We draw particular attention to excess casualty, D&O and financial lines, where social and cultural drivers of inflation can impact materially the ultimate cost of claims.

4. **Attritional loss deterioration:** Some firms have experienced reserve deterioration linked to attritional losses on older years. When this happens, firms would benefit from considering whether their loss development patterns and other material assumptions remain appropriate. We note reports of this being more marked in US Property and Cargo classes in particular.

5. **Transparency over key judgements and assumptions in management information (MI):** From our review of the MI provided to boards to support the sign-off of reserves, we conclude that this MI may be difficult to follow. Firms would benefit from seeking to strike a better balance between reporting that is sufficiently detailed to inform decision-making, and being sufficiently concise to navigate and provide practical effective challenge. To that end, boards would benefit from clearer presentation of the most material assumptions, with those key judgements which drive reserve estimates being clearly sign-posted.

6. **Other relevant areas of uncertainty:** We highlight below a number of other areas that we expect firms to consider actively as part of their 2019 year-end reserving. In particular, we expect that adequate allowance is made, where appropriate, for:

   - significant ongoing uncertainty in gross loss estimation related to 2018/9 Japanese typhoon losses including Jebi, Faxai and Hagibis, as well as large Aviation market losses including Boeing contracts related to manufacturing liability;
   - latency in claims experience related to opioids, gender equality, sexual molestation and sexual harassment claims;
   - risk of liability catastrophes and associated accumulation risk within portfolios;
   - uncertainty regarding claims experience on newer classes of business, such as cyber, where data is limited, or where a firm has less experience; and
   - uncertainty regarding continued reliance on historical data, where the relevance of the data may have diminished given legislative and other changes. The motor market, with changes to the Ogden rate, MedCo, Claims Portal and Whiplash reforms, is an example of an area that may be affected.

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Support to control functions

We have also written today to CEOs in regulated GI firms with a number of points of feedback from recent work on reserving, underwriting, exposure management and firms' culture. We have reminded senior management of the importance of supporting those running control functions, including actuarial functions, in helping deliver management's responsibilities for ensuring the prudent management of the firm, and to support actuarial function holders in discharging their own responsibilities.

For example, we have heard, anecdotally, that management challenge on actuarial judgements can sometimes focus on areas of potential reserve surplus and less on potential reserve deficiency, particularly at times of heightened commercial pressure. We have highlighted to management to ensure that they consider what mechanisms are in place to ensure that control functions are supported appropriately, for example through providing opportunities for control functions to have access to non-executive directors outside board meetings. We would encourage you to consider what channels would be most appropriate within your firm in the event that you had concerns that could not be addressed through your usual reporting line.

Next steps

It is our expectation that you will bring this letter to the attention of your audit and/or reserving committee and that firms will make explicit reference to how they have considered the findings in the main body of this letter in their 2019 year-end reserving exercises and associated actuarial reports. Whilst not all observations will apply to all firms, we expect firms to consider these and be able to explain where these have been deemed as inapplicable. We have also included further feedback in the appendix, which we believe is still important for many firms, and we would expect these points to be considered over a longer timeframe.

If you would like to discuss the content of this letter, please speak to your usual supervisory or actuarial contact in the first instance.

Yours faithfully

James Orr
Chief Actuary, General Insurance

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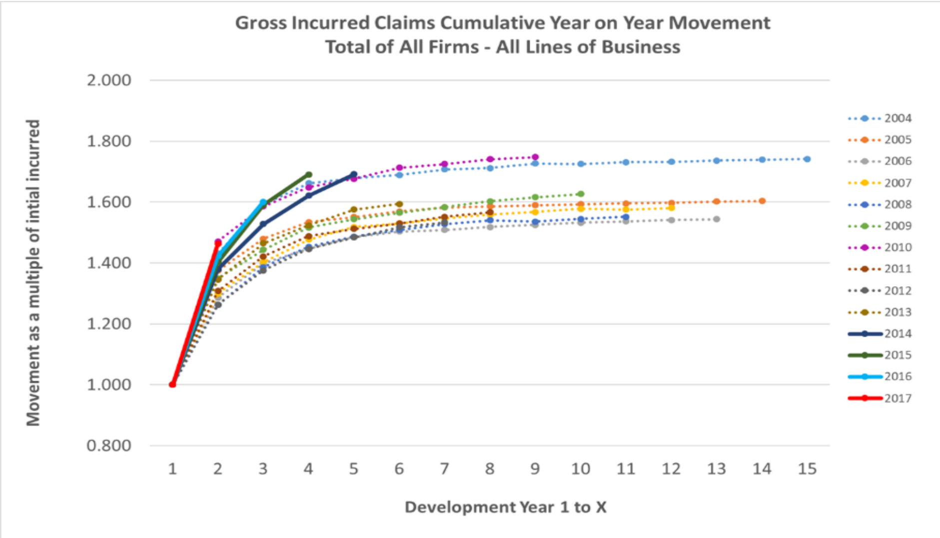
APPENDIX

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 2014 and post compared to prior years; the experience arises from both attritional and large claims. The graph shows the incurred movement after the 1st year of development.

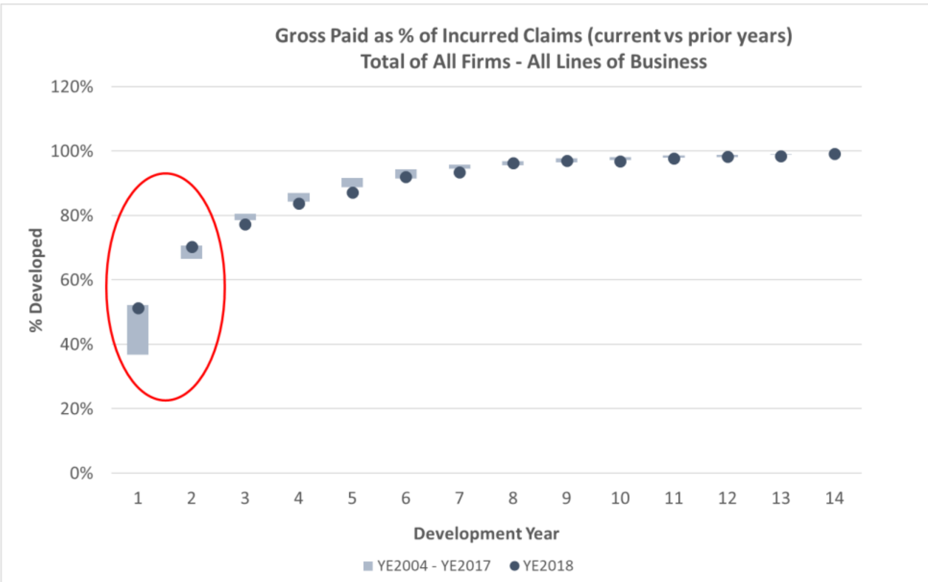
Note that years 2004 and 2010 are distorted due to large events occurring in year 2 but not in year 1 for firms reporting on an underwriting year basis. Hurricane Katrina occurred in 2005 but also impacted underwriting year 2004 for some firms. The 2011 natural catastrophes (including Australia Floods, New Zealand Earthquakes and Thai Floods) occurred in 2011 but also impact underwriting year 2010 for some firms.



Source: PRA analysis of SII triangles as at year end 2018

Figure 2: Weakening of case outstanding claims

The graph opposite indicates potential weakening of market case reserve estimates for the more recent accident and underwriting years as at year end 2018. For the first two time periods the paid-to-incurred claims as at year end 2018 is 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 SII triangles as at year end 2018

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FURTHER FEEDBACK POINTS FROM PRA ACTUARIAL REVIEW WORK

A. **Inadequate and inconsistently applied case reserving policies:** We have observed inconsistencies in the setting of case reserves in firms with loosely-worded case reserving policies. We have also observed inconsistencies where third parties, such as lawyers and delegated authorities, have been responsible for setting case reserves, including failures to follow policy adequately or to assess appropriately key elements of claims, such as expenses.

   We also observed excessive delays between claim notifications and case reserves being recorded on firms' systems. Such delays undermine the quality of data used to monitor and manage financial performance and financial risks within firms. Some information in 'claims watch-lists' had not been incorporated in case reserves, further undermining the quality of data recorded on firm systems. These various factors contributed to unexpected reserve deteriorations, as actuaries had been unable to estimate adequate IBNR due to distortions in the reserving data.

B. **Allowance for reserve uncertainty in reserve margin held versus capital:** Firms use a range of approaches when considering where and how much allowance is made for reserve uncertainty. Some firms will make allowances within their held reserves via a margin, others will include this in capital, and others use a combination of the two. However, such allowances are often implicit and many firms are unable to substantiate or quantify the allocation. Boards would benefit from having this allowance made clear, so that they can discuss and challenge it as part of the reserve setting exercise. Furthermore, this transparency would enable boards to better understand what different margins are for and when it may be suitable to release them in future.

C. **Deficiencies in claims management information:** We observed less monitoring of claims development for 'follow' business versus 'lead' business. Some claims teams did not differentiate between these classifications in tracking trends, such as claims life-cycles, claims settlement, frequency and severity. This is of particular concern given material unexpected reserve deteriorations that have emanated from policies where insurers wrote 'follow' business.

D. **Limited top-down validation:** We have seen limited top-down validation of held reserves in firms' internal reserve reports and heavy (or even sole) reliance on external reports. Better practice includes active monitoring of claims trends, scenario tests to demonstrate IBNR adequacy and analyses of year-on-year adequacy of ultimate claims. Such validation can better facilitate the discussion and challenge required at board level before reserves are set.

   We have seen an over-focus by firms on point estimate comparisons between their own best estimates and those from third party reviews. Whilst a useful comparison, boards would benefit from considering the uncertainty surrounding estimates to better understanding the nature and extent of potential downside in best estimate reserves. Consideration of the range of probable outcomes can also inform the board's determination of its held reserves. Whilst we have seen consideration of reserve adequacy focussing on an aggregate position only, boards would benefit from understanding the nature and extent of surplus and deficit at individual class and year of account level, as well as the associated drivers of uncertainty.

E. **Feedback loops:** Our observed experience of interactions between functions has been mixed. Whilst we have seen progress in the nature and extent of interactions between underwriting, pricing, exposure management, claims and reserving teams, this is not always consistent or effective. Firms for which historical performance has been good have typically been ones where feedback loops between these teams have been strong. For example, such firms' reserving teams often made allowance within reserving assumptions for relevant portfolio analyses performed by other teams. These firms have been better able to identify and mitigate adverse claims trends as part of 'business as usual' rather than reactively seeking explanations for poor performance.

F. **Motor reserving findings:** Earlier this year we carried out a thematic review of motor reserving within firms across the market. To minimise data requests to firms, we trialled this using submitted SII data and existing reports. This was successful but it does rely upon clear and accurate reporting. Some of the issues we encountered included:

a. **Reserve margin percentiles:** Firms are expressing their reserve margin as a percentile within reports but some are failing to say whether this relates to the coming year only or the ultimate settlement of claims. Boards would benefit from having a clear understanding of the basis of such figures.

b. **Key judgements and assumptions:** Some reports focus on the process by which reserves are set, but fail to explain key judgements and assumptions used. These could be explicitly discussed to help users better understand the reserving process.

c. **Reporting mistakes:** Our review highlighted mistakes in submitted Solvency II data for a number of firms, indicating that validation of returns could be improved upon.

Key technical findings from our review were:

d. **Portal and whiplash claims:** There are a number of moving parts in motor claim legislation. It is important that firms analyse the affected claims and monitor the impact on their business of each element separately, as well as in totality.

e. **Ogden Rate Changes:** Firms are using expert judgements to revalue historical claims on the current Ogden rate, but would also benefit from supplementing these with additional analysis to either remove dependence or as a sense check on those judgements.

f. **Noise in claims history:** Changes to Ogden rate, MedCo, Claims Portal, Whiplash reforms etc. mean the assumptions underlying chain ladder reserving approaches may not hold. Some firms use expert judgement to ensure historical analysis is on the same consistent basis. However, this may lead to noise being removed from data. In this case, they would also benefit from considering whether the uncertainty in the final reserve number is sufficiently reflected in company account (IFRS/GAAP) reserve margins or within Solvency II numbers.