GUIDANCE NOTE GN12

General Insurance Business : Actuarial Reports

1. Introduction

1.1 This Guidance Note was issued in August 1987 with a requirement for it to be reviewed at the end of 12 months in the light of the experience of members using it.

1.2 Specific submissions on GN12 have been received from the London Market Group, the Faculty of Actuaries and the Institute of Chartered Accountants. There have also been some comments made by individuals including the reportage of the discussion at Harrogate.

1.3 New guidance (Advice on Professional Conduct - APC3) to clarify the linkage between the Memorandum on Professional Conduct, Bye-Law 66 and the Guidance Notes (GN Series) has been drafted and, it is believed, may be issued in the not too distant future. In the light of the discussion which preceded GN12 (when the initial concept was one of "Notes of Recognised Practice") and those which took place subsequently, APC3 is an important development which might have influenced some of the submissions made if it had been previously promulgated. Section 2 outlines the contents of this draft advice.

1.4 This report has been prepared by myself at the request of the General Insurance Committee and its recommendations will be considered, alongside any comments made at the Brighton Convention, at the next meeting of that Committee.

2. APC3

2.1 The Memorandum on Professional Conduct refers to Guidance Notes in Section 12 and to Bye-Law 66 in Section 6. The Disciplinary Scheme referred to in Bye-Law 66 sets out the definition of unprofessional conduct and includes the words "having regard to any advice or guidance on professional conduct, practice or duties".

2.2 The Guidance Notes issued by the Councils of the Institute and the Faculty have been categorized into mandatory, best practice and advisory. Guidance Notes categorized as advisory have little significance for professional conduct.

A material breach of a Guidance Note categorized as mandatory is of itself a ground for complaint under Bye-Law 66. A member who considers it inappropriate to comply with any aspect of a Guidance Note in this category must disclose and justify the lack of compliance in his report.

A failure to comply with a Guidance Note in the best practice category is not of itself a ground for complaint under Bye-Law 66. However a Committee investigating a complaint under Bye-Law 66 would take into account any such failure, which would be regarded as more serious if the failure had not been disclosed by the member concerned.

2.3 GN12 is a best practice note. The phrase "take into account" is associated with best practice and often appears in GN12.

2.4 The possibility now exists of not only modifying GN12 but preparing further Guidance Notes, possibly of an advisory nature. Views on this from those attending the Brighton Convention would be welcome.
3. **The need for Guidance**

3.1 People have questioned whether there is a need for guidance at all in general insurance, although the vast majority appears to accept the need to have Guidance Notes.

3.2 The value placed on actuarial reporting in general insurance depends not only on the quality of the reports which actuaries submit but also on the fact that the actuary is working within a professional discipline. It is now a fact of life that this discipline entails reference to guidance issued by the profession.

3.3 With no statutory responsibilities current in the UK, the existence of Guidance Notes helps to distinguish our profession from other possible experts in the area. Such guidance is now expected e.g. by auditors where they rely on expert advice.

3.4 Once issued, withdrawal of the Guidance Notes would give a signal which would be regarded as adverse to the profession.

3.5 Although by no means a unanimous view, support for the usefulness of the guidance note has been received from a significant number of practising actuaries.

4. **Coverage**

4.1 One criticism was that the guidance was too restrictive in scope, e.g. it did not cover rate making. This could be the subject of an advisory guidance note.

4.2 The guidance note was drafted to cover the activities of UK actuaries in a wide range of situations. For any given report there would be a number of unique features. In particular many actuaries working in the London Market expressed the view that there should be a specific section relating to London Market business. The London Market Group prepared a draft on these lines and Appendix 1 contains this submission and comments thereon.

4.3 The conclusion was that the guidance note was sufficiently broad to encompass the specific aspects raised by the London Market as special points. In view of the problem of reporting on business which embraces both London Market and other business, or indeed not being able to categorise certain business as London Market or not, the recommendation is for the Guidance Notes to retain their basic shape.

5. **Interaction with SORP**

5.1 There was comment that it was odd that no reference was made to the insurance industry SORP.

5.2 This was deliberate - partly, but not wholly, because the SORP itself may prove to be a moving target. Not just because the SORP itself will prove to be a moving target.

5.3 There is a reference in GN12 to guiding accounting principles. Thus a report on the claim reserves to appear in the shareholders' accounts of a listed UK insurer must recognise the accounting principles adopted in those accounts. These might or might not be in accordance with the current SORP.
5.4 The reports could be part of the evaluation of an appraisal value. In this case current guiding accounting principles are not relevant and the guidance note allows for this through the phrase "where appropriate". The guidance note makes it clear that the actuary should think about what is and what is not appropriate.

6. Paragraph 3.5

6.1 One submission has suggested that 3.5 is unnecessary with 3.6 being sufficient to cover the points made in 3.5.

6.2 Paragraph 3.5 contains the words "should have regard to" and "where appropriate". There are situations where the actuary may be agnostic on the reasonableness of certain assumptions and may wish to cover the point. There is always the example, outside the general insurance context, of reports from the Government Actuary based on assumptions provided by the Government.

7. Text book or Guidance Notes

7.1 The comment that some of the guidance note has the appearance of a textbook has been made and the validity of this comment is indisputable. A survey of guidance given by the profession in other countries shows that this feature is not unique to the UK.

7.2 It is difficult to envisage how this textbook material can be left out without reducing the guidance to statements of the kind which should be true for any actuarial reporting - not just General Insurance. There may be a case for a non-specific guidance note to cover all actuarial reports and for expansion of the "Advisory Guidance Notes" to cover specific GI briefs. These would not be exhaustive but could provide a range of examples. Any exercise of judgement involving a departure from such guidance would be the professional responsibility of the actuary, who must be able to rationalise and explain his reasoning to a "reasonable person, but not an expert", quoting GN7.

8. Conclusion

8.1 The format of GN12 should continue in its current shape and there should be no specialist sections.

8.2 Recommendations for some modification in wording are shown in Appendix 2.

8.3 There should be further guidance on specific topics, either of a best practice or even mandatory nature if the report is to satisfy a statutory or semi-statutory obligation, or of an advisory or best practice nature if the report is not founded on statute.

8.4 The General Insurance Joint Committee should continue to adopt a monitoring role and encourage actuaries to report to it on their experiences of GN12.

8.5 The General Insurance Joint Committee may wish to consider whether or not to advocate the adoption of a more generalised guidance note on actuarial reporting with more specialist non-mandatory guidance on specific reporting issues.

W.M. Abbott
16.10.89
LONDON MARKET GROUP SUBMISSION

A1. A draft of the revised GN12 was prepared by the London Market Group (LMG). This was drawn up on the basis of a Section 1 with slight revisions and a new section 5. Only Sections 1 and 5 (and presumably 6) would apply to London Market operations.

A2. The draft for Section 1, which would incorporate bits of Section 2 was:

1.1 Unchanged.

1.1A(new) This note applies only when an actuary is reporting in a formal professional capacity. The occasions on which an actuary is acting in a formal professional capacity include those cases where third parties (e.g. auditors) are likely to rely on his report [Drafting note - alternative definition ?]. If the actuary produces a report which third parties might not be able to rely on (e.g. marshalling arguments to support his client in commercial negotiations) then this should be implied by the wording of the report.

Comment: GN12 refers specifically to a report written in a professional capacity in 1.6. The issues raised by LMG are real, but not unique to general insurance. The requirement to give terms of reference, or purpose of the report, would cover the final sentence.

There are circumstances where beyond doubt an actuary is working in a formal actuarial capacity - presumably all the time for an "independent actuarial consultant". The guidance is intended to be of more general applicability to and recognise that there is a grey area and that actuaries should be aware of professional guidance whether or not the report has been formally signed off by an actuary described as a Fellow of the Institute/Faculty of Actuaries.

1.2 (i) Delete the underlined in "The actuary must not depart from the guidance without having cogent reasons for believing that the circumstances are such that the guidance is not applicable" and replace by "unless he or she believes that the circumstances are such".

Comment: There is a small shift of nuance here. The word cogent implies that the actuary must have a good reason for believing that a departure from the guidance is acceptable. However APC3 does mention that departures from mandatory Guidance Notes are possible. By implication best practice allows departures such that there is no necessity to disclose and justify non-compliance in a report, although the actuary must still be able to justify if necessary. A paragraph of this nature is not attractive in Guidance Notes and APC3 may have resolved the issue so that the paragraph could be deleted entirely.

(ii) Add "; if the actuary departs from the guidelines the issues involved must be set out in the report".

Comment: This is effectively a transference of 1.6 (vi). In the light of the comments above, following APC3 there is now no need for this caveat.

1.3 Unchanged.
1.3A New "This note applies equally to employed actuaries and to consulting actuaries".

Comment: The point is accepted but it is questionable whether it needs to appear in the guidance notes - it does not appear in other guidance notes.

1.4 Delete.

Comment: This links with the suggestions for 1.1A and 1.3A. 1.4 assumes that GN12 applies to employed actuaries but identifies that such an actuary may have difficulty in deciding whether reporting is in a professional capacity or not. The suggested alterations attempt to tighten up the guidance to "formal" reporting but have met the same difficulties as the original drafters in coming up with acceptable wording.

1.5 Unchanged.

1.6 (i) Delete "(i) where this is different from (i) the addressee of the report. 
(ii) the terms of reference given."

Replace by "(i) the address of the report 
(ii) who has commissioned the report and the terms of reference given or why the report has been issued"

Comment: The underlined phrase is the real change. Why the report has been issued is effectively "implied terms of reference". The original wording may be crisper if (iii) is replaced by "the purpose of the report".

(ii) Delete "(v) the key assumptions made

Replace by "(v) the methodology used and the key assumptions contained therein.

Comment: As it stands a key assumption could be the choice of methodology. If changed there is no requirement to comment on the choice of methodology but on specific assumptions within that methodology. Views on this would be welcome.

1.7 Underlining is additional, brackets are deletions. The section is not intended to be a comprehensive list but it is preferable for it to cover the more common briefs.

(i) A report commissioned by the management of an insurance company or Lloyd's syndicate to recommend the level of outstanding claim reserves to be established in the accounts, both statutory and, if different, financial or fiscal. Such reports may give some discretion to management on the final choice of the reserving amount. [The actuary ... ... rating].

Comment: Addition accepted. Deletion also, assuming that the issue of the use of actuarial reports for purposes other than that intended is a more general point and not specific to GI.

(ii) A report commissioned by management or by shareholders to provide an independent check of a reserve estimation and to establish its reasonableness. [For the purpose of this check] Typically the actuary would have full access the insurer's data and, where appropriate, worksheets of the original computations.
APPENDIX 1

Comment: Accepted.

(iii) - (vii) as before.

1.8 Delete. Replace by a new 1.6A

Also Delete 2.2 "Where appropriate .... .... principles".

"Unless implied by his terms of reference, the actuary is under no obligation to present his results in accordance with any relevant accounting framework. However he should be aware that his principal may wish to incorporate the results in a particular accounting framework. If the actuary does present his results in accordance with this accounting framework, then the report should state how the accounting framework has been interpreted".

Comment: The existing wording contains that weasel phrase "where appropriate". It therefore embraces the view of the suggested redraft. However pedantically one could argue that if there is a relevant accounting framework then the actuary must have regard to it otherwise it is not relevant. The phrase where appropriate means that if an actuary is advising on the claim reserve to be incorporated in an insurer's Companies Act accounts, recognition of the guiding accounting principles is appropriate. If the valuation is part of a willing buyer/willing seller appraisal, then there are not appropriate guiding accounting principles. On balance I would prefer to live with the existing wording.

1.10 (old 2.1)

There is no universally accepted terminology used within general insurance and the actuary must draft a report so that the words used leave no room for misunderstanding on the part of those likely to place reliance upon it.

In particular:-

(a) (old 2.3)

The word "solvency" is capable of a number of interpretations. Where the actuary is reporting on the solvency or financial strength or soundness of an insurer, the word "solvency" should not be used without further clarification, e.g. it might be explained that a company was said to be solvent in that it satisfied the minimum solvency requirements.

(b) (old 2.4)

Following the EC directives, actuaries may use the words "provisions" and "reserves" interchangeably. They must, however, be aware of any distinction which is made under the relevant legislation.

(c) It is widespread practice not to discount future payments and receipts for the time value of money, and the actuary may follow this practice without explicitly stating it in the report. If the actuary does discount - either explicitly or implicitly - this should be disclosed.

Comment: The particularisation (a) and (b) is an improvement. (c) is not really a particularisation and must be seen in the context of 3.8. If the actuary has justification for not explicitly stating that future payment estimates have not been discounted, then APC3 would apply.
1.11 Reports on technical reserves may relate to "London Market and Business" or "Conventional Business". These two areas generally involve such distinctive features that they require different guidance notes and are dealt with separately below. For the purposes of this note "London Market Business" is defined as all business written by Lloyd's, all business signed through PSAC or the ILU, or any similar business; this may include inwards reinsurance business.

Comment: This would be a major change to GN12 requiring general insurance business to be identified as either London Market or Conventional. LMG have tried to define "London Market" but the phrase "or any similar business" indicates the problem.

There are conceptual difficulties in that a report may cover both "London Market" and "Conventional" business and business which could be classified as either. There would be a problem if the guidance for the two categories is in conflict. If there is no conflict, then the need for separate guidance evaporates.

Whilst it is true that there are distinctive features of London Market business there are distinctive features for other categories of business, e.g. extended warranty, medical care. The logic of a separate section could easily be extended to other categories of business.

Thus there are significant problems with the approach suggested. The actual contents of the suggested Section 5 are discussed below. It may therefore be more appropriate to stick with the present concept of GN12 and look for alternative ways of addressing the needs of London Market actuaries for more particular guidance.

A3. The presumption from the LMG draft is for 2.5-12,3 and 4 to remain, Section 5 to be replaced, and Section 6 presumably to remain. The suggested draft for London Market Business was:

5.1 This section applies to London Market Business.

Comment: I am not sure whether the old Section 5 on combined reserves would disappear or not. Combined reserves is a phrase picked up from EC directives (and SORPS?). Even if there were a separate section on London Market business, there would still need to be a section to cover non-London Market business accounted for on this basis.

5.2 London Market Business and practices are generally complex and idiosyncratic. The actuary should be aware of the differences between London Market Business and other general insurance, and should take into account the requirements of Section 14 of the Memorandum on Professional Conduct and Practice.

Comment: With the disappearance of 2.3 and 2.4 within 2.1, a new 2.3. could read:

"There are a number of categories of general insurance business where practices are idiosyncratic and have varying degrees of complexity. In particular London Market business is complex and any actuary working in this area must be aware of the particular features of this business." The relevance of the Memorandum on Professional Conduct and Practice should go without saying within a guidance note.
5.3 An Actuary reporting on a Lloyd's syndicate must be aware that the regulatory, accounting (and taxation) systems are unique to that market. An actuary asked to comment on the reinsurance to close of a Lloyd's syndicate should make clear whether he is reporting on the estimated ultimate claim costs of the business being transferred, or the overall appropriateness of the nature and amount of the reinsurance to close premium. If the latter then the actuary must take into account the value and nature of the corresponding assets, including any relevant "Time and Distance" (or similar) reinsurance policies.

Comment: Apart from a problem on the definition of estimated ultimate claim cost, the second sentence is covered by 1.6 where the actuary has to make clear the terms of reference/purpose of report. As has been said before Lloyd's is unique, but so are the regulatory, accounting and taxation systems of many other countries.

5.4 A report on the technical reserves of a London Market operation (whether accounted for on a funded basis, or by identifying outstanding claims, unearned premium, etc. separately) should indicate how the following issues have been addressed in the actuarial projections:-

(a) the source of the data, and any steps taken to verify its factual accuracy and correct interpretation;

(b) the grouping of data and currencies for projection purposes;

(c) the effect of any significant changes in underwriting practices (including mix of business written, policy coverages, and line structures);

(d) any significant changes in the reinsurance programme;

(e) potential exhaustion in the reinsurance programme (both sideways and vertical), and reinsurance failures (both known or at the valuation date, and potential future failures);

(f) any changes in the claims settlement and claims estimation procedures;

(g) any known changes in the data processing, data reporting, or accounting procedures;

(h) any known or potential significant changes in the legal and social environments;

(i) future claims handling expenses, both direct external costs and internal costs;

(j) the treatment of any abnormal types of claim;

(k) the treatment of future premiums in and out (including reinstatement premium), profit commission and portfolio transfers.

Comment: Without disputing items (a) to (c), they are not unique to London Market business.

(a) - see 2.6 where the existing wording can be improved as suggested.

(b) - within 2.7.
(c) - within 2.6 (iii).

(d) - within 2.10, but add in second line after arrangements "significant changes therein and the potential for exhaustion of those arrangements".

(e) - see (d)

(f) - within 2.6 (iii).

(g) - within 2.6 (iii).

(h) - within 2.6 (iii).

(i) - within 3.4, accessed through old 5.3 as the context permits.

(j) - within 3.6 (ii).

(k) - meant to be within 5.2 which could be extended to read on the third line "Outstanding handling expenses, premiums (in and out including reinstatement premiums) and commissions (normal and profit). The ..".

5.5 When dealing with London Market Business the actuary's conclusions will often be subject to margins of error which may be large, and which it may not be possible to quantify. Notwithstanding the uncertainty, it is professionally acceptable for an actuary to give positive opinions and provide estimates of the technical reserves. The report should however make clear that the eventual outcome will almost certainly differ from the estimates contained therein.

Comment: within 2.5.

5.6 Estimates of reserves may be expressed as estimated mean values or as values lying within a range. If the latter, then the interpretation of the range should be made clear (e.g. a range containing all "likely" outcomes, or a range indicating the impact of changes in a few key parameters, etc.).

Comment: The point estimates may not necessarily be "mean" - it depends on the brief. Within 2.5 but insert after "acceptability" in the second line, "but the interpretation of either should be made clear".

---oOo---

W. M. Abbott
16.10.89.
GN12: GENERAL INSURANCE BUSINESS:
ACTUARIAL REPORTS

[This guidance note was issued to members in August 1987.]

1. INTRODUCTION

1.1. This guidance note has been produced to assist actuaries working in the field of general insurance. It is restricted to general points that an actuary should take into account in reporting on reserves or on the financial soundness of a general insurance company. The note does not cover other aspects of reporting in which an actuary may be involved, e.g. ratemaking.

1.2. It is recognized that actuarial reporting in general insurance is not yet fully developed and there may be circumstances in which the guidance given below may not be applicable. The actuary must not depart from the guidance without having cogent reasons for believing that the circumstances are such that the guidance is not applicable.

1.3. General insurance business in the UK is carried on under the terms of the Insurance Companies Act 1982. Actuaries have no statutory responsibility for general insurance under this Act.

1.4. In general insurance, unlike life assurance, there is not a long tradition of actuarial involvement in the UK. In these circumstances it is especially important to give consideration to the nature of the brief given to the actuary. The report may have been commissioned from the actuary specifically in a professional capacity. For an actuary who is an employee of an insurer, there may be some difficulty in identifying the capacity in which he/she prepares the report. The report may be in a form which does not indicate that the writer is acting in an actuarial capacity. However, the actuary should still take this note into account if only because it may be difficult to prevent the report's recipient from referring to it as an actuarial report.

1.5. There may be circumstances in which a report has been commissioned where the actuary has a statutory responsibility. Typically these rare instances may relate to some overseas regulatory authorities requiring statements on UK branches or subsidiaries. The actuary may also be concerned with reporting on an overseas company or branch to the local management or authorities. The actuary should be familiar with the legislation concerned and whether or not the report is in accordance with any local professional code of practice.

1.6. A report written in a professional capacity should state, *inter alia*.

(i) who has commissioned the report;
(ii) where this is different from (i), the addressee of the report.
(iii) the terms of reference given.

August 1987 (Supp. 3)
(iv) the extent to which the report meets those terms of reference, and any
departure from or extension to those terms;
(v) the key assumptions made;
(vi) if advantage has been taken of paragraph 1.2 of this guidance note the
report should state the reasons for departure from the guidance of
subsequent paragraphs;
(vii) the name of the actuary and that he/she is a Fellow of the Institute of
Actuaries or of The Faculty of Actuaries (or the professional actuarial body
which is appropriate).

1.7. Examples of the varying briefs which could be received by an actuary are
given below:

(i) A report commissioned by the management of an insurance company to
recommend the level of outstanding claim reserves to be established in the
insurer’s accounts, both statutory and, if different, financial or fiscal. Such
reports may give some discretion to management on the final choice of the
reserving amount. The actuary may need to comment on the suitability or
otherwise of the chosen reserves as a basis for making decisions on premium
rating.

(ii) A report commissioned by management or by shareholders to provide an
independent check of a reserve estimation and to establish its reasonableness.

(iii) A report commissioned by an insurer to provide supporting evidence for
outside bodies (e.g. tax authorities, potential purchasers, supervisors).

(iv) A report relating to the totality of technical reserves rather than being
limited to outstanding claims.

(v) A report commissioned by supervisors, potential purchasers, reinsurers,
investment analysis firms, etc., without the knowledge or assistance of the
insurer to provide a view on the strength of the reserves. Typically such a
report would be based on published data.

(vi) A report for supervisors on the financial strength of an insurer which will
provide sufficient evidence for the supervisor to act (or provide comfort not
to act).

(vii) A report to company management or its shareholders on the capital
considered necessary to establish the insurer as being financially sound.

1.8. Reports on technical reserves may relate to:

(i) business accounted for on an annual or a deferred annual basis
   — outstanding claims (see section 3);
   — unexpired risks (see section 4);
   — technical reserves (which includes both outstanding claims and unexpired
     risks);
(ii) business accounted for on a fund-accounting basis:
— the outstanding liability (combined reserves) in respect of closed and open
years, separately or in aggregate (see section 5).

2. GENERAL POINTS

2.1. There is no universally accepted terminology used within general insurance
and the actuary must draft his report so that the words used leave no room for
misunderstanding on the part of those likely to place reliance upon it.

2.2. Where appropriate, recognition should be given to the guiding accounting
principles. It should be clearly stated how the report relates to any such
principles.

2.3. The word 'solvency' is capable of a number of interpretations. Where the
actuary is reporting on the solvency or financial strength or soundness of an
insurer, the word 'solvency' should not be used without further clarification, e.g.
it might be explained that a company was said to be solvent in that it satisfied the
minimum solvency requirements.

2.4. Following the EC directives, actuaries may use the words 'provisions' and
'reserves' interchangeably. They must, however, be aware of any distinction
which is made under the relevant legislation.

2.5. Reports on reserves may be produced in terms of point estimates or ranges
of acceptability. Where appropriate, reports should indicate the sensitivity of the
estimates to variations from the stated assumptions. There may be situations
where the actuary should indicate specifically that the reserving basis makes no
provision for particular unforeseen contingencies.

2.6. It would be normal practice for the actuary to consider and, where
appropriate, comment on:

(i) the nature and accuracy of the data and the steps taken to verify the
accuracy of the data;
(ii) the last similar report and any changes in the basis used or the key
assumptions;
(iii) the effect of changes in underwriting practices, claims handling, data
processing, accounting procedures and known or potential changes in the
legal and social environment;
(iv) the extent of the reliance on other professionals.

2.7. The actuary should give due consideration to the categorization of the
business into homogeneous groups, as far as practical, and, where appropriate,
comment on the degree of grouping or subdivision of the data (including
grouping by currency) and comment if necessary on the limitations imposed by
this grouping.

August 1987 (Supp. 3)
(ii) business accounted for on a fund-accounting basis:  
—the outstanding liability (combined reserves) in respect of closed and open  
years, separately or in aggregate (see section 5).

2. GENERAL POINTS

2.1. There is no universally accepted terminology used within general insurance  
and the actuary must draft his report so that the words used leave no room for  
misunderstanding on the part of those likely to place reliance upon it.  

2.2. Where appropriate, recognition should be given to the guiding accounting  
principles. It should be clearly stated how the report relates to any such  
principles.

2.3. The word ‘solvency’ is capable of a number of interpretations. Where the  
actuary is reporting on the solvency or financial strength or soundness of an  
insurer, the word ‘solvency’ should not be used without further clarification, e.g.  
it might be explained that a company was said to be solvent in that it satisfied the  
institutional solvency requirements.

2.4. Following the EC directives, actuaries may use the words ‘provisions’ and  
‘reserves’ interchangeably. They must, however, be aware of any distinction  
which is made under the relevant legislation.

2.5. Reports on reserves may be produced in terms of point estimates or ranges  
of acceptability. Where appropriate, reports should indicate the sensitivity of the  
estimates to variations from the stated assumptions. There may be situations  
where the actuary should indicate specifically that the reserving basis makes no  
provision for particular unforeseen contingencies.

2.6. It would be normal practice for the actuary to consider and, where  
appropriate, comment on:

(i) the nature and accuracy of the data and the steps taken to verify the  
accuracy of the data;
(ii) the last similar report and any changes in the basis used or the key  
assumptions;
(iii) the effect of changes in underwriting practices, claims handling, data  
processing, accounting procedures and known or potential changes in the  
legal and social environment;
(iv) the extent of the reliance on other professionals.

2.7. The actuary should give due consideration to the categorization of the  
business into homogeneous groups, as far as practical, and, where appropriate,  
comment on the degree of grouping or subdivision of the data (including  
grouping by currency) and comment if necessary on the limitations imposed by  
this grouping.

August 1987 (Supp. 3)
2.8. The reserves may be established:

— separately for gross reserves and for reinsurance recoveries;
or
— as net reserves.

Especially where the gross account is protected by excess of loss reinsurance, the actuary might feel more confident about the net position than the gross. This confidence may be attached to the gross position provided that there is a caveat on the dependence on reinsurance.

2.9. Where separate gross and reinsurance recovery reserves are being estimated, and similar principles or methods are not being used for both these reserves, the actuary should comment on the appropriateness of the different principles or methods.

2.10. Where a report covers the position net of reinsurance, the actuary should consider the nature and spread of the reinsurance arrangements and comment on the extent to which the possible non-performance of such reinsurance has been taken into account.

2.11. Where appropriate the actuary should report on the extent to which the expected basis used in establishing the estimates compares with the actual experience.

2.12. The actuary should consider the relevance of cross-funding, i.e. whether a liability is sufficient in aggregate but one part is deficient. For example:

(i) unexpired risks by outstanding claims or vice versa;
(ii) combined reserves for one cohort year by another year or years;
(iii) one class of business by another class of business.

Given the purpose of the report, and where appropriate, the actuary should indicate the degree to which cross-funding exists.

3.1. These reserves should cover, unless specifically excluded:

— known (i.e. reported) outstanding claims;
— claims incurred but not reported (IBNR);
— reopened claims;
— future claims handling expenses.

3.2. The reported and IBNR reserves may be established:

(i) On a case-by-case basis for the reported claims and (normally) a statistical estimate for IBNR. The case estimates would be the responsibility of a claims expert.
(ii) As (i), but with some of the estimates for reported claims being on a statistical basis.

(iii) Either separately or jointly on a statistical basis. If a joint reserve for reported and IBNR claims is calculated, but it is necessary to show a separate reserve for IBNR, the latter would need to be calculated on a statistical basis and the reserve for reported claims would be obtained as a balancing item. If, on the other hand, case estimates were to be deducted from the joint reserve, the result would be a reserve for IBNR with an adjustment to allow for under- or over-provision in the case estimates.

3.3. The reopened claim reserve may be calculated as an explicit item or it may be contained as an allowance in the reported and IBNR claim reserve.

3.4. Where there is a reserve for future claims handling expenses, this should be consistent with the reporting objectives. For example, in reporting on the business as a going concern, these reserves could cover only the variable and overhead costs of the claims function.

3.5. The results produced by statistical methods will be dependent on the methods and assumptions used. The actuary should have regard to significant sources of likely variation from these assumptions and methods and, where appropriate, comment on the size and likelihood of the potential difference. In any event a professional report should state whether the assumptions made are reasonable and in line with the current state of knowledge.

3.6. Various methods are available to the actuary for the statistical estimation of claims reserves. The choices depend on the class of business, data available and the judgement of the actuary. Particular points to consider are:

(i) homogeneity or changing mix of data, including the currencies underlying the claims;

(ii) effect of large claims including catastrophe claims from a single event;

(iii) cyclical or temporary trends;

(iv) handling and administration procedures etc.

In particular, consideration should be given to the basis of projection and the effect of actual experience varying from that expected.

3.7. In arriving at the estimates of future payments on the existing claims, the actuary should consider the impact of future escalation of claim costs. A ‘full undiscounted claim reserve’ must contain an allowance for future claim escalation at a rate considered appropriate for the claims in question. Where no explicit allowance is made for inflation, the actuary should ensure that the implicit allowance is appropriate.

3.8. Any report by the actuary should make clear whether or not the reserves have been arrived at after discounting, either explicitly or implicitly and, if
explicitly, the 'rate of discount used and the extent to which the nature of the covering assets has been taken into account.

3.9. If an opinion is given on reserving levels the actuary should make clear the context in which the opinion is given, whether the opinion is in accordance with any guiding accounting principles that are applicable and the relationship of the opinion to any such accounting principles. If the actuary is required to give an opinion on the adequacy of the reserves, as already pointed out in section 2.1 he must draft his report so that the words used leave no room for misunderstanding by those likely to place reliance upon it. He should bear in mind, and make these distinctions clear in his report, that when he uses the word 'adequate' this is likely to imply 'with margins for caution', whereas the same may not apply where words such as 'prudent' or 'sufficient' are used.

4. UNEXPIRED RISK RESERVES

4.1. These reserves cover:

—the unearned premium reserve (UPR);
—an additional amount for unexpired risks not covered by the UPR.

This combination constitutes the reserve for unexpired risks.

4.2. The UPR may be a 'reserve net of an allowance for deferred acquisition costs, or it may be gross with these deferred costs shown as an asset.

4.3. The calculation of unearned premiums should normally be a standard accounting calculation. The actuary should consider the appropriateness of the approximations made in these calculations, in particular those relating to

(i) the incidence of risk over the policy duration,
(ii) the grouping of base dates, e.g. daily, monthly, quarterly or at mid-year;
(iii) the treatment of non-annual premiums;
(iv) the choice of base date, e.g. debit of premium, inception of policy.

Consideration should be given to the prudence of ignoring unbooked premiums and lapses and, where appropriate, of establishing the appropriate estimates.

4.4. The amount of acquisition costs deferred will depend upon the philosophy underlying any appropriate accounting principles used including any statutory constraints. The actuary must identify these principles before commenting on the appropriateness of any quantification of the deferred amount.

4.5. The unexpired risk reserve may be considered to be the amount necessary to cover the future outgo arising from the exposure to risk still existing at the accounting date. This amount may be considered as the product of the unearned premium and an appropriate claim ratio. This claim ratio should allow for claims handling expenses. If the claim ratio is based on historical ratios, exceptional influences should be removed, suitable adjustment made for rate changes and the
ratios projected forward. The projected ratio should then be adjusted to allow for known events between the accounting date and the computation date.

4.6. Where a measure of exposure such as vehicle years is available, the unexpired risk reserve may be calculated as the product of the outstanding exposure, projected claim frequency and projected average claim amount, including handling costs.

4.7. The additional amount for unexpired risks should be excess, if any, of the unexpired risk reserve over the unearned premium reserve (net of deferred acquisition costs). This amount may be further reduced in accordance with the guiding accounting principles by anticipating future investment income (to the extent that it has not already been anticipated) in the outstanding claim and unearned premium reserves, making clear the extent to which the nature of the covering assets has been taken into account.

5. COMBINED RESERVES

5.1. In view of the various types of fund accounting methods which exist, the actuary must have regard to the accounting concepts involved. In particular the actuary needs to consider:

(i) the definition of the cohort; and
(ii) the duration at which a profit is first allowed to emerge, i.e., the point of first closure.

5.2. The calculation of the estimated outstanding amount at the point of closure may cover not only outstanding claims whether notified or not, but also outstanding handling expenses, premiums and commissions. The actuary should consider whether each of these items requires a separate calculation or whether one aggregate figure will suffice. The terminology IBNR may be used but it should be recognized that it may be essentially different in character from that used in annual accounting bases.

5.3. The guidance given under section 2 and, where the context permits, in sections 3 and 4 is equally applicable. The factors associated with fund accounts may be especially complex, both in regard to the nature of the business and the administrative arrangements associated with the accounting basis.

5.4. The basis for the calculation of open-year funds is a cash accumulation amount augmented by the additional amount considered necessary to ensure the sufficiency of the reserves. The very nature of the funded business often means that information is not available on which a satisfactory estimate may be made. The actuary however can:

(i) establish a model of an expected emergence of premiums, claims, commission and expenses in the open years or of the development of claim ratio patterns.
(ii) take adverse divergences from this model as the additional amount required to support the open-year fund.

The model may be based on past experience and on views on current levels of profitability.

6. FINANCIAL STRENGTH AND SOUNDNESS

6.1. An actuary may be called on to report on whether a company has satisfied the statutory solvency requirements. Where this relates to a past accounting date, then the report would refer to an assessment of the technical reserves and a check on whether the shareholders' capital and reserves are sufficient to comply with the regulations in force.

6.2. Where the actuary is concerned in reporting on the continuing solvency of an insurer over a period, i.e. on the financial soundness of the insurer, due consideration should be given to:

(i) expected volume, nature and profitability of new/renewed business;
(ii) fluctuations of all types relating to claims experience;
(iii) fluctuations in and ability to realize asset values; and
(iv) suitability of the reinsurance arrangements;

in projecting the experience over the period to establish whether or not the shareholders' capital is adequate and whether the company is likely to continue to be able to satisfy the statutory solvency requirements.

6.3. In addition the actuary should recognize that there may be aspects of a subjective nature which are not necessarily within the actuary's brief. It would be appropriate for a report to identify the wider issues involved. These may include:

(i) departures from expected profit margins through bad management etc.;
(ii) security of reinsurance arrangements; and
(iii) possibilities of fraud.

Furthermore, and within the competence of the actuary, there is the possibility of discovery of deficiencies in the technical reserves. Any report by the actuary should recognize these issues and describe the vulnerability of the insurer to these risks. The report may consider ways of managing the risks involved. In particular the actuary may be willing to indicate the amount of shareholders' capital considered commensurate with acceptance of the risks. This advice may take into account the availability of fresh capital as required.