



Institute of Actuaries of Australia

XVth GENERAL INSURANCE SEMINAR

Evolution of the Industry

Premium Liabilities

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Introduction

- Short definition
 - Liabilities arising from the insurer's unexpired risk at the balance date
- Regulatory reporting since July 2002
 - Determine minimum capital requirement for Australian insurers and reinsurers
- Statutory reporting for reporting periods on or after 1 January 2005
 - Revised AASB1023 issued in July 2004. Subsequent amendment issued in May 2005.
 - Liability Adequacy Test ("LAT")



Presentation Structure

- Definition of Premium Liabilities
- Impact on Insurers
- Current Approaches
- Selection of Assumptions
- Adequacy Assessment
- Risk Margin



Liability Adequacy Test

- $(UEP - DAC - Def RI)$ Less Premium Liability (incl risk margin)

If greater than 0 => disclosure requirement

If less than 0 => unexpired risk liability + disclosure requirement

- Performed on “broadly similar risks that are managed together as a single portfolio”



Definition - Similarities

- Premium Liabilities defined as
 - Future Claim Costs
 - + Claims Handling Expenses
 - + Policy Administration Expenses
 - + Future Reinsurance Costs
 - Future Recoveries (Reinsurance and Third Party)
 - + Risk Margin



Definition - Differences

- Risk margin
 - APRA: 75 % of probability of adequacy
 - AASB1023: no specific requirement.
- Treatment
 - Groupings
 - APRA: Class of business
 - AASB1023: “broadly similar risks and are managed together as a single portfolio”
 - Recognition
 - APRA: Always a APRA balance sheet item
 - AASB1023: Only when LAT fails
(that is $UEP - DAC - Def RI < Premium Liabilities$)



Impact on Insurers

- APRA
 - No impact on published profits and losses
 - Impact only on reported insurance liabilities to APRA for minimum capital requirement assessment.
- Revised AASB1023
 - Only impact published profits and losses when LAT fails
 - Recent hard market cycle + good claims experience
 - LAT likely to produce a surplus
 - If the market cycle turns
 - LAT may produce a deficit => unexpired risk liability



Current Approaches

- Technical guidance note prepared in 2002 suggested two approaches
 - Premium approach
 - UEP less profit margin + adjustment of inflation and discounting
 - Claims approach
 - Average claim size * Claim Frequency
 - Loss Ratio * UEP (“Loss Ratio”)
- Other approaches
 - Stochastic modelling (eg risks with low frequency and high incurred costs)
 - Premium refunds
- Common Approach: “Loss Ratio” Approach



Selection of Assumptions

- Central Estimate Premium Liability
 - Gross claims cost
 - Other non expense cash outflows Future recoveries
 - Future reinsurance cost
 - Claims handling expense
 - Policy administration expense
- Gross Claims Cost - Focus on “Loss Ratio” Approach



Selection of Assumptions

- Loss Ratio
 - Examine historical loss ratios' trends
 - Definition of premium used to determine historical loss ratios
 - May include items which distort claims experience analysis
 - Output tax liability, FSL, Stamp duty
 - Considerations for historical and future claims and exposure changes
 - Other considerations
 - Seasonality
 - Large claims / Catastrophic events
 - Portfolios with no working losses
 - Allocation of premium



Selection of Assumptions

- UEP at Balance Date
 - Ledger or Recalculate from policy unit records
 - Ultimate UEP for Premium Liability include
 - UEP at balance date
 - Unclosed business
 - Premium adjustments
 - Unclosed business: projection / manual adjustment
 - Premium adjustments: specific to policy conditions
 - Monthly renewable
 - Contractual obligation
 - Retrospective rated policies



Selection of Assumptions

- Other types of Non Expense Cash Outflows
 - Premium Refunds
 - “Refund claims” or “Expenses”
 - Can be significant in Consumer Credit and Personal Lines
 - Policy termination rates
 - Special recovery items
 - Commission clawback
 - Stamp duty rebates
 - Different expense rate



Selection of Assumptions

- Endorsements
 - In or out?
 - Out: A new policy
 - Not a obligation under the general insurance contracts
 - In: Standard business practice
 - Unless specified, historical claims and premium experience includes endorsements
 - If the ultimate UEP which loss ratio applies to include endorsement
 - premium liabilities include endorsements



Selection of Assumptions

- Future Recoveries
 - GST, Third Party, Reinsurance
 - GST, Third Party: % of gross central estimate
 - Reinsurance: % of gross central estimate
gross and net loss ratios
- Future Reinsurance Cost
 - Cost and arrangements generally known at assessment date
 - Need to understand payment arrangement and accounting accruals to avoid double counting
 - Other factors to note
 - Run off pattern of unexpired risk
 - Profit Commission / Reinstatement Premium



Selection of Assumptions

- Claim Handling Expense (CHE)
 - Common approach : same rate for outstanding claims and premium liabilities
 - Vary over the life of a claim depending of level of activity
 - Higher at initial stages of a reported claim
 - Premium liabilities
 - Claims are yet to be established => CHE for premium liabilities should be higher



Selection of Assumptions

- Policy Administration Expense
 - Definition open to subjective interpretation
 - Include:
 - Administration of monthly premium payments
 - Policy maintenance
 - General enquiries
 - Portion of overheads
 - Largest component: allowance for overheads
 - Range between 1% and 8% of gross unearned premium
 - Detailed analysis: expense allocation exercise
 - Other approximate methods



Adequacy Assessment

- Explicit requirement in FCR and AASB1023
- FCR requirement
 - “A Financial Condition Report **must** include an **assessment of the adequacy of past estimates of insurance liabilities** (including both outstanding claims and premium liabilities) against subsequent actual claims experience. Any impacts on current estimates arising out of the review of historic estimates must be **commented on.**”
- AASB1023 requirement
 - Explanation of Recognised Amounts (paragraph 17.6)
 - Amount, Timing and Uncertainty of Cash Flows (paragraph 17.7)



Adequacy Assessment

- The specification of FCR requirement is broad
 - Insurance Liabilities vs Outstanding Claims vs Premium Liabilities
 - Adequacy Assessment: “Rolling Basis” ?
 - Type of Comments ?
- Insurance Liabilities/Outstanding Claims/Premium Liabilities
 - Separate analysis: feed back into assumption setting
 - Straightforward for outstanding claims
 - A bit more complex for premium liabilities



Adequacy Assessment

**Previous
Valuation at
30 June 2004**

**Premium liability estimate
- policies with attachment
dates on and before
30 June 2004 and earned in
the year ending
30 June 2005**



**Claims arising from policies with
attachment dates on and before
30 June 2004 and earned in the
year ending 30 June 2005**

**Current
Valuation at
30 June 2005**

**O/s claims liability estimate
- accident year ending 30
June 2005**

**Claims arising from policies with
attachment dates after 30 June
2004 and earned in the year ending
30 June 2005**



Adequacy Assessment

- Adequacy Assessment: “Rolling” basis ?
 - Outstanding Claims Liabilities:

Outstanding Claims Liabilities (\$'000)				
	Development Year			
Accident Year Ending	0	1	2	3
30 June 2002	8,000	7,500	7,000	7,200
30 June 2003	6,000	6,200	6,500	
30 June 2004	5,500	5,000		
30 June 2005	6,500			

Accident year ending 30 June 2003, development 1

6,200 = Reassessment of O/s claims liability at 30 June 2004
+ Payments made in year ending 30 June 2004



Adequacy Assessment

- Premium Liabilities:

Premium Liabilities (\$'000)				
Valuation Date				
Underwriting Year	30 June 2002	30 June 2003	30 June 2004	30 June 2005
30 June 2002	2,000	2,500	2,700	2,800

Premium Liability *O/s Claims* *O/s Claims* *O/s Claims*

At valuation date 30 June 2002,

2,000 = Premium liabilities at 30 June 2002

At valuation date 30 June 2003,

2,500 = O/s claims liabilities at 30 June 2003 +
Claim Payments made in the year



Adequacy Assessment

- Type of Comments?



Risk Margin

- APRA requirements
 - 75% probability of adequacy for insurance liabilities
- AASB1023 requirements
 - Risk margins are required
 - No particular probability of adequacy targeted
 - Probability of adequacy for premium liabilities different from that for outstanding claims liabilities
 - => comments/justifications disclosed in financial statements



Risk Margin

- Board and management: decide probability of adequacy
Actuary: determines the risk margin based on Board decision
Auditor: assess reasonableness
- A distinction between liabilities for events occurring before and after the balance date ?
- Premium liability risk margin subject to higher degree of scrutiny



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THE END