

OFFSHORE GROUP OF INSURANCE SUPERVISORS



**GUIDELINES
SEPTEMBER 1998**

**TECHNICAL RESERVES FOR PROPERTY AND
CASUALTY INSURERS**

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Introduction

This paper will attempt to address the question of what standards should be exercised by an insurance supervisor when faced with the challenge of determining whether or not an insurer has established adequate technical reserves. A question to which there is certainly no easy answer.

“The ability to predict ultimate reserve requirements is as much an art form as it is an actuarial science, particularly in casualty lines of business.” (A.M. Best 1997 Reports)

It is accepted that the issue may be fairly easily disposed of when dealing with captive insurers that may write only monoline parent company business. But there are also captives writing a broad book of parent related business and many OGIS members also have domestic insurers under their regulatory purview. In those cases the supervisor needs to approach the challenge with a good deal of caution and all the expertise he can bring to bear.

“The fact that loss reserves cannot be established at precise amounts should not dissuade anyone from attempting to improve the process Regulators must do what they can in support of improved loss reserving practices. The reliability of property / casualty insurance company financial results depends now, as much as ever, on the accuracy of loss reserves.” (Loss reserving, Ernst & Whinney)

Of all the liabilities appearing in the balance sheet of an insurer the most significant are those attributed to claims reserves including incurred but not reported (IBNR), reserves for unearned premiums and unexpired risks – known collectively as technical reserves.

The significance of the technical reserves lies in the effect which relatively minor adjustments can have on the insurer’s capital and surplus, together with the supervisor’s difficulty in coming to a determination as to their accuracy, bearing in mind that in their preparation the insurer itself will have relied upon a variety of tests and assumptions which in themselves may be uncertain.

The supervisor should be able to rely upon the reported shareholders funds (capital and surplus) for the overall solvency of the insurer. To illustrate the ‘minor adjustment’ issue consider a company with technical reserves of \$5million, total assets of \$6million and shareholder funds of \$1million. The correction of a 20% underestimation of the company’s reserves would effectively reduce shareholders funds to nil.

Consequently, if there is a basic measure to be applied it will be found in this relationship between technical reserves and shareholders funds. It can be said without question that the greater the multiple of loss reserves to surplus the more critical it becomes that the reserves be accurately stated, because the company's solvency is so dependent upon them. However, because of the wide diversity of risks in most general, and some captive, insurers, it is very difficult to set fixed standards for an appropriate ratio. In general reserves can much more easily be set for insurers writing only property business than for those writing casualty, particularly the long-tail lines (i.e. for those lines of business that take time, after claims occurrence, before the claims are reported and subsequently settled) such as products liability, environment impairment and asbestosis. A.M. Best suggests a normal range for this (total loss reserves to surplus) test is from 50% to 100% for property insurers and from 200% to 300% for long-tailed casualty insurers.

If there are no fixed standards for the supervisor to use when evaluating reserves it follows that the process must become one of very subjective judgment. It is therefore important that the supervisor looks first at his own capabilities / expertise (or such as is available to him) and then to determine whether or not he needs assistance from some sort of external resource. It is appreciated that the internal resources available to supervisors within the Group may vary considerably; some may enjoy the luxury of the services of loss development analysts or even actuaries.

At the very least a supervisor should seek to gain a basic familiarity with the lines of business written and their historical loss development trends both on a 'per company' and a 'per industry' basis. He should also keep abreast of legal awards and judgements arising out of liability cases before the courts in his own jurisdiction (and any others in which his insurers might be operating). Loss development statistics should be available both through the local industry and occasionally through the trade press, which may also report court proceedings.

He should understand that there are limitations with any method of assessment and he should consider:

- The composition of the portfolio may have changed over the years.
- The method of reserving may have altered over time, especially because it is often based on the judgement of human beings, not science.
- Deductibles may vary year to year, distorting the information
- Adding a security loading to allow for judicial inflation, currency movements and the unexpected.

It is assumed that in every member jurisdiction there will be a basic filing requirement of an audited financial statement. A statement in some statutory format and other reports, possibly including an actuarial report and amplified claims analyses, may supplement such statement. The basis of a good loss-reserving programme is an information system that provides the necessary statistical history of past and current claim settlement experience. This data can be used to project future claim settlement patterns but the data must be able to allow the directors to interpret why past experience evolved as it did. Changing conditions that are likely to cause future experience to deviate must be analysed and taken into account. It is not sufficient to rely wholly on past experience. Lack of claims in the past (especially of the high security/low frequency type) does not guarantee lack of claims in the future. It is suggested that for all insurers writing an appreciable volume of casualty business the supplementary information should always include claims reserve history per line of business per underwriting year. The

information is most usefully presented in the tabular form known as triangulation, which provides one of the best forecasting tools available. A full actuarial report where appropriate, should also be provided at least every other year. To interpret all of this information intelligently the supervisor will also need a breakdown of business by line and geographical area, or in other words, a good familiarity with the insurance operations of the company. Depending on his assessment of the information thus far the supervisor may wish to look right through the reported numbers to the company's reserve setting practices, the speed at which the reserves are set, the frequency at which they are reviewed and the thoroughness of the application of any reinsurance protection. He may further wish to review the methodology used in establishing IBNRs to ensure that recognised techniques are involved – the expertise of the person or claims committee involved may also be significant.

During on-site inspections, where considered applicable, the supervisor should examine the claims register and consider the development history of individual cases compared to the triangulation.

The supervisor should consider the gross claims (ie before reinsurance) and consider separately the reinsurance, including the security of the reinsurers contained within the programme. The contract wordings could be considered although this task may be outsourced to insurance managers, if these are authorised, or the auditors and actuaries.

The insurance supervisor should ensure that the records. Internal control. Personnel involved in setting the claims reserves and the directors, auditors and actuaries are all of sufficient standard to allow the insurance supervisor to make a subjective decision on the adequacy of the technical reserves.