

GUIDANCE NOTES GN12, GN14 AND GN18

Institute of Actuaries and Faculty of Actuaries

GN12: GENERAL INSURANCE BUSINESS: ACTUARIAL REPORTS

Classification (see APC)

This Guidance Note is classified in relation to the code of professional conduct as *best practice*.

Scope

World-wide.

Application

Any actuary preparing a formal report on the reserves or on the financial soundness of a general insurance undertaking, including a Lloyd's syndicate, whether as a consultant or as an employee. This Guidance Note does not cover other aspects of general insurance, such as rate-making.

Legislation or Authority

There is no United Kingdom legislation specifically relating to actuarial reporting on general insurance business. There are separate Guidance Notes for actuaries appointed in terms of Lloyd's Byelaw No. 17 of 1989 (GN14) and actuaries signing certificates for submission to the Non-Admitted Insurers Information Office in the United States of America (GN18).

First issued

August 1987.

Revised

July 1991.

1. INTRODUCTION

1.1 This Guidance Note has been produced to assist actuaries working in the field of general insurance, including the general insurance business of Lloyd's syndicates, whether as consultants or as employees. It is restricted to general points which should be taken into account when making a formal report (as distinct from a brief statement or opinion) on the reserves or on the financial soundness of a general insurance undertaking. The Guidance Note does not cover other matters on which an actuary may report, such as rate-making.

1.2 It is recognized that there may be circumstances in which some of the guidance given below will not be applicable. The actuary's report should indicate any areas which are inconsistent with the guidance.

1.3 It is important that the nature and scope of the brief given to the actuary and the capacity in which the actuary is reporting should be clearly defined. Examples of briefs which could be given to an actuary are listed below:

July 1991 (Supp. 17)

- (i) A report commissioned by the management of an insurance company or a Lloyd's syndicate to recommend the level of reserves to be established in the insurer's accounts and/or statutory returns. The brief may be limited to outstanding claim reserves or it may cover the totality of technical reserves.
- (ii) A report commissioned by management or by shareholders to provide an independent check on the amount and adequacy of the reserves. For this purpose the actuary will normally need to have full access to the insurer's data.
- (iii) A report commissioned by an insurer to provide supporting evidence for outside bodies, such as tax authorities, supervisory authorities or potential purchasers.
- (iv) A report commissioned by an outside body, such as a supervisor, a potential purchaser or an investment analyst, to provide an opinion on the strength of the reserves, without the knowledge of the insurer concerned. Typically such a report will be based on published information.
- (v) A report commissioned by management or shareholders, or by a supervisor or other outside body, on the financial strength of the insurer. Such a report may require the actuary to recommend the amount, if any, of additional capital necessary to establish the insurer as being financially sound.

1.4 Where the report relates to business written in another country, or has been commissioned by a supervisory authority or other body in another country, the actuary should be familiar with the relevant legislation, local conditions and, where applicable, any professional code of practice in the country concerned.

1.5 Section 2 of this Guidance Note sets out general points which an actuary should take into account. Sections 3 and 4 are concerned specifically with reporting on reserves and financial soundness respectively.

2. GENERAL POINTS

2.1 The report should state:

- (i) who has commissioned the report and, if different, the addressee(s) of the report;
- (ii) the purpose of the report or the terms of reference given;
- (iii) the extent, if any, to which the report falls short of, or goes beyond, its stated purpose;
- (iv) the name of the actuary, his professional qualification and the capacity in which he has prepared the report; and
- (v) whether it is in accordance with this Guidance Note or, if not, any material areas where the Guidance Note has not been applied.

2.2 It would be normal practice for the actuary to comment on:

- (i) the methodology used and the key assumptions contained therein;

- (ii) any changes made in the methodology and key assumptions as compared with the last similar report; and
- (iii) the extent of any reliance on the opinions of others, for example in regard to certifying the accuracy of the data.

2.3 The report should indicate, where appropriate, how the following issues have been addressed

- (i) the nature, accuracy and interpretation of the data;
- (ii) the grouping of the data by class of business, category of risk and currency;
- (iii) comparisons of actual experience with that expected under the assumptions made in the previous report;
- (iv) the effect of underwriting, claim reporting and settlement, data processing and accounting procedures, with particular reference to any significant known changes therein;
- (v) the nature and spread of the reinsurance arrangements, with particular reference to any significant changes therein;
- (vi) potential exhaustion of the reinsurance coverage and the possibility of non-performance of reinsurance;
- (vii) the effect of any significant known changes in the legal and social environments;
- (viii) future claim handling expenses, both direct external costs and internal costs;
- (ix) the treatment of any abnormal types of claim; and
- (x) the treatment of future premiums in and out (including reinstatement premiums), profit commission and portfolio transfers.

Significant issues emanating from the above list might be identified from discussions with underwriting or claim personnel, from inspection of the data, or from the actuary's wider experience of the business being projected.

2.4 Where the report is being prepared in regard to technical reserves for statutory accounts or returns to a supervisory authority, the actuary should be aware of, and give due recognition to, any relevant accounting principles or statutory requirements. In the United Kingdom, for example, a Statement of Recommended Practice produced by the Association of British Insurers comments on such matters as reporting of gross and net reserves, claim handling expenses and deferred acquisition costs and recommends that there should be no cross-funding or implicit discounting.

2.5 General insurance terminology includes a number of words and phrases which, although commonly encountered, are not accepted universally or are capable of different interpretations. The actuary should seek to ensure as far as possible that any such words or phrases in a report will not be misunderstood. The following are common examples:

July 1991 (Supp. 17)

- (i) The word 'solvency' is capable of a number of interpretations and should not be used without further clarification. For example, if the criterion for 'solvency' is that a company satisfies the minimum statutory solvency requirements, this should be stated in the report.
- (ii) It is common for actuaries to use the term 'reserves' when referring to the value placed on an insurer's liabilities and this term is also used in the United Kingdom Insurance Companies Acts and Regulations. Accountants, on the other hand, use the word 'provisions' for the amount held in the accounts to meet specific liabilities and attach a rather different meaning to 'reserves'. It is acceptable for actuaries to use the words 'provisions' and 'reserves' interchangeably provided the meaning is clear from the context of the report. Actuaries should, however, have regard to the definitions incorporated in any relevant legislation.
- (iii) The term 'IBNR' can be used in two senses. The first just covers claims which have been 'incurred but not reported'. The second extends the first definition to include development (positive or negative) on notified claims.
- (iv) Particular care should be taken when using terms such as 'best estimate', 'adequate', 'cautious', 'prudent', etc. which, although imprecise in their meaning, are nevertheless intended to provide an indication of the strength of the reserves. In the United Kingdom, the word 'adequate' in connexion with reserves usually suggests that there is a more than even chance, but not much more, that they will prove large enough to meet the liabilities. The words 'cautious' or 'prudent' usually imply a rather higher probability and the word 'sufficient' implies a very high probability that the liabilities will be met. However, even these imprecise definitions are not universally adopted and it is always possible that the meaning attached to any of these words by recipients of the report may differ from that intended by the actuary. In the United States, for example, the phrase 'good and sufficient' has generally been taken to have the same meaning as that attached to 'adequate' in the United Kingdom. For these reasons it is strongly recommended that the actuary provides additional comment if there is any possibility of misunderstanding. A report might explain, for example, that 'adequate' indicates that there is little more than an even chance that the reserves will be large enough to meet the liabilities, or 'cautious' implies that the reserves incorporate some margins for caution. If the word 'prudent' is used, it should be made clear whether it is intended in the actuarial sense indicated above or in the accounting sense of being rather more likely to give rise to a subsequent release of profit than a need to recognize a loss.

When any of the terms in (iv) is used, it should be made clear whether it is used purely in relation to an estimate of the ultimate cost of claims or in relation to an estimate of a reserve which takes account of other factors such as investment income or currency matching.

2.6 Reports on reserves or on capital requirements may be produced in terms of

either point estimates or ranges of acceptability. With some types of business the conclusions will often be subject to margins of error which may be large. Notwithstanding such uncertainty it is acceptable for the actuary to give positive opinions and provide estimates of the liabilities. The report should draw attention to the uncertainty, making it clear that the eventual outcome will almost certainly differ from any projections made; the actuary may wish to draw attention to particular unquantifiable contingent liabilities for which no explicit allowance has been made.

2.7 Where appropriate to the purpose of the report, the actuary should indicate the degree to which cross-funding exists, i.e. where the reserves are adequate in the aggregate but one or more parts are deficient, for example:

- (i) a deficiency in the reserve for unexpired risks offset by some redundancy in the outstanding claim reserve, or vice versa;
- (ii) a deficiency in the combined reserve for one cohort year offset by some redundancy in that for another year;
- (iii) a deficiency in the reserve for one class of business offset by some redundancy in that for another class.

3. REPORTING ON RESERVES

3.1 The reserves may be calculated either as net reserves or as gross reserves with a separate offset for the effect of reinsurance. In either case the actuary should describe the methods and assumptions used to allow for reinsurance.

3.2 Consideration should be given separately to the liabilities in respect of outstanding claims and unexpired risks, unless the business is accounted for on a funded basis, in which case a combined reserve may be considered.

3.3 Outstanding claim reserves should cover, unless specifically excluded:

- reported outstanding claims (estimated ultimate cost);
- claims incurred but not reported (IBNR);
- reopened claims; and
- future expenses of handling these claims.

Each of these reserves may be calculated and reported explicitly or any two or more of them may be aggregated together.

3.4 Any reserve for future claim handling expenses should be consistent with the reporting objectives. When reporting on the business as a going concern, this reserve should cover only the costs of the claim function. If the business is being run off, expenses might rise significantly and might include areas other than claims, such as general management.

3.5 The choice of method for the estimation of claim reserves depends on the

class or nature of the business and the form and quality of the data. It is for the actuary to select the method(s) appropriate in the circumstances. Particular points to consider include:

- (i) lack of homogeneity or changes in the mix of the data;
- (ii) the effect of large claims, including catastrophe claims and aggregations from a single event;
- (iii) cyclical characteristics or temporal trends, including the effect of inflation;
- (iv) patterns of claims paid or settled; and
- (v) the effect of reinsurance.

3.6 When applying statistical methods of estimation, the actuary should be aware that, in addition to the effect of random variation, there may be significant sources of error associated with the choice of model or its parameters. The actuary should consider how these uncertainties should be communicated to the recipients of the report.

3.7 In estimating future payments on reported claims, the actuary should consider the effect of future escalation of claim costs. Where no explicit allowance is made for inflation, the actuary should indicate how allowance has been made.

3.8 The reserve for unexpired risks comprises:

- the unearned premium reserve (UPR); and
- any adjustment considered necessary to cover future outgo, including future claim handling expenses, arising from unexpired periods of exposure to risk existing at the accounting date.

3.9 The actuary should consider the appropriateness of any approximations underlying the method of calculation of the UPR, in particular those relating to:

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

Where unbooked premiums and lapses have been ignored, the actuary should consider whether it would be prudent to establish additional reserves.

3.10 The UPR may be net of an allowance for deferred acquisition costs or it may be gross with these costs shown separately as an asset.

3.11 The actuary should state whether or not allowance has been made for future investment income and, if applicable, how such allowance has been made and the rate of discount used. If allowance for future investment income has been made, attention should be paid to the nature, term and value of the assets backing the technical reserves. Consideration should be given to the effects of possible

future changes in the value of the assets on their adequacy to cover the liabilities and, where necessary, provision should be made for such effects.

3.12 In the case of business accounted for on a fund-accounting basis, the factors to be taken into account may be especially complex in regard to the nature of the business, the accounting methods and the associated administrative procedures. The actuary must have regard to the particular features of the business and should pay particular attention to:

- (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.

3.13 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 claim 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 term 'IBNR' may be used but the definition should be made clear (see 2.5 (iii)).

3.14 The basis for the calculation of open-year funds is reported premium income less paid claims, expenses and exchange adjustments, augmented by any additional amount considered necessary to ensure that the amount of the fund is prudent, having regard to the potential net liabilities. The nature of funded business means that information for making a satisfactory estimate is often not available. However, the actuary should make his best assessment in the circumstances.

4. REPORTING ON FINANCIAL SOUNDNESS

4.1 An actuary may be asked to report on whether a company has satisfied statutory solvency requirements. Such a report would refer to an assessment of the adequacy of the technical reserves as well as to a check on whether the shareholders' capital and reserves are sufficient to comply with the statutory solvency requirements. Where the actuary is reporting on the continuing solvency, i.e. the financial soundness, of an insurer over a period, aspects to be considered would include:

- (i) the expected volume, nature and profitability of new/renewed business;
- (ii) fluctuations in the claims experience, including the effect of inflation;
- (iii) the nature, term and value of the assets;
- (iv) fluctuations in investment income;
- (v) fluctuations in and the ability to realize asset values;
- (vi) the suitability and security of the reinsurance arrangements; and
- (vii) the insurer's ability to withstand adverse deviations, including catastrophe claims.

July 1991 (Supp. 17)

D/66

4.2 There may be factors which are relevant to the insurer's financial condition but which are not necessarily within the actuary's brief. These could include, for example, political risks, the adverse consequences of bad management or fraud. It would be appropriate to draw attention to such factors where they may be material.

GN14: ACTUARIAL REPORTING ON LLOYD'S RUN-OFF YEARS OF ACCOUNT

Classification (see APC)

This Guidance Note is classified in relation to the code of professional conduct as *mandatory*.

Scope

United Kingdom.

Application

Actuaries appointed by Lloyd's managing agents to provide the required reports.

Legislation or Authority

This Guidance Note is written with specific reference to actuaries appointed in terms of Lloyd's Byelaw No. 17 of 1989 which forms part of the regulatory control of the Lloyd's insurance market, under the Lloyd's Act 1981. Actuaries appointed by Lloyd's managing agents to report on run-off years of account are expected to interpret this Note with reference to Byelaw No. 17.

Date of issue

April 1990.

1. INTRODUCTION

1.1 This Guidance Note is written with specific reference to actuaries instructed by Lloyd's managing agencies to report on the run-off years of account of syndicates under their management, in accordance with their duties under Lloyd's Byelaw No. 17 of 1989. This Byelaw forms a part of the regulatory control of the Lloyd's insurance market, under the Lloyd's Act 1982.

Syndicate Accounting Byelaw No. 11 of 1987, *inter alia*, lays down the framework under which the managing agent can close an underwriting year of account of a syndicate by reinsuring the outstanding liabilities into the open years of a Lloyd's syndicate. This is normally into a later year of account of the same syndicate. The premium for this transaction, known as the reinsurance to close, is required, under the Syndicate Accounting Byelaw, to be equitable as between the two generations of Names. It is in the circumstances in which the managing agent feels unable to determine such a premium that the Byelaw No. 17 of 1989 takes effect.

1.2 This Guidance Note supplements the requirements of that Byelaw. In addition, it supplements the provisions of any other relevant guidance given by the Institute or Faculty of Actuaries which remains generally applicable.

September 1990 (Supp. 13)

1.3 It should be noted that Byelaw No. 17 of 1989 refers to the Insurance Companies Act 1982. The effect of this is that for the purpose of the Byelaw an actuary must be a Fellow of the Institute of Actuaries or of the Faculty of Actuaries who has attained the age of 30. It should also be noted that an 'independent' actuary for the purposes of this Byelaw shall not be under a contract of service with the managing agent who commissioned the report in question, or with a company which is a related company with that managing agent.

1.4 The nature of the report required under Lloyd's Byelaw No. 17 of 1989 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 his previous experience and work, whether doing so would be in line with proper professional behaviour and standards.

Of prime importance to this consideration will be the extent of his experience of work on Lloyd's syndicates; it is the duty of any actuary who is in doubt as to his proper course of action to seek help from another actuary with relevant experience or from an Honorary Secretary of the Institute or Faculty. It is emphasized, however, that the responsibility for signing the opinion and report is his and his alone. The profession's rules of conduct make it clear that every actuary, in his professional capacity, whether remunerated by salary or fee, has a duty to his profession, and his responsibility to his employer or client must be consistent with this.

1.5 If the actuary is concerned that he might not be impartial, or that it would be difficult for outsiders to believe he was impartial (as might, for example, be the case if he were a Name on one of the ceding or accepting years of account of the syndicate) then he should arrange for another actuary to produce and sign the report.

1.6 An actuary carrying out work for a Lloyd's syndicate which does not involve an instruction to report on the run-off years in accordance with Byelaw No. 17 of 1989 is not required to consider or comment on whether it is reasonable to close or keep open an underwriting year.

2. REPORTING REQUIREMENTS

2.1 The actuary accepting an assignment under the terms of the Byelaw is required to provide for the managing agent a report containing an opinion on the issues in paragraph 7 (b). This is the Report of the Independent Actuary and hereafter in this Guidance Note will be referred to as the full report. The full report will be incorporated in the managing agent's report and will effectively be in the public domain.

2.2 The Appendix to this Guidance Note illustrates an acceptable form of words

for the full report containing a clean opinion. Whilst there is scope for extending the report, the opinion must follow explicitly the wording in the Byelaw except as stated in paragraph 2.3 below.

2.3 In relation to the accounting records, the word 'adequate' from the Byelaw has been replaced by the phrase 'adequate in the sense that they are reasonable in the circumstances'. This is illustrated in the Appendix and has been agreed with Lloyd's. This has been done in view of the differing understanding of the word 'adequate' between members of the actuarial profession and other interested parties.

It should also be noted that the accounting records on which an opinion is required is restricted to that relevant to the reserving process. The accounting records relevant to the reserving process would be considered reasonable if no practical and cost-effective enhancement would materially reduce the uncertainty of the reserve estimate. Materiality is assessed against the 'normal uncertainty' as perceived by the actuary using the definition in section 5 of this Guidance Note. However, for the purposes of this paragraph 'normal uncertainty' should exclude any items, such as pollution, which of themselves are dominating the 'normal uncertainty', even if they have not been identified by the managing agent as a reason for keeping the year open. The actuary may refer, in the full report, to normal market practice in relation to data availability.

2.4 The actuary may need to supplement the full report by a separate management report amplifying certain issues. This will depend on how much, if any, additional detail has been inserted in the full report. The management report is outwith the terms of the Byelaw.

The purposes of the management report would be to provide any necessary explanation of the opinion given in the full report, and offer any ancillary recommendations. It would have the additional advantages of reducing the amount of unpublished working papers which the actuary will need to retain and of reducing the degree of publication of commercially sensitive information regarding the syndicate's business. No reference should be made to the management report in the full report, which is, as stated, publicly available; the management report would only be available on the same basis as other records which are confidential to management.

2.5 It is not, under the terms of the Byelaw, necessary for the actuary to provide an estimate of the syndicate's liabilities (but see also the second paragraph of paragraph 4.1). There is, however, the possibility of a reserve or premium estimate being requested as a supplementary assignment, and the actuary should not accept the original brief unless he is prepared to extend it in this way.

2.6 Under the terms of paragraph 7(h) of the Byelaw, the actuary is required to produce a short report if the full report cannot be prepared within the very tight time-scale involved. The short report will contain only that part of the opinion

wording required under section 7(b) (iii) and 7(b) (iv) of the Byelaw. A report is normally required in time to enable the solvency return to be completed by the solvency deadline of each calendar year following failure to close the account at the normal time and at the end of each year thereafter. Lloyd's normally advises the date of the solvency deadline a few months in advance.

There may be circumstances in which it is impossible to comment on 7(b) (iii) and 7(b) (iv) in isolation, in which case the full report will have to be provided. If a short report is produced it should be recognized that this is likely to preclude the syndicate auditor finalizing his work. In addition, a full report will be required as soon as possible.

2.7 In cases where the actuary is able to give an opinion that the managing agent has acted reasonably in proposing to keep the year of account open owing to material uncertainties, it may still be that the methods and assumptions used in estimating the future liabilities are not considered reasonable. In these circumstances, the actuary is likely to propose alternatives. Provision of numerical estimates is, however, considered to be outside the terms of the Byelaw and would, therefore, be subject to the managing agent requesting the actuary to carry out a supplementary assignment.

3. RELATIONSHIPS

3.1 Under paragraph 7 of the Byelaw, the managing agent has to provide access to whatever available data and information the actuary considers relevant; these should include information as to the recent involvement of any other actuaries, together with copies of any relevant reports which they have produced. This process may, of course, involve a series of discussions, as further questions arise from the actuary's work and findings to date.

3.2 The actuary should make it clear to the managing agent, at the outset, that he may require access to the board of directors or partners of the managing agency.

3.3 The actuary should inform the Council of Lloyd's of his having taken on the assignment.

3.4 The actuary should liaise with the syndicate auditor to enable them both to have a proper understanding of their respective responsibilities and to avoid, as far as practicable, duplication of effort in areas such as accounting records and data. The actuary should ascertain the extent of the work to be done by the auditor and consider whether this is sufficient for his own purposes. If not, he may elect to carry out additional data checking himself, or request the auditor to extend his planned work. Conversely, the auditor will wish to obtain an understanding of the actuary's approach and the basis for his opinion; this may be assisted if the report to management deals comprehensively with these matters.

3.5 When the actuary has all the data which he needs for the production of the full report, he is recommended to prepare, for the managing agent to sign, a 'letter of representation' outlining the basic facts which have resulted in the managing agent coming to the view that he may have to leave the year of account open. Once signed, a copy of this 'letter of representation' should be supplied to the syndicate auditor.

3.6 The reports of the actuary, auditor and managing agent need to dovetail with one another. The actuary should not sign his report until final agreed drafts from the other parties are available.

3.7 The managing agent is the actuary's principal, and it would be improper to disclose the opinion, report or findings to any third party other than the syndicate auditor. Under the Byelaw, it is the duty of the managing agent to distribute copies of the report to other parties.

3.8 Under the Byelaw, the actuary will be required to attend a meeting of members' agents who have placed Names on the syndicate years of account concerned. At this meeting, he may be required to provide some explanation of the reasons for reaching his opinion.

4. SCENARIOS

4.1 The managing agent is required, under the Byelaw, to attempt to obtain an outside quotation for the reinsurance to close premium before the requirement for an actuarial opinion.

If an outside quotation has been obtained and rejected, it is likely that the actuary will need to carry out his own calculations as to the quantum of the syndicate's liabilities.

Three situations are envisaged:

- (i) the actuary has already concluded that the managing agent has acted unreasonably in not closing the year of account. In this case, the rejection of the quotation becomes irrelevant to the actuary's opinion;
- (ii) the rejection of the quotation is clearly unreasonable. In this case, the actuary should give an opinion that the managing agent has acted unreasonably in rejecting the quotation; and
- (iii) in other cases, which may be the majority, the actuary is recommended to give an opinion that the managing agent has acted reasonably, but that acceptance of the quotation may, nonetheless, be attractive to certain Names on the syndicate. A specimen wording is shown in the Appendix.

In coming to the decision regarding into which of the categories a particular case falls, the actuary should bear in mind the criteria outlined in section 5 of this Guidance Note.

4.2 In the event of the actuary's arriving at an adverse opinion (i.e. one which states that the actuary believes that the managing agent has acted unreasonably), he should liaise with the managing agent and the syndicate auditor. In such a case, the actuary is likely to be given a supplementary assignment to produce an estimate of the reinsurance to close premium. Such a supplementary assignment would not be a regulatory requirement, and would not, therefore, be subject to this Guidance Note.

4.3 It is possible that as a result of the actuary's giving, or proposing to give, an adverse opinion, the managing agent will decide to close the year of account. In these circumstances, the Byelaw requirements fall away and any report confirming the advice given would be outside the Byelaw.

4.4 In the event of the actuary's arriving at an opinion that the managing agent has acted reasonably, he should make it clear that whilst the methods, data and assumptions are all reasonable, the final reserve remains that of the managing agent.

5. MATERIALITY

5.1 The reinsurance to close involves the payment of a premium, the setting of which is an underwriting decision. An actuary accepting an assignment under the terms of Lloyd's Byelaw No. 17 of 1989 is not required to make the decision, but to make specific comment on the reasonableness of the decision made by the managing agent that he is unable to determine an equitable premium. It is therefore necessary to have regard to the managing agent's duties in this respect.

5.2 Where the premium is payable to a later year of account of the same syndicate, or, in fact, to any other syndicate managed by the managing agent, the decision should consider the interests of both ceding and accepting Names. A decision not to close is equivalent to concluding that a willing buyer/willing seller price cannot be determined owing to the extent of the uncertainty involved in the liabilities.

5.3 The decision as to materiality is a matter for the actuary's judgement, to be made in conjunction with the overall policy of the syndicate regarding reinsurance to close. The following factors should be included among those taken into account in making this decision:

- (a) the 'normal uncertainty', which is that which would obtain in the absence of the factors identified by the managing agent as responsible for keeping the year open. This can be assessed by considering the level of risk and uncertainty to the accepting Names having regard to the normal nature of the syndicate's liabilities (including any reinsurance to close which would normally be accepted without any specific problems), the nature and volatility of the business written by the syndicate in the accepting year of account, and the underwriter's attitude to change in portfolio mix;

- (b) the absolute size of the transferred liabilities in relation to the size of the business portfolio of the accepting syndicate; and
- (c) the timing of the likely resolution of, or substantial reduction in, the uncertainty involved in (for example) a pending law suit; greater expected speed of resolution of a factor is likely to make it a more material consideration, as seen from the perspective of the accepting Names.

5.4 The managing agent implicitly has to consider utility functions for the Names on whose behalf he is acting as agent. The utility function for the ceding Names will relate the cost to the risk reinsured; that for the accepting Names will require the premium to be adequate compensation for any excess risks. These utility functions will not be known to the actuary, but he will need to obtain some understanding of them by consideration of:

- (a) current market standards and practices;
- (b) current underwriting philosophy of the syndicate as well as the terms of past reinsurance to close premiums (given the information available at the time); and
- (c) any claim that the managing agent would close the relevant year of account in the absence of the specific factors identified.

5.5 The actuary's decision as to materiality should include a combination of his actuarial knowledge with the criteria outlined in 5.3 and 5.4 above. In this way, the degree of reasonableness of the managing agent's decision can be gauged from its consistency or otherwise with past decisions.

6. OTHER ASPECTS

6.1 The actuary is expected to follow normal practice and to take due cognizance of any other relevant guidance given by the Institute or Faculty of Actuaries in relation to the sections of his report dealing with the data, methods and assumptions used by the managing agent. It is necessary for him to take due account of the characteristics of the syndicate and its portfolio of business in assessing data requirements and the practicalities involved. It is also important to recognize the emphasis placed on reinsurance protection by many Lloyd's syndicates, including Time and Distance policies. This may result in the need for evaluation of the adequacy, security and timing of the reinsurance programme.

6.2 In accordance with normal practice, the actuary is advised to make it clear in his report that the findings and conclusions are based on the current state of knowledge as to methodology and the external world and in particular make clear the impossibility of guaranteeing the outcome of outstanding or future litigation. This would be particularly important in environmental pollution liability but also applies more generally.

6.3 The assets side of the syndicate's finances will probably be outside the terms

D/80

of reference of the investigation, since the basic requirement is for an opinion as to the reasonableness of a decision not to close an account, rather than any assessment of the overall financial state of the syndicate.

6.4 In checking the reasonableness of the managing agent's assumptions, the actuary should watch out for situations where a whole range of assumptions each tend to be on the low side, with the result that the final answer is likely to be unduly optimistic and hence unreasonable.

Appendix

REPORT OF THE INDEPENDENT ACTUARY

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

In accordance with your instructions under Lloyd's Byelaw No. 17 of 1989, I submit the following report in respect of the year of account 19XX of the PQR syndicate. This report has been prepared in accordance with the relevant guidance of the Institute of Actuaries and the Faculty of Actuaries.

The following factors have been identified by the managing agent as the reason(s) for leaving the year open:

(List of statements, such as, 'the uncertainty caused by the outstanding dispute with LMN syndicate'.)

In my opinion:

- (i) the accounting records kept by the managing agent pursuant to the Syndicate Accounting Byelaw are adequate, in the sense that they are reasonable in the circumstances, as a basis for the determination which has been made by it of the amount to be retained to meet all known and unknown liabilities;
- (ii) the methods and assumptions used by the managing agent, in order to make the determination, are reasonable;
- (iii) the factors taken into account by the managing agent in forming the view that it is or may not be possible to close the year of account are material; and
- (iv) the managing agent has acted reasonably in forming that view. [I would, however, point out that this has involved declining an external quotation. Whilst the quote seems high, it is possible for the liabilities to exceed this premium and there may be some members who would pay such a premium to reinsure their liabilities.]

Under the Byelaw, I am not expected to provide numerical estimates, and hence this report does not constitute confirmation of the adequacy of the reserve.

GN18: CERTIFICATION OF LOSS RESERVES FOR THE NON-ADMITTED INSURERS INFORMATION OFFICE

Classification (see APC)

This Guidance Note is classified in relation to the code of professional conduct as *best practice*.

Scope

United Kingdom.

Application

Any actuary signing a certificate of loss reserves for submission to the Non-Admitted Insurers Information Office (NAIIO) in the United States of America.

Legislation or Authority

This Guidance Note applies specifically to certificates of loss reserves required by the NAIIO.

Date of issue

July 1991.

1. United Kingdom insurance companies authorized to write excess and surplus lines non-life insurance in the United States of America are required by the Non-Admitted Insurers Information Office (NAIIO) to certify the adequacy of their reserves each year. This Guidance Note applies to any actuary who is involved in signing such a certificate. It is expected that the actuary will be familiar with the latest version of the instructions issued by the NAIIO for this purpose.
2. The certificate takes the form of a statement of opinion and is therefore much briefer than the type of reserve reporting covered by GN12. However, it is expected that the actuary signing the certificate will previously have prepared a report in accordance with GN12 or will have access to sufficient information from which such a report could have been prepared.
3. A specimen certificate is provided as an Appendix to this Guidance Note. Whilst it is expected that this will be used as a model by actuaries signing NAIIO certificates, modifications may be necessary to suit particular cases.
 - 3.1 In the normal case the reserves covered by the certificate will be those relating to claims in Form 15 of the return to the Department of Trade and Industry for the year in question. These are worldwide reserves and are net of reinsurance. There may, however, be circumstances where the worldwide reserves are not contained within a single return. It is essential that the actuary has examined all the reserves covered by the certificate; if this is not

July 1991 (Supp. 17)

the case the certificate should be modified so as to identify clearly which reserves are covered by the opinion.

- 3.2** If none of the reserves have been discounted the relevant sentence should be abbreviated accordingly.
- 3.3** The sentence regarding the bad debts provision may be modified or omitted if this provision has been examined by the actuary and/or it is considered to be immaterial.
- 3.4** Care must be taken to avoid giving the impression that pollution and asbestos property claims are covered, unless this is the case. since there is a danger that such an impression could be used as evidence of admission of liability. This is particularly important while such claims are being contested. The specimen certificate incorporates a suggested paragraph which has been drafted with this point in mind. The argument as to whether insurers are liable for asbestos and pollution losses is, however, a developing one and the actuary may wish to amend or extend the relevant paragraph to reflect the latest position. For example, if a provision is being held for such risks, perhaps on legal advice and without admitting liability, the actuary may wish to indicate this in the certificate. The relevant paragraph may be omitted if it is either not applicable or not material.
- 3.5** The word 'reasonable' in the final sub-paragraph of the specimen certificate is, of course, central to the opinion. It is intended to indicate that the reserves do not necessarily contain any significant margins for caution. In the United States, the phrase 'good and sufficient' was commonly used with the same meaning, although the word 'reasonable' is now accepted. In the United Kingdom, 'good and sufficient' is generally taken to imply a significantly stronger reserving basis and the use of this phrase is therefore not recommended.

Appendix

To: The Non-Admitted Insurers Information Office

CERTIFICATE OF LOSS RESERVES

I, am an actuary employed by the Insurance Company (the Company) and a Fellow of the Institute/Faculty of Actuaries with experience of loss reserving.

I have examined the assumptions and methods used in determining the reserves listed below, as shown in the annual returns of the Company prepared for submission to the Department of Trade and Industry in respect of the year ended 31 December 19.....

	£000	\$000 (at \$ = £1)
Claims outstanding: reported claims		
Claims outstanding: IBNR		
Expenses for settling outstanding claims		
Funds		
Claims equalization		
Total		

The above reserves are not discounted for the time value of money, except for those in respect of business, which are discounted and are included above at their discounted values.

'Funds' include unpaid losses, unpaid loss adjustment expenses and unearned premiums received.

I have relied upon data prepared by the responsible employees of the Company. I have also relied upon the provision for bad debts, as estimated by the responsible employees of the Company, as being a reasonable provision for the risks of non-performance of outwards reinsurance and other non-recovery of debts. In other respects my examination included such review of the assumptions and methods used and such tests of the calculations made as I considered necessary.

The opinion given below is based on the view of the Company that, in general, claims arising from the removal of asbestos from buildings and cleaning up of hazardous waste sites are not covered by insurance and that the only obligations in respect of such claims will be those arising from the Company's own legal expenses.

In my opinion, subject to the above comments, the reserves identified above:

July 1991 (Supp. 17)

D/106

- (i) are computed in accordance with accepted loss reserving standards and are fairly stated in accordance with sound loss reserving principles;
- (ii) are based on factors relevant to policy provisions;
- (iii) meet the requirements of the insurance laws of the United Kingdom; and
- (iv) make a reasonable provision for the unpaid loss obligations and allocated loss adjustment expenses of the Company as at 31 December 19..... under the terms of its policies and agreements.

Signed

Fellow of the Institute/Faculty of Actuaries

Date

