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Covid-19: Board considerations for year-end 2020 reserves

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Insurers can expect a greater level of scrutiny on adequacy and accuracy of year-end 2020 Technical Provisions from regulators, external auditors and where relevant external Reviewing Actuary.

COVID-19, the global story for 2020, has resulted in huge operational disruptions, market volatility and reserving uncertainties for Irish insurers. As the pandemic escalated in Europe during Q1 2020 most Irish insurance companies were preparing to submit year-end 2019 annual regulatory returns and apart from additional disclosures submissions were largely unaffected.

As you begin to plan year-end 2020 financial statements and regulatory returns there are several areas that will be of particular focus for the CBI and external auditors and which will need to be carefully considered by Boards.

We have spoken with various stakeholders and our learnings can help insurers prepare for year-end 2020.

There will be a greater level of uncertainty in Technical Provisions than for a normal year-end and this will mean that there will be a far higher degree of expert actuarial judgement. There will be an expectation of greater Board involvement in the Technical Provision setting process. Boards will need to be satisfied that assumptions are appropriate, that selections are justified and documented, alternatives assessed and expert judgement justified and were possible quantified through increased scenario and stress testing.

Central Bank of Ireland Expectations

At KPMG's recent insurance briefing where Andrew Candland, Head of Actuarial, Advisory and Major International Insurance Firms at Central Bank of Ireland spoke and can be accessed here, and the CBI will expect to see evidence of more Board involvement in the year-end 2020 Technical Provision setting process. The September 2020 Insurance Newsletter from the CBI also provides a helpful steer on how insurers (and their Boards) can navigate the challenges of Covid-19 in the context of adequacy of Technical Provisions[1].

From a non-life perspective, it is also worth noting that in the UK the Prudential Regulation Authority, via a letter to non-life insurers' CROs dated 13 November 2020, is encouraging Boards to satisfy themselves that loss development patterns remain appropriate and that there is no unjustified anchoring to business plan loss ratio assumptions. While the effect of Covid-19 will vary by line of business and from insurance company to insurance company the operational disruptions faced by all businesses will mean that claims experience during 2020 is unlikely to be a good guide to future loss development for virtually all insurance and not just covers that have been directly impacted by Covid-19 such as Travel, Event Cancellation, Motor, Business Interruption and Credit & Suretyship.

From both non-life and life insurer perspectives, the CBI notes that insurers should:

"regularly assess the need to update their best estimate assumptions and refresh their approach as actual experience emerges (relative to prior assumptions) and as expert opinion about future prospects develops (for example, on the possible long term effects of Covid-19 on mortality and morbidity rates)"

Boards will need sufficient detail of year-end reserving approaches to effectively challenge adequacy of the actuarial best estimate.

[1] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/insurance-reinsurance/solvency-ii/communications/insurance-quarterly-news/the-insurance-quarterly---september-2020.pdf?sfvrsn=6

Reserving Uncertainty

The CBI has communicated through Head of Actuarial Function ("HoAF") forums of the Society of Actuaries in Ireland on their expectation that HoAF's consider this increased level of uncertainty in year-end 2020 actuarial best estimate. HoAFs will need to consider Article 76 of the Solvency II Directive which sets out the rules relating to Technical Provisions and states that:

Technical Provisions shall be calculated in a prudent, reliable and objective manner.

Non-Life Perspective

Earlier this year the Society of Actuaries in Ireland carried out a survey of the impact of Covid-19 on claims experience. Responses ranged from improved claims frequency to higher than normal claims frequency and from increased speed of settlement to a slowdown in claims settlement.

Improved claims frequency was most noticeable for Motor, Employers' Liability and Public Liability as the level of economic activity declined while claims frequency increased for Travel and Event Cancelation.

Disruptions to claims functions, access to courts, ability for loss assessor inspections and delays to medical reports will all result in settlement delays. If any slowdown in claim settlement isn't correctly allowed for it could result in under projection of Technical Provisions.

On the other hand, despite operational disruptions, reduced claims frequency has resulted in increased capacity within claims functions which has allowed existing claims backlogs to be cleared, perhaps for the first time in years. This speed up of claims settlement, if not correctly adjusted for, could result in over projection of Technical Provisions.

Given the uncertainty in relation to the appropriateness of the historic data we would expect that reserving actuaries take account of the principles of 'prudence', 'reliability' and 'objectivity' when deriving assumptions for actuarial best estimates.

Life Perspective

From a life perspective, many insurers have observed a reasonably limited impact to date in terms of increased mortality and morbidity rates for a myriad of reasons such as very few additional claims, different risk/ age profiles of insured book to those most impacted by Covid-19, risk mitigants such as offsets between annuity and protection portfolios, high levels of reinsurance or product features (such as deferred periods on morbidity business and exclusion clauses). The more observable impacts for life insurers (particularly those writing savings and investment business) has been in relation to knock-on impacts of economic effects, such as persistency experience and impacts observed in terms of lapse and paid up rates, which has been more pronounced for certain product lines and then market volatility on the value of investments. While setting demographic and persistency assumptions can require significant expert judgment at the best of times, this is even more pronounced this year-end as HoAFs consider suitability and range of historical data, company initiatives in response to changes in customer behaviour, shorter term impacts and application of overlays to form a forward-looking best estimate view in line with Solvency II requirements.

Questions Boards should ask

From a non-life perspective, when deriving Technical Provisions there are a few key areas where the HoAFs will apply expert actuarial judgement, including:

- Loss development patterns;
- Initial expected loss ratios; and
- Selected methods.

In relation to loss development patterns, Boards will need to satisfy themselves that the HoAF has appropriately allowed for the 2020 distortion and how any adjustments have been justified. Where loss development patterns are not supportable alternative projection methods such as frequency severity analysis could be considered.

Actuarial reserving methods for the most recent year will often be weighted to plan loss ratios. Where these methods are selected the Board must satisfy themselves that plan loss ratios are not overly optimistic or that they have been revised with appropriate allowances for Covid-19.

From a life perspective, in addition to short term impacts, longer term implications on demographic and lapse assumptions and knock-on impacts can be more challenging to gauge and warrant detailed ongoing consideration at senior management and Board levels. More granular analysis will be expected to be carried out and presented in a transparent and digestible manner to facilitate board engagement to ensure that year-end assumptions reflect uncertainty and indeed "Events Not in Data" in a way that is clear, makes sense with maintains consistency in approach over time. Documentation of the expert judgments taken will be expected to be transparent to external stakeholders such as external auditors and the CBI. It is worth referring again to the letter sent by the CBI to Boards and HoAFs during February 2017 on "Board Oversight of key assumptions", covering the role expected of the Board in relation to assumption setting[2]. From a Board perspective, a key consideration is the plan in relation to assumption setting and carrying out of experience studies in the short term. This includes the governance framework for monitoring of assumptions on an ongoing basis, including priority order and triggers for monitoring more closely in response to "red flags" should be a key focus areas.

In conclusion, the events of 2020 and levels of uncertainty will mean that the annual reserving processes will involve increased scenario testing, involve more cross functional engagement, require more governance and greater levels documentation at year-end 2020 and on an ongoing basis throughout 2021.

For further insight please get in touch with us via email or telephone, contact details below.

[2] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/insurance-reinsurance/solvency-ii/requirements-and-guidance/20170207-letter-to-board.pdf?sfvrsn=6

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