Bank of England PRA

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Dear Chief Risk Officers of general insurance firms regulated by the PRA

2023 Thematic review of expected underwriting profit allowed for in Internal Models for General Insurance firms

Earlier this year I wrote to general insurance firms with an approved internal model to provide feedback from the Prudential Regulation Authority's (PRA) thematic review. Other firms have asked the PRA to share the findings more widely. We are therefore publishing this letter to inform you of the key findings from the thematic review and set out the next steps.

In recent years the PRA has observed that, at an aggregate level, general insurance firms have been assuming increasing underwriting profits within their approved Internal Models (IM). This observation is particularly evident in the latest year. It's not unusual for firms' business plans to contain an element of 'stretch'; even then, the actual underwriting results have not always been consistent with the planned assumptions. However, carrying this optimism through into IMs can have the effect of reducing the calculated Solvency Capital Requirement (SCR) without justification.[1] This is a continuation of the observations made in the Dear CEO letter published in May 2018.[2]

[1] See Chapter 11 of the Solvency Capital Requirement – Internal Models Part of the PRA Rulebook which sets out requirements on statistical quality standards

[2] May 2018: www.bankofengland.co.uk/prudential-regulation/letter/2018/market-conditions-facing-specialist-general-insurers-feedback-from-recent-pra-review-work.

Further, the reduction in the SCR is often greater than the nominal increase in assumed profits due to the impact on the tail as well as the mean of the SCR distribution. The impact differs by insurer, for example due to differences in risk profile and reinsurance. To explore this further, the PRA carried out a thematic review in 2023 H1 to examine firms' business planning processes, the expected underwriting profit assumed in IMs, and the extent to which this assumption has been validated, as required for IMs.[3]

The key findings from the review are:

1. The expected underwriting profit is a key assumption feeding into firms' IMs. The PRA has observed that the extent of independent validation of this assumption varies by firm. We observed that some firms did attempt to identify and remove part of any known or suspected optimism. However, only a few firms performed sufficient sensitivity or scenario testing to assess the impact[4], particularly on the SCR, resulting from potentially optimistic assumptions on underwriting profit.[5] Other firms simply used figures from their business planning, without adjustment.

2. For some firms in the review, the PRA has observed that the risk function had identified a degree of optimism in firms' business plans. However, there was limited evidence that this information had been considered in model validation. The PRA has observed that many firms do not differentiate between aspirational business planning and the underwriting profit assumed for the IM. The former could be ambitious, but the latter needs to be realistic and justified, representing a best estimate.[6]

3. More widely, the PRA has observed some potential weaknesses in business planning processes: 1) a lack of adequate actual versus expected analysis against the business plan to feedback into the next business planning cycle; 2) past weather and other extreme events assumed to be one-offs without appropriate justification; and 3) a lack of robust and effective challenge.

In addition to these findings, our modelling using data collected from Internal Model Outputs (IMO) showed that the impact of overestimating the expected underwriting

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[3] See Chapter 14 of the Solvency Capital Requirement – Internal Models Part of the PRA Rulebook which sets out requirements on validation standards.

[4] Supervisory statement 4/18 sets out the PRA's expectations on firms' risk appetite statements, including sensitivity and scenario testing, and business plans: **www.bankofengland.co.uk/prudential-regulation/publication/2018/financial-management-and-planning-by-insurers-ss**.

[5] See Chapter 14 of the Solvency Capital Requirement – Internal Models Part of the PRA Rulebook which sets out requirements on validation standards.

[6] See Chapter 11 of the Solvency Capital Requirement – Internal Models Part of the PRA Rulebook which sets out requirements on statistical quality standards.

profit on the SCR is not trivial. The impact can be more material for firms which have limited reinsurance cover or where reinsurance programmes start to exhaust in the tail. This is an area where all IM firms should carry out robust validation and update model assumptions, where required.[7]

Next steps

The findings from this review will shape our ongoing assurance work and the development of the supervisory review process for Internal Model Ongoing Review in the remainder of 2023 and beyond.

As part of our business-as-usual supervision, you should be prepared to discuss how you have considered the above thematic findings and any actions you have taken. We may also seek to understand the outcome of discussions with your Board and other key stakeholders in relation to these findings.

In the meantime, please let us know if you have any questions.

Yours faithfully

Dan Curtis

[7] See Chapter 14 of the Solvency Capital Requirement – Internal Models Part of the PRA Rulebook which sets out requirements on validation standards.