

LLOYD'S SYNDICATES - GUIDANCE FOR RESERVING:

TASKFORCE RECOMMENDATION 33

The draft guidelines which accompany the correspondence which follows are included in this booklet so that they may be discussed at the General Insurance Convention.

Your ref:
Our ref: MGW/hrc/6466a/28
Extn: 6377

3 September 1992

TO MEMBERS OF THE LONDON MARKET ACTUARIES GROUP

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Dear Colleague

LLOYD'S SYNDICATES - GUIDANCE FOR RESERVING

I enclose a copy of a document which has just been released by Lloyd's. You will note that the covering letter asks for responses by 9 October.

Although the document is not written for insurers other than Lloyd's, it should nevertheless be of some interest to those working outside the Lloyd's Market.

The topic is scheduled to be discussed at the next London Market Actuaries meeting (17 September) but if in the meantime you should wish to make any comments to me, either by phone or in writing, I should be very grateful. Unfortunately, it has taken some time to publish the document so we need to gather ideas quickly.

Yours sincerely



Martin White
Actuary.

Enc:

Our ref: SRD/BJM/dle/8369z.57
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26 August 1992

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Dear

Lloyd's Syndicates - Guidance for Reserving: Taskforce Recommendation 33

As part of their consideration of managing old and open years of account, the Taskforce examined the standards of reserving throughout the Lloyd's market and found that both the methods and standards used differ widely across the market.

To assist in raising the standards of all syndicates to the standards of the best, the Taskforce considered a set of draft reserving guidelines. These have been endorsed in principle by the Council of Lloyd's who now wish to offer them for consultation before putting them into effect.

The new draft guidelines reflect those areas covered in the existing guidance contained in the explanatory notes to the Syndicate Accounting Byelaw (No. 11 of 1987), but go somewhat further in spelling out a recommended approach to calculating the premium for the reinsurance to close and in determining appropriate reserves for open years and run-off years of account.

Two other Taskforce recommendations will have a direct bearing on the reserving guidelines: firstly the recommendation to endorse the principle of a risk premium as part of the RITC and, secondly, the proposal to permit explicit discounting. Both of these recommendations will require negotiation with, and the agreement of, the Inland Revenue and the Department of Trade and Industry and, accordingly are subject to much longer timescales for implementation.

The Solvency and Reporting Committee will be reconsidering the guidelines later in the year and would welcome any comments you may have.

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Comments should be addressed to me, to arrive no later than 9 October 1992. I would like to take this opportunity of thanking you in advance for your help.

Yours sincerely

Barbara Merry
Secretary
Solvency and Reporting Committee

Enclosure

LYOYD'S SYNDICATES - GUIDANCE FOR RESERVING

SECTION 1: INTRODUCTION

- 1.1 This document is intended as a practical guide to the procedures and documentary standards to be adopted in the calculation of the Reinsurance To Close (RITC) premium and also to examine reserving in the wider context. In particular it should have force not only in the context of RITC but also for all solvency and for all unclosed years of account.
- 1.2 The document should be considered in the context of the particular circumstances of individual syndicates and years of account. In particular, the onus should be on the underwriter and managing agent to demonstrate that the guidance has been followed. Furthermore, the underwriter should be able to display the manner in which he has exercised his own professional judgement and relied on internal advice, or external professional advice, in determining reserve amounts.
- 1.3 The document does not set out any standard methodologies which should be utilised within the reserving exercise, rather it provides a framework outlining the procedures to be adopted and the various aspects of the process to be considered in deriving an appropriate level of RITC.
- 1.4 Additional considerations may arise in preparing documentation to support the amount claimed as a deduction for tax purposes in respect of the RITC. These are not considered within this document.
- 1.5 The remainder of this document is structured as follows:-

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SECTION 2: BYELAW PROVISIONS RELATING TO THE REINSURANCE TO CLOSE

- 2.1 In Schedule 1 (Interpretation) RITC is defined in terms of an agreement between members of a syndicate for a year of account and members who comprise that or another syndicate for a later year of account. This definition recognises that while the RITC is normally effected with a subsequent year of account of the same syndicate, cases do arise where a year of account is closed by reinsurance into a different syndicate managed by the same agency or into an unrelated syndicate managed by a different agent.
- 2.2 Where the RITC is placed outside the syndicate with a syndicate managed by an unrelated agent, it can be regarded as a transaction on an arms-length basis agreed between the underwriters of the particular syndicates involved. The accepting underwriter will determine the amount of the premium he requires in order to assume the RITC of the syndicate in question. The ceding underwriter will need to consider whether this premium rate is at a level which represents a fair charge to the members paying the premium. Where the RITC is effected with a subsequent year of account of the same syndicate the underwriter of the syndicate is acting on behalf of two groups of members and is in the position of having to address both of the considerations referred to above.
- 2.3 Schedule 2 contains additional provisions relating to accounting records in support of the general requirements set out in paragraph 2 of the byelaw itself. Paragraph 1(d) of Schedule 2 provides that the accounting records maintained in respect of each managed syndicate must contain, inter alia, "calculations and other relevant information relating to each reinsurance to close". Section 4 of this document provides guidance as to the nature of the records to be maintained in order to comply with this provision.
- 2.4 Schedule 3 includes as a fundamental principle the requirement that the treatment of items affecting more than one year of account, such as investment income and syndicate expenses, shall be equitable between members participating in each year of account. Paragraph 4 of Schedule 3 specifically requires an equitable treatment in respect of the premium for the RITC having regard to the nature and amount of the liabilities reinsured.
- 2.5 Schedule 4 of the byelaw prescribes the format for the preparation of the underwriting accounts for inclusion in the syndicate annual report. This format requires the disclosure of the RITC premium and that the underwriting account for a closed year includes the charge for the RITC for that year of account. These disclosure requirements extend to the provision of information relating to RITC premiums both gross and net of whole account quota share adjustments.
- 2.6 In relation to a closed year of account, the overriding requirement of the byelaw is that the annual report should give a true and fair view of the profit or loss, such profit or loss having been determined after charging the RITC premium for the year of account in question. Determination and disclosure of the RITC premium is therefore of importance in ensuring that a true and fair view is given.

SECTION 3: FACTORS RELEVANT IN DETERMINING THE RITC

- 3.1 The objective in determining RITC should cover the issues outlined in paragraph 2.2 above including specifically the need to derive a figure which represents a fair price to both paying and accepting Names.
- 3.2 Whatever method is adopted by an underwriter in calculating the RITC the premium arrived at will take account of the known outstanding claims and the claims incurred but not yet reported (IBNR), together with the costs and risks associated with them. This section highlights some general factors relating to outstanding claims and IBNR but should not be regarded as a comprehensive list of such items. Separate consideration is not given to syndicates writing short term life business because, although particular use is made of actuarial techniques in quantifying the liabilities, the objectives of the calculation of the RITC remain the same as for other syndicates.
- 3.3 Where at its normal date of closure a year of account is left open the underwriting account for such a run-off account must nevertheless include an amount to meet known and unknown outstanding liabilities. Such amount will be determined not only at the normal date of closure but also at subsequent year ends during the course of the run-off. In carrying out such a calculation the same considerations as apply to the RITC will be relevant, with the exception of equity between Names, in spite of the fact that the objective is not to determine the final profit or loss for that year of account.

Outstanding claims

- 3.4 Outstanding claims will be based on the estimated cost of settling notified claims including direct expenses and legal costs.
- 3.5 The effects of inflation will vary across different classes of business with excess of loss business being potentially the most sensitive. Therefore the significance of inflation will depend on the type of business written by the syndicate. Price inflation both in the UK and overseas will affect the level of claims generally although currency movements may mitigate these effects. In addition an inflationary effect may be observed because of changes in the social environment, such as an increased recourse to the courts or higher damages being awarded by them.

Allowing for reinsurance

- 3.6 In determining the amount of outstanding claims regard will generally be given to the gross position and that arrived at after the deduction of reinsurance recoveries. Thus an assessment should be made of the effect of policy limits and deductibles and, where relevant, of the availability of reinstatements. Reinsurance exhaustion should be allowed for, where appropriate. Particular care should be taken in projecting data net of reinsurance when the assumption that sufficient reinsurance is available may not be valid. Regard should be had to the relationship between the net and gross positions, comparing the implied reinsurance credit with that actually available. Specific account may need to be taken of premiums payable either on reinstatement or on an adjustable basis such as the burning cost.
- 3.7 In considering the effect of outwards reinsurances, these should be evaluated on the basis of economic substance. Reinsurance should be valued consistently with the liabilities to which it relates, but only to the extent that it fully indemnifies against these liabilities.

- 3.8 The cost of financing future claims until reinsurance recoveries are met should be considered and quantified. This is especially important if collections under reinsurance policies are not likely to be requested for many years and when reserves are not discounted for the time value of money.
- 3.9 Another important matter for review is the security of the reinsurers and their ability to meet claims on the reinsurance policy. Reinsurance failure, including both bad debts and the cost of slow payers, should be given full recognition. This should be costed against IBNR and outstandings separately, and should include allowance for potential problems with reinsurers not yet in difficulties.
- 3.10 The underwriter should consider whether profit commission payable on reinsurance business accepted by the syndicate should be recognised in the RITC calculations. The treatment of profit commission should be consistent throughout the reserve projections.

IBNR claims

- 3.11 The nature of the business written by the syndicate will be one of the main factors affecting the size and relative importance of the IBNR element of the RITC. Therefore different classes of business will give rise to different considerations and the underwriter will need to specify the appropriate classes by which he intends to subdivide his analysis.
- 3.12 In determining the relevant classes for his syndicate the underwriter will have regard to a number of factors which should include some or all of the following:-
- (a) the likely claims settlement pattern;
 - (b) the nature of business accepted, i.e. direct/facultative or by reinsurance treaties;
 - (c) the method of accepting business e.g. by binding authority, line slips, etc;
 - (d) the geographical location of risks;
 - (e) the currency in which risks are denominated; and
 - (f) special losses which do not develop in accordance with the usual run-off statistics, e.g. asbestos and pollution claims.
- 3.13 Having established the nature of the account and the manner in which records are maintained the underwriter will be in a position to identify the considerations which apply to different classes.
- 3.14 The loss experience of the different classes of business can then be reviewed by the underwriter both as to the current year of account and the previous years reinsured therein. In carrying out such a review the underwriter may wish to consider the loss ratio of the current year and previous years of account either on an incurred or on a paid basis, both gross and net of reinsurance. The precise basis of the statistics used, whether paid or incurred, will depend on the circumstances and would be determined after examination of the data available.

- 3.15 In the course of reviewing loss experience, the underwriter will accumulate run-off statistics over a number of years. Projections of the underlying data consisting of paid and outstanding claims in order to calculate the IBNR will provide a basis of comparison with previous years of account giving an indication of the experience of the account to date and its likely outcome.
- 3.16 Where the underwriter makes use of projections and other statistical methods these methods and any assumptions used should be tested, so far as possible, against the past. This does not necessarily mean that a method which would have given poor results in the past should be rejected, but such a situation should be justified by reference to all relevant facts. A variety of methods should normally be used and the results compared in the light of how well the methods suit the data, before judgements are made of the suitable reserve levels.
- 3.17 The underwriter's knowledge and experience of the market generally and the particular classes written by the syndicate will be particularly important in the interpretation of the statistical data. The extent to which the syndicate has underwritten risks for which losses are subject to significant delays in notification will be a major factor in assessing the IBNR provision. Risks falling into this category are generally associated with long tail business, although a similar effect can occur in connection with business which is primarily short tail particularly where the syndicate acts as reinsurer.
- 3.18 The identification of the extent of these claims may itself be a complex and lengthy exercise and may include a review of primary settlement patterns. Where losses on such risks are substantial there is generally an impact throughout the primary and reinsurance markets.
- 3.19 The considerations discussed in paragraphs 3.6 to 3.9 will be equally relevant in arriving at the assumptions on which the calculation of the IBNR is based. In particular the effect of different reinsurance programmes protecting different years of account may be a significant aspect of the IBNR calculation. This will be the case particularly where there have been changes in the type and extent of reinsurance protection taken out from one year of account to another. In addition for each account the interplay of policies protecting different layers should also be considered. The security of the reinsurers with which protection has been taken out will again be critical to the assessment of the IBNR.
- 3.20 The underwriter may have taken the question of currency into account in determining the classes of business relevant to the syndicate. The degree to which potential exchange rate movements are to be recognised in the calculation will depend on the volatility of rates for those currencies in which the syndicate does business and on whether assets are held to match the currency liabilities in question.

Expenses

- 3.21 A reserve should be established for the cost of future claims-related administration expenses and the cost of administering reinsurance arrangements in respect of the years of account concerned. Furthermore, consideration should be given to the rate at which future expenses are expected to inflate.

Future investment income

- 3.22 The effect of future investment income, or the lack of it, should be carefully considered. Future investment income is, in some circumstances, regarded as a cushion against future reserve deterioration and future expenses. Whilst it is true that long tail liabilities have most potential to deteriorate but also have high investment returns, it is not always safe to assume that investment income will provide sufficient margin. Investment income on undiscounted reserves is also not necessarily a good match for future internal claims handling expenses, particularly where there is significant credit taken for reinsurance.
- 3.23 The effect of large reinsurance assets in the balance sheet on the future investment income should be considered. Particularly when future investment income is being disregarded in order to provide a margin against another factor, it should be remembered that a balance sheet with investments at a low level by virtue of large reinsurances and correspondingly low net liabilities is weaker than a balance sheet with the same gross liabilities but higher net liabilities.
- 3.24 Paragraphs 3.22 and 3.23 above should not be taken as requiring that the value of future investment income be deducted in determining RITC.

Change in factors affecting the syndicate

- 3.25 Having identified factors such as those discussed in paragraphs 3.4 to 3.24 the underwriter will determine their relative importance. In many cases this will be assessed by the extent to which they represent a deviation from previous practice or a new development, either in the environment generally or as regards the business approach of the syndicate. Special consideration may need to be given to the interpretation of statistical information where there have been changes of underwriter during the period under review.

SECTION 4: DOCUMENTATION

- 4.1 Paragraph 2.3 above refers to the fact that calculations and other information relating to the RITC form part of the accounting records of a syndicate. The purpose of this section is to explain how such records should be drawn up in order to comply with the general requirements set out in paragraph 2 of the byelaw.
- 4.2 Paragraph 2(b) of the byelaw requires that the accounting records "shall be sufficient to show and explain the transactions entered into on behalf of the members of the syndicate" and goes on to require that the records shall be such as to enable the managing agent to prepare annual reports and other documents in compliance with the applicable requirement of the Lloyd's syndicate accounting rules.
- 4.3 It is clear therefore that the RITC must be supported by records setting out the manner and bases upon which the final figure was determined in sufficient detail to "show and explain" the nature of the transaction. This information can be subdivided under the following headings.

Outstanding claims information

- 4.4 The record of assets and liabilities maintained under paragraph 1(c) of Schedule 2 extends to records of outstanding claims. These records will form the basis from which analyses of outstanding claims can be drawn up under relevant headings, e.g. by reference to the classes of business adopted by the underwriter as appropriate to the syndicate.
- 4.5 Outstanding claims data should be available on a gross basis as well as net of potential reinsurance recoveries. Details of the reinsurance protection taken into account in arriving at a figure for notified outstanding claims should therefore be recorded along with the assessment made of the collectibility of the potential recoveries recognised in the calculation - see paragraphs 3.8 and 3.9 above.

Statistical data

- 4.6 The underwriter will compile statistics relating to the settlement patterns of previous years of account. These may take a number of forms from basic data in monetary units to loss ratio triangulations and may also extend to computer based loss projection models. In addition, statistics concerning expense overheads relating to the old years should be maintained. However statistical data can only form a basis which the underwriter may use to derive assumptions in order to compute the IBNR element of the RITC premium. It is nevertheless important that the statistical information is consistent with the rest of the accounting records of the syndicate.

Past Reserving

- 4.7 The overall success of the past reserving should be reported for each year of account including previously estimated ultimate loss ratios where these have been reassessed. This information should be shown excluding the effect of any special or unusual reinsurances, such as time and distance policies, and should ideally be shown both net and gross of ordinary syndicate reinsurance. This information is particularly valuable if shown in graphical form for each year of account and currency.

Assumptions and conclusions

- 4.8 As part of the process of determining the IBNR the underwriter will have considered many factors such as those highlighted in Section 3 above. However, it is important that this more judgemental aspect of the RITC exercise is documented to the same standard as is adopted in relation to outstanding claims. The documentation supporting the final RITC premium should cover all aspects of the calculation and explain fully the development of the final figure in order to comply with the requirements referred to in paragraph 4.1 above.
- 4.9 Documentation should therefore include a record of the overall factors taken into account by the underwriter in deriving the RITC. Such records should cover those factors which the underwriter considers have a significant impact on the year of account. In addition, the conclusions drawn from the use of statistical techniques and the assumptions based on these conclusions which are to be applied in the calculation of the IBNR element of the RITC should be recorded by the underwriter.

Analysis supporting the final figure

- 4.10 The final RITC figure should be supported by analyses linking the various constituent elements. This figure should be presented as follows:-

Liabilities	Assets
(1) Outstanding claims	(2) Reinsurance on outstanding claims
	(3) Minus allowance for reinsurance failure and delay on outstanding claims
(4) IBNR claims	(5) Reinsurance on IBNR, net of reinsurance exhaustion
	(6) Minus allowance for reinsurance on IBNR claims
(7) Expenses (internal claims handling)	
(8) Margin for error	(9) RITC

- 4.11 A summary of the final figure by appropriate classes and currencies should be given as well as formal approval for the final figure by the underwriter and the managing agent. In addition, a formal policy document for the reinsurance to close should be prepared and signed, embossed and dated at LPSO in accordance with the provisions of the Reinsurance to Close Byelaw (No 6 of 1985).
- 4.12 Paragraphs 4.1 to 4.10 above set out the considerations applicable to the preparation of records relating to the calculation of the RITC. Matters of general application to all types of accounting record are equally relevant to the RITC documentation; such general matters (e.g. retention of records) are addressed in Section III of the explanatory notes accompanying the byelaw. Guidance relating to RITC documentation is expressed in general terms in this document because of the need for the underwriter to have regard to the particular circumstances of his syndicate. The syndicate auditors will review the documentation prepared by the underwriter as part of their audit of the RITC and may require further information and explanation.