Global Conference of Actuaries 2011

Impact of Reserving on the Profit and Loss Account

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Agenda

1. Demise of HIH
2. Reasons for the demise
3. Importance of reserving
4. Incurred claims / Profit and loss Account
5. Solvency Requirements
6. Reserving and Solvency

The demise of HIH Insurance

- On 15 March 2001 the major companies in the HIH Insurance group were placed in provisional liquidation.

- Formal winding-up orders were made on 27 August 2001

- By then the deficiency of the group was estimated to be between $3.6 billion and $5.3 billion

But the shambling journey towards oblivion began a long time before March 2001.

<u>Reasons for the demise</u>

- The failure to provide adequately for future claims is called **‘under-reserving’ or ‘under-provisioning’.**

- **Why was there such serious under-reserving and why were the risks not properly priced?**

- **<u>The answer was HIH was mismanaged.</u>**

They were epitomised by :

- rapid expansion,
- under pricing,
- inadequate reserving
- Reckless and incompetent management
- False reporting
- lack of integrity in the company’s internal processes and systems.

Importance of proper reserving

❑ **Liabilities need to be understood, analysed, properly valued and disclosed**

➢ There was a consistent failure of HIH, and FAI before it, to set aside enough money to pay their claims. Under-reserving had arisen because HIH was mismanaged.

➢ According to AM Best, 51% of insurance company failures are due to reserve deficiency.

➢ Deliberate manipulation of claims estimates by FAI management, contributed to under-reserving. Excessive under-reserving of FAI's long-tail business. Est. loss $590M.

Incurred Claims / Profit and Loss Account

Particulars	Balance Sheet		Profit & Loss
Incurred Claims	31-Mar-10	31-Mar-11	
Claims Paid			1,000
Case Reserves	3,000	2,000	(1,000)
IBNR	2,500	6,000	3,500
	5,500	8,000	3,500

- The Balance Sheet reflects the position as on the reporting date
- The Profit and Loss Account reflects the net movement of the balance sheet
- Each time a reserve is created the P/L is debited and a liability established
- Each time a claim is paid the reserve is released and the claim paid .
- The final claim payment would establish the efficacy the reserving process
- Incurred Claims = Claims paid + Change in case reserves + Change in IBNR
- Loss Ratio = Net Incurred Claims / Net Earned Premium

Particulars	
Gross Written Premium	**A**
Net Written Premium	B
Net Earned Premium	C
Net Claims Incurred	D
Net Commission	E = F-G
Commission paid	F
Commission earned	G
Expenses of management	H
Net underwriting results	**I=C-D-E-H**
Investment Income / other income	J
Profit before tax	**K=I+J**
Provision for taxes	L
Profit before tax	M=K-L
Profitability Ratios	
Loss Ratios - LR	D/C
Commission Ratio - CR	E/B
Expense Ratio -ER	H/B
Combined Ratio - COR	LR+CR+ER

Solvency requirements

- The solvency norms for non life insurance companies in India are laid down in the Insurance Act 1938 as well as the solvency regulations
- The minimum solvency a non life insurance company is required to keep at all times is **150%.**
- Solvency is the ratio of **Available Solvency Margin** divided by the **Required Solvency Margin** .
- **Available Solvency Margin** is the Net worth of the company with the following adjustments :
  - All fictitious assets have to be excluded
  - No credit is given for investments in furniture and fixtures
  - No credit is given for receivables over 90 days
  - IT Hardware and Software assets have to be considered at 75% , 50% , 25% and 0% (in case they are 1 , 2 , 3 and 4 years old)
- **Required Solvency Margin** is calculated in two steps (RSM1 & RSM2). The higher of the two amounts is treated to be the Required Solvency Margin.
  - RSM 1 (based on premiums): Determined as twenty percent, of the amount which is the higher of the Gross Premiums multiplied by factors (provided by IRDA regulations) and the Net Premiums.
  - RSM2 (based on claims): Determined as thirty percent, of the amount which is the higher of the Gross Incurred Claims multiplied by factors (provided by IRDA regulations) and the Net Incurred Claims.
  - INR 500 MN
  - **Highest of the above three has to be considered**

Reserving and Solvency

- The solvency norms for non life insurance companies in India are based on the **Gross Numbers** which after multiplication by the prescribed factors are compared with the **Net Numbers .**
- Hence the **Gross Reserves** created for a loss have a very significant impact on the **Solvency .**
- Accordingly although the Net Loss on the books of the insurer might be limited the gross loss might have an impact on the solvency of an insurance company .
- Example :
  - Mumbai Floods
  - Mangalore plane crash
  - **However losses incurred in the 26th November terrorist attack are not treated in equal light as the above two**

- The importance of adequate reserving (case) or IBNR needs to be re-emphasised . A figure in the books of accounts translates into capital having to be kept aside .
- Depending on the adequacy of capital it might require of capital infusion .
- Done properly / thoughtfully proper reserving strengthens the Balance Sheet .
- Done recklessly it can bring down a company .