Summary Document

Dealing with a Market Turning Event (MTE) in the general insurance industry – Consultation Paper | CP32/16 issued by the Prudential Regulation Authority (PRA)

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Background

The 'insurance cycle' is a phenomenon that has been characteristic of the insurance industry since the 1920s. The cycle consists of a 'soft period' in which premiums are low, capital base is high and competition is consequently high. Premiums continue to fall as some insurers offer cover at unrealistic rates, and established businesses are forced to compete or risk losing business in the long term. This period persists for some time until such time as a catastrophe takes place, which leads to an increase in claims, fall in profits, and an increase in premiums. Smaller companies are driven out of business and even the larger insurers come under stress. Such an event, which affects the insurance industry at large, is referred to as a **Market Turning Event (MTE).**

This consultation paper (CP32/16) issued by the Prudential Regulation Authority (PRA) outlines its expectations from general insurance firms with respect to significant loss events which might impact the firms' solvency and future business plans in the event of an MTE.

Overview of CP32/16

In this consultation paper, the PRA specifies its expectations from firms when planning for a MTE or in the event of an MTE taking place, with particular focus on those firms that are likely to breach their solvency capital requirement (SCR) within the three months following an MTE. Additionally, the draft paper outlines some areas that the PRA would expect firms to consider in the medium and long-term after an event, to assess the lessons which might be learned from the experience and to assess the potential consequences for their business model and risk profile as a result of the MTE.

The provisions of this CP are applicable to all PRA-regulated general insurance firms, which fall within the scope of Solvency II Directive (the Directive), and to the Society of Lloyds' managing agents (Solvency II Firms). This statement is aimed particularly at those firms operating in the global specialty insurance and reinsurance market known as the London market, whose business models are exposed to low probability, high severity catastrophe risks.

Interestingly the consultation paper stays away from defining an MTE but simply states that it should be material enough to generate significant insurance claims and impact multiple insurers. However, it does provide broad guidelines for ascertaining an MTE.

Key requirements of CP32/16 for firms affected by an MTE

The CP32/16 outlines its expectations of firms affected by an MTE under the following four broad headings: *Risk Management, Capital Management and Financing, Governance and Reporting and Disclosure*.

<u>Risk Management:</u> As part of their overall risk management strategy, the PRA expects firms to put in place appropriate processes and procedures that would enable them to prepare for an MTE. This includes preparing answers for the following questions:

- How would the insurer gather initial estimates of exposures and possible losses, the speed at which it might be able to produce credible initial estimates, and the range of possible uncertainties it might face in collecting and compiling relevant data
- How the insurers own resources might need to be mobilized to ensure a timely internal response to an MTE
- What lessons might be drawn from previous events concerning a firm's ability to calculate reliable loss estimates

- Where firms are part of larger international groups, how any local responses might need to be coordinated or managed as part of a wider group initiative

The CP also stipulates that following an MTE, firms should consider appropriate methods for:

- Assessing potential uncertainties around initial loss estimates
- Establishing and maintaining appropriate reserves for the loss event
- Making revisions to the business plan
- Assessing the continued appropriateness of a firm's investment strategy
- Re-visiting its own internal models to ensure that they confirm to required tests and standards

Capital Management and Financing: Firms are required to monitor their solvency capital requirement (SCR) on an ongoing basis. In the event of a breach or potential breach of the SCR the firms are required to inform the PRA within three months and provide a realistic recovery plan. Firms impacted by an MTE are required to keep the PRA informed of their assessment of the impact of the event on their financial position, their strategy and business plans, their operational capabilities, and any other issues which might be material to the PRA's prudential assessment. The overarching theme is that this rule requires insurance firms to be capitalized at all times. In line with this theme, the PRA may consider using supervisory tools (including as a temporary measure) to ensure that any risks are adequately mitigated.

Governance: The PRA expects firms to consider in advance and to put in place appropriate arrangements to ensure that their boards and senior management teams are able to provide effective management oversight following an MTE, and to ensure that significant decisions can be made quickly where necessary. Furthermore, the PRA states that it is the responsibility of a firm's board of directors to assess whether the financial position of the firm is sufficiently secure to enable it to continue to trade and to meet its ongoing legal and regulatory obligations. Additionally, the PRA expects that after an MTE, a firm's board would need to take particular care to consider how the financial position of the firm might have been affected by the event when deciding how it should respond, particularly given the likely uncertainties involved in developing loss estimates in the early stages after an MTE.

Reporting and Disclosure: Most general insurance firms are likely to have obligations to a number of external and internal stakeholders. These include market participants, policyholders, staff and regulators, The PRA mandates that firms need to ascertain the obligations they have in these areas and make the requisite disclosures. While planning for an event, firms must decide what sort of disclosures they need to make to the PRA, Society of Lloyds or other authorities as the case maybe. Additionally, the PRA also expects firms to consider (in advance, and at the time of an MTE) whether any aspects of their proposed response to an MTE might require prior approval from the PRA or other bodies, or whether there are matters which might require prior notification to the PRA, based on requirements within the PRA Rulebook.

Conclusion

The PRA concludes this document by stating that it expects firms to consider what longer-term lessons might be drawn from the event, so that they are better prepared for similar events in the future. Some factors that the PRA would expect a firm to consider include what lessons might be drawn for the robustness of previous assumptions, modelling techniques, processes and controls; and whether any crisis management, disaster recovery or business continuity arrangements invoked by the firm operated as expected during the event, or are there any changes needed to improve the firm's response to the similar future events.