

# Reflections on the reserving environment

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# Outline

- **Current reserving environment**
- **Solvency II**
- **Technical provisions**

# Current environment

- **Challenging economic conditions**
  - pressure on top line
  - low prospective yields exposing underwriting results
  - soft market conditions in many sectors
- **Claims cost pressures**
  - PPOs
  - fraud
  - bodily injury and other inflationary effects
- **Changed and evolving relationship between key parties**
  - underwriters
  - finance and senior management
  - claims function
  - risk management
  - capital management

# Reserving governance – some observations

- **Prevalence of companies having two numbers**
  - “Best Estimate” → the actuarial number
  - “Booked Amount” → (higher) firm number
- **Does this split view undermine focus?**
  - is this efficient use of resources?
  - is this confusing to actuaries as to their role?
- **Complex communication processes may increase risk**
  - beware lots of ad-hoc meetings
  - observed inverse relationship between
    - number of meetings
    - quality / quantity of documentation
- **Documentation quality falls short of Solvency II expectations**
  - claimed compliance with GN12 not always convincing
  - TAS impact and compliance unclear

# Corporate governance

- **Fit for purpose**
  - different firms need different structures
    - nature, scale, complexity
- **Possible fitness tests**
  - is firm small enough that everyone knows what's going on?
  - in big firms (>150 staff?) is governance structure (including MI) such that you can substitute any individual?
    - they have the right information
    - they know what it represents and what their role is
  - do key decision-makers trust the information they receive
    - are they right to?
    - including Non-executive directors
  - when does a firm stop being small and start being big?

# Variations on Goodharts law

*Any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes*

Charles Goodhart's original 1975 formulation

- **Practices to be wary of**
  - firms relying on a stable relationship between case reserves and final settlement levels
  - firms relying upon a stable relationship between actuarial best estimates and the firm's figures
- **Both have clear information asymmetries**
  - almost always to the detriment of the actuaries
- **Symptoms**
  - ignoring certain indications without any challenge, e.g. paid projections
  - failure to verify stability of claims processes, e.g. paid/incurred

# European Union and EEA



# Motivation for Solvency II

- **Maximum harmonisation directive**
  - applying to 27 European Union Member States
    - plus three European Economic Area (EEA) countries
  - establishing an “EU passport” for insurers
    - allows operation in all Member States, if meet the EU conditions
    - directed at achieving a single market in insurance
- **Solvency II aims to achieve consistency across Europe on**
  - market consistent balance sheets
  - risk-based capital
  - own risk and solvency assessment (ORSA)
  - senior management accountability
  - supervisory assessment
- **Current “bifurcation” *assumptions***
  - will become law in Member States from 30<sup>th</sup> June 2013
  - will be applied to insurance firms from 1<sup>st</sup> January 2014



# A reporting revolution?

- **History of opacity**
  - GI business model
    - pooling, transferring, retaining and mitigating risk
    - liquidity advantage and the “float”
    - pricing based on incomplete knowledge of the true cost
  - liability valuation
    - complex products, risk drivers and claims processes
    - high levels of subjectivity and use of implicit margins
    - potential for cost emergence to be managed or distorted over time
- **Implications**
  - challenges for senior management
    - coping without an objective measure of cost and risk
  - challenges and concerns for investors
    - value-creation or just a source of volatility?

# Communication challenge

- **Essential to communicate risk to Board**
  - chance for GI actuaries to step out from back room
- **Also, with markets and regulators**
  - explaining movements in market consistent valuations
  - greater transparency leading to more realistic risk view
- **Emphasis on controls and governance**
  - faster closing, better and smoother processes
  - migration of tools from actuarial to IT departments?
- **Narrative reporting**
  - think about what this involves and how it should look

# Cash-flow projections underlying best estimate

- **Claims, expenses, premiums, salvage and subrogation**
- **Separate treatment of Gross and Reinsurance cash flows**
  - take account of counterparty default
- **Developments in external environment**
- **Take account of uncertainties of cash-flows**
- **Best estimate calculation by currency**
- **Calculation methodology**
  - reflect nature of obligations
  - reflect risks which affect cash-flows
  - transparent

# Data quality

- **Directory of all data used in calculating TPs**
  - data dictionary
- **Written Data Policy covering:**
  - definition and assessment of data quality
    - accurate, complete and appropriate
  - assumptions and data updates
- **Accurate - error-free, consistent over time and timely**
- **Complete - homogeneous risk groups, sufficient historical info**
- **Appropriate - consistent with use, no undue estimation error**
- **Used consistently over time**
- **Use of external data subject to requirements**
- **Limitations documented**

# “Decide and explain”

- **Key decisions will require judgement**
  - selection of methods and assumptions
  - partitioning of data
  - must capture these key judgements
- **We expect firms to take a proportionate approach**
  - focus on material issues
  - prioritise within development efforts
- **FSA does not have resource to provide detailed guidance**
  - well thought-through and referenced approaches ☒
  - “following the herd, without question” ☐
  - “defending past practice, without review” ☐

# Assumptions

- **Identifying and explaining all relevant assumptions**
  - explain and justify
  - define when assumption false
- **Based on characteristics of the portfolio**
  - not the undertaking
- **Derived consistently over time**
- **Document changes**
- **Market consistent future financial market parameters**
- **Evidence of credibility of information used**



# Approximations and simplifications

- **To calculate best estimate**
  - insufficient data of appropriate quality
  - provided insufficiency not due to inadequate internal processes
- **Proportionality principle applies**
- **Net best estimate may be derived from gross**
  - if good reason for not deriving R/I recoverable cash flows
- **Simplified methods may be used for calculation of**
  - risk margin
  - counterparty default adjustment

# Proportionality – what it is

- **We take existing knowledge of individual firms into account when devising tailored, risk-based workplans and schedules of presentations**
- **Follow-up work will vary between firms depending on:**
  - existing knowledge of the firm and ongoing issues
  - key issues uncovered during presentations
  - scale, nature and complexity of the firm
- **The consequence is that for certain requirements, we will consciously undertake less review work in coming to our views**
- **Better validation by firms allows us to be more proportionate**



# Proportionality – what it is not

- Proportionality of review work does not mean being able to ignore ‘less important’ requirements in coming to our decisions – *burden of proof remains with the firms*
- Proportionality of review work does not mean being able to *ignore* areas that only make up a small portion of the firm’s SCR
- Proportionality of review work does not mean simply giving credit for a large capital surplus
- To date, firms’ validation work has not always been complete or of good quality, which has necessitated us doing more detailed work in certain areas than would otherwise be the case

# Conclusion

- **Significant challenge and change**
- **Trend to greater accountability**
- **Essential qualities**
  - perspective
    - proportionality
    - rationale for judgements
    - suitability of governance
  - GSOH

# Questions