

ASSETS AND MATCHING

WORKSHOP

General Issues for Discussion:

Which Liabilities do we wish to Match?

Shareholders' liabilities

General Insurance liabilities

Shareholders Funds:

Currency Requirements:

Statutory Solvency Margin

General Insurance Liabilities:

Claims - both Balance Sheet and Technical

Claims Handling Expenses

We must match the Best Estimate

The liabilities MUST be assessed GROSS

Analyses is by Nature, Term and Currency.

General Insurance Assets:

What are a company's technical assets?

N.B. Look up what a Fellowship Student should be
able to discuss!

P.N.Downing,
Chairman,
Asset / Liability Working Party
September 1992

ASSETS AND MATCHING
WORKSHOP

General Issues:

Which Liabilities do we wish to Match?

Shareholders' liabilities

General Insurance liabilities

Life Insurance liabilities

N.B. In a Composite;

Statutory Separation of Life assets

No Statutory Separation of General Insurance
assets

Should Shareholders' Funds be subject to Statutory
Separation?

Even if not, should management recommend internal
separation?

Whether Statutory or Internal, should the Actuary have
any responsibility for, or involvement in, the
investment Policy/Strategy of Shareholders
Assets?

Should the Actuary be responsible for considering the
Investment Policy/Strategy of General Insurance
funds?

Should he have any regard to:

- i) the Investment Policy/Strategy of
Shareholders' Assets? and/or
- ii) the Investment Policy/Strategy of Life
Assets?

Whilst it is hopefully accepted that the Actuary is
responsible for defining the Nature, Term and Currency
of the Liabilities, what are his responsibilities
vis-a-vis the Finance Director (Accountants) in
relation to the Assets?

Shareholders Funds:

Should they be invested for:

- i) Shareholders' return
- ii) Covering the Statutory Solvency Margin
- iii) Investment in Subsidiaries
- iv) Depositing with authorities to obtain local
licences

N.B. ii), iii) and iv) require growth for effective Shareholder protection (equity type investment?), but may have a requirement to always exceed a fixed value (volatile market value of investments very undesirable).

Should Shareholders' Funds be regarded as always available to support short-term technical liquidity problems?

Should Shareholders' Funds assets be invested anticipating the possible partial transfer to support a future General Insurance deficit?

Currency Requirements:

As a U.K. Company, Shareholders' expectations are in Sterling

But should companies match the currency component of the Statutory Solvency Margin? - if so, 100% or only, say, 60%?

Or should the matching have regard to the Internal margin?

If Shareholders' expectations are in Sterling, should the 'mismatch' of overseas' subsidiaries' currency capital be eliminated?

Do similar considerations apply to the 'mismatch' of deposited overseas currency assets with local authorities for obtaining local licences?
- or should the 'mismatch' be eliminated?

N.B. In several territories, the deposit requirement is cover for GROSS liabilities plus a Solvency Margin.

In the light of the conclusions regarding overseas Subsidiaries and Branches, do we need to revisit the currency expectations of shareholders, especially if the U.K. company is wholly, or substantially, owned by overseas interests?

Statutory Solvency Margin

Should the Actuary responsible for the General Insurance funds be required to project the estimated currency component of the Statutory Solvency Margin over the next 3 - 4 years? - is this realistically possible, except in very broad terms?

On an on-going basis, is it sensible to look at the likely movements ('exposure' would not seem an appropriate concept) in currency requirements? - if so, should we look at more than a very few currencies?

General Insurance Liabilities:

Desirable to list the liabilities - which may include items which are effectively, and quite correctly, negative assets in conventional accountancy terms.

Claims payable to Policy-holders (or Ceding Companies):

- i) 'Paid' - but unsettled at the Balance Sheet Date
- ii) Advised, and agreed, but not accounted, i.e. unsettled
- iii) Advised, but not agreed/or quantified, i.e. outstanding and unsettled:
 - could well escalate in amount (usually incorporated in the IBNR provision) - could well be reduced, or even deleted as 'no claim', i.e. negative IBNR
- iv) Incurred But Not yet Reported - the technical IBNR provision

Claims Handling Expenses (both own, and external, staff)

Premiums due to Reinsurers (retrocessionaires)

- i) 'Paid' - but unsettled at the Balance Sheet Date
- ii) Due, but not accounted, i.e. are unsettled
- iii) Burning cost adjustment premiums (or is this a genuine negative asset?)
- iii) Reinstatement premiums (or is this a genuine negative asset?)

The liabilities MUST be assessed GROSS (not net of reinsurance/retrocession recoveries).

We should also distinguish between the 'Best Estimate' and any 'Safety Loading' in the determining of the liabilities

We must match the Best Estimate

- but how do we match the Safety Loading - which, hopefully, will never be required?

i.e. is effectively part of Shareholders Funds (N.B. on the Life side, matching is on the valuation reserve, i.e. including the safety loading - is this simplistic model suitable for General Insurance?)

The traditional analysis is by Nature, Term and Currency.

i) Currency

Claims - both Balance Sheet and Technical

i) 'Paid' - but unsettled at the Balance Sheet

Date: the currency for matching is the settlement currency, not the underlying currency of claim (or premium)

ii) Advised, and agreed, but not accounted, i.e.

unsettled: the currency for matching is the currency of the underlying claim (or premium), not the settlement currency.

iii) Advised, but not agreed/or quantified, i.e.

outstanding and therefore unsettled: the currency for matching is the currency of the underlying claim (or premium)

iv) Incurred But Not yet Reported - the

technical IBNR provision (N.B. this is often defined on a simple formula basis. A model based on Incurred claims is likely to be a better currency exposure estimator than a model based solely on Outstanding claims.)

Claims Handling Expenses

For own staff, this will generally be in sterling whatever the currency of the underlying claim, unless overseas based staff are involved, or home-based staff have to travel overseas, and incur costs more likely to be in the currency of the claim

For external staff, e.g. Claims adjusters, Lawyers, etc., the costs are more likely to be incurred in the currency of the claim

Premiums due to Reinsurers (retrocessionaires)

- i) 'Paid' and Due, i.e. unsettled, see considerations for claims above
- ii) Burning cost adjustment premiums - the currency of the underlying claims giving rise to the adjustment
- iii) Reinstatement premiums - the settlement currency of the contract (but how do you estimate what provision is 'likely' to be required?)

N.B. 'Provisions', such as for Bad Debts, are Assets, not Liabilities - albeit negative assets, or reductions in asset values.

Particularly for a Reinsurer writing a World-Wide account, but also for certain classes of direct business, this is probably the most crucial matching issue - particularly in the light of September 1992!

It will be realised that the determination of the currency profile must be extremely subjective - what is the underlying currency exposure of a Home-Foreign account, - what is the underlying currency exposure of an international Marine account, e.g. the expected currency of the overseas repair yards - what is the underlying currency exposure of the IBNR exposure?

ii) Term

All Paid but unsettled (i.e. accounted) items
must be immediate, i.e. Dead Short, namely
current liquidity

Virtually all other technical, advised,
liabilities are either Short (early
expectation of settlement) of Medium/Long
(delayed expectation of settlement) e.g all
forms of 'Liability Claims'.

N.B. these claims may be subject to
substantial reinsurance/retrocession - hence
Gross liability profile may be substantially
different from Net profile.

For most General Insurance portfolios, the mean term
of the liabilities may be extremely short - the key
question is the 'risk' of deliberately mis-matching
long i.e. a mean term of assets as high as, say, 3
years, which may seem eminently reasonable to
Managers, Directors and Shareholders!

iii) Nature

All Paid but unsettled (i.e. accounted) items
must be immediate, i.e. fixed in amount

Virtually all other technical, advised,
liabilities are either fixed in amount
(early expectation of settlement) or subject
to 'inflationary' escalation (delayed
expectation of settlement) e.g all forms of
'Liability Claims'.

N.B. these claims may be subject to
substantial 'inflationary' escalation,
economic, Judicial and Social

General Insurance Assets:

In general, assets are purchased and sold in response to emerging technical liabilities assumed: the asset profile must respond to the liability profile, not the other way round.

N.B. the absence of suitable matching assets must not be allowed to directly change the liability profile: it may well cause a change in underwriting policy - and if it does, this will eventually impact on the liability profile (which will need to be matched).

Currency

Quite apart from the uncertainty of the currency liability profile, it may not be possible for non-residents to hold certain currency assets, i.e. unsettled balances may provide a currency match - but generally we like to get our hands on 'our' money!

Furthermore, the liability exposure to many currencies may be so small that it is too expensive to try to match.

Even for more major currency exposures, the range of available investments may be restricted and/or the costs of establishing and dealing in those investments may be more costly than the risk exposure.

What are a company's technical assets?

- i) All unsettled balances due to the company
(premiums due by Policy-holders (or Ceding Companies) of Claims payable by Reinsurers/Retrocessionaires

N.B. the time-frame for expected settlement may often not be Dead Short - and its value may be subject to substantial diminution, e.g. trading and/or collection costs, non-collectibility (bad debts)

- ii) Cash Balances (providing they are remittable!, including monies on short term deposit
- iii) Short term investments, say 3 -12 months
- iv) Medium Term fixed interest investments, say 1 - 5 years
- v) Long Term fixed interest investments, say over 5 years
- vi) Index-linked fixed interest investments corresponding to iii), iv) and v) above
- vii) Equity type (inflation linked?) investments;
Ordinary Shares / Common Stocks
Property (but watch marketability)

It should be noted that the volatility of the market value tends to increase (undesirable?) as one goes down the list of asset types, with the exception of Index-linked investments, which should be more stable in value.

Just as with liabilities, it is probably helpful to categorise assets as:

Dead Short - immediately realisable

- 1st line liquidity

Short - fairly easily realisable - normal

maturity, say, 3 - 12 months

- 2nd line liquidity

Medium - 1 - 5 years to maturity

Long - over 5 years to maturity

Irredeemable (probably not appropriate, except

for Shareholders' Funds' assets - Subsidiary

Companies may fall in this category!)

From the above, it can be inferred that marketability may influence the appropriate 'Term' for matching purposes.

P.N. Downing,
Chairman,
Asset / Liability Working Party
September 1992