General Insurance Risk Margins – An Overview

Introduction

For reporting periods commencing on or after 1 January 2007, all reporting entities in New Zealand must comply with the New Zealand International Financial Reporting Standards (NZ IFRS).   Early adoption of the NZ IFRS is permitted from 1 January 2005.   In Australia, where most of New Zealand's insurance industry is controlled, all insurers must comply with IFRS for reporting periods commencing on or after 1 January 2005.

In this newsletter we discuss what is meant by a "risk margin", an innovation introduced in *NZ IFRS 4 Insurance Contracts* (NZ IFRS 4). We consider how large it should be, and review what companies are doing in this area.

Outstanding claims liability
– Current practice

For New Zealand-based general insurers that have not yet shifted to international accounting standards and NZ IFRS 4, the current rules for the financial reporting of insurance activities are set out in *FRS-35 Financial Reporting of Insurance Activities*.   These rules have applied for reporting periods commencing on or after 1 July 1999.

Risk margins are not mentioned in FRS-35. Rules for the recognition of outstanding claims liabilities are set out in section 5.18 and the associated commentary.   In summary, these are:

- Outstanding claims liabilities must be measured as *"the present value of the expected future payments"*,

- *"The risks and uncertainties that inevitably surround claims are to be taken into account in reaching the best estimate of the outstanding claims liability"*, and

- *"… uncertainty does not justify the deliberate overstatement of the outstanding claims liability"*.

This does not provide a great deal of clarity, and in practice insurers and their auditors have developed their own approaches within this framework.

The new rules are intended to provide greater consistency and transparency.

– Future practice

The detailed general insurance accounting rules are set out in Appendix D of NZ IFRS 4.   Section 5 sets out the rules for the calculation of the outstanding claims liabilities:

- Section 5.1 states *"An outstanding claims liability shall be recognised … as the central estimate of the present value of the expected future payments for claims incurred with an additional risk margin to allow for the inherent uncertainty in the central estimate"*.

- "*Present value of the expected future payments*" means the probability-weighted expected cost of settling incurred claims, discounted to present value at the valuation date using an appropriate rate of interest.

- "*central estimate*" is defined in section 5.1.4 as the average value of expected future payments; i.e. it is a value that is not deliberately overstated or understated - a form of "best estimate".

- "*claims incurred*" are those that occurred prior to the reporting date, whether reported or not.

Risk margins - definition

Section 5.1.6 of NZ IFRS 4 states that the risk margin *"relates to the inherent uncertainty in the central estimate of the present value of the expected future payments."*   The risk margin is a recognition in the accounting standards that the future cost of claims is unknown and that it is therefore reasonable for insurers to establish provisions that are greater than "best estimate".

This approach is at variance with the traditional "true and fair" accounting concept but is consistent with the "prudent concept given the highly uncertain nature of some claims liabilities. In any case, the actual claims liabilities will be the amount ultimately paid - the provisions merely shift the recognition of the resulting profits or losses between periods.

NZ IFRS 4 does not provide explicit rules in this respect but it does provide some guidance in section 5.1.11 *"Risk margins adopted for regulatory purposes may be appropriate risk margins for the purposes of this Appendix, or they may be an appropriate starting point in determining such risk margins."*

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APRA requirements

APRA Prudential Standard GPS 210, which took effect from 1 July 2002, sets out the rules for "*the consistent measurement and reporting of the insurance liabilities of all general insurers*" with the principal concern being the financial soundness of general insurers rather than profit reporting. GPS 210 states that the Approved Actuary (a statutory role in Australia) must provide advice on the valuation of insurance liabilities at a 75% level of sufficiency. This means that the liability would be expected to be sufficient to meet the future costs of incurred claims 75% of the time. This may sound less than should be required, but APRA also has minimum capital requirements which ensure a higher probability of an insurer being able to meet its insurance liabilities.

Risk margins - how big?

Still, none of this answers the question "how big should the risk margin be?" Intuitively, the greater the uncertainty about the final cost of incurred claims for an insurance portfolio, and the greater the level of sufficiency required, the greater the risk margin should be. Several other considerations are set out in Section 5.1.8 of the standard:

- Robustness of the valuation models (i.e. how sensitive the result is to changes in assumptions);

- Reliability and volume of available data (more and better data usually means less uncertainty);

- Past experience of the insurer and the industry (generally a guide as to future experience);

- Characteristics of the classes of business written (some are inherently riskier).

Another complication is that the risk margin is to be applied to the net outstanding claims for the entity as a whole. In practice risk margins are calculated for each class of business (GPS 210 requires this) and in most cases the aggregate of those risk margins is expected to be greater than would be required for the entity as a whole. This is simply a manifestation of the statistical phenomenon whereby the relative claims variability is generally less for a larger grouping of risks. In GPS 210 this is referred to as the diversification effect.

Unearned premium reserve adequacy

Risk margins also feature in the adequacy testing of the unearned premium liability.

Sections 9.1 and 9.1.2 of NZ IFRS 4 set out requirements that are consistent with those used to determine risk margins for the outstanding claims liability.

Risk margins - current practice

At a recent NZ Society of Actuaries general insurance seminar, C Ormrod and P Yeates presented a paper *Survey of Risk Margins held by NZ General Insurers*. Twelve insurers were approached and seven agreed to participate in the survey. The key findings were:

- 5 insurers had risk margins.

- The weighted average level of sufficiency was 88% with a range of 75% to 90%.

- The average diversification allowance was 44% with a range of 40% to 50%.

- The "after diversification" average risk margins ranged from just over 9% for private motor portfolios to just under 16% for professional indemnity portfolios.

The responding insurers were asked how they would decide what risk margin they would hold until specific direction is provided by either a relevant accounting or actuarial body. Of the five that calculate risk margins, four indicated that they would look to APRA requirements.

The future

Finally, it should be noted that the process of setting the international financial reporting standards as they apply to insurance contracts is only partly completed. At an international level, there is a great deal of debate between the interested parties as to how insurance liabilities will be calculated and recognised in the balance sheet. It is possible that the "level of sufficiency" risk margin approach used in Australia and New Zealand will not be consistent with that finally adopted. However, because the debate may continue unresolved for some time, the approach outlined in this newsletter should be with us for a while yet.

Clearly, there is much work still to do in this area.

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