Institute of Actuaries of Australia

Financial Condition Reporting for General Insurers – A Case Study

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Section 1 - Introduction

APRA's requirement for a Financial Condition Report (FCR) from the Approved Actuary to the Board of Directors of an authorised insurer has markedly increased the tangibility of the FCR concept for general insurers. APRA's guidance on the construction of FCRs, supported by the IAAust's draft professional standard and guidance note, has been encouraging and is clearly emphasising the value of a document that addresses all aspects of an insurer's financial condition. This makes sense as a market supervisor is motivated – as are individual insurers – to build increasing market financial strength. Nevertheless, APRA, as regulator, must be more focused on issues of the "present" than those of the "future". Individual insurers must therefore take care not to lean too heavily on the "statutory minimum requirement" in developing their FCRs if they are to become a valid tool in building future financial strength.

At Insurance Australia Group (IAG), the first steps were made to build a financial condition paradigm from an actuarial perspective in 2002. The timing, shortly after the demise of HIH, was not coincidental. It was already apparent that no true attempt to analyse the financial condition of HIH had taken place, certainly during its final years. At IAG the initial FCR activity was largely an attempt to collect together all the actuarial advice being provided to the respective business areas within the Group and to lay out that advice in a single source document. The resulting work products were valuable from an actuarial perspective, as they highlighted areas of potential development for actuarial activity. However, from a business perspective they were less helpful, as their internal actuarial focus made it difficult for the business owners (and hence, potentially, the Board of Directors) to identify with the financial condition of the business. As a result the reports did not stray far from their actuarial naissance.

In early 2003 a "guinea pig" was chosen for a more interactive attempt at an FCR. The choice was IAG's captive reinsurer, IAG Re. In one respect, IAG Re was an odd choice as it had a number of management characteristics that differentiated it from other areas of the Group's activities. In important other areas though it was an attractive choice. In particular, the senior management of IAG Re were open-minded and enthusiastic about the FCR opportunity and were able to foresee the value the document could provide. Also, it was a new, rapidly growing business with many areas for examination and comment. Section 2 of this paper comments in greater detail on the development of the first FCR for IAG Re. The initial engagement by the business owners and the iterative, interactive development of the report over a period of several months enabled joint ownership of the FCR by business and actuarial area to be guaranteed. The final report was presented to the Board of IAG Re and received encouraging feedback. Nevertheless, in retrospect, there were a number of observable flaws. In particular the report "flowed" poorly. The early sections were those with the strongest actuarial input, and that input gradually weakened in subsequent sections, as the report developed. Also, it was apparent that not enough time and effort had been devoted to the Summary Section, which ended up almost as a "dot point précis" of the full report, which was clearly not as valuable as it could have been.

In 2004, we felt we were ready to extend the process to the full Group, together with lessons learned from our experiences over the previous two years. There were several key lessons:

1) The FCR has to be business-specific in order to have meaning. (This was reasonably closely, but not exactly, aligned with a split by legal entity.)
2) Planning needs to be intensive, and to include substantial input from the business owners.
3) The process should represent a merger between a “bottom-up” development of issues from detailed business analysis and a “top-down” analysis of the recognised key business issues.
4) The process should not be seen as a “once off” exercise. Rather it should be embedded within the existing business structure.

Also, by early 2004 we had a reasonable template for the eventual APRA requirements (through the November 2003 APRA discussion paper and the initial draft actuarial standard). This was used broadly as a sounding board for our work.

The resulting efforts are summarised in three sections of this paper. Section 3 examines the approach to IAG’s Personal Lines business, Section 4 concentrates on the Commercial Lines and Section 5 summarises the approach to the Group report.

Section 2 – The IAG Re "Experiment"

The process behind the preparation of the 30 June 2003 Financial Condition Report for Insurance Australia Group's reinsurance captive, IAG Re, has been discussed at other forums, but has not previously been fully documented.

The first step was to learn from the experience gained in preparing draft FCR's for various areas of IAG's business in the previous year. As discussed briefly in Section 1, these reports were driven almost entirely by the Research and Development (including actuarial) area of the Group. They essentially formed an insular perspective on the advice being provided from the area. Not surprisingly, given these circumstances, they were heavily weighted towards liability valuation work and outstanding claims valuation in particular. Whilst they provided a helpful compendium of information for the Group Actuary, it was difficult for the business owners within the Group to see the resultant draft reports as balanced representations of the financial condition of the businesses.

A key reaction to these findings was to obtain a view of the contents of an FCR from the perspectives of the several key "owners" of each business. This part was quite easy in practice. Each of the key business managers was asked to give their views! The process was commenced for all areas of the Group's business. However, IAG Re quickly emerged as the business area with the clearest view of the potential value to be gained from this process, which put them ahead in the running to be our "guinea pigs". Counting against them in this role were some idiosyncratic aspects of the business, which set them apart from the direct insurance areas of the Group. Nevertheless, these aspects were considerably outweighed by the enthusiastic response by IAG Re's management and the reinsurance business was thus chosen as "guinea pig" for the re-focused financial condition reporting case study.

The project benefited significantly from APRA's early pronouncements (dated November 2003) on the scope of the "potential statutorily required FCR" from an Approved Actuary. Whilst the still skeletal "contents list" included in this Stage 2 Reforms Discussion Paper was not used as direct guidance for our work, we did use it as a sounding board at various stages of the project. APRA's initial suggestions for the contents of the FCR can be summarised as follows:

- A review of recent experience
- Liability valuation summary
- Assessment of adequacy of past reserves
- Asset/liability "matching" issues
- Current/future capital adequacy assessment
- Reinsurance programme and/or needs review
- Assessment of any non-risk transfer arrangements
- Premium setting advice; and
- Risk management system review

The IAAust General Insurance FCR Taskforce also issued an initial discussion draft on FCRs in November 2003. It was largely consistent with the APRA discussion document but contained several important differentiating aspects. The main difference was the lack of a suggestion from the Taskforce that the Approved Actuary should be expected to opine on general risk management system issues.

The broad report headings for our IAG Re study were agreed after taking into account the feedback from the business management representatives. They were:

- Introduction (including a discussion of the meaning of "financial condition", the scope of the report, a brief recent history and rationale for the business, and qualifications and limitations attaching to the report)
- Liability Risk (introducing the various sources of risk, including outstanding claims, unexpired risk and risk margins)
- Asset Risk and Asset/Liability Management (including assessment of credit risk, market risk and liquidity risk)
- Solvency and Capital Adequacy (including the MCR calculation summary and the basis for the internal capital adequacy measurement and management process)
- Pricing and Premium Rating (including the modelling of price, and premium rating controls)
- Business Strategy (contrasting the understanding of current strategy with the potential range of strategies)
- Assessment of Management Processes (including underwriting, claims management, investment, external reinsurance and IT)
- Business Performance and Outlook (discussion of current P&L account and balance sheet, as well as budgeted future outcomes)

The discussion of the meaning of financial condition in the first section was important. It developed a sense not only of the value of the business from a purely financial viewpoint, but also of the continuing "solidity" of the value. In a more tangible sense the report was intended to add an analysis of the strength of future balance sheets inherent in the current operational and strategic planning within the entity, thereby clarifying the current balance sheet value. Interestingly (and understandably, given the intentions) it was this representation of future value generation capability that was the main differentiating factor with the APRA FCR "template".

The report developed through a series of iterations, with more than ten versions of the draft report were created before an executive summary was even contemplated. The section headings were hardly compromised at all during this process, although the sections on pricing/premium rating and strategy were eventually merged as the strategy of the business was seen to be largely bound up in the (captive) underwriting of risk.

Logistically, the report was initially populated with the existing actuarial analysis and was gradually supplemented and improved by relevant input from the business on management issues. This procedure highlighted two key areas of learning that were new, at least to the IAG Re business area of the Group. Firstly, it highlighted the interactions between various inter-connecting areas of management for the business. (The most obvious was perhaps the claims management and claims liability assessment linkage, but there were other more subtle learnings.) Secondly, it generated a paradigm of continuous development. Mere recognition of the relevant information for each area of the report, or even the issues raised by recognition of the meaning of this data was clearly not enough. The report caused an almost automatic self-generation of improvement of the inherent processes through the questions raised by the issues. Whereas this three-stage “control cycle” was already in evidence, the FCR process added a formality to the process that reduced any possibility of areas being overlooked.

In retrospect, there were also two main areas of improvement to be targeted from future FCR activity. The first was the structure of the report. Despite discussions with business leaders, section headings were still based on “inputs” rather than “targeted outcomes” and tended to be weighted by the extent of existing actuarial analysis rather than business value. Also, although the Executive Summary was quite rightly left until the remainder of the report was in a reasonably complete draft state, it suffered from lack of planning and ended up being merely a précis of the main body of the report. As such, an opportunity was missed to communicate “top down” as well as “bottom up” issues.

Section 3 – Personal Lines

The development of the Personal Lines FCR commenced in May 2004. The structure of the report, formatting and contents was tentatively established at the outset to ensure consistency between the Business Unit FCR's and the Group FCR. The structure was largely derived from the IAG Re report and the Discussion Draft Professional Standard 3XX, November 2003. This provided the framework within which the Personal Lines FCR evolved.

The Personal Lines FCR is structured according to six broad sections.

1. Executive Summary: this provides an overview of each component of the main report, and draws conclusions that fall across several of the following sections.

2. Part I Introduction, Purpose and Scope: this section outlines the purpose of the report, the structure and financial objectives of the Personal Lines Business Unit, and provides a summary of the current and prospective financial position as assessed by the Business Unit.

3. Part II Profitability – quality of earnings: considers capital and the return of capital, how premiums are derived and there adequacy; and summarises reinsurance arrangements.

4. Part III The Balance Sheet – strength and capital management: deals with insurance liabilities and there adequacy relative to the balance sheet; and the capital management philosophy.

5. Part IV Risks and stress testing: provides a summary of the risk management strategy and the systems to address these risks.

6. Appendices: Detailed financial and management information.

Given the scope of the report, input was required from a number of stakeholders, including but not limited to: the budgeting team, the pricing team, the valuation team, group actuarial, finance, reinsurance, asset management and risk management.

This information was collated and entailed various discussions with the suppliers of the information to ensure clarity and accuracy. This was a lengthy and involved process.

A draft version of the report was prepared as at 30 June 2004 and distributed to business management for feedback. The response was unwelcoming.

The business management felt that the report duplicated information that existed elsewhere and did not expand on management's knowledge of the business. Of course, the audience is broader than the business management; it also encompasses the Board and APRA itself. The FCR provides an up to date compendium of how the business is run and is particularly ideal for a new Board member.

Business management also felt that the report was too long and entailed considerable expense in its development and ongoing maintenance (which they ultimately paid for). However there are a number of legal entities and numerous products covered by Personal Lines in IAG, and the APRA requirements are comprehensive; hence the report was necessarily long.

These messages were communicated to the business to promote the merits of a FCR and to engage them for further involvement. The issue of detail was a matter to be resolved by the Group Actuary and the Personal Lines Chief Executive. A discussion then took place between actuarial and senior business representatives, which effectively resolved the issues of duplication and detail.

The Personal Lines FCR was first prepared as at 31 December 2004 and presented to the Board. The feedback received was positive. The second version is presently being prepared as at 30 June 2005.

Preparation of the FCR at both the half year and year end proved to be a challenge. There are a number of inputs which need to be coordinated; timing becomes critical with half year / year end interdependencies. A timetable detailing the inputs, the provider and the expected delivery date was prepared and distributed to all parties in advance. Each party was asked to review the timetable, confirm the provider and confirm that the delivery date was achievable. Typically, draft financial inputs are received initially, followed by final results once the general ledger has closed. Version control is critical to ensure the most up to date information has been used throughout the report and the commentary is commensurate with the results. As results change, review is required.

The Personal Lines FCR is unique in that its scope straddles a number of entities writing personal lines insurance; two of these are jointly owned with external parties. The IAG Board and the Personal Lines Management team have uncompromised access to the FCR. Presently the Board of the joint venture entities do not have access to the FCR due to the strict confidentiality of the report's contents as it relates to each entity. IAG has been unable resolve this issue other than to prepare separate FCRs for each of these joint ventures.

A strength of the Personal Lines FCR is the Executive Summary. This provides an extract of the key issues appearing in the main body of the report, alphabetically labelled according to the key sections of the report. This allows the Board and management to readily understand and respond to the main issues.

A limitation of the report is the length (approaching 150 pages) – this can detract from its overall impact. The FCR needs to be concise and relevant, otherwise key issues are buried. This will be a challenge when Professional Standard PS 305 and Guidance Note GN 355 are finalised. The drafts distributed in February 2005 are prescriptive. Ideally a trade off between compliance and relevance should be achieved.

Section 4 – Commercial Lines

Background

Like most full service commercial insurers, IAG's "Australian Commercial Lines" business (Commercial) is a complex aggregation of disparate commercial classes that includes public liability, fire, accident, motor and worker's compensation, together with specialty classes such as professional risks, marine and homeowner's warranty. Product is predominantly distributed through intermediaries, although there is a material call-centre component aimed at small business. Commercial also generates fee-based revenue through premium funding, worker's compensation administration and consulting.

The Commercial business is principally based on CGU, which was acquired by IAG in 2003. This business was combined with IAG's existing commercial business and integrated into IAG. Commercial has experienced considerable structural, management and cultural change over the last three years. This has been a key driver towards the goal of creating a business-orientated FCR that successfully engages management.

Commercial's strong actuarial team is well integrated into the business. While the actuarial team is responsible for the usual tasks of reserving and budgeting, they also undertake a considerable amount of "pricing and decision support" and have a close working relationship with underwriters, product managers, distribution managers and senior management.

Development of the FCR for Commercial

Commercial's first attempt at an FCR was in 2003. This rough, unfinished draft provided a solid foundation by defining two critical elements for subsequent FCR's – underlying philosophy and structure.

The 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. In order to assess financial condition it is necessary to understand the current and prospective setting of each policy lever, and the potential shocks to each of those settings.

The structure of the FCR is based on four distinct, yet inter-related parts:

1. Introduction and financial position
2. Profitability – quality of earnings
3. Quality of the balance sheet
4. Risks, stress testing and monitoring

The final underlying element is the meaning of the term "financial condition". It took some time for this definition to evolve. The most recent version is that "financial condition refers to the sustainability of the business – its continued ability to achieve financial objectives and its long term business aspirations".

An FCR that simply follows the minimums prescribed in the (draft) IAAust Professional Standard (the Standard) risks becoming a list of vaguely connected facts and figures. The addition of the three elements described above, underlying philosophy, structure and definition, allow the emergence of a coherent, value-adding report.

It is important to emphasise that the Commercial FCR is not a full FCR because Commercial is not a stand-alone business. Commercial is part of a larger group (IAG) and certain key policy levers are managed at the Group level (such as investment strategy and capital management).

Commercial FCR – what does it look like?

The latest Commercial FCR (at June 2005) closely follows the structure outlined above, with the addition of what is the most critical section, the Executive Summary. With the full report (including appendices) approaching 150 pages, the Executive Summary compresses the key points and recommendations into a handful of pages and relates these to the "financial policy levers".

The structure of the document is expected to remain constant, but is highly amenable to variation in specific content. The body of the report is structured as follows:

1. Introduction and Financial Position – sets the scene by describing the business in words and numbers – type of business written, management structure, historical financial results, budget and projected financials. This part examines recent experience and future trends in considerable detail. The insurance cycle, for example, is of particular importance for commercial lines.

2. Profitability – Quality of Earnings – deals with the factors that influence the sustainability of earnings, principally "premium rate strength", both historical and prospective, expense levels, the reinsurance programme and budget.

3. The Quality of the Balance Sheet – considers assets, liabilities and capital. It sets out and comments on key aspects of the insurance liabilities and discusses the level of capital held in the business. The Commercial FCR focuses less on the financial policy levers, such as investment strategy, that reside at the Group level.

4. Risks, Stress Testing and Monitoring – considers risks and threats to the business, and has a role in monitoring actions taken in response to past recommendations.

Each of the four parts is divided into a number of sections that deal with components specified in the Standard. The Commercial FCR also includes several appendices that provide a depth of information that would be inappropriate in the body of the report.

In many ways the Commercial FCR is an aggregation of existing work. It draws this work together and provides a coherent view. This is surprisingly important given the many and disparate information flows within a large general insurer.

The FCR also provides an opportunity to identify areas where additional work is required, both to meet FCR requirements, and to meet the information needs of the business. The simple act of "writing down" existing work reveals the analytical gaps and emphasises to the actuaries and to management where additional work is required; the Commercial FCR revealed several issues that have since become areas of focus for further analysis and attention.

Lessons learned

- The FCR is by necessity evolutionary. Like any new report, the FCR will change based on experience and familiarity, and the finished document needs to be read, considered and digested in its entirety before one can make substantive revisions.

- The value of the FCR is not initially obvious, particularly where much of the information is already available elsewhere. The critical issue is that this information is not available in one place, and therefore not necessarily accessible. Information that is not accessible may as well not be available.

- The Standard provides a general guidance[1]. When one considers what is required to make the FCR a complete, coherent document it is necessary to go beyond the Standard. There is a need to balance the prescriptive requirements of the Standard with the business imperative to communicate useful information in an engaging way.

- Staff across the business have different views of the purpose and the value of the FCR, and will therefore approach the FCR in different ways. They have different expectations and what they might get out of the document and different views on what it should cover.

- There is a careful balancing act between making the FCR a forum for criticising management, versus discussing and highlighting positive developments in the business. While the actuary needs describe the risks and threats associated with developments, crying wolf to often is a sure way to be ignored.

- Beware of FCR overload. Management are busy and probably don't want to see multiple versions of an FCR. Conversely, ensure that management has plenty of opportunity to view and comment on the FCR. Later drafts of the FCR should not contain any surprises. Any issue raised in the FCR should have already been raised with management.

- A good, robust, logical structure is imperative. This makes it quite obvious what is missing. The Executive Summary can make or break the report.

- Don't underestimate the difficulties in comparing and reconciling the information that goes into the FCR, which is typically undertaken for a variety of purposes and obtained from different sources.

[1] In the sense that it is limited in its coverage.

Section 5 – The Group Report

The FCR for Insurance Australia Group as a whole constituted a “pyramid” of sub-reports. At the lowest level of the pyramid were the detailed inputs to the reporting process. These were also included as appendices to the individual business reports (namely Australian Commercial Insurances, Australian Personal Lines Insurances, New Zealand Insurances – not included in this discussion – and the Reinsurance Captive). The main elements of the appendices were the reports on claim and premium liabilities, but also included were important technical supporting documents for pricing and other areas of actuarial input to the business.

The next layer of the pyramid included the various business reports themselves in the form that they were presented to the management of each of the businesses.

The third layer was a Group Report with the same structure of each of the business reports, but with a specific focus on Group issues.

Above this was a Group Summary Report in the form of a page-by-page (audit report-type) treatment of each of the top twenty or so Group issues from the perspective of financial condition reporting.

Finally a brief “Key Issues” paper formed a “Board Paper” summary of the 20-page Summary Report.

The detailed Group Report began its life in parallel with the individual reports. The Group Report author liaised with each of the business report preparers to identify the issues that could remain at business level as well as those that needed to be addressed at Group level, together with the additional factors (if any) that needed to be considered at Group level for these key issues.

At the same time, a “dummy list” of key “top down” Group issues was created. This list was used to elicit a development of the priority level and relevant actions for each of the issues raised and also to prompt additional Group issues not raised on the dummy list.

There then followed an interesting exercise, essentially aimed at coordinating the issues emerging from the “bottom up”, business-driven process with the top down list. By and large there was a pretty close correlation between the two groups of issues. Nevertheless there was a handful of issues either not visible at the business level or not recognised at Group level that required further investigation and discussion amongst business leaders and the Group Executive.

Finally a series of meetings was organised for members of the Group Executive and other important players in the FCR process (both in the actuarial group and in the business) to rationalise the Group Report and to finalise the Group Summary Report (which was based on the initial dummy list, as amended). Effectively this involved an informal assessment of each of the issues on a “Risk vs. Value” matrix in Group terms.

Section 6 – Conclusions

We learned a number of important, practical lessons during our initial financial condition reporting exercises. A brief description of each of the key points is provided in the following paragraphs.

Timing: The year end and half-year end timetables were already pretty cluttered. It was important not to try to "tack on" the FCR to the existing process. We found that, by planning in advance, much of the reporting needs could be prepared in readiness for inclusion of any new figure-work and updating of existing calculations. (Nevertheless, it was apparent that an extension to the existing reporting framework was necessary in order to obtain the full value from the FCR process.)

Early Involvement of Business Representatives: An essential requirement for a financial condition report is the active involvement of representatives from all areas of the business throughout the project. Otherwise the danger is that the document becomes a sanitised (and largely out-of-touch) actuarial viewpoint

The FCR as "Living Document": The Financial Condition Report must not be seen as an annual or a biannual exercise. FCR issues need to be part of day-to-day management discussions and decision processes. In this way issues raised in the report may be dealt with and the report updated on a regular basis. This approach also helps avoid the perception that the FCR is "complete". By definition, improvements will continue to emerge over coming months and years.

"Top Down" and "Bottom up" Linkage: The business issues need to be clarified. This means getting the views of senior management on the key determinants of the financial condition of the organisation as well as recognising, and developing issues by examination of the base business data. The result is a common (and, hopefully, reasonably comprehensive) list of items than affect (and have the potential to affect) the organisation's value.

Ranking of Issues According to Actuarial Competence: Although our approach may have over-stated the differentiation between areas for which actuarial support is traditionally of value and those for which an actuarial input is less expected, it was important to avoid the potential for spurious actuarial comment. To combat this we used a three-tiered approach. We differentiated *between* "issue identified", "issue clarified and detailed" and "issue acted upon". This encouraged non-actuarial input (and recognition within the report) in areas that contributed to the financial condition, but were not part of standard actuarial control cycles.

Planning: An underlying philosophy and robust structure is vital before commencing on detailed work. The preparation of a timetable and its distribution to all contributors is also important. The timetable identifies the inputs required to prepare the FCR, their interdependencies and establishes if the timeframe is achievable for all parties.
This point applies particularly to data sourcing and reconciliation. There are potentially immense practical difficulties here that can only be resolved by a well-thought through approach.