Deloitte.

# Faculty of Actuaries Student Society

## Current Topics 2010 - General Insurance

April 2010

## Authors
Tim Jenkins

James Rakow

## With contributions from
Jahan Anszar

Rakhee Chatwani

Jayne Faulkner

Kendra Felisky

David Hindley

Luke Kevan

Julian Leigh

Alex Marcuson

Chris Marinan

Darren Michaels

Shreyas Shah

Chris Short

# Contents

# 1. Introduction & Industry Update

*We start by giving an overview of the hot topics currently affecting the largest UK general insurers. Our source documents for these topics are the published report and accounts for five of the largest insurance groups writing UK general insurance; Aviva, RBS Group, Zurich Financial Services, RSA and AXA. In 2008 these five insurance groups accounted for 47% of the £41 billion of gross written premium in the company market.*

Each company faces different issues as a result of having different products, distribution channels and geographical spread. However, there are several topics which were highlighted by more than one of the companies in their annual reviews and the notes to the financial results.

## 2009

Although the words used by the five insurers were different, there was a consensus that 2009 did not give insurers an easy time. UK trading conditions for general insurers were variously described as:

"challenging", "rocky", "difficult", "tough"

That said, three of the five insurers had UK general insurance results in 2009 that were similar to those in 2008 and two saw their results deteriorate.

## UK motor

The five insurers are all major players in the UK motor market. On a positive note (for insurers, but not consumers) the personal lines market was seen as hardening, with double digit rate increases (for new business) and a return to "realistic pricing" being reported.

News on claims was more pessimistic. Bodily injury claims, credit hire claims and high attritional losses were all mentioned as sources of additional claims cost. Reference was also made to prior year reserve releases returning to more normal levels in 2009 after several years of exceptional releases across the market.

In section 2 we give more detail on some of the emerging developments in personal injury claims.

## Recession

Insurers with exposure in commercial lines found their business volumes affected by lower economic activity – fewer business starts ups and more failures. Lower volumes in breakdown insurance and creditor business were reported.

In section 5 we provide some background on the UK's latest recession and its implication for insurers.

# The weather

The UK weather in 2009 was a lot kinder to UK insurers than the floods of 2007. The Cumbria floods and snow at the end of 2009 were highlighted by some of the insurers. The Cumbria floods were used to provide examples of how insurers can learn lesions from past events – one insurer sent 29,000 text messages to its policy holders and another has set up a twitter channel to answer customers' questions.

# Periodic Payments

An increase in personal injury claims settled by way of periodic payments (annuity) was reported. Insurers made different levels of disclosure in their accounts about how they have valued these claims on their balance sheets – at the moment there does not appear to a consensus regarding these disclosures. Insurers reported mean terms in excess of 30 years for these payments.

# Asbestos

Two of the insurance groups reported material strengthening of their asbestos reserves – in both cases the amounts were in the region of £300m net of reinsurance.

In section 3 we provide some background on latest research on asbestos claims.

# 2. Personal Injury update

*The publication of Lord Justice Jackson's review of civil costs is one of the most important developments affecting personal injury claims seen in recent years.*

## Introduction

Personal injury claims form the largest part of the reserves for classes such as motor, employers' liability and medical malpractice. During 2009 and early 2010 there were a number of potential reforms announced that could significantly impact the parties involved with personal injury claims. This section gives a brief summary of the key recent announcements. Developments specific to asbestos are discussed in section 3.

## Review of Civil Costs

In response to the limited success of the Woolf reforms to control the cost of civil justice, the Master of Rolls, Sir Anthony Clarke, appointed Lord Justice Jackson to lead a fundamental review into the costs of civil litigation.

On 14 January 2010, Jackson LJ published the final report on his review of civil costs which began in January 2009. The report includes proposals for a package of reforms designed to bring litigation costs under control and make them fairer and is based on extensive consultation.

### Purpose of the Review

In conducting the review Lord Justice Jackson was to:

- Establish how present costs rules operate and how they impact on the behaviour of both parties and lawyers.
- Establish the effect case management procedures have on costs and consider whether changes in process and/or procedure could bring about more proportionate costs.
- Have regard to previous and current research into costs and funding issues; for example any further Government research into Conditional Fee Agreements - 'No win, No fee', following the scoping study.
- Seek the views of judges, practitioners, Government, court users and other interested parties through both informal consultation and a series of public seminars.
- Compare the costs regime for England and Wales with those operating in other jurisdictions.
- Prepare a report setting out recommendations with supporting evidence by 31 December 2009.

## Findings of the Final Report: January 2010

This first ever fundamental review focused specifically on civil costs sets out a package of interlocking reforms which are designed to reduce litigation costs and promote access to justice. If the package of proposed reforms were introduced, Lord Justice Jackson anticipates that the majority of personal injury claimants would end up with more compensation under the proposals; that costs payable to claimant solicitors by liability insurers would be significantly reduced and that costs would be more proportionate because defendants would no longer pay success fees and after-the-event (ATE) insurance premiums.

The executive summary to the report identifies some of the major recommendations as follows:

- **Success fees and ATE insurance premiums should cease to be recoverable** – Conditional Fee Arrangements (CFAs), of which "no win, no fee" are the most common species, are identified as being the major contributor to disproportionate costs in civil litigation. It is recommended that success fees and ATE insurance premiums should cease to be recoverable from unsuccessful opponents in civil litigation.

- **Increase in general damages** - To balance the impact of the non-recoverability of success fees Jackson LJ recommends, as a complementary measure, that awards of general damages are increased by 10%, and that the maximum amount of damages that lawyers my deduct for success fees be capped at 25% of damages (excluding future care or future losses).

- **Referral fees** - The report proposes banning the payment of referral fees by solicitors which Jackson LJ sees as a regrettable feature of civil litigation which adds to the cost of litigation without adding any real value to it.

- **Qualified one way cost shifting** – Jackson LJ proposes that the personal injury claimant, if unsuccessful, should not be required to pay the defendant's costs.

- **Fixed costs in fast track litigation** – Costs for fast track claims (those up to a value of £25,000 where trial can be concluded within 1 day) should be fixed. If fixed costs were to be introduced, the Advisory Committee on Civil Costs would be disbanded and be replaced by a Costs Council which would also review fast track fixed costs.

Whilst the timing of any implementation of the proposed reforms to the civil litigation process is uncertain, all stakeholders will need to consider the implications of the report.

For the full report by Lord Justice Jackson, refer to the following internet address:

http://www.judiciary.gov.uk/about_judiciary/cost-review/reports.htm

# Ministry of Justice Low Value Personal Injury Claims in Road Traffic Accidents

In October 2009 the Ministry of Justice published details of a new claims process and costs provisions which are to apply to road traffic accident personal injury claims of between £1,000 and £10,000. The need for changes was addressed in the response to the consultation paper 'Case track limits and the claims process for personal injury claims' published by the Ministry of Justice in 2007. The proposed changes are due to come into effect from April 2010.

The new process will apply where the value of claims excluding damage to the vehicle and hire charges fall between £1,000 and £10,000. This differs from the existing scope which applies where the total amount covered by way of settlement is of less than £10,000.

The key features of the process include:

- **Stage 1 – Notification:** Fixed recoverable costs to be paid on all claims. Insurers must make a decision on liability within 15 business days after notification of claims.

- **Stage 2 – Negotiation:** Fixed recoverable costs will be paid and reasonable disbursements will be met where there was a reasonable prospect of claims exceeding £1,000. Insurers have 15 days from receipt of the stage 2 settlement pack to accept the offer or to make a counter-offer. If the insurer makes a counter-offer, a period of 20 days is permitted for further negotiations. If at the end of this period the claim still cannot be settled, the insurer must pay the full amount of its offer by way of an interim payment and a stage 3 settlement pack must be submitted.

- **Stage 3 – Quantum determination**: Quantum determination is by a paper hearing, unless the District Judge directs otherwise or either party requests an oral hearing.

- **Exiting the process**: Once a claim leaves the new process it cannot re-enter it and conventional cost rules would apply.

The full publication can be viewed at the following internet address http://www.justice.gov.uk/publications/personal-injury-claims-road.htm

# Reform of Law on Damages

On July 1st 2009 the government published its much awaited Response to the Law on Damages Consultation which was closed in July 2007.

Within the consultation paper the government indicated that changes will be made to the Fatal Accidents Act 1976 to extend the categories of people eligible to claim damages to include any person being wholly or partly maintained by the deceased person immediately before death. The government also intends to increase the category of claimants entitled to bereavement damages. This could include children under 18 for the death of a parent, cohabitants of at least two years for the death of a partner and unmarried fathers with parental responsibility for the death of a child under 18.

The full consultation paper and responses can be viewed at the following internet address http://www.justice.gov.uk/consultations/cp0907.htm

# Rehabilitation Standards

In May 2009 the United Kingdom Rehabilitation Standards council (UKRC) issued version one of the rehabilitation standards. The UKRC were commissioned to develop these standards by the Department for Work and Pensions.

The aim of the standards is to help potential users of rehabilitation to make informed choices when selecting a provider, to establish a framework recognising best practise on behalf of providers and to influence the creation of cost-effective services.

Practice standards and professional codes of conduct already exist in some areas of the rehabilitation practice but often focus on technical aspects of the service given, rather than the relationship between the provider and the user. The new standards aim to consolidate codes of conduct across all areas of the practice and support standards already in place to enhance the quality of service delivered to the user.

The standards are initially to be adhered to on a voluntary basis, but users of the standards will be expected to meet the benchmarks set out in the standards.

Over 30 groups were consulted in the formation of these standards. They are expected to be widely used by insurers, civil servants and personal injury lawyers as an assessment tool when commissioning rehabilitation from private-sector providers.

The standards can be downloaded from the following internet address http://www.rehabcouncil.org.uk/standards.php

# NHS Injury Costs Recovery Scheme

The tariff and ceiling on charges payable under the NHS Injury Cost Recovery Scheme increased on 1 April 2009. The increases will apply only to injuries sustained on or after that date.

Changes to the tariff are as follows:

- Where the injured person is provided with NHS ambulance services, the charge was increased from £165 to £171 for each occasion.
- Where the injured person receives NHS treatment, but is not admitted to hospital, the charge increased from £547 to £566.
- The daily charge for NHS in-patient treatment was increased from £672 to £695.

The maximum charge in respect of an injury was increased from £40,149 to £41,545.

# 3. UK Asbestos update

*The UK Asbestos Working Party has doubled its estimated future cost of UK asbestos claims to the insurance industry. The increase has been largely driven by a near doubling in the proportion of people suffering from Mesothelioma that are claiming for compensation*

## Summary

On 26 January 2010 the UK Asbestos Working Party (AWP) of the UK Actuarial Profession published an update to their original 2004 paper (UK Asbestos – The Definitive Guide). The AWP's updated undiscounted estimate of the cost of UK asbestos claims to the UK insurance industry for the period 2009 to 2050 is £11bn. Of this amount, £9bn relates to the period 2009 to 2040, which compares to the equivalent figure in the previous study of £4.7bn.

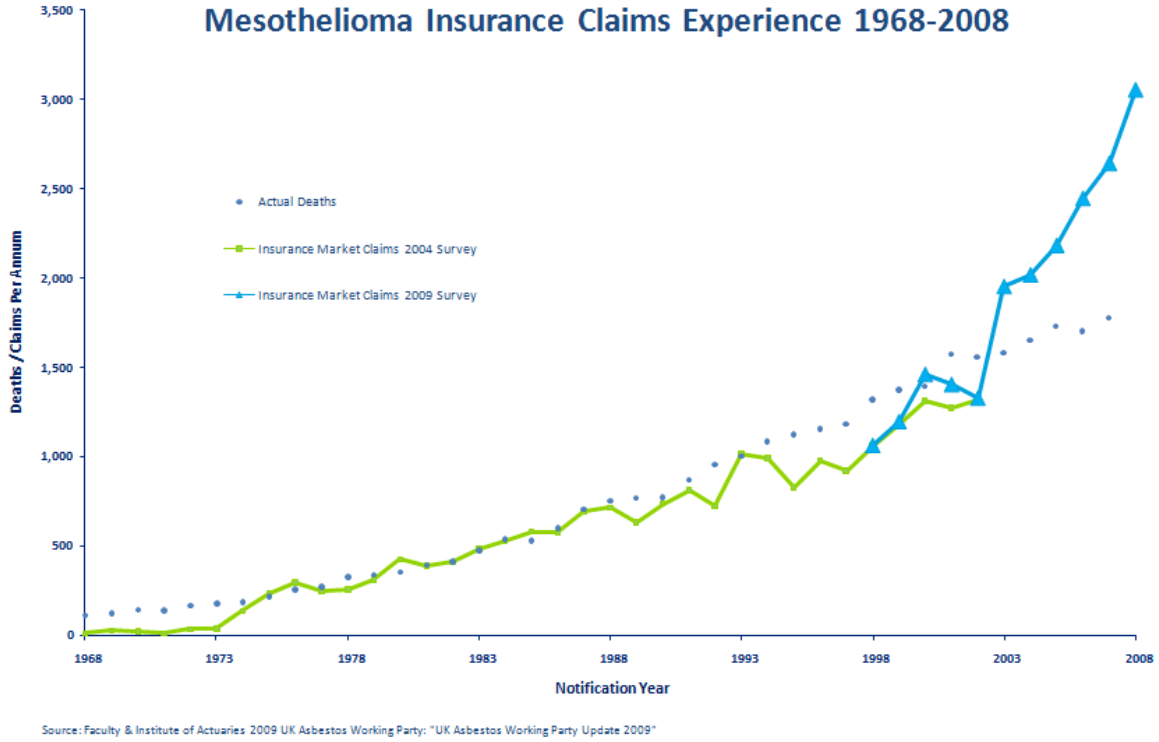
This increase is largely driven by the observed increase in the proportion of mesothelioma sufferers who are claiming for compensation, which was not expected in the 2004 study, but has become evident in recent years. In 2004, the proportion of mesothelioma sufferers that made an insurance claim was approximately one third, whereas in 2009 the proportion was nearly two thirds.

The non-insurance costs of UK asbestos-related claims are not covered by the AWP and relate to costs that: will fall to the Government; are in respect of periods of self-employment; and are in respect of periods of self-insurance, i.e. where companies chose not to purchase insurance prior to Employers' Liability cover becoming compulsory in 1972.

In developing their revised projections, the AWP took into account the revised projections of the future number of people dying from mesothelioma in Great Britain published by the Health and Safety Executive's statisticians in August 2009. The AWP also considered other projection models in the course of their work.

## Mesothelioma

Approximately 90% of the AWP's revised estimate relates to mesothelioma claims. At the time of the previous study, the annual number of insurance claims for mesothelioma was close to the annual number of deaths from mesothelioma. Underlying this, it could be seen that approximately 40% of deaths led to claims for compensation and on average each claimant was submitting approximately 2.5 insurance claims. Claimants make more than one insurance claim because their employers often have different periods of insurance coverage with more than one insurance company and also because many claimants will have worked for more than one company during their career. This broad equality between the numbers of mesothelioma deaths and insurance claims, as shown in the graph below, was assumed by the 2004 working party to continue in future. However, the experience since 2004 demonstrates that this relationship no longer holds. For example, it can be seen from the graph that the number of claims was nearly double the observed number of deaths in 2008.




Source: Faculty & Institute of Actuaries 2009 UK Asbestos Working Party: "UK Asbestos Working Party Update 2009"

There may be several reasons for the increase in the proportion of mesothelioma sufferers claiming for compensation. The AWP have suggested that some of them might be:

- Increased publicity – more prominent coverage of asbestos-related diseases and claims issues in the press, e.g. due to legal developments, such as the compensability of pleural plaques, the Compensation Act and individual court cases related to mesothelioma claims;
- The NHS Mesothelioma Framework – this has raised awareness of the disease and is believed to have led to an increase in the diagnosis rate before sufferers die, which in turn leads to more successful insurance claims being made; and
- The Internet – information is more readily available and groups with a common interest can easily communicate, regardless of their geographical location.

The AWP have highlighted the difficulty of projecting the future relationship between the number of deaths from mesothelioma and the number of insurance claims . They have illustrated the uncertainty by presenting results based on a number of scenarios. These range from maintaining a constant ratio of insurance claims to deaths in each age band going forwards, to the ratio reaching its theoretical maximum by 2013. The AWP estimates for future mesothelioma costs to the UK insurance industry range from £5bn to £20bn.

# Pleural plaques

The AWP's report covered all asbestos-related claims, except for pleural plaques, which were specifically excluded due the current state of legal uncertainty across the UK.

In October 2007, the House of Lords upheld a Court of Appeal ruling that pleural plaques do not constitute actionable or compensable damage. In response to this there been various developments in the different countries within the United Kingdom.

The Scottish Executive passed a bill in April 2009 to make pleural plaques compensable in Scotland. Four insurance companies subsequently launched a judicial review in order to overturn the Act. However, this was rejected by the Court of Session in January 2010. The insurers are appealing the decision. In the meantime therefore, all Scottish pleural plaques claims are effectively stayed pending the outcome of the appeal.

In England & Wales, the Ministry of Justice launched consultation in July 2008 in response to representations following the House of Lords decision. This process was concluded in February 2010 when the Lord Chancellor and Secretary of State for Justice, Jack Straw made a statement indicating that the Government have decided that, "based on the medical evidence received during the review, they are unable to conclude that the Law Lords' decision should be overturned at this time or that an open-ended no fault compensation scheme should be set up". He further stated that, "any increased risk of a person with pleural plaques developing an asbestos-related disease arises because of that person's exposure to asbestos rather than because of the pleural plaques themselves. However, if new medical or other significant evidence were to emerge, the government would obviously reassess the situation." So, it appears that pleural plaques are unlikely to become compensable in England and Wales in the near future. However, Jack Straw's statement did introduce some measures to assist sufferers of asbestos-related diseases. One of these was awarding compensation of £5,000 to people who were in the process of making claims for pleural plaques at the time of the House of Lords ruling in October 2007.

# Insurance Industry Impact

Even though the recent AWP estimates are approximately double those of the previous AWP estimates, most of the insurance industry should have already allowed for the higher than expected claims experience over the last few years. One reason for this is that most of the UK insurers with large exposures to UK asbestos claims were represented on the working party. Insurance companies not represented on the AWP, should still have seen their own experience emerging since 2004.

# 4. Solvency II

*The amount of work that companies are going to have to put in to comply with Solvency II means that preparations need to be reasonably advanced now.*

## Introduction

Solvency II is the European Union's initiative to improve the capital supervision and risk management of insurance companies. It involves all but the very smallest insurers, whether life, general or composite, but affects them in different ways. The draft directive was published in 2007 and comes into effect in November 2012, but the amount of work that companies are going to have to put in to comply means that preparations need to be reasonably advanced now.

General insurers have previously had minimum regulatory capital set according to a simple formula based on their premiums or claims. It was long recognised as producing an answer that was too low for proper solvency. British regulators dealt with this by informally requiring much higher levels of capital than the minimum: double or more, depending on the insurer's riskiness. This was made more formal with the ECR and the ICA. Different national regulators had different approaches. One of the objectives of Solvency II is that all national regulators will apply the same solvency standards to the firms they regulate and that regulation will be consistent throughout the EEA.

## Pillar 1

Solvency II has three areas sections, known as "pillars". Pillar 1 has probably received the most attention and is the most actuarial of the pillars. It is concerned with the minimum amounts of capital that insurers must hold. There are two levels that companies must calculate: the SCR and the MCR. The Solvency Capital Requirement ("SCR"), is the amount that companies must hold if they are to operate normally. If they fall below that level then they must prepare and stick to a plan to restore themselves to the minimum level; they could do this either by raising more capital or by de-risking, thus reducing the SCR. If they fall below the MCR then the regulator will have powers to intervene in the running of the company, up to stopping it accepting new business.

There are two ways of calculating the SCR: a standard formula or an internal model, although companies can decide to use the standard formula for some of their risks and an internal model for the others. The standard formula is much more complicated than the old standard formula. It has different rates applied to the premium in each class of business, rather than one rate for liability insurance and another rate for everything else, as the old formula had. However, the differences go well beyond that: there is in addition a similar loading on the technical reserves, to reflect the fact that a company's risks arise from the running off of its liabilities as well as the writing of new business. There are also capital requirements arising from the possibility of changes in the value of assets held and the credit risks presented by reinsurers and brokers owing money to the insurer. Finally, when all of these capital requirements are calculated there is a deduction to allow for the diversification between the various risks.

Current proposals for the parameters to be used in these formulae suggest that the regulatory capital requirement for most insurance firms will increase very substantially: treble the current amount might

be a reasonable indication of the average, but this figure will vary widely with the riskiness of the firm. This may sound draconian, but it is worth remembering that the current legal minimum was almost universally accepted as being much too low and each national regulator imposed its own formal or informal requirements in addition. The new formula is intended to be a genuine requirement and one that can be enforced consistently throughout the EEA.

The alternative to using the standard formula is to use an internal model of the firm's business. This is subject to approval from the national regulator. The FSA has engaged closely with firms on this issue, and firms that want to use an internal model from November 2012 should already have notified the FSA and be ready to start an "dry run" approval process in the next few months. If a firm wants to use a model to calculate the SCR from November 2012 but has not started the process yet then it is possibly already too late.

Using an internal model has always been expected to produce a lower SCR than the standard formula for most insurers, because the standard formula was calibrated to higher-risk insurers. The EU did not want to create a situation where the riskier firms were better off not using an internal model. However, this has recently been given a boost by a new calibration of the standard formula in the consultation papers CEIOPS produced last December. These increased insurers' standard-formula capital requirement very substantially, by something between a third and two thirds. We have not yet seen CEIOPS's final advice to the Commission, and there were a lot of critical comments from the industry. However, if this goes forward then the incentive to use an internal model goes up commensurately.

The standard formula is not set in stone for all insurers but companies do have to satisfy the regulator that it is appropriate. Given the way that it has been calibrated that is likely to be a fairly easy test, but on the other hand companies can apply to use different factors in the standard formula if they can establish that they are appropriate for their business.

Claims reserving will also change under Solvency II with the requirement for a best estimate of unpaid claims, discounted at a risk-free rate with a risk margin added. Discounting the reserves might seem normal to life actuaries but it is a significant departure from normal practice in general insurance, and an extremely radical one in some markets. Even using a best estimate is something of a change, as currently many insurers like to keep safety margins in their reserves, and in some countries, notably Germany, very substantial margins are expected. These changes will make insurance accounts much more comparable between countries and between individual companies than they used to be.

The risk margin is a new requirement, although it reflects the fair-value accounting proposals that have been discussed for the best part of a decade. The discounted best estimate is the expected amount of assets that we need to pay the outstanding claims. The idea of the risk margin is that it raises the reserve to a level that a rational buyer should accept to take over the liability. The method that has been prescribed is the risk-adjusted cost of the capital needed to support the runoff of the liabilities, the theory being that this is the extra amount that would persuade the buyer to commit that amount of risk capital.

The best indications are that reserves under Solvency II will usually be slightly less than the undiscounted best estimate reserves. This suggests that reserves are not actually going to change very much, although they will need to be constructed rather differently. However, companies that hold

prudential margins in their reserves will have to release them, and in some markets these releases could be substantial.

# Pillar 2

The second pillar is the supervision by regulators. The biggest change here for insurers is that they will have to have an Own Risk and Solvency Assessment ("ORSA") in which they assess their solvency needs, their compliance with the SCR and the practices of good risk governance. A report on this assessment will have to be prepared for the regulator. The ORSA is not a report in itself, and it is not clear what form that report will take; it might simply be a set of references to where all the aspects of the assessment process are documented. The ORSA is the process of assessment itself.

There are some misconceptions about the ORSA. The most important one is that it will provide a different assessment of capital requirement from the SCR, and one that is likely to be used for regulatory capital. Under this conception the ORSA is to the SCR more or less what the ICA is to the current EU Required Minimum Margin or the Enhanced Capital requirement. The ORSA will not produce an alternative capital requirement. Rather, it establishes that proper risk governance is in place, identifies that the calculation of the SCR is appropriate for the insurer and documents the insurer's risk-management and risk-governance procedures.

Pillar two also includes the regulators' power to intervene in the running of the insurers they supervise. Unlike now, companies that achieve the minimum capital and can show that they have proper procedures in place can expect little interference: with the risk-based approach to capital it can be assumed that companies that meet their SCRs have sufficient capital. If they fall below the minimum capital requirement regulators will have a variety of powers, culminating in stopping them writing business. Between the SCR and the MCR regulators will require a company to plan how it will restore its position and then stick to the plan.

One power that regulators will not have under Solvency II is the power to impose discretionary add-ons to the capital requirement. The circumstances in which an add-on will be allowed are tightly defined and add-ons are expected to be rare. This is an important part of making sure that the rules are interpreted and implemented consistently throughout the EU and stops regulators imposing *de facto* super-equivalent capital requirements.

# Pillar 3

The third pillar is the release of company information for public scrutiny. It is clear that companies will have to release substantial amounts of information, although the details are still vague. This may be less of a change for UK companies, who are used to the FSA returns, than for continental ones. However, there will clearly be a compliance burden, especially as the form of material will be much changed from the FSA returns. There are two main returns to be completed: the Report to Supervisor ("RTS") and the Solvency and Financial Condition Report ("SFCR"). The RTS will be private between an insurer and its regulator while the SFCR will be publicly available. Both include a mixture of quantitative and qualitative information that establish that the insurer is following proper procedures as well as giving statistical information.

Companies that intend to use an internal model for calculating the SCR should already be in the middle of a major project to get this approved. However, all companies need to put in significant work

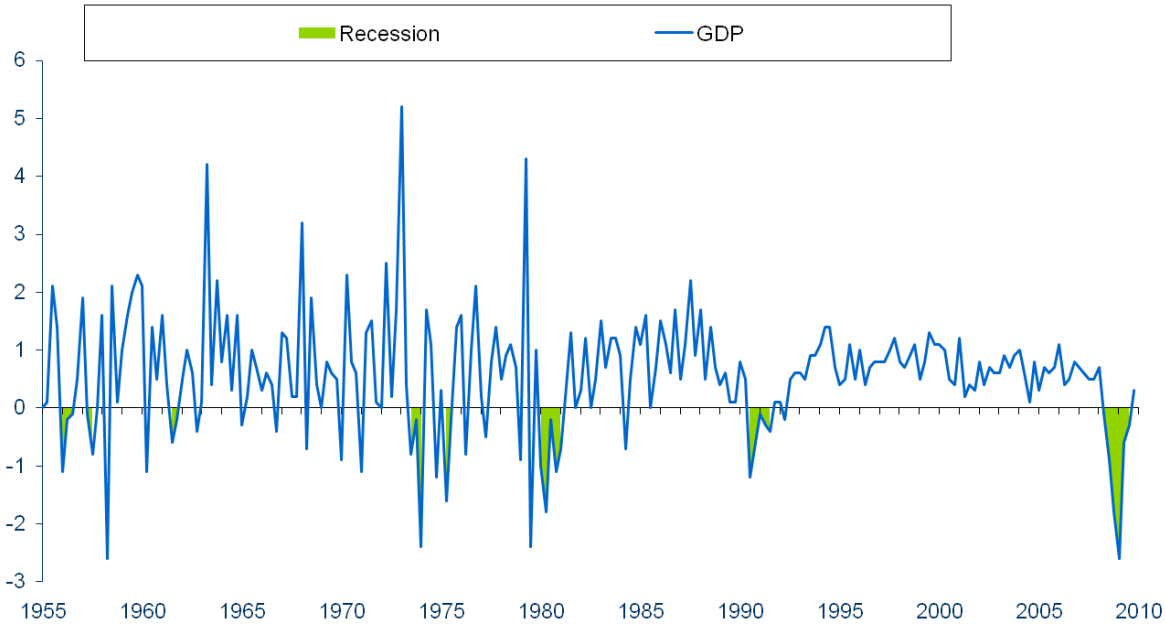
over the next two years to investigate how their regulatory capital requirements will change, how they will fulfil the reserving requirements, get their risk governance up to scratch and produce an ORSA. Solvency II has been high on the list of current issues for about four years and is likely to be for at least another three.

# 5. Recessionary Issues

*Recessions affect certain claim types more than others, often increasing overall claims costs. Reduced economic activity and household and corporate budgets lead to a fall in demand for insurance, and lower claims frequencies in some sectors.*

## Introduction

A recession is commonly defined as a period when GDP falls for at least two quarters. There are other definitions used as well. This section discusses the impact of recession on the general insurance industry. The chart below shows periods when the UK economy has been in recession. The most recent recession has been the worst in modern times.




Source: ONS

## What Classes of Business are Typically Affected In a Recession?

In a recession there is usually an increase in unemployment. This often results in a rise in theft claims and fraudulent claims. Key classes affected by recession are:

**a. Personal Lines**

i. Motor – An increase in theft claims – however, since the mid 90s theft claims have been on a downward trend as vehicle security measures have improved; and fire claims from arson.

ii. Household – Theft claims from an increased number of burglaries. There may be a possible increase in fraudulent claims by people claiming for damaged or stolen property they never owned.
iii. Other – Family Legal Protection Cover (increased claims due to increased litigation over employment disputes), Rent Guarantee for Landlords.

**b. Commercial Lines**

i. Trade Credit Risk – increases in claims due to higher rates of insolvency and defaults.
ii. Political Risks
iii. Property – An increase in theft and arson claims as there are more unoccupied commercial buildings

# Potential Effects of the Recession on Claims and Pricing

**a. Higher unemployment, smaller household budgets**

As unemployment increases, household budgets get squeezed, and certain insurance covers are not taken out. For example, demand for non-compulsory covers, such as fully comprehensive motor insurance, may decrease. Some homeowners with mortgages may forgo household contents cover and only take out buildings cover.

**b. Buying behaviour**

Insurance buyers may be more likely to shop around during renewals when they are under financial pressure. This has been compounded by the rise of price comparison websites. This will result in an increased churn rate i.e. switching of policies from one insurer to another.

**c. Uninsured levels increase**

The percentage of drivers driving without insurance cover may increase if they cannot afford to pay the premiums. In the UK, the Motor Insurers' Bureau (MIB) compensates the victims of negligent uninsured and untraced motorists. The MIB is funded by a levy paid by insurers. Any increase in payments by the MIB may ultimately result in a loading on premiums.

**d. Reduced car mileage, implies lower risk**

A feature observed in some insurance markets is lower use of vehicles as more people stay at home or are forced to as a result of unemployment. This can lower the claims frequency of motor insurance claims.

**e. Commercial property unoccupied**

If firms facing financial difficulties increase during a recession, occupation of commercial property may decrease resulting in lower policy volumes, and premiums, especially if premium rates decrease due to depressed demand.

**f. Increase in Fraudulent Claims**

In prior recessions, there has been a surge in fraudulent claims. This surge has not yet been observed to the same extent in the UK market. Many insurance companies have used technology to combat fraudulent claims and increased the size of their fraud detection departments.

**g. Claims Inflation**

Recessions often lead to periods of low inflation or deflation. This could result in a reduction in the growth of average claim sizes. For example, motor damage claims may come down if the cost of spare parts and wage inflation of car mechanics reduce.

# Claims Reserving for Classes Impacted by Recession

Adjustments may need to be made when selecting assumptions using traditional actuarial methods. Some examples are illustrated below:

a. **Average cost per claim method** – The frequency of motor claims may decrease due to a reduction in driving, as explained above.

b. **Chain-ladder method**
   i. Apart from changes in possible claims development profiles due to variability in the mix of claim types, there may also be changes in processing delays if there has been a surge of certain claim types or reduction of claims handling staff for the insurer.
   ii. The historic rate of claims inflation which is implicitly projected into future claims settlements may not be appropriate if the recession results in lower inflation rates or deflation. Results from chain-ladder methods will need to be explicitly adjusted for this.

c. **Bornhuetter-Ferguson method** – To allow for decreased profitability in certain classes, a higher initial expected ultimate claims ratio may be selected. This approach is often used for commercial classes or inwards reinsurance business.

# Other Impacts of the Recession on Insurance

a. The current recession has resulted in low interest rates. This is likely to cause discounted reserves to increase. However, in the UK most reserves are not discounted, so this impact may be small. Under Solvency II, where reserves need to be discounted explicitly, the impact may be significant.

b. Pricing – Premium rates may need to be reduced if insurance buyers become more price conscious. Conversely, if the recession results in a reduction in capacity as some insurers get into financial difficulties, competition may decrease resulting in increased premium rates, especially for niche products.

c. Mergers and acquisitions activity often increases after a period of recession as insurer companies rationalise their businesses. Opportunities may arise for acquisitions of insurance companies in financial difficulties.

# Summary

Recessions affect certain claim types more than others, often increasing overall claims costs. Reduced economic activity and household and corporate budgets lead to a fall in demand for insurance, and lower claims frequencies in some sectors.

Standard reserving techniques may need to be adjusted to allow for the effects of recession. Structural impacts of the recession could be a restructuring in the corporate insurer sector as a result of mergers and acquisitions and changes in products.

# 6. Tax

*During 2009, new regulations in respect of the tax deductibility of general insurance technical provisions were brought into force. These new regulations seek to prevent insurers reserving too prudently for tax purposes.*

## Summary

The relevant tax legislation is Schedule 11 to the Finance Act 2007 - Technical Provisions made by General Insurers and associated regulations - The General Insurers' Technical Provisions (Appropriate Amount) (Tax) Regulations 2009 SI2009/1926. The regulations came into force on 1 September 2009 and apply to accounting periods ending on or after 31 December 2009. They are designed to prevent UK general insurers, UK branches, Lloyd's syndicates and captive insurers from getting a tax benefit through reserving too prudently. Although the Government's stated aim is not to target the vast majority of general insurers, the rules apply to, and have an impact on, all of them.

Under the regulations, the technical provisions in the accounts should be allowable for tax purposes, provided the claims reserves elements of those provisions (effectively the case reserves plus earned IBNR/IBNER) are based on an opinion that those provisions are not excessive. In most cases, this opinion would be expected to be provided by an actuary (although that is not a requirement) and in any case needs to comply with relevant actuarial standards.

The insurer's tax return may be challenged if HMRC considers that the technical provisions stated in the accounts exceed an "Appropriate Amount". In the event of a challenge, if an insurer does not provide a suitable opinion, then the default basis for the claims reserves that will be allowable for tax purposes will be the undiscounted best estimate, defined as the mean of the distribution of potential outcomes.

A small working party of the Institute of Actuaries produced a paper entitled "UK Tax Legislation for General Insurance Technical Provisions" dated 10 August 2009. This paper explains the regulations in detail and how one might interpret and comply with these.

## Conditions for the "appropriate amount"

The technical provision in the accounts that is used for the purpose of the Regulations (defined as the "Appropriate Amount") is defined as the sum of the:

a. UPR;

b. additional amount for unexpired risk (ie the URR); and

c. claims outstanding provision (i.e. case reserves plus any earned IBNER and IBNR)

....all on a net of reinsurance basis, and may include provisions for claims handling expenses.

There are three conditions which all need to be met for the Appropriate Amount to be the technical provisions in the accounts.

a. i) The general insurer must give written confirmation with tax return that item (c), the case reserves plus IBNER and IBNR, is not excessive, and

a. ii) That confirmation is founded on or supported by the written opinion of an actuary or other suitably skilled person that the amount stated in the accounts is not excessive.

b. The actuarial opinion must reflect the circumstances at the time the provisions are adopted by the general insurer (i.e. when the accounts are approved by the directors).

c. The actuarial opinion must be based on standards set by the Board for Actuarial Standards (or equivalent if a non-UK entity).

If one or more of the conditions are not met, the Appropriate Amount for the claims provision is potentially limited to the undiscounted best estimate (with the possible need to demonstrate that this is a "reasonable" best estimate).

The "suitably skilled person" in condition a. ii) is not further defined, but it will need to be someone able to interpret and follow actuarial guidance. The opinion must therefore be an actuarial one, even if the person giving it need not be an actuary. The person can be a director or other employee of the company but, if it is, the confirmation given with the tax return must include a statement identifying the status of the person.

# Definition of excessive

The regulations deem the liabilities to be an excessive estimate unless "the estimate includes no more than a reasonable margin to take into account the nature or type of risks to which the liabilities relate and the uncertainty in measuring those risks". This seems to suggest that an amount that is equal to a best estimate plus a risk margin, may be acceptable, as long as that risk margin is "reasonable", taking into account the portfolio being considered.

This issue is at the heart of the actuarial considerations involved in providing the actuarial opinion.

Numerous tools are available to the actuary tasked with determining whether or not the claims provisions are excessive. Considerations for the actuary could include:

- The quality of the data available to conduct the provisioning exercise;
- The extent to which adverse scenarios have or have not already been factored into the actuary's best estimate.
- The potential for latent claims within the insurer's portfolio;
- The extent to which high inflation assumptions have been factored into the actuary's estimates;
- The general statistical uncertainty underlying the estimation process;
- The historical record of the actuary's estimate against the ultimate outcome (though this presupposes a reasonably long "track record" for the estimates);
- What allowance, if any, should be made for discounting, particularly for longer tail liabilities;

- Impact of changing key assumptions to reflect adverse scenarios;
- An estimate the distribution of the future claims, and the percentile on that distribution of the carried provision.

Further, most UK insurance companies will already be assessing reserve uncertainty for the purpose of their ICAS work. They may well be able to make use of that work to determine where the booked claims reserves are in the spectrum of potential future outcomes, and hence determine whether the proposed booked claims reserves contain a reasonable allowance for risk.

# 7. Market Cycles

*The increase in surplus capital, together with expectations amongst clients and brokers of more generous contract conditions, is likely to have a negative impact on prices in 2010 - Lloyd's Annual Report 2009*[1]

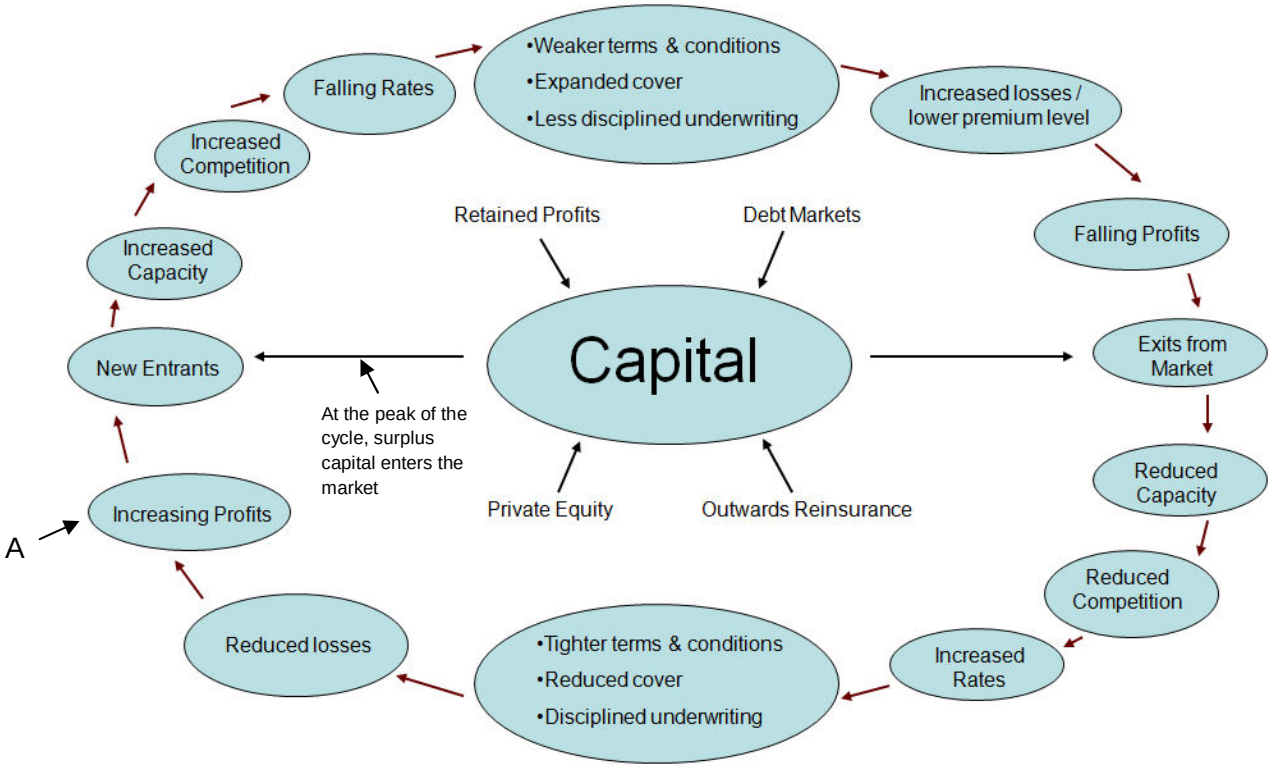
Two market cycles that occur in the insurance sector are:

1) the Underwriting Cycle and

2) the Reserving Cycle.

## The Underwriting Cycle

Summary of the Underwriting Cycle




## Where are we now?

"The increase in surplus capital, together with expectations amongst clients and brokers of more generous contract conditions, is likely to have a negative impact on prices in 2010. The market is,

[1] http://www.lloyds.com/NR/rdonlyres/CB5C3909-263A-4566-BEDF-894ED6794DC2/0/AR2009_AnnualReport_v2.pdf

therefore, entering a softer phase of the underwriting cycle which means that it is imperative that underwriting discipline be maintained" – **Lloyd's Annual Report 2009**[2]

# What is the Underwriting Cycle?

The underwriting cycle is the cyclical manner in which profits within the insurance sector tend to rise and fall over a period of time and is due to changes in market behaviour which may vary due to a number of factors; two of the most significant are: catastrophic events and capital availability.

# Why does the Underwriting Cycle occur?

In order to understand *why* the underwriting cycle occurs, it is useful to set out how the cycle progresses. Starting at point A in the diagram on the previous page:

- At the peak of the underwriting cycle, **profitability** within the insurance sector is **high**.
- As a result, **surplus capital** enters the market to take advantage of the high profitability.
    - New entrants to the insurance sector have little difficulty raising capital from debt/equity markets.
    - Existing participants use retained profits and/or outwards reinsurance to increase their capital position.
- The increased number of participants in the insurance markets leads to increased **capacity** and increased **competition**. The result of this is to push **premium rates** down.
- Another consequence of increased competition is weaker terms & conditions on policies as well as expanded coverage. There is generally **less disciplined underwriting**.
- As premium rates fall, so do the **profits** in the market. The market eventually becomes unprofitable and insurers either start to exit the market or to cut back on the amount of business they write. Any catastrophic losses that occur also exacerbate this drop in profits.
- **Competition** is **reduced** in the market and this allows insurers to **increase** their **premium rates** in order to improve their profitability.
- The increased premium rates result in **increased profits** in the market.
- The cycle begins again...

The actual length of the cycle can vary according to the class of business and the geographic location of the business being written as well as the underlying trigger for change.

[2] http://www.lloyds.com/NR/rdonlyres/CB5C3909-263A-4566-BEDF-894ED6794DC2/0/AR2009_AnnualReport_v2.pdf

# Steps to Manage the Underwriting Cycle

In November 2006, Lloyd's published a report 'Managing the Cycle – How the Market can take Control'. The report included seven key steps for managing the underwriting cycle, which are still valid today:

- Don't follow the herd – disciplined insurers are prepared to walk away from a risk when prices fall below a prudent risk-based minimum.
- Invest in the latest risk management tools – insurers must make full use of these tools to ensure robust pricing.
- Don't let surplus capital dictate your underwriting – surplus capital can all too easily push an insurer to deploy that capital in unprofitable ways. If resources are deployed to back risky lines, insurers must at least ensure that sufficient capital is held to pay unexpected future claims.
- Don't be dazzled by higher investment returns – pricing decisions should not be over-reliant on an optimistic investment environment.
- Don't rely on 'the big one' to push prices upwards – insurers are increasingly unable to rely on major loss events as an excuse to push prices up in unrelated lines of business.
- Redeploy capital from lines where margins are too thin – insurers should set up internal monitoring systems to help ensure that they scale back on lines of business in which margins have become unsustainable and migrate to other lines.
- Get smarter with underwriter and manager incentives – incentives should target increased shareholder returns rather than volume growth.

Solvency II will require the introduction of formal risk management techniques for insurers. This may involve an explicit model of the underwriting cycle as part of the underwriting risk assessment. The intention is to smooth out the underwriting cycle under Solvency II.

# The Reserving Cycle

What is the Reserving Cycle?

This is the cycle of over- and under- reserving, where there is tendency for insurers to over-reserve when underlying loss ratios are low and under-reserve when underlying loss ratios are high.

It is most prevalent in longer tailed business as well as in business that is typically analysed on a funded account basis rather than an accident year basis.

This cycle is distinct from the underwriting cycle, but it has a strong relationship with it.

Why does the Reserving Cycle occur?

- Through inappropriate use of **historic trends** and **patterns** due to the impact of the underwriting cycle. Most commonly used reserving methods tend to assume that the

development profile of the business will be the same for all origin years, whereas the true underlying development profile tends to exhibit cyclical characteristics which if not adjusted for, will lead to over/under reserving.

- Inappropriate use of **premium rate indices** due to the impact of the underwriting cycle. Through past underwriting cycles, premium rate tracking has generally tended to systematically underestimate the rate of decline of rating strength in a softening market, as indeed it has tended to under-state the rate of strengthening.

- Booking a reserve that is different to actuarial best estimate – actuaries or management deliberately choose to **move away from best estimate** figures at different stages of the underwriting cycle, possibly in order to manage results.

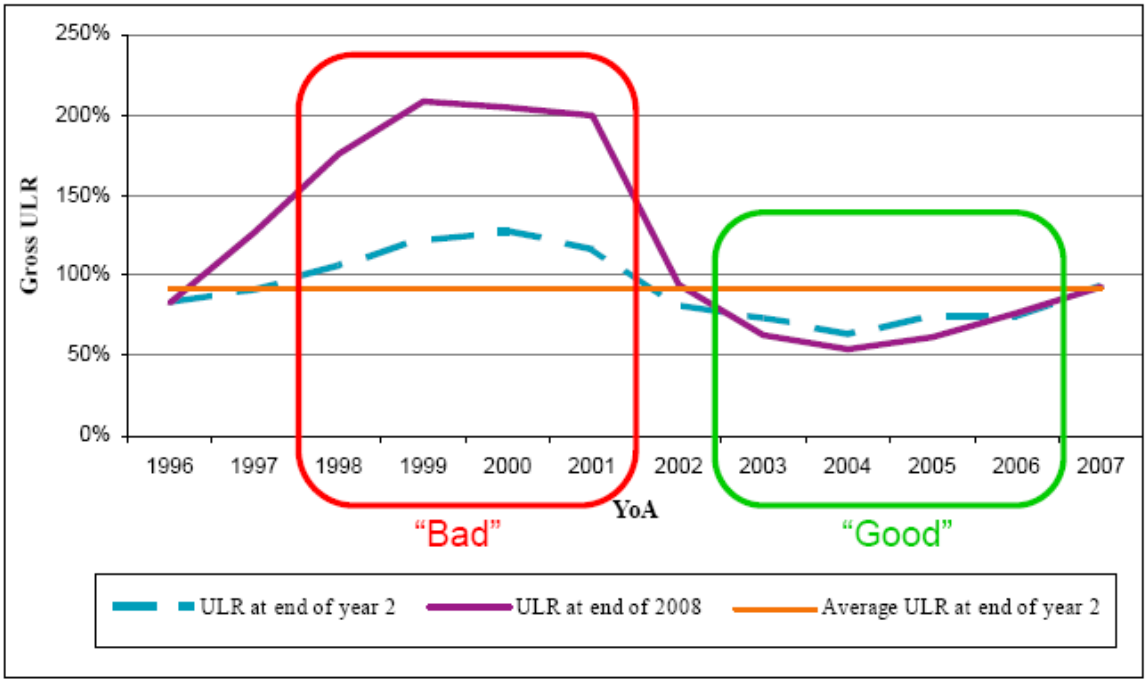
- Lack of **understanding** of the nature of the underlying business.

- **Denial** of the reserving cycle – or its full extent.

The chart below demonstrates the existence of the reserving cycle. It shows the Gross Ultimate Loss Ratios (ULRs) for Casualty business written in the Lloyd's market at the end of year 2 as well as at the end of 2008.

A key point to note about the behaviour show in the chart below is that in poorly performing years (highlighted in the "Bad" region), the ULRs deteriorated more than they improved in the better performing years (highlighted in the "Good" region) for Casualty business at Lloyd's.

## Gross ULRs of Casualty business at Lloyd's of London




Source: Lloyd's SRD Database