LLOYD'S

Reserving Guidance - Allowing for Inflation

This email is being sent to you as you are the CFO, Chief Actuary or the designated compliance contact for your Managing Agency. Please forward this email to your colleagues who are responsible for setting reserves.

The purpose of this communication is to set out our expectations on reserve setting for managing agents in response to the high inflationary environment and provide some helpful guidance.

Introduction

In March, US inflation hit its highest level in over 40 years. There are signs this may have been the peak – figures published recently for April showed a decline against March – but forecasts for the UK and Europe show rises are set to continue.

Financial market movements suggest investors are expecting a slow decline in inflation, but with levels remaining high in the near term and significant uncertainty in forecasts over the next 12 months.

Inflation is the big issue of 2022 and we must manage this in an adequate way. Not dealing with inflation is wrong, but so is being too prudent. We must find the right balance and your actuaries have to make explicit and reasonable allowances.

We expect inflation to be explicitly considered for best estimate reserve setting. Inflation assumptions should be set in a way that considers class of business as well as geography, is consistent with other areas of the business and is subject to appropriate review and challenge by the Board.

More details on our expectations and guidance on possible approaches are outlined below, as well as notification of an information request.

Quantifying the impact of inflation

Quantifying claims inflation and the impact on reserves is not straightforward. Firstly,

whilst economic indices (such as CPI) are available, these are unlikely to be completely relevant or capture all drivers of claims cost increases for your portfolio of business. Therefore, analysis should be performed to determine how your average claim cost and claim frequency has changed and what the drivers of this are.

There will likely be specific cost increases that are more relevant to your claims costs than standard published economic indices, for example, the cost of timber may increase by more than the standard basket of goods that CPI captures. So, in addition to economic inflation (defined as changes in claims costs as captured through published economic indices), you should also explicitly consider excess inflation (including social inflation) which is defined as changes in claims costs beyond what is captured in economic indices, including factors which are specific to a (re)insurers' business.

There are two key elements of allowing for inflation in reserves; (1) allowing for claims inflation up to now for claims that have not yet settled, and (2) forecasting how inflation will impact claims costs between now and their settlement.

Looking at how claims frequency and severity metrics have increased recently will provide an indication of how the current supply-led inflationary environment is beginning to impact your claims cost, which could be different from previous experience or expectations.

There is significant uncertainty on how inflation will develop in the future over the short and medium-term. You should consider the various economic forecasts in determining what future assumptions are appropriate to factor in, including for different geographies.

Reserving Expectations

We expect syndicates to explicitly consider economic and excess inflation (including social inflation) in their reserving process when setting best estimate reserves. This is particularly important when historical data is unlikely to be representative of the future and traditional reserving techniques do not address this.

- Economic inflation is an area of specific focus due to recent changes in the inflationary environment and this could impact multiple lines of business depending on how aligned the drivers of claims costs are to economic indices.
- Allowances for excess inflation will depend on the nature of business written by the syndicate and it is the responsibility of syndicates to ensure they are appropriately considering all potential risk factors that could lead to excess inflation. In particular, the impact of social inflation on reserves should be considered where relevant. We are planning to issue further guidance on allowing for social inflation later in the year

based on the reserving thematic review currently taking place.

Where syndicates are not making an explicit additional allowance in their best estimate reserves for inflation, they must be able to explain why their approach is appropriate and how they have gained sufficient comfort that their reserves are adequate.

Inflation is expected to impact different classes of business and geographies in different ways and we expect this to be taken into consideration based on understanding of underlying exposures and the drivers of inflationary impacts.

The assumptions made need to be clearly communicated to, challenged by and agreed with the Board – including the uncertainty and different scenarios around the best estimate.

Information Request

We will incorporate an information request alongside your Q2 QMA reporting (similarly to the COVID-19 and Ukraine supplementary returns) on your approach to allowing for the high inflationary environment within your total reserves and the quantitative impact of inflation on your total best estimate reserves.

Additionally, information will be collected in the syndicate capital 'Focus Area return' as part of the capital setting process for us to be able to review the appropriateness of the approach taken in your capital modelling. As a reminder, controls loadings are applied to syndicates deemed not to comply with the reserving or capital principles and/or Solvency II regulation.

Suggested Considerations

Syndicates should be clear on how they are allowing for inflation within their reserves and where they expect explicit additional allowances may be required. This section is intended to provide some guidance on how you can allow for inflation in your reserving methodology and things to consider when setting inflation assumptions. These suggestions are not exhaustive but represent what we expect syndicates to consider.

The following list can be considered when adjusting your reserving methodology to allow for inflation. However, it is important to ensure that there is no double counting in the way that you adjust your reserving methodology to allow for inflation.

- Appropriateness of IELR (Initial Expected Loss Ratio) assumptions where exposure-based methods are used to estimate IBNR (incurred but not reported) reserves.
- Impacts of inflation on unpaid reported claims (existing case reserves) across all

years of account.

- Whether explicit inflation uplifts are required for older years of account which are reliant on methods such as the basic chain ladder which assumes future inflation will be the weighted average of historical inflation.
- Appropriateness of payment pattern assumptions by class of business used in any cashflow approaches to inflate reserves or for determining the eligibility for discounting.
- Any changes to inflation and/or interest rate assumptions used to discount reserves which are already applied in your reserving approaches prior to the current high inflationary environment (e.g. for periodical payment orders).

With regards to selecting inflation assumptions you should consider:

- Implied historical inflation already in the data and where future inflation is expected to deviate from this.
- Future inflation should be considered on a calendar year basis until all claims are run-off to understand the impact on ultimate claims estimates. This requires consideration of the expected severity and persistence of inflation shocks (i.e. when inflation is likely to revert to long-term targets).
- The key drivers of inflation for different classes and how these are expected to impact claims costs (e.g. cost of raw materials, wage indices, geographical differences).
- The level of inflation assumed to be priced into premiums for more recent years of account and the appropriateness of inflation trend and selected RARC (Risk Adjusted Rate Change) assumptions when assessing on-levelled loss ratios.
- The period to which inflation allowances apply (e.g. claims relating to compensation for loss of earnings will need to consider wage inflation over the period of loss of earnings from the accident date, which could be a significantly longer time horizon than to settlement)

Potential Approaches

The following list identifies some potential approaches that can be used to allow for inflation in reserve setting. These vary in complexity and are not mutually exclusive. This is not an exhaustive list and reasonable alternatives that are appropriately evidenced are acceptable.

We acknowledge that the timeframes for Q2 2022 reserving may be too tight to fundamentally change existing reserving processes to allow for more complex approaches, and this may also not be considered a proportionate response for several

reasons. Therefore, simplified methods will be acceptable but should still be justified and validated.

1. Actuarial reserving methods that use explicit inflation assumptions, e.g., the Inflation-adjusted chain ladder, the Bennet Taylor method, etc. The advantage of these is the ability to quantify explicitly and be transparent with relevant stakeholders the inflation assumptions, by future calendar period, used in claims projections.
2. Discussion with underwriting and claims teams on the underlying nature of business to understand how inflation is expected to impact claims (case reserves, IBNR and IBNER) with explicit IBNR provisions set up where appropriate.
3. Applying payment patterns to claims reserves projected using standard actuarial techniques to determine the incremental reserve payments over future calendar periods and uplifting these payments by an inflation factor (compounded over time). This should be considered at a class of business and YoA (year of account) level. The inflation factor is intended to allow for inflationary effects beyond what is implied by historical data and can be derived in different ways with various levels of sophistication/granularity (e.g., weighted average of existing relevant inflation indices overlaid with expert judgement from underwriting and claims teams).
4. Explicit loading applied to IELRs based on analysis of how inflation is expected to impact ultimate loss ratios (applied at class/YoA level). The selection of any loading factor must be clearly justified.

Where uplifts are being made, the reserving function should ensure that these are explicitly quantified and clearly communicated with transparency around any underlying assumptions.

Definition of Claims Inflation

We want it to be clear to the market what we mean when we refer to claims inflation and the different elements of it. We have provided our definition below, which is what we will consistently use when referring to the impact on claims.

We define “claims inflation” as the change in claims costs for a like-for-like policy over time, where claims cost is considered as all costs in relation to the payment and settlement of a (re)insurance claim. This includes loss adjustment expenses directly associated with the claim, such as claims handling.

Like-for-like means having consistent policy wording, exposure and level of coverage, such that the change in claims cost is considered after normalizing for changes in policy terms and other differences in the policy.

Our definition of claims inflation covers changes in claims cost due to trends which

affect the number (frequency) and/or size (severity) of claims.

Claims inflation can be broken down as the sum of “economic inflation” and “excess inflation”:

- **Economic inflation**: Changes in claims costs as captured through published economic indices relevant to a (re)insurer’s mix of business.
    - Typically, this is inflation in the cost of a basket of selected goods and services or average wage costs, which are captured in price and wage indices (such as RPI, CPI and ASHE in the UK, which are produced by ONS).

- **Excess inflation**: Changes in claims costs beyond what is captured in economic indices, including factors which are specific to a (re)insurers’ business and including social inflation, i.e., social inflation is a subset of excess inflation.
    - Typically, this is inflation associated with resources specific to the nature of the claims costs of the (re)insurer (beyond that captured in generic inflation indices); or emerging risk from new materials, medicines and technologies; changes in the legal environment; evolving social attitudes towards claiming; and political developments.
    - We define **social inflation** as a subset of excess inflation, which more narrowly pertains to claims inflation as a result of societal trends. For example, this includes rising costs of claims resulting from increased litigation, larger compensatory jury awards and social movements.

Further support

If you have any questions or would like to discuss the content of this communication, please get in touch with your reserving point of contact or one of us.

Kind regards,

Burkhard Keese CERA
Chief Operating Officer &
Chief Financial Officer
Burkhard.Keese@lloyds.com

Emma Stewart
Chief Actuary
Market Reserving & Capital
Emma.Stewart@lloyds.com

Mirjam Spies FIA
Head of Actuarial Oversight
Market Reserving & Capital
Mirjam.Spies@lloyds.com

Lloyd's, One Lime Street
London
EC3M 7HA

Telephone: +44 (0)20 7327 1000
Website: www.lloyds.com

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