

Finalised guidance

Adequacy of Year-end Reserving

March 2011



Dear CEO

Adequacy of Year-end Reserving

We are writing to all general insurance firms with our concerns about how current market conditions are increasing the risks of inadequate reserving, and its potential effect on pricing, in the sector, and creating potential pressures within firms' reserving governance arrangements. The purpose of this letter is to remind you of our relevant rules and guidance in this area and, in relation to these, of your responsibilities for setting adequate claims reserves. We ask you to ensure that there is appropriate recognition of these risks within the reserve-setting process in your own firm as the 2010 year-end numbers are finalised, and also in future reserve setting & monitoring exercises.

Why we are doing this

The current market conjuncture continues to place pressure on the insurance sector and wider economy, and the FSA is acutely aware of the challenging trading and operational conditions with which insurance companies have to contend. These pressures are exacerbated by increasing competition and the consequent further downwards pressure on premiums in many lines of insurance business. In this regard we understand some firms are extending the terms and scope of cover simply to preserve nominal premium levels. We are also conscious of the high levels of inflation experienced in third party bodily injury claims, and the greater levels of fraudulent claims activity in the motor insurance sector in particular. All of these factors may be exacerbated by a background of continued low investment returns from firms' investment portfolios.

In recent years many general insurance companies have been able to use releases of surplus reserves from earlier years of account to offset current underwriting year losses. However, our analysis of market-level data strongly suggests that we are now at the point where increases in prior-year reserves may be necessary. We are concerned that this situation is placing pressure on the reserving function (actuaries and statisticians for example) at a time when firms also need to address the challenges of Solvency II, and we have already observed a number of significant large reserve deteriorations within the market in this area. Our concern is that realisation of these risks is likely to result in a severe strain to the capitalisation of the whole of the general insurance market.

Whilst the level at which reserves are booked is the responsibility of you and your management team, it is important that those involved in reserving processes provide you not only with an objectively derived best estimate determined in compliance with actuarial standards (where appropriate), but also give you an understanding of the main assumptions, uncertainties and risks implicit in those reserves.

We therefore want to remind you, and your board, of your responsibility to ensure that adequate claims reserves are being held and to be mindful of the pressures that might influence decision-making in this regard. In particular, we expect all firms to be able to demonstrate, when asked, that the processes they follow in setting reserves are robust and subject to adequate internal challenge.

How this fits in with our rules

The FSA's Prudential Sourcebook for Insurers (INSPRU) includes the following relevant provision at 1.1.12R:

For general insurance business, a firm must establish adequate technical provisions:

- (1) in accordance with the rules in INSPRU 1.3 for equalisation provisions; and*
- (2) otherwise, in accordance with GENPRU 1.3.4R.*

INSPRU 1.1.13G also gives the following guidance:

*For general insurance business, the technical provisions include outstanding claims provisions, unearned premiums provisions, unexpired risk provisions and equalisation provisions. **These provisions take into account the expected ultimate cost of claims, including those not yet incurred, related expenses and include an allowance for smoothing claims (the equalisation provision).***

The FSA's Handbook (GENPRU) includes the following provision at 1.3.4R:

A firm must recognise the asset, liability, exposure or income statement item and measure its value in accordance with whichever of the following are applicable:

- (1) the insurance accounts rules;*
- (2) Financial Reporting Standards and Statements of Standard Accounting Practice issued or adopted by the Accounting Standards Board;*
- (3) Statements of Recommended Practice, issued by industry or sectoral bodies recognised for this purpose by the Accounting Standards Board;*
- (4) the Building Societies Regulation 1998;*
- (5) international accounting standards;*
- (6) the Companies Act 1985; and*
- (7) the Companies Act 2006.*

What we require of you and next steps

In order to comply with INSPRU 1.1.12R, we expect firms to take a considered and proportionate approach to the reserve-setting process, and have robust processes in place which adequately capture the risks associated with an increasingly challenging claims environment. We expect such processes to include, as a minimum, the monitoring and assessment of:

- The potential for external developments, such as changes in Ogden rates, impacts of increased levels of Periodical Payment Orders, increased fraud rates;
- The adequacy of individual case reserves;
- Underlying claims processes;
- The adequacy of data quality; and,
- The reserve projection and selection process.

Firms, and especially their senior management, must have a proper understanding of, and be able to explain, their risk appetite and the consequences of that risk appetite in setting reserves. In their decision-making process, senior management should demonstrate full understanding of the assumptions, uncertainties and risks implicit in their reserving choices, and be able to explain these if challenged by the FSA.

Through our ongoing supervision we will be following up on this issue more frequently and to a greater depth than previously. Firms can expect more on-site visits, more detailed discussions with the actuarial, underwriting and claims functions, and increased monitoring of reserve committee work within firms as well as Board oversight. We will also be explicitly reviewing reserve setting as part of our ICA regime and in discussing your preparations for Solvency II.

Additionally, we will undertake focussed reviews of reserve-setting processes at a number of firms during the first quarter and second of 2011. Depending on the lessons learned from this exercise, we may repeat it across a larger sample of firms.

We will consider the findings of these reviews and decide what further action may be appropriate to improve risk management standards in this area. For example, in cases where the FSA has identified weaknesses and such weaknesses have not been rectified to the FSA's satisfaction, one of the options available to us may be to use our power under section 166 of the Financial Services and Markets Act 2000 to require nominated Skilled Persons to report on matters as specified by the FSA, such as to review and make recommendations on reserve setting processes. The costs of undertaking a section 166 Skilled Persons Report are borne by the firm, and firms should already be aware that section 166 Skilled Persons reports will form an increasing part of our risk assessment framework.

We therefore suggest that you bring this letter to the attention of your Board, including the chairperson of both your audit and reserving committees, and other appropriate persons involved in the reserve-setting process. We are copying this letter to all major Accounting and Actuarial Consultancy firms, given their involvement in this area.

Yours sincerely,

Colin Lawrence
Director
Prudential Risk Division