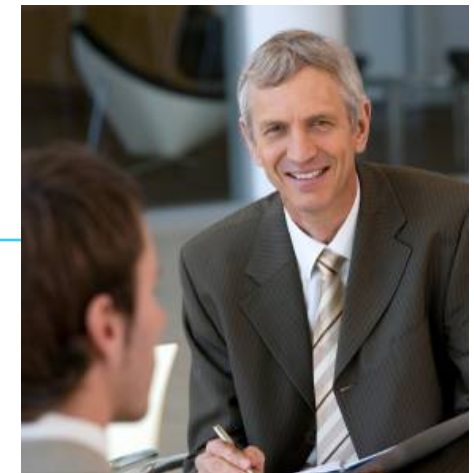




TOWERS  
PERRIN



# An Introduction to Financial Condition Reports For General Insurance

Ron Kozlowski, FCAS, MAAA  
October 30, 2009  
IRDA/Appointed Actuary Meeting

# Table of Contents

---

- Introduction
- Overview
- Insights
- Details
- Final thoughts

# Introduction

---

- August 13 Circular from IRDA regarding Role of Appointed Actuary for general insurance companies.
  - ...requires appointed actuary to prepare financial conditions report (FCR) for non-life insurance company
  - ...expands role of appointed actuary beyond loss and premium liabilities/reserves
- Underlying philosophy is that the financial condition of a general insurance business is driven by a number of financial policy levers such as pricing, reinsurance, business mix, growth, capital management, investment strategy and reserving.
  - intended to provide an up to date summary of how business is run and critical issues facing the insurer
  - preparation broadens the actuary's understanding of the company's plans, helping him to provide more appropriate feedback and guidance

## Introduction (cont'd.)

---

- Regulation 8 of the IRDA Regulations (Appointed Actuary) 2000 specifies the duties and obligations of the Appointed Actuary...
  - rendering actuarial advice to the management of the insurer, in particular in the areas of product design and pricing, insurance contract wording, investments and reinsurance
  - ensuring the solvency of the insurer at all times
  - certifying the value of assets and liabilities
  - dealing with the maintenance of required solvency margin
  - specifically for general insurance business, ensuring
    - the rates are fair in respect of those contracts that are governed by the insurer's in-house tariff
    - the actuarial principles, in the determination of liabilities, have been used in the calculation of reserves for incurred but not reported claims (IBNR) and other reserves where actuarial advice is sought by the Authority

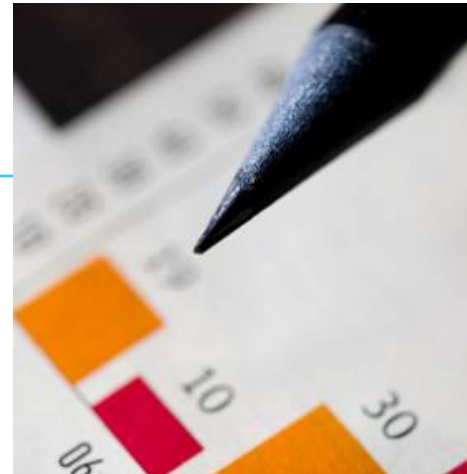
## Presentation based on ...

---

- India's Appointed Actuary Annual Report (AAAR) Committee's draft requirement for life insurers
- Australian Financial Condition Reports for General Insurance
  - Australian Prudential Regulation Authority (APRA)
    - *Prudential Standard GPS 310: Audit and Actuarial Reporting and Valuation*
  - The Institute of Actuaries of Australia
    - *Professional Standard 305: Financial Condition Reports For General Insurance*
  - Miscellaneous presentations and papers
    - *Financial Condition Reporting for General Insurers – A Case Study*, by Dave Finnis, Stewart McCarthy, Vicki Younis
    - IAA's Appointed Actuary Working Group's: *A stakeholder assessment of our regulatory regime so far*
    - Various ARMA presentations
- Additional guidance
  - Countries with stress testing - Malaysia, Singapore, Canada, Mexico



TOWERS  
PERRIN



## Overview

# Overview

---

- The FCR:
  - includes **discussions on the implications of material risks** identified during the assessment of the insurer and, where these implications are adverse, make recommendations as to how to address these risks
  - provides the appointed actuary's **objective assessment of the overall financial condition** of the insurer
  - forms an **important input into decision-making by the Board and senior management** in respect of the operations of the insurer

## Overview (cont'd.)

---

- The FCR is:
  - prepared on an annual basis
  - prepared such that the Board has a reasonable opportunity to consider and use the FCR in preparing the insurer's yearly statutory accounts
  - provided to the IRDA on or before the day that the insurer's yearly statutory accounting accounts are due
  - addressed to the Board of the entity; also sent to management team, IRDA, and possibly auditor

## Overview (cont'd.)

---

- An FCR addresses (but not need be limited to) each of the following matters:
  - business overview
  - recent experience and profitability
  - loss liability valuations
  - adequacy of past estimates of insurance liabilities
  - pricing, including premium adequacy
  - asset and liability management
  - capital management and capital adequacy
  - reinsurance arrangements
  - risk management
- The FCR should look at these matters from a historical analysis as well as future implications/actions.
- If a matter referred to above is not relevant to the operations of the entity, the matter may be omitted from the FCR, citing reasons for such omission.

## Overview (cont'd.)

---

- If the actuary identifies additional material matters, the actuary should address them in the FCR.
- Rather than addressing the matters by company, address impact or influence of classes or line of business, where applicable.
- A single FCR may be produced for an insurance group, unless otherwise requested. Considerations include:
  - addressing the operations of each entity within that insurance group
  - the financial position of the corporate group affecting the position of the entity
  - the financial position of the entity affecting the position of insurance group
- For foreign insurers, the FCR should be prepared in respect of the Indian branch operation
  - considering financial position of the head office and its potential to materially affect the position of the branch

# Appointed Actuary Requirements - Life

---

- Appointed Actuary Annual Report (AAAR) Committee (Life) is completing up their final draft
  - Sections include:
    - Executive Summary
    - Analysis of Business Written and Distribution Channels
    - Analysis of Experience
    - Analysis, and Distribution, of Surplus
    - Risk Management
    - Current Financial Condition
    - Future Financial Condition
    - Conclusions

# Appointed Actuary Requirements – Life (cont'd.)

---

- Appointed Actuary Annual Report (AAAR) Committee's draft includes:
  - Executive Summary
    - succinct and sharp highlight of key points and main messages in relation to impacts on the financial condition of his/her company
    - 5-year history of premiums, reinsurance, benefits paid, expenses, profit, capital contribution, liabilities, new business, persistency, in-force policies, lives insured, solvency ratio
  - Analysis of Business Written and Distribution Channels
    - 5-year history of premium by type, sum insured, # of policies, average policy term, average policy size, average policyholder age, average payment term
  - Analysis of experience
    - 5-year history of persistency, claims, and expenses by type of product
  - Analysis, and Distribution, of Surplus
    - break-down of the surplus (or deficit) by various sources
    - explanation of how the surplus is shared between shareholders and policyholders

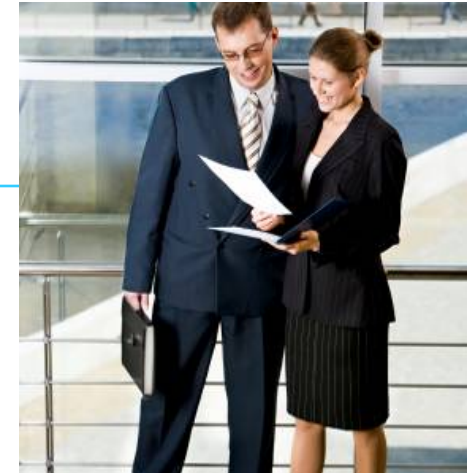
# Appointed Actuary Requirements – Life (cont'd.)

---

- Appointed Actuary Annual Report (AAAR) Committee's draft includes:
  - Risk Management
    - views on appropriateness of company's risk management strategy and framework, how various risks are identified and classified, actions plans, actions taken, commentary on significant new risk exposures and significant changes in risk management practices and implications
      - the risks mentioned here should include investment risk, asset liability mismatch risk, operational, investment guarantees risk, insurance risk
    - address economic capital
  - Current Financial Condition
    - commentary on the current financial condition, AA's own understanding of the business, adequacy of reserves, solvency position, and adequacy of premium rates and charges on products
  - Future Financial Condition
    - project financial statements and solvency position for following three years, include stress test for two plausible adverse scenarios with a description of possible management actions to ensure maintenance of regulatory solvency
  - Conclusions



TOWERS  
PERRIN



## Insights

# Insights

---

- *The Appointed Actuary needs to reach out to others in order to complete the FCR.*
  - *some requirements are beyond what the appointed actuary may be involved with or have expertise (e.g., business overview, risk management, reinsurance, investments)*
  - *planning needs to be intensive, as it includes substantial business input from different departments*
  - *staff will have different views of purpose and value of FCR, so they may approach it differently*
  - *don't understate difficulties in comparing and reconciling data that goes into the report; data may come from different sources and a variety of purposes*

## Insights (cont'd.)

---

- *In preparing the report keep the following in mind:*
  - *be business-specific in order to have meaning*
  - *emphasize business implications and practical suggestions*
  - *sections don't need to be "matter" specific but rather written in "coherent, operational" sections (e.g., introduction and financial position; profitability; quality of balance sheet; risks, stress testing and monitoring)*
  - *combine "bottom-up" development of issues from detailed business analysis and a "top-down" analysis of the recognized key business issues*
  - *Version control is critical*

## Insights (cont'd.)

---

- *Go beyond just duplication of other reports, if they exist*
- *Process is not a “once off” exercise but rather needs to be embedded in existing business structure*
- *FCR is not a control sign-off but rather an assessment of possible risks and weaknesses*
- *Based on review of Australian FCRs, majority of documents between 50 and 100 pages*
  - *however, Australia AA’s have other reports that cover segments in more detail*
  - *but readers prefer shorter, more focused documents*
- *“Two biggest challenges include:*
  - *Dealing with areas outside your area of expertise*
  - *Year-end timing/work involved “*



TOWERS  
PERRIN



## The Details

# Appointed Actuary Statements

---

- The Appointed Actuary signs and states the date of completion of his or her written FCR. The actuary should also state:
  - who commissioned the actuary's reporting
  - scope of and purpose of the FCR
  - the specific terms of reference and any restrictions or limitations placed upon the Actuary
  - that he has complied with applicable professional standards
- In performing the Actuary's duty, he should comply with applicable codes of professional conduct.

# Information Requirements

---

- The actuary needs to advise the entity of the information required including:
  - relevant data, information, reports and staff of the insurer that the Actuary will need in order to prepare the FCR
  - access to the insurer's Board and Board Audit Committee
- The actuary should identify in the FCR all information upon which he or she has placed material reliance.
- The actuary should take reasonable steps to verify and document the consistency, completeness and accuracy of the information.
  - the degree to which the actuary relies upon others to test or verify the data should be explained in the FCR
  - material discrepancies must be outlined in the FCR, together with the consequent limitations of the FCR
- If relying on work carried out by other actuaries, the actuary must be satisfied as to the suitability of the work.
  - if not satisfied, alternative analyses must be undertaken and explained in the FCR

# Business Overview

---

- An FCR should include:
  - general background information about the corporate/management structure and operations
  - financial condition of company and solvency measures
  - mix of business and profitability
  - trends in volume and new initiatives
  - entity's plans, including forward projections, and about any requirements imposed on the entity by IRDA
  - material risks arising from the entity's plans
  - possible information to include:
    - 5-year history of premium (net, gross, written, earned), reinsurance ceded, losses paid, change in reserves (case, IBNR), expense components, profit, capital contribution, new business versus renewal, in-force policies, claim counts (reported, open, closed), exposures, solvency ratio, etc.

# Recent Experience and Profitability

---

- An FCR should comment on the past profitability, over a period of at least three to five years, including any significant features or trends,
  - by line of business, business segment, or distribution channel
    - premiums, losses, expenses, commissions, underwriting profit/loss, investment income, return on equity, claims, average severity, average frequency
  - deviations of actual experience from the expected, including an assessment of the reasons for these deviations
  - steps taken, or proposed to be taken, to address areas of deviation and/or adverse experience
  - commentary on profitability of business; numbers not enough
  - commentary on underwriting cycle to extent that one exists

# Insurance Liability Valuation

---

- An FCR should include:
  - summary of the key results of the appointed actuary's analysis of the loss liabilities prepared (as of same date)
  - material issues arising from or disclosed by appointed actuary
  - changes in methodology/assumptions especially if it causes release of reserves
  - significant observations in the data and operations that may affect the actuarial analysis (e.g., large losses, trends)
  - stochastic versus central estimate, if applicable
  - address risk margins, diversification, discounting if applicable
  - data and assumption needs for improvement to quality of analysis

# Adequacy of Past Estimates of Insurance Liabilities

---

- An FCR should include:
  - an assessment of the adequacy of past central estimates of loss reserves
    - of either outstanding claim liabilities or all insurance liabilities against the subsequent actual claims experience over a period of at least three to five years
  - any material implications for the adequacy of current estimates of insurance liabilities arising out of the review of historical estimates
  - recommendations on corrective measures where past estimates have not been adequate
  - discussion of net and gross results where use of reinsurance has significantly affected results
  - commentary on case reserve estimates and case reserve adequacy

# Premium and Pricing Adequacy

---

- An FCR should:
  - consider the adequacy of premiums, highlighting areas with inadequate rates
    - address underwriting profit and “total” profit
    - address implications of premium adequacy reserves
  - describe how pricing process works, actuary’s involvement or competitive pricing
  - comment on material issues arising from the entity’s pricing processes and underwriting and claim management practices
  - address expense levels
  - consider whether expected future profitability arising from the assessment of premium adequacy is materially in line with the entity’s plans

*Regulators often see this as weakest section*

# Asset and Liability Management

---

- An FCR should comment on material issues arising from the entity's approach to asset and liability management.
- In undertaking this assessment, the Actuary should outline, consider and comment on material risks arising from:
  - the entity's liability profile and liquidity needs
  - the entity's investment assets, in particular its investment strategy and the nature, quantum and performance of those assets
  - the entity's other assets, in particular reinsurance and non-reinsurance recoveries
  - the entity's insurance liabilities
  - the entity's non-insurance liabilities
  - the entity's net assets
  - the methods for valuing assets and non-insurance liabilities, particularly, changes in those methods

## Asset and Liability Management (cont'd.)

---

- In an FCR, the actuary needs to mention if an ALM analysis was undertaken or not, and what techniques were used.
  - results of the ALM analysis need to be documented
  - any insights obtained from the analysis need to be mentioned
- For any technique used, basic assumptions need to be documented.
  - e.g., assumptions on losses, expenses and commissions, reinsurance availability, investment environment, premium renewals and new business
  - hard-to-value assets or liabilities should be mentioned in further detail separately from the rest
- Recommendations to the Board should be made on what kinds of pressures are anticipated on the business and what may be done to avoid those.

# Capital Management and Capital Adequacy

---

- An FCR should:
  - outline the entity's approach to setting and monitoring capital resources, including processes and controls in place to monitor and ensure compliance with the capital requirements, and dividend policies
  - comment on approach, as well as material risks arising from its application, having regard to the entity's current capital adequacy and needs for future capital to support the entity's plans
  - comment on trends in the entity's compliance with its capital adequacy and its capital targets at least in the last three years at quarterly intervals
  - comment on the extent and reasons for any identified breaches of the entity's capital adequacy and the actions that were taken by the entity to rectify such breaches
  - comment on the entity's capacity to meet its capital adequacy and its capital targets over at least the next three years
  - comment on stress testing and recommended actions.
- Companies are encouraged to calculate Economic Capital ("EC"), and take capital management decisions based on this measure.

# Reinsurance Arrangements

---

- An FCR should consider:
  - material issues arising from the use of the entity's specified reinsurance strategy, and from its actual current and past reinsurance arrangements
  - intra-group reinsurance arrangements and relationships with other entity's within the corporate group
  - method used to calculate the entity's maximum event retention (MER) and it's appropriateness and materiality to the operations of the entity
  - material risks arising from the entity's reinsurance arrangements, including:
    - documentation and extent of placement of reinsurance arrangements
    - obligations to pay future reinsurance premiums
    - credit-worthiness of reinsurance companies
  - material risks arising from use of limited risk transfer products, such as financial reinsurance or purported reinsurance (whether financial or otherwise)
  - risk concentrations with each reinsurer.

## Reinsurance Arrangements (cont'd.)

---

- The Actuary needs to address the reinsurance arrangements, and whether they are appropriate given the risk profile of the insurance company.
  - If higher retentions will lead to better use and return of available capital, that should be suggested.
  - If lower retentions are warranted based the available capital, that needs to be brought to the attention of the management and the Board.
- If an economic capital model has been constructed, effects of various retentions and limits can be modeled and analyzed explicitly. The end-result may be easier to present to the Board as well.

# Risk Management

---

- An FCR should comment on:
  - elements of the entity's risk management strategy and framework,
  - appropriateness of such strategy and framework
  - material risks arising from the risk management framework of the entity.
- The entity's risk management framework is intended to identify the risks that may affect the entity's financial condition. This includes:
  - how various risks are identified and classified
  - the entity's risk management policies and procedures, processes and controls
  - risk appetite and risk tolerance levels
  - affirmation of responsibilities of the Actuary, management, Board, and others with particular attention to the fact that there is no break in the chain
  - actions plans and actions taken.

## Risk Management (cont'd.)

---

- The Actuary should comment on material sources of risk and measures to mitigate them.
  - the risks mentioned here should include underwriting/pricing risk, reserving risk, catastrophe risk, investment risk, asset liability mismatch risk, credit risk, operational risk
  - commentary on significant new risk exposures and significant changes in risk management practices and implications
- Any issues associated with capture and analysis of data needs to be addressed.
- Where there are limitations on such commentary, particularly those caused by the Actuary's limited exposure to, and interaction with, the entity's risk management strategy and practice, the Actuary must note this in the FCR, together with an assessment of the consequent limitations of the FCR.

## FCR's Conclusions and Summary

---

- The assessment of the financial condition of the entity must include a discussion of the implications of material risks and issues identified during the assessment of the financial condition of the entity.
- Where the Actuary identifies material risks with adverse implications for the entity's overall financial condition, the Actuary must include in the FCR, recommendations intended to address these risks.
- The Actuary must also comment on the extent to which the entity has addressed recommendations provided in the previous FCR.

*Tends to be one of the weaker sections, especially if only bullet points are pulled from prior sections. Needs to be well coordinated and planned.*

*Needs to address the most difficult issues.*

*Provide recommendations and suggestions for improvements, grouped in terms of impact to insurer's financial conditions.*

# Final Thoughts

---

- *Think of reports from users standpoint*
- *Draw out key observations in reports*
  - *Executive Summary can make or break the report*
- *There is a careful balance between criticizing management and highlighting positive developments in the business*
- *The best reports are those where the actuary is fearless*
- *Expect “teething” problems*
  - *FCR is by necessity evolutionary*
- *Remember that FCR was designed to “lift the standard” of actuarial analysis*
- *Beware of FCR overload*
  - *Readers prefer shorter, more focused documents*
- *Encourage actual presentation at Board meeting to facilitate discussion*



# Questions

---

Ronald T. Kozlowski, FCAS, MAAA  
Director of General Insurance, Asia  
Towers Perrin  
852-2593-4589  
[ron.kozlowski@towersperrin.com](mailto:ron.kozlowski@towersperrin.com)