

GN20: Actuarial Reporting for the Purposes of Lloyd's Solvency Test

Classification

Practice Standard

Legislation or Authority

Insurance Companies Act 1982 (1982, c.50). Section 83 (5) (b).

Lloyd's of London. *Solvency and reporting byelaw*.

(Byelaw No.13 of 1990, 5 December 1990).

Lloyd's of London. *Valuation of liabilities in the annual solvency test*.

(Lloyd's Valuation of Liabilities - rules issued yearly on 31 December).

Application

Actuaries appointed by Lloyd's managing agents to provide an actuarial opinion in support of a solvency reserve lower than the Lloyd's Test 1 reserve.

Author

General Insurance Board

Status

Approved under Fast Track.

Required to complete Due Process by 01.09.96.

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1 Introduction

- 1.1 This Guidance Note is written with specific reference to actuaries instructed by Lloyd's managing agencies to provide an actuarial opinion as referred to in The Solvency Rules. The Solvency Rules are issued each year and the actuary should be in possession of the correct version and be sufficiently familiar with the content. The rules currently allow the managing agent to establish a solvency reserve lower than the Test 1 reserve, provided the proposed reserve is supported by an actuarial opinion in a form approved by the Secretary of State.
- 1.2 It should be noted that The Solvency Rules are promulgated under the Lloyd's Solvency and Reporting Byelaw, Byelaw 13.

That Byelaw defines 'actuary' by reference to the Insurance Companies Act 1982. The effect of this is that for the purpose of The Solvency Rules an actuary must be a Fellow of the Institute of Actuaries or of the Faculty of Actuaries who has attained the age of 30.

- 1.3 This Guidance Note supplements the requirements of The Solvency Rules. In addition, it supplements the provisions of any other relevant guidance given by the Institute of Actuaries or the Faculty of Actuaries which remains generally applicable.
- 1.4 The nature of the opinion required under The Solvency Rules is such as to place a high level of responsibility on the profession. Any actuary, before signing such a document, must consider carefully, in the light of previous experience and work, whether doing so would be in line with proper professional behaviour and standards.
- 1.5 Of prime importance to this consideration will be the extent of the actuary's experience of work on Lloyd's syndicates; it is the duty of any actuary who is in doubt as to the proper course of action to seek help from another actuary with relevant experience or from an Honorary Secretary of the Institute of Actuaries or the Faculty of Actuaries. It is emphasised, however, that the responsibility for signing the opinion lies with the individual alone.
- 1.6 In deciding whether to act, the actuary needs to have special regard to any possible conflict of interest, for example if the actuary were a name on one of the ceding or accepting years of account of the syndicate.

2 Reporting Requirements

- 2.1 The opinion of the actuary in connection with The Solvency Rules ('the solvency opinion') should be supplemented by a separate management report, addressed to the managing agent, amplifying certain issues. Any such management report would be outside The Solvency Rules and would not be subject to this Guidance Note. However, the actuary should bear in mind that the management report may be read by parties other than those for whom it is immediately intended.
- 2.2 The appendix to this Guidance Note sets out the form of words agreed by the Secretary of State for solvency opinions rendered under The Solvency Rules.

- 2.3 This guidance does not cover any opinion regarding the amount of reinsurance to close premium (RITC premium) the managing agent may determine to be equitable between ceding and accepting groups of names. The amount of RITC premium is a commercial decision, quite distinct from the determination of the reserves to be held for solvency purposes. When a year of account is not closed by way of RITC, the 'amount retained to meet all known and outstanding liabilities', as disclosed in syndicate accounts, is also a commercial figure, distinct from the reserves held for solvency purposes. The opinion does not comment on the reasonableness of the decision to close the year or leave it open. In the final paragraph of the opinion wording, the appropriate form of words should be chosen, depending whether or not the year of account is to be closed by way of RITC as at the effective date of the opinion.
- 2.4 The purpose of the solvency opinion is to enable the managing agent to reserve for solvency purposes a lower amount than the Test 1 reserve as set out in The Solvency Rules. The actuary should therefore inform the managing agent if investigations indicate that his view of the required reserve is likely to be at or above the Test 1 reserve. The actuary is entitled to rely on the managing agent's calculations of the Test 1 reserve for this purpose.
- 2.5 If the available data and information are not sufficient for the purposes of the solvency opinion, the actuary should inform the managing agent of this and should not provide the opinion. It may be appropriate to produce a report covering the work carried out, but the report should not contain any opinion as to the solvency position of the syndicate, either explicitly or by implication, and would be outside the scope of this Guidance Note.

3 Relationships

- 3.1 At the time of accepting this assignment, the actuary should obtain confirmation in writing that the client accepts a number of conditions, including the following:
- 3.1.1 The managing agent will need to provide access to whatever available data and information the actuary considers relevant.
- 3.1.2 The managing agent will need to provide information about the recent or current involvement of any other actuaries, and give permission to discuss their work with the actuary or actuaries

involved, and to receive copies of any relevant reports or other work that they produced.

- 3.1.3 The actuary may require access to the board of directors or partners of the managing agency.
- 3.1.4 The actuary will require access to the syndicate auditor, whether or not the actuary completes the assignment in full by producing an actuarial opinion, and may freely discuss the results with the auditor.
- 3.1.5 If requested by Lloyd's, the actuary may disclose his findings to the Council of Lloyd's or such individual or body as Lloyd's may stipulate.
- 3.1.6 The managing agent will need to provide a letter of representation to the actuary.
- 3.1.7 The managing agent will need to confirm that the information provided to the actuary has been maintained in accordance with the Lloyd's Syndicate Accounting Byelaw.
- 3.2 The process of obtaining information may, of course, involve a series of discussions, as further questions arise from the actuary's work and findings to date.
- 3.3 The actuary should be satisfied about the accuracy and completeness of the data used in the production of the opinion. The actuary is entitled to rely on the managing agent and syndicate auditor for the completeness and accuracy of the data supplied, provided the actuary is satisfied about the scope of the audit work.
- 3.4 The actuary should be aware of the Test 1 and Test 2 amounts, but is not required to check their accuracy.
- 3.5 When the actuary has all the data required for the production of the solvency opinion, a letter of representation should be obtained from the managing agent. This letter of representation should cover at least the following points.
 - 3.5.1 that, as far as the managing agent is aware, the managing agent has made available all the information that would be relevant for the purposes of the actuary's opinion under The Solvency Rules;
 - 3.5.2 that the managing agent proposes that the amount to be reserved for solvency purposes in respect of the year of account

XXXX of the PQR syndicate as at 31 December YYYY should be £x;

- 3.5.3 that the amount the managing agent has determined for the purposes of Test 1 of The Solvency Rules is £y;
- 3.5.4 that the information provided to the actuary has been maintained in accordance with the Lloyd's Syndicate Accounting Byelaws.
- 3.6 The managing agent is the actuary's principal, and, subject to 3.1.5, it would be improper to disclose the opinion, report or findings to any third party other than the syndicate auditor, without the consent of the managing agent.

4 Valuation Principles

- 4.1 For the purpose of the solvency opinion, reserves should be valued on the following basis:
 - 4.1.1 the reserves in respect of the year of account concerned are to be estimated on a wind-up basis;
 - 4.1.2 the reserves should make provision for all future costs and expenses, including claims handling expenses, the costs of financing any relevant syndicate borrowing and future bad debts, including reinsurance failure;
 - 4.1.3 there are restrictions within The Solvency Rules on the credit which may be taken for certain reinsurance policies;
 - 4.1.4 discounting for the time value of money is prohibited, but the implicit margin inherent in future investment earnings of the syndicate may be taken into account in assessing the need for, and amount of, any margin over 'best estimate' in accordance with 4.1.5 and 4.3.
 - 4.1.5 the reserves should include a margin over the 'best estimate' to cover reasonable adverse deviation, to the extent that the actuary is not satisfied that future investment earnings of the syndicate provide an adequate margin;
 - 4.1.6 reserves for US and Canadian dollar business should be established separately in these currencies.
- 4.2 The 'best estimate' referred to in 4.1 is intended to be an estimate of the mean of the distribution of possible outcomes.

- 4.3 The margin referred to in 4.1.5 is not intended to be excessive, but to be at a level that may be exceeded in a significant minority of cases. In considering the required margin, the actuary should take account of the nature of the liabilities and the quality and level of detail of the data provided. To the extent that future investment earnings of the syndicate can reasonably be anticipated, they may be taken into account in assessing the margin required. The wording of item ii of the opinion should be modified to include the words in brackets if investment earnings have been taken into account.
- 4.4 The actuary should obtain a clear understanding of the accounting policies of the syndicate, for example the treatment of reinsurance accruals.

Claims handling and other expenses

- 4.5 All future expenses need to be provided for within the total reserves. Accordingly, separate provision is required for expenses other than those (such as legal expenses and loss adjusters' costs) which are treated as part of the claim costs (and are thus provided for within the claims reserves). These other expenses will include internal claims handling expenses and all the other costs of administering the claims and running off the business. It would be appropriate, however, to take into account any efficiency savings that are expected to be achieved in the notional circumstances of run-off, as well as any additional costs (such as liabilities to existing employees) which would be expected in those circumstances. The actuary should also consider the future ability and willingness of brokers to continue to process claims.
- 4.6 The reserve set up should reflect the currencies in which expenses will be incurred. It is necessary to consider at least the Lloyd's accounting currencies; US Dollars, Canadian Dollars and Sterling.

Reinsurance security

- 4.7 In forming an opinion of the reserves net of outwards reinsurance, the actuary should have regard to potential non-performance of reinsurance recoveries in respect of:
- 4.7.1 reinsurers already insolvent;
 - 4.7.2 reinsurers known to be in financial difficulty or slow paying;
 - 4.7.3 possible future financial difficulty of all other reinsurers;

- 4.7.4 other causes, such as coverage disputes with reinsurers.
- 4.8 For the purposes of 4.7:
 - 4.8.1 subject to 4.7.4 reinsurance placed at Lloyd's should be regarded as fully recoverable;
 - 4.8.2 a more conservative allowance should be made if the data do not include information about potential recoveries analysed by reinsurer in respect of outstanding claims;
 - 4.8.3 the actuary is entitled to rely on work undertaken by the managing agent and the syndicate auditor in analysing the security of reinsurers. However, the actuary should review any assumptions made about the risks of non-performance of individual reinsurers or groupings of reinsurers.

Financial reinsurance

- 4.9 Financial reinsurance should be valued on a net present value basis or current surrender value if greater. In estimating the net present value, all potential recoveries and payments should be taken into account, including profit share payments, additional or contingent premiums and penalties on early draw-down or surrender. For this purpose:
 - 4.9.1 'financial reinsurance' means 'special reinsurance policies' as defined in The Solvency Rules;
 - 4.9.2 no value may be placed on any financial reinsurance policy, or part of any such policy, unless it is supported by 'acceptable security', as defined in The Solvency Rules.
- 4.10 Financial reinsurances are usually complex and require special attention. They may also be large in relation to the total reserves of a year of account. The actuary should obtain a sufficiently detailed and comprehensive understanding of their operation.

Currencies

- 4.11 The Solvency Rules require that the actuary give an opinion of the appropriate proportions of the reserve relating to US dollars and Canadian dollars. The actuary should exercise judgement regarding the allocation of items, such as whole account reinsurances, which cover more than one currency. Reserves relating to expenses should be allocated to the currencies in which they are expected to be payable, even when the claims are expected to be payable in other currencies.

Appendix

Actuarial Opinion

To the Directors (Partners) of the ABC Managing Agency:

You have instructed me to provide an actuarial opinion as referred to in the Lloyd's rules for the valuation of liabilities (The Solvency Rules), which are approved by the Secretary of State for the purposes of Section 83 (5) (b) of the Insurance Companies Act 1982. In this connection, I submit the following opinion in respect of the year of account XXXX of syndicate PQR as at 31 December YYYY. This opinion has been prepared in accordance with the relevant guidance of the Institute of Actuaries and the Faculty of Actuaries.

The managing agent has determined that the amount to be reserved for solvency purposes ('the solvency reserve') should be £x.

In my opinion:

- (i) The data provided to me by the managing agent are adequate as a basis for the determination of the amount to be reserved for solvency purposes.
- (ii) Future payments are subject to uncertainty and the final outcome could exceed the solvency reserve of £x, possibly by a material amount. However, the solvency reserve exceeds my expectation of the final outcome and [having regard to investment earnings that would accrue to the premium trust fund] covers the majority of likely foreseeable scenarios.
- (iii) Of the amount £x to be reserved for solvency purposes, £p (US\$q) and £r (CAN\$s) are appropriate amounts in respect of the US\$ and CAN\$ liabilities respectively.

In giving this opinion, I have not considered, and express no view on [the amount as shown in the syndicate accounts to be retained to meet all known and unknown liabilities or the decision to leave the year open/the amount of the reinsurance to close premium to be paid or the decision to close] in respect of this year of account as disclosed in the syndicate annual report as at 31 December YYYY, and this opinion does not in any way constitute such a view.

Signature

Name

Qualification

Date