

**A STATUTORY LIABILITY VALUATION STANDARD
FOR GENERAL INSURERS**

September 1999

Australian Prudential Regulation Authority

PREAMBLE

APRA is seeking comments by 17 December 1999 on the following draft policy proposal for the development of a statutory liability valuation standard for general insurers. It is proposed that the Liability Valuation Standard will govern the valuation of general insurance liabilities and will be a subordinate instrument to the *Insurance Act 1973*. Further consultation on the issues raised in this paper will occur following receipt of initial comments. This will take place in early 2000.

The development of a Liability Valuation Standard builds on work previously undertaken by the Insurance and Superannuation Commission. In March 1995, the then Insurance and Superannuation Commissioner, Mr George Pooley, raised publicly the issue of whether a measure of technical or adjusted solvency of general insurers can or should be disclosed. A discussion paper was subsequently issued to the general insurance industry. Consultations arising from the discussion paper raised the question as to whether the existing measures of capital and solvency contained in the Insurance Act were adequate.

As a result, the ISC wrote to the Institute of Actuaries in Australia (IAA) seeking its assistance in the development of practical minimum solvency standards which meaningfully reflect the variations in risk facing general insurers. In response to this request, the IAA established two working groups. One to examine ways of achieving greater consistency and reliability of companies' outstanding claims provisions and the other to consider how solvency standards could be updated and better reflect the business line risks of insurers. These working groups reported to APRA early this year.

This paper is issued, and should be read, in conjunction with two other papers entitled *Study of the Prudential Supervisory Requirements for General Insurers in Australia* and *A New Statutory Solvency Standard for General Insurers*. These two papers consider, respectively, proposals to improve and modernise the operation of the prudential supervisory requirements for general insurers and proposals to develop a new minimum statutory solvency requirement that better reflects the risks of individual general insurers.

Comments and any questions about the proposals should be submitted in writing by
17 December 1999 to:

Mr Brian Gray
Executive General Manager
Policy, Research and Consulting
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

Email: giregime@apra.gov.au

INTRODUCTION

The *Insurance Act 1973* (Insurance Act) requires an insurer to set aside a provision in respect of its liabilities. General insurance general purpose accounts are governed by AASB1023 *Financial Reporting of General Insurance Activities*. Among other things, AASB1023 requires that a general insurer establish provisions in respect of its unearned premiums and outstanding claims.

The prudential regime under the Insurance Act imposes a minimum solvency requirement on general insurers. This requires companies to maintain assets (at market value) in excess of reported liabilities by at least a prescribed amount. The calculation of the provisions for liabilities is governed by AASB1023. That is, the same provisions have been accepted for prudential and solvency reporting purposes under the Insurance Act and general purpose financial reporting under the Corporations Law.

Under AASB1023:

- assets are at market value;
- premium revenue is brought to account in line with the incidence of risk;
- outstanding claims liabilities:
 - are inflated and discounted;
 - include an allowance for claims incurred but not reported;
 - include an allowance for claims incurred but not enough reported; and
 - include an allowance for claims handling expenses.

However, inconsistent application of AASB1023 in relation to the valuation of liabilities raises questions about the appropriateness of current practice, particularly within the context of the existing solvency framework.

Where actuarial advice is obtained, the outstanding claims provision is typically represented as:

Central Estimate + Prudential Margin

To the extent that the range of all possible claims liability outcomes can be thought of as a probability distribution, then the central estimate is the discounted mean of that distribution. The prudential margin is an additional component to take account of the risk that the actual claims liabilities will be greater than the central estimate. This terminology is now widely used in Australia, and although there may be a common understanding of the meaning of the term “central estimate”, there is less consensus on the setting of prudential margins.

One interpretation of AASB1023 suggests that the outstanding claims provision should be equal to the actuarial central estimate of the liability (although the discount rate that should be used is not unambiguously specified). AASB1023 is silent on prudential margins. This silence has given rise to different interpretations. Practice varies between companies, sometimes widely. In some classes of business insurers are adopting prudential margins which vary from 0% to 30% for what would appear to be portfolios of similar uncertainty.

The factors that drive the size of adopted prudential margins include:

- the assumed degree of uncertainty in the liability estimate;
- the risk appetite of the insurer;
- the amount of available capital;
- the desire for consistency from one year to the next;
- market practice;
- advice from actuaries;
- the impact on reported profit; and
- taxation.

In the context of the current statutory solvency framework, it is inappropriate to allow some of the factors above to drive the reported liability. For example, the amount of the legislated minimum capital requirement for a particular insurer should not depend on the amount of capital that is available.

A solvency structure that starts with the balance sheet liabilities requires a consistent approach to the valuation of liabilities, suitable for the solvency purpose.

Importantly, because of the relative sizes of the balance sheet liabilities and the required solvency margin, any inconsistency in the liability valuation process has a magnified effect on solvency coverage ratios.

In respect of unearned premium, AASB1023 requires that premium revenue be brought to account in line with the pattern of risk. It also requires a write down of the Deferred Acquisition Costs asset (DAC) if the unearned premium minus the DAC is less than the present value of the unexpired risk (ie the present value of expected future claims and settlement costs, in relation to business written to the balance date). AASB1023, however, only requires the DAC to be written down to zero. This may not be optimal from a prudential perspective – where there is a premium deficiency (ie, the present value of unexpired risk is greater than unearned premium after DAC write down to zero), prudential principles suggest that a reserve should be established.

This paper proposes changes to the existing liability valuation framework to overcome these prudential concerns. Bringing greater consistency to the liability valuation framework will bring the additional benefit of enhanced transparency with balance sheet information being provided to the marketplace on a more consistent basis. It is intended that the liability valuation framework would be suitable for prudential and general accounting purposes.

Briefly, it is intended that a solvency structure that starts with the reported liability will be retained. However, there will be refinements to the detail of the solvency structure,¹ and liabilities for statutory purposes will be governed by a valuation standard. A liability valuation standard that will be subordinate to the Insurance Act will be developed. The remainder of this paper will set out the general framework within which the liability valuation standard will be set.

¹ For details on the structure of the proposed new solvency refer to the paper *A New Statutory Solvency Standard for General Insurers* issued by APRA in conjunction with this paper.

VALUATION PRINCIPLES

In the Australian context assets are valued at market value.

In the absence of a deep market in insurance liabilities, it is only possible to estimate the value of a general insurer's liabilities, which is suitably consistent with the market valuation of assets. To facilitate consistency, the estimation process would need to be governed by fairly prescriptive guidance, but may be broadly based on risk theoretic concepts. This paper proposes a construct for the estimation of the statutory value of insurance liabilities.

It is framed within the context of a proxy marketplace, consisting of hypothetical 'buyers and sellers'.

The basic principles underpinning the construct are:

- an arms-length buyer would like to be fairly certain that the settlement price is adequate. This may be re-expressed in terms of a requirement to expect a return for assuming the risk associated with the uncertainty of the outcome; and
- an arms-length seller would be willing to pay a premium for transferring the risk associated with the uncertainty of the outcome to another party.

The expected return to an arms-length buyer (or equivalently, the premium to a seller) can be considered to be a function of:

- the level of uncertainty surrounding the estimate of the liability; in particular, the amount of downside risk; and/or
- the cost of capital required to "support the business" (statutory requirements and market forces impose capital requirements).

For presentational purposes, it may be helpful to think of the value of liabilities as comprising a:

Central Estimate + Risk Margin

The Risk Margin represents the excess of the liability value over the central estimate, and is derived having regard to the principles outlined above.

PROCESS AND STRUCTURE

Guidance will need to be developed which:

- enables consistent valuation; and
- allows for actuarial and other professional judgement where necessary.

It is proposed that IAA guidance is developed in line with the conceptual basis described above.

The resulting legislative structure would see a Liability Valuation Standard subordinate to the Insurance Act which:

- sets out the principles and methodologies for valuation of the liabilities;
- sets out the conditions under which actuarial advice is required (based on criteria such as size of company, class of business, solvency position);
- sets out the reporting requirements for actuaries; and
- sets out the reporting requirements for companies.

It is proposed that the same principles will apply to the valuation of the unexpired risk and outstanding claims liability.

