Market Bulletin

LLOYD'S

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FROM:	Head, Market Reporting
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REFERENCE:	Lloyd's Actuary103103/Y3165
SUBJECT:	DECEMBER 2003 SOLVENCY TEST: VALUATION OF LIABILITIES
SUBJECT AREA(S):	2003 Solvency Test
ATTACHMENTS:	Valuation of Liabilities Rules
ACTION POINTS:	Note the rules applicable for the 31 December 2003 solvency exercise
DEADLINE:	For immediate attention

Attached to this bulletin are the Valuation of Liabilities Rules for the 2003 Solvency Test. There are no material changes to the rules for this year that need to be brought to the attention of managing agents. Any queries on the Valuation of Liabilities rules should be referred to Henry Johnson on extension 5235.

This bulletin has been sent to the compliance officer of all underwriting agents and recognised accountants and for information to all market associations.

John Parry

VALUATION OF LIABILITIES

FOR LLOYD'S SOLVENCY PURPOSES

VALUATION OF LIABILITIES

INTRODUCTION

These rules are made by the Council of Lloyd's under paragraph 9 of the Solvency & Reporting Byelaw (No.13 of 1990) for the valuation of members' liabilities and as regards the valuation of general business liabilities. Lloyd's has consulted the Financial Services Authority on these rules. A syndicate's liabilities must also comply with sections 12.4 or 12.5, as appropriate, of the Lloyd's Sourcebook.

Members' underwriting liabilities are determined by reference to the liabilities of the syndicates on which they participate. The attribution of those liabilities to members for the purposes of the annual solvency test is undertaken by Lloyd's centrally. These rules therefore focus only on the determination of syndicate liabilities.

GENERAL INSURANCE BUSINESS

Equitas Reinsurance Ltd has reinsured all 1992 and prior general business liabilities with effect from 31 December 1995. The rules therefore relate only to the 1993 and subsequent years of account.

The basis of valuing liabilities is as follows:

- managing agents must determine solvency reserves in accordance with the rules set out below;

- managing agents must appoint an actuary (the Syndicate Actuary), who is in possession of a current general insurance practising certificate issued by the Institute of Actuaries or Faculty of Actuaries, to provide an opinion on those reserves, for each syndicate;

- where an unqualified actuarial opinion will or may not be available, the managing agent concerned must report to the Lloyd's Director of Finance, Risk and Operations. Solvency reserves will be determined by the Lloyd's Actuary who, after consultation with the Syndicate Actuary, will take the relevant facts of the syndicate's business and reinsurance arrangements into account when forming his opinion

Any managing agent which is not able to secure an unqualified actuarial opinion on its solvency reserves for a particular syndicate will normally be subject to a monitoring review by Lloyd's Market Supervision Department.

Where it becomes apparent that there may be any difficulties in obtaining an unqualified actuarial opinion, or that the "Additional Comments" section of the opinion is likely to contain material issues, Lloyd's should be informed as soon as is practicable.
Section 11.3 of the Financial Services Authority's Lloyd's Sourcebook requires a minimum margin of solvency to be calculated at member level, known as the member's

margin. The method for determining the member's margin is similar to that used for EC required minimum margin calculations, as adapted for the circumstances of members of Lloyd's. Those calculations are performed by Lloyd's centrally, and are outside the scope of these rules.

DETERMINING THE SOLVENCY RESERVE

1. The managing agent must, in respect of each syndicate managed by it, establish a solvency reserve for each year of account which became closed or remained open as at the solvency test date. Both a gross and net of reinsurance reserve must be established: the net of reinsurance reserve shall be the solvency reserve.

2. For the purposes of determining the solvency reserve for any year of account which has accepted a reinsurance to close, account must be taken of the liabilities associated with earlier underwriting years which have been reinsured into that year, and thus the solvency reserve will be the aggregate of all these years taken together. This solvency reserve will also include a reserve specifically for that latest year itself.

3. The solvency reserve in respect of any year of account which is being closed by reinsurance to close must be at least equal to the reinsurance to close premium.

4. When reinsurance arrangements are changing from year to year the appropriate method of deriving the net of reinsurance reserve is by subtracting future reinsurance recoveries, less future reinsurance premiums, from the gross reserve. The rules for determining the gross reserves and reinsurance recoveries are set out below.

ACTUARIAL OPINIONS

5. As referred to above, the reserves determined for each year of account are required to be subject to an actuarial opinion in the form prescribed at Appendix A to these rules. This assessment is to be performed in accordance with guidance note 20 prepared by the Institute of Actuaries and Faculty of Actuaries. Although not mandatory account should be taken of relevant advisory notes issued by the Institute of Actuaries and Faculty of Actuaries and the Code Of Practice: "Management Of Reserving Risk" issued by Lloyd's.

6. Provisions for future unallocated claims handling costs and provisions for reinsurance bad debts fall within the scope of the actuarial opinion.

7. Acceptable signatories to the actuarial opinion are:
    - fellows of the Institute of Actuaries;
    - fellows of the Faculty of Actuaries; and
    - fellows of the US Casualty Actuarial Society who are also members of the Institute of Actuaries or Faculty of Actuaries.

8. Signatories must hold a current practising certificate issued by the Institute of Actuaries or Faculty of Actuaries and may be either external consulting actuaries or employees of the managing agent.

9. The actuarial opinion includes a section entitled "Additional Comments" which allows the actuary to highlight material issues for the Council of Lloyd's attention. Such comments are intended to enhance the disclosures made in the opinion and do not constitute a qualification. Any matters which materially increase the degree of uncertainty underlying the opinion beyond that which would reasonably be expected or which involve a material deviation from accepted actuarial methodologies would normally justify a reference in this section. Actuaries should not, however, assume that such additional comments are expected.

GROSS RESERVES

10. The gross reserve must not be less than the best estimate of the monetary amount which is expected ultimately to be payable in order to discharge all liabilities in respect of the underwriting year before taking reinsurance recoveries into account. It must include gross notified outstandings, incurred but not reported losses and provisions for future claims handling costs including the expenses of managing the run-off of the business. It should take account of inflation, currency exposure and any other factors which may influence the final monetary cost of settlement including any costs of borrowing that may arise.

    A prudent allowance may be made for future premiums not yet accrued. However except to the extent that there is a legitimate set off against other liabilities, the liabilities arising from such future premiums to be received on any group of contracts should not be assumed to be less than those premiums. "Future premiums" in this context means those that arise on binding authority and lineslip contracts, where the underlying declaration has not attached as at 31 December; under IDA, the risk will be bound under the main contract to the 2003 (or prior) year of account. Credit should be taken for salvage and subrogation rights, net of any related bad debts.

11. For practical reasons, it should be assumed that the costs of handling gross claims and reinsurance recoveries should be included in the gross provision for Unallocated Claims Handling Expenses. Where it is reasonable and prudent to do so, the provision for unallocated future claims handling should be calculated on the practical assumption that each syndicate is a going concern. Otherwise, provision should be made on the basis that the syndicate has ceased or will cease trading, in whole or in part, as appropriate.

12. Discounting is not permitted when calculating reserves for solvency purposes.

13. The gross reserve should take into account the particular circumstances of the syndicate, any relevant statistical evidence and the judgement of the underwriter as to the eventual outcome of each year in question. Historical statistics may not, however, satisfactorily reflect a syndicate's exposure to significant losses. Accordingly, the incurred but not reported reserves must provide for circumstances where a syndicate is exposed to losses arising from one or more known major catastrophes or a known potential cause of loss.

14. Careful consideration must be given to ultimate exposures (irrespective of currently reported losses/current reserves) in respect of known catastrophes on any year of account, including events following the solvency test date affecting earlier underwriting years. Furthermore, if there is likely to be a greater than usual incidence of attritional losses, then appropriate reserves must be established. These requirements are especially important when assessing the reserves for the open years of account when loss advice information is more limited than for older years.

15. If there are circumstances or an event that materially increases the uncertainty and makes estimation of the claim reserves particularly difficult for any year of account, then alternative approaches will need to be considered. Syndicates should have a clearly documented methodology and should be able to demonstrate reasoned judgements for the estimation of such liabilities. If the approach adopted for all or part of the reserves is not regarded as a generally accepted actuarial method then a comment should be made in the opinion and details given in the report. Claims reported or precautionary advices received to date should be monitored and reserved for in the usual way.

REINSURANCES

16. The deduction in respect of reinsurance recoveries should be the net monetary amounts which are expected ultimately to be received in respect of each year of account, net of related future reinsurance premiums. Such amounts should include any costs of borrowing necessary to cope with delays in reinsurance recoveries. An appropriate provision should be made for potential reinsurance bad debts.

17. Since the solvency reserves cover all relevant liabilities at the year end, the managing agent should be aware of the need to provide for the reinsurance premium cost of the protection of the liabilities covered by the solvency reserves, irrespective of the year of account to which the relevant reinsurance premiums will be charged. Care should be taken where a syndicate has contracts that provides protection over several years to ensure all future costs of reinsurance are properly allocated to the year of account they are protecting so that the solvency reserve is not underestimated. Where the reinsurance has not yet been purchased, the appropriate provision should be no less than the reduction in liabilities which has been assumed from that reinsurance cover. This could be particularly important where reinsurance is placed on the basis of losses occurring during the

year of account and when policies are written for periods in excess of one year or under binding arrangements. Recoveries under a stop loss contract should not be used to offset this charge if the recoveries could not be relied upon if the syndicate went into runoff.

18. The reinsurance bad debt reserve will include appropriate amounts in respect of reinsurance disputes as well as reinsurer insolvency. There is potential for these amounts to increase significantly, as well as gaps occurring in the reinsurance cover when the circumstances or an event as envisaged in paragraphs 14 or 15 occur. The reinsurance bad debt reserve should also cover all stop loss reinsurance contracts.

19. Lloyd's security should be treated as 100% recoverable except for an allowance where considered appropriate for reinsurance disputes between different Lloyd's syndicates which should not be confined to identified disputes.

20. Reinsurances should be assessed in accordance with the principles of Financial Reporting Standard 5. That is, if the contract is in the nature of an investment it must be treated as an asset and valued for solvency purposes at its net present value; alternatively, if it is a contract of reinsurance, it should be treated as such. Some reinsurance contracts have large profit sharing elements attaching to them, which are clearly financial elements. For these contracts the profit commission should be treated as a financial element and therefore as an asset and valued for solvency purposes at its net present value.

NO ACTUARIAL OPINION

21. Where an unqualified actuarial opinion is not available for any particular year of account, including any year which has earlier underwriting years reinsured into it, the managing agent concerned will need to seek further instructions from the Lloyd's Director of Finance and Operations. In particular, the Lloyd's Actuary, after consultation with the Syndicate Actuary, will determine a solvency reserve for each year of account in respect of which an unqualified opinion is not available.

US & CANADIAN DOLLAR, AND EURO BUSINESS

22. The estimated liabilities on United States and Canadian dollar currency accounts must be calculated in these currencies, in accordance with the rules set out above. Similarly, the estimated liabilities in respect of business denominated in Euro must be determined.

23. The pre-1 August 1995 LATF is not specifically covered by any of these opinions, at least not in isolation. New York Insurance Department (NYID) had previously satisfied itself as to the level of reserves in the LATF, on the basis that reserves were established at the higher of (old) Test 1 and Test 2.

24. Since the Test 1 arrangements have effectively been withdrawn, NYID needs some further comfort as to the adequacy of the LATF reserves. Accordingly, the UK actuarial opinion addresses the breakdown of the net reserves for each year of account, so as to identify separately amounts attributable to the pre-1 August 1995 LATF.

25. US and Canadian dollar liabilities, and liabilities in Euro must be converted into sterling at the rates of exchange prevailing at the close of business on the effective date of calculation. These rates of exchange will be determined and notified to the market early in the following year.

RESPONSIBILITIES OF SYNDICATE AUDITOR AND SYNDICATE ACTUARY

26. The syndicate auditor's responsibility with respect to the determination of the solvency position of each syndicate is unchanged, notwithstanding the requirement for an actuarial opinion on the solvency reserves. In other words, the syndicate auditor is required to submit the prescribed audit report on the syndicate return in the usual way.

27. The auditor will, however, be able to place reliance on the actuary's opinion, in accordance with the appropriate professional guidance.

28. Where an unqualified actuarial opinion is unavailable, this may have implications for the syndicate auditor's report and accordingly, the actuary and auditor will need to liaise closely and report to Lloyd's as soon as any difficulties are identified.

29. Where it becomes apparent that there may be any difficulties in obtaining an unqualified actuarial opinion, or that the "Additional Comments" section of the opinion is likely to contain material issues, Lloyd's should be informed as soon as is practicable once advisers will have discussed matters with their client.

LIFE BUSINESS

30. A syndicate with long term insurance liabilities must comply with section 12.5 of the Financial Service Authority's Lloyd's Sourcebook. Paragraph 12.5.3 requires that the managing agent must appoint a Syndicate Actuary to certify the reserves for life business using the form of opinion approved for this purpose. The basis and method of the calculations are set out in the remaining paragraphs of that section.