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Lloyd’s Capital and Reserving NED forum 2021

17 November 2021

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Key findings from Lloyd's Actuarial Oversight

Lloyd's Actuarial Oversight is changing

What does this mean for Syndicates?

- Changes to Lloyd's team structure to create one Actuarial Oversight team, to better align oversight and market engagement on capital and reserving

- Project RIO – "Re-imagining Oversight" project. Main objectives:
  - Reducing complexity – moving away from tick-box minimum standards to outcome-based principles
  - Providing differentiated, risk-based oversight based on syndicate's materiality
  - Support impactful and decisive interventions for underperforming syndicates and development incentives for outperforming ones – consistent and fair outcomes
  - Transparency and consistent understanding and application of decisions
  - Joined up and holistic oversight across teams

To be launched officially in December – consultations going on with LMA at the moment

"No, it's too late for the oversight committee, send it to the hindsight committee."

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Actuarial Oversight is moving to a principle-based approach

Capital and Reserving Principles clearly defined under RIO Framework

Capital Principles

Managing agents should ensure syndicates Solvency Capital Requirement (SCR) appropriately reflects their risk profile and is calculated using a SII compliant internal model. All applicable regulatory guidance should be met.

To support this, Managing Agents should ensure their syndicates:

1. Maintain an internal model which captures all material risks that the syndicate is exposed to
2. Use modelling assumptions which are realistic and justifiable, methodology which is adequate and material limitations are understood.
3. Have strong feedback loops joining the business and the model
4. Demonstrate robust governance and understanding of the model. This includes adequate understanding and challenge at Senior Management level.
5. Implement changes to the model which are reasonable and justified and their impact on the SCR adequately explained.
6. Conduct objective challenge of the internal model through independent validation.

Reserving Principles

Managing agents should ensure syndicates set reserves which are underpinned by a robust reserving process. All Actuarial Function requirements should be met in line with Solvency II.

To support this, managing agents should ensure their syndicates:

1. Have clear governance and ownership of the reserves
2. Make appropriate allowance for uncertainties when setting reserves
3. Use assumptions to set reserves which are realistic, transparent and consider historical experience
4. Identify, understand and justify any differences in assumptions between reserving and other functions
5. Reserving processes and assumptions are periodically and objectively challenged
6. Best estimate reserves are set in line with Solvency II principles with any allowance for UK GAAP margins set explicitly in addition

The Principles provide a more succinct articulation of the basis underpinning the previous Minimum Standards requirements.

The principles are set around outcomes-based requirements that Boards should already be focussed on meeting.

Syndicates' Boards play a key role in challenging and ensuring that the sub-principles are met.

Principle-based approach has significant benefits

Enables Syndicates and Lloyd's to focus on doing the right thing and adding value

Benefits

- Less annual review (of LCR submission, annual reserving meetings)
- Expectations are differentiated based on level of materiality
- Waiving of immaterial loadings – faster and more predictable capital setting process

Shift in focus

- Shift to more targeted deep dives
- Supplement review of the numbers with qualitative review of governance/processes
- Transparent and clear application of oversight
- Focus on material issues
- Application of controls loading/SII loadings as intervention consistently across teams

So what does this mean for Syndicates?

More value should come out of engagement with Lloyd's and fewer surprises

Less review in capital setting season – more time to resolve issues

Look deeper when we look – action plans

More predictable capital – no (immaterial) loadings

(potentially) more controls/SII loadings

Thematic reviews to give more insight into market best practice

Thematic reviews unearth issues

More focus on governance/risk management

What have we found so far?

2021 Actuarial Oversight has identified areas where Boards can ask the questions we are asking

- **Validation** – Is it effective and is it sufficiently independent? Has external validation been considered to get fresh views?
- **Challenge** – Is it working? Where is the challenge happening? Is there the right level and balance of top-down and technical challenge taking place?
- **Committees** – Are they getting sufficient (and good) information to make informed decisions? Is there enough information on the risks and uncertainties? Quarter by quarter or also long-term trends? Is training happening – and being actively requested?
- **Resourcing** – Are there shortages? Is there Contingency? Is it possible and appropriate for Group resources to support the syndicate where needed?
- **Skills** – Do people have time/skills to tackle the difficult questions or do they churn out numbers? Are they able to explain movements or a lack of movement in a changing environment?

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How are actuaries dealing with the changing insurance environment?

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Thematic focus areas driven by changing environment

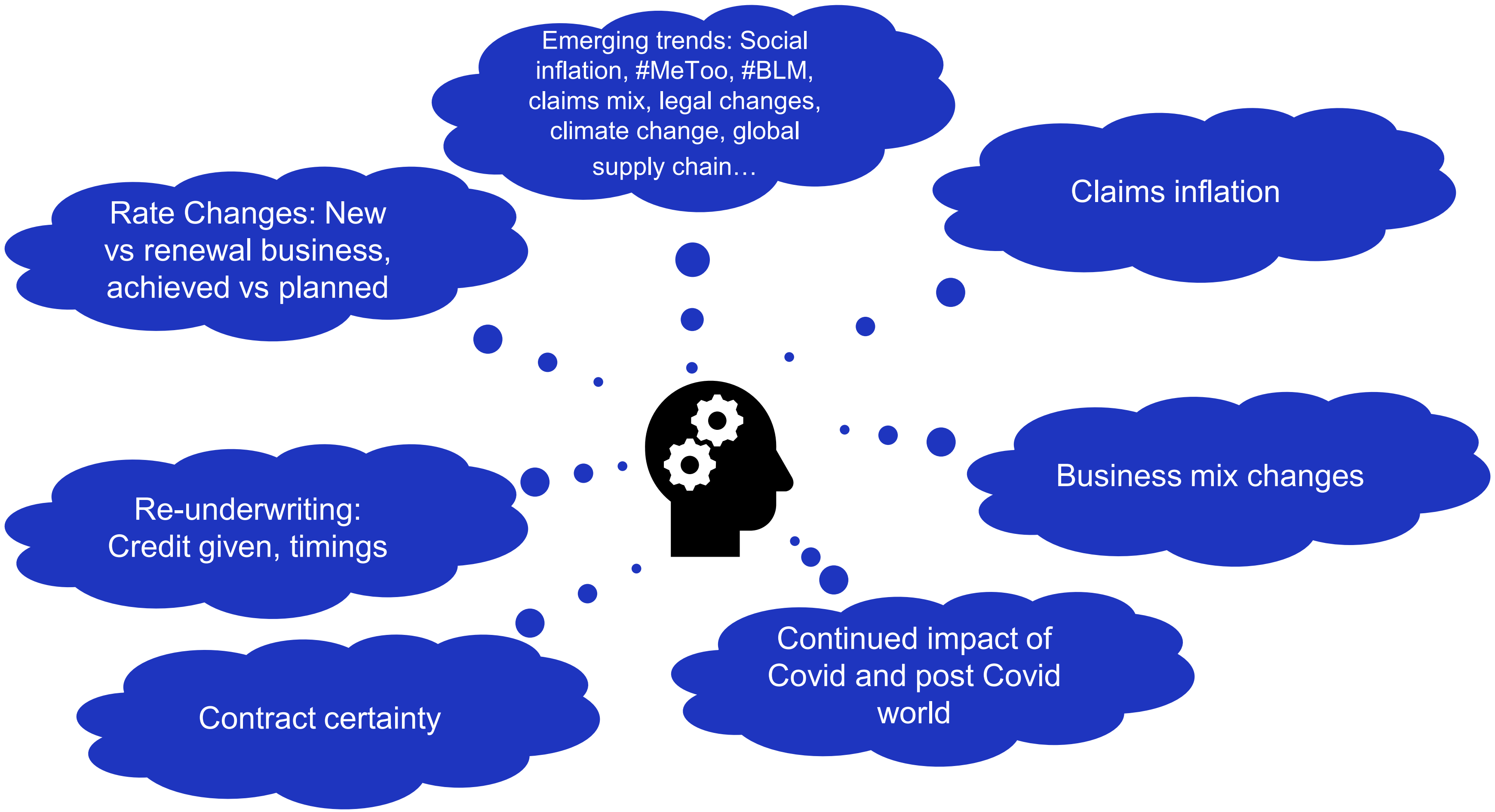
Annual review of market reserves has highlighted focus areas also relevant to capital modelling

Allowing for how the future will differ from the past in reserving	How emerging trends, claims inflation, rate changes, business mix changes and re-underwriting are accounted for
Cyber Experience	Difficulties in reserving for this relatively new class and changing claims mix with increase in ransomware claims
Casualty Reserving	Potential reserving deficiencies on Casualty classes and concerns over adequate allowance for inflation.
COVID-19 Experience	Direct COVID-19 losses are now well understood but secondary impact of economic impact still highly uncertain.
Appropriateness of Loss Ratio assumptions	Appropriateness of methodology and IELR selections and resulting loss ratio assumptions for recent years of account.

A common theme is the need to make allowance for historic experience not being representative of the future.
– Within traditional actuarial techniques there is often an implicit assumption that the past is a guide to the future, so explicit consideration is required to ensure reserves are adequate.

Many reasons why the future may differ from the past

Explicit consideration is required in these areas and adjustments to models will often be needed



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Accounting for how the future will differ from the past

Overall the Market appear to have a positive outlook which requires justification given experience

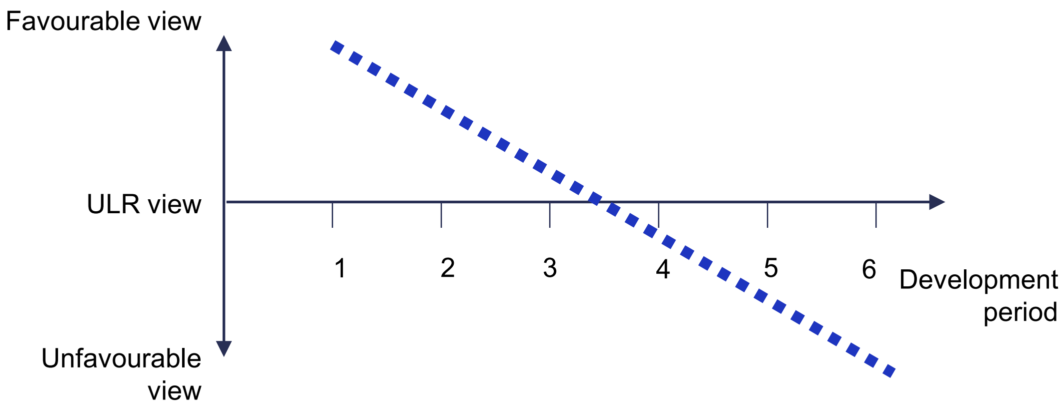
Loss ratios in more recent years have been reducing on many classes.

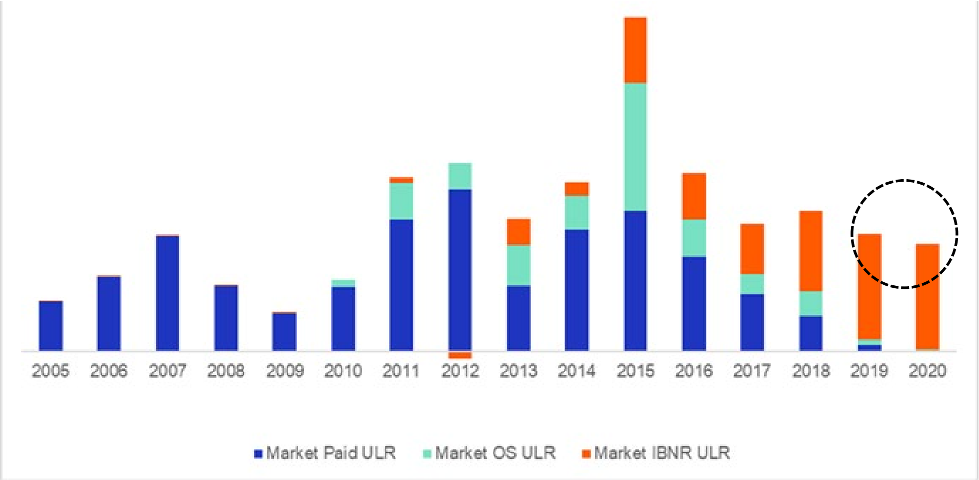
Appropriate justification is required for assumptions used and how they appropriately reflect the past and future expectations, including:

- Remediation allowed for in recent years
- Inflation expectations
- Rate change

This is of particular concern for long tailed classes where:

- Historical experience has been unfavourable
- Historical trends indicate a turning point in views on expected ultimate experience after 3-4 years from favourable to unfavourable.

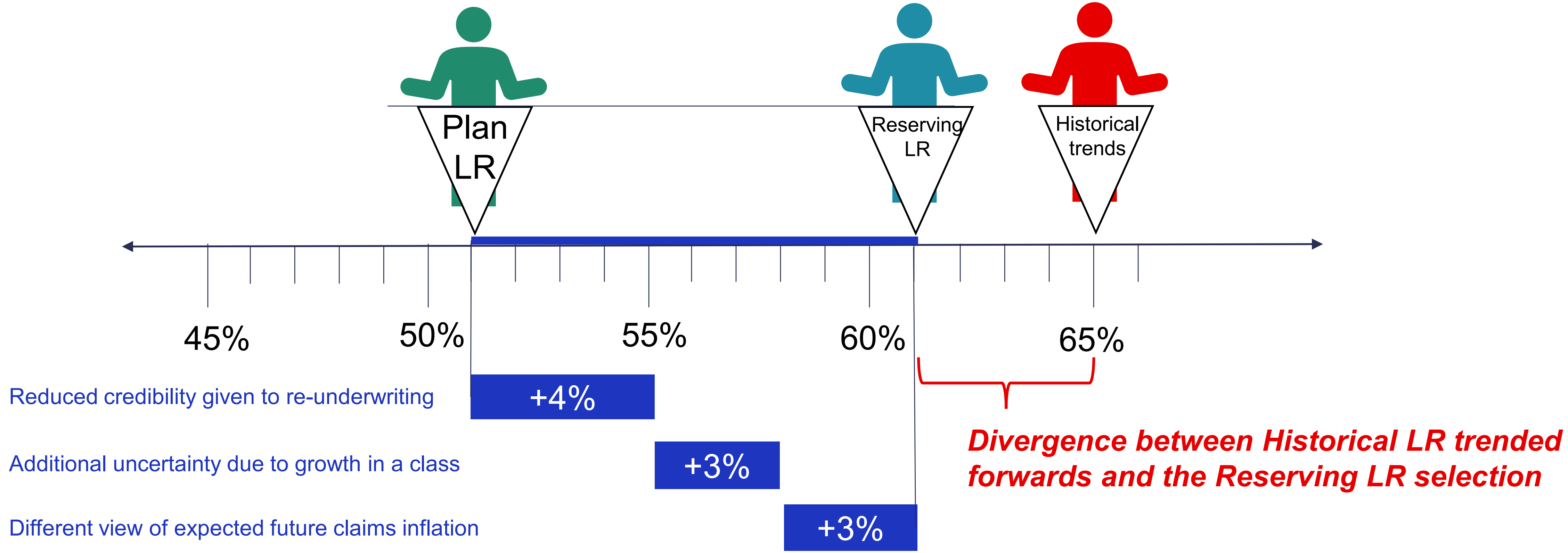




Appropriate Loss Ratio selection

We have previously discussed 'bridging the gap' between differing loss ratios…

…is there clear rationale for difference in views between loss ratio selections?

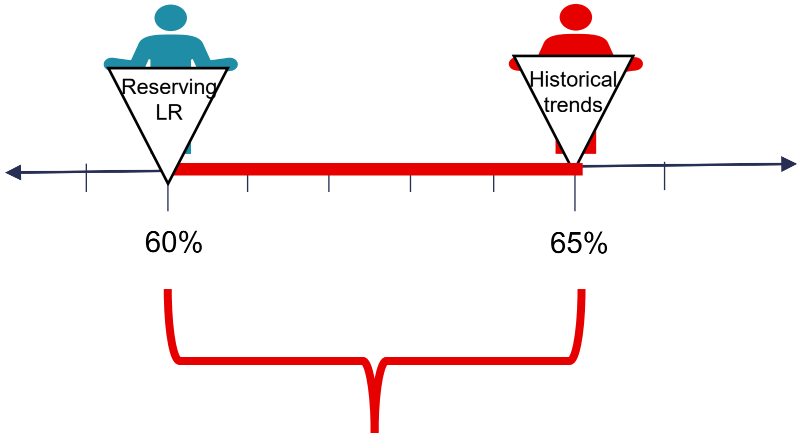


Justification of the bridging between the loss ratio views should be understood by the Board and challenged.

Appropriate Loss Ratio selection

You should understand the key assumptions underpinning the reserving loss ratio selections

How has each key element of the 'bridge' been assessed and validated?



This gap should be challenged and understood by the Board

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Assessing Loss Ratio appropriateness

Examples of questions the Board could consider asking

- How is the level of uncertainty associated with the Cyber class being accounted for in the reserving process?
- How are claims inflation assumptions used within the reserving process set?
- Has the business considered how the claims environment might differ in the post Covid world?
- How are re-underwriting and RARC allowed for within the reserve setting process, and how is this justified?
- What are the differences between the historical, plan and reserving loss ratios and are these differences justifiable?

Focus areas for 2022 Actuarial Oversight

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2020 year-end central reserve review exercise findings

2021 Focus Areas – thematic rather than class of business specific

The Lloyd's central reserve review exercise as at 2020YE identified the following areas for further investigation:

Casualty FinPro	Cyber	Recent unfavourable experience High degrees of uncertainty Concerns across other areas of the business
Casualty FinPro	Allowing for ways in which the future differs from the past	Widening deficits on the D&O, FI (non-US) and PI (non-US) classes despite investigation last year, with material deficits across multiple Casualty FinPro classes, focussed on more recent years.
Marine	Approaches used to set reserves	Contributes significant surplus to the overall surplus, focussed on more recent years.

Claims inflation

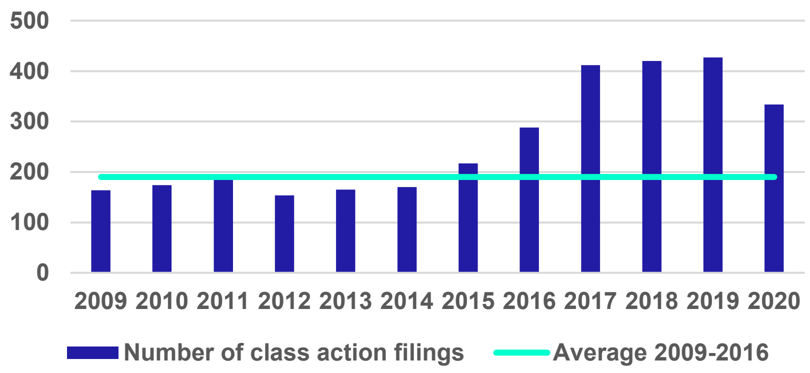
Social inflation – emerging trend or old news?

#BlackLivesMatter

Johnson & Johnson pays $230m to settle New York opioids case

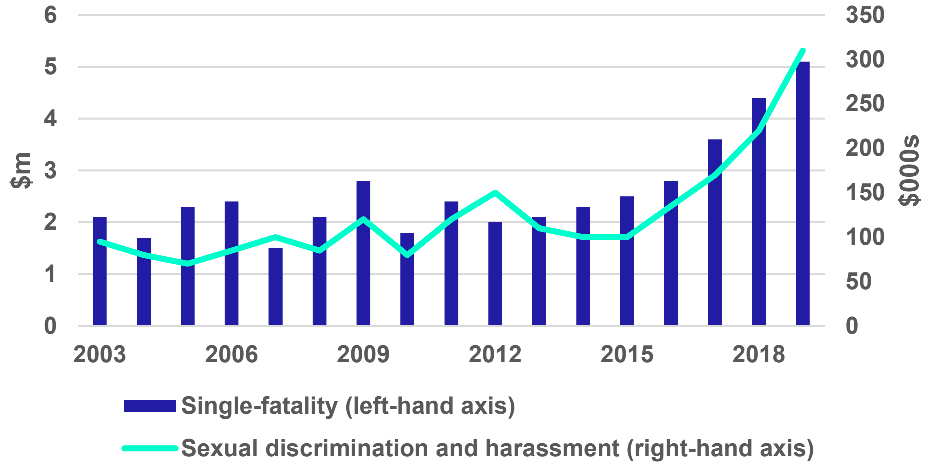
The Guardian

No. of securities class actions filed in the US (Cornerstone Research)



#MeToo

Median cost of single-fatality and discrimination cases (Advisen)



4.12.2020 EN Official Journal of the European Union L 409/1

DIRECTIVE (EU) 2020/1828 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 25 November 2020

on representative actions for the protection of the collective interests of consumers and repealing Directive 2009/22/EC

FINANCIAL TIMES

Insurers face extra $15bn asbestos bill

Claims on historic policies 'show no sign of abating', study finds

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Claims inflation

Our definition

Claims inflation

Change in expected claims cost level of a like for like policy over time, where like for like means having consistent policy terms, coverage and exposure. This includes impacts from both severity and frequency effects.

Pure inflation

Change in average price of goods and services related to a basket of representative claims, due to changes in price level and / or utilisation. This includes, for example, labour, energy, construction and care costs. Pure inflation in claim costs is equivalent to general economic inflation.

Excess inflation

Ways in which claim costs rise above general economic inflation. It captures, for example, growth in costs associated with emerging risk from new materials, medicines and technologies, changes in the legal environment and social attitudes. The spread between pure inflation and the full extent of claims inflation from the additional cost drivers is excess inflation

Social inflation

Change in claim costs over and above pure inflation resulting from increasing litigation, broader definitions of liability (excluding those caused by changes in policy terms and conditions), more plaintiff-friendly legal decisions and larger compensatory jury awards

Claims inflation

Key Findings

Excess inflation assumptions tend to be implicit

- Inflation embedded in data, often dependency driver for capital –> not explicitly modelled or quantifiable
- How can assumptions be validated/informing decisions if not quantifiable?

Excess inflation assumptions are not challenged enough

- Validation often limited to qualitative assessments and price/wage inflation, limited detail on claims inflation

Syndicates not always proactive to reflect emerging trends

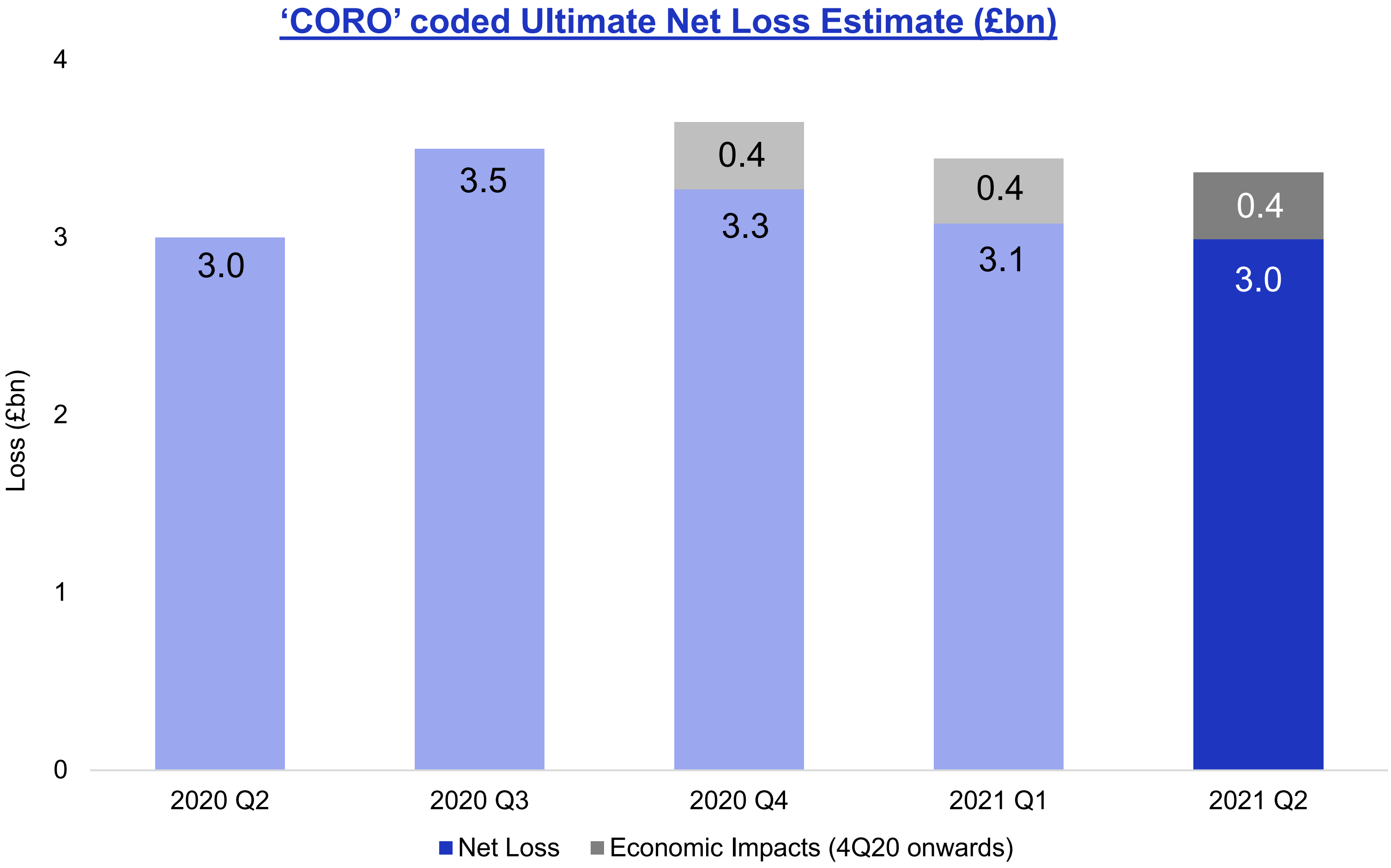
- Use knowledge across the organisation (working groups?), internal and external data
- "Traditional" actuarial methods might need adjustment - don't cope well when past is not representative of future – range of estimates and uncertainty around them clearly communicated

Consistency between teams could be enhanced

- Views between pricing, planning, claims, reserving and capital don't need to be the same but need to be consistent → Inflation framework

COVID-19 Ultimate Net Loss Estimate

Loss estimates remain stable since 2020 Q3



Figures use FX rates at time of reporting

- **Loss estimates and economic impacts have remained stable since 2020 Q3**
- Small decrease in net loss estimates from £3.5bn to £3.4bn, with view of losses arising from economic impacts unchanged
- Allowance has been made for both direct and indirect losses due to COVID-19 within the 'CORO' catastrophe code
- Additional allowance for economic impacts is also held outside of the 'CORO' catastrophe code (i.e. in other general reserves) and reported to Lloyd's
- Observations are in line with expectations given analysis of data received at 2020 Q4
- Reinsurance recoveries stable at 42% of gross loss
- **COVID-19 loss estimates still uncertain but more developed**
- The ultimate net loss estimates should not materially increase if the pandemic restrictions continue until 2021 Q4 in a third wave scenario
- 24% of anticipated recoveries have been received to date

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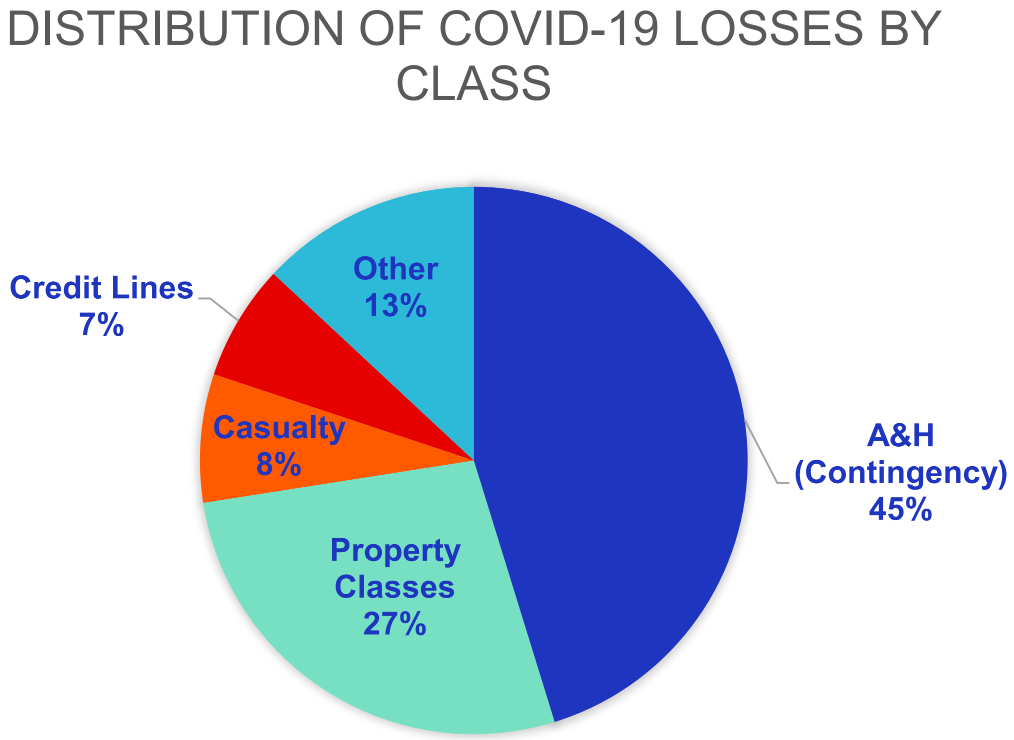
COVID-19 Classes

Key classes impacted are as expected

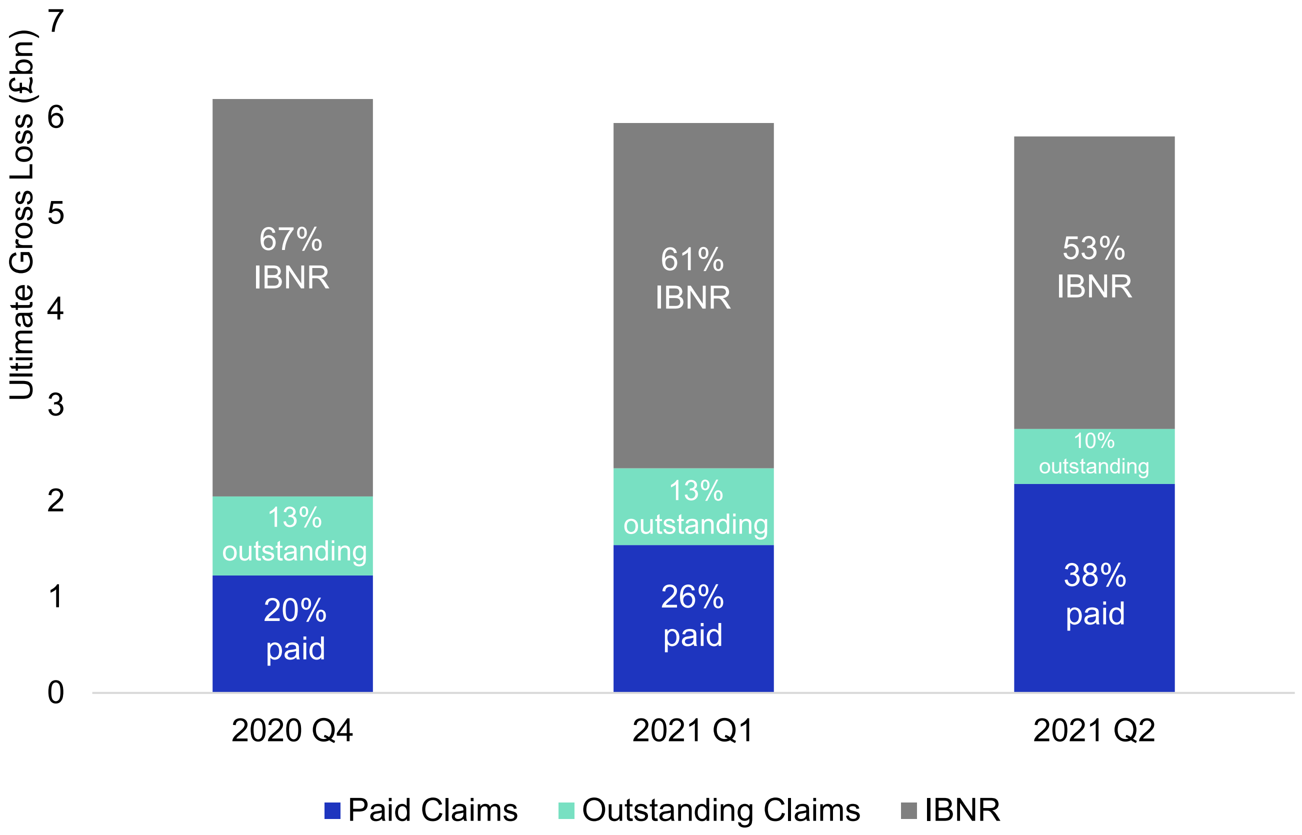


- **Direct impacts:**
  - Accident & Health (Contingency)
  - Property
- **Indirect impacts:**
  - Political Risks, Credit & Financial Guarantee
  - FinPro Casualty
  - D&O (US and non-US)

COVID-19 Ultimate Gross Loss Estimate

Loss estimates remain stable since 2020 Q4

'CORO' coded Ultimate Gross Loss Estimate (£bn)

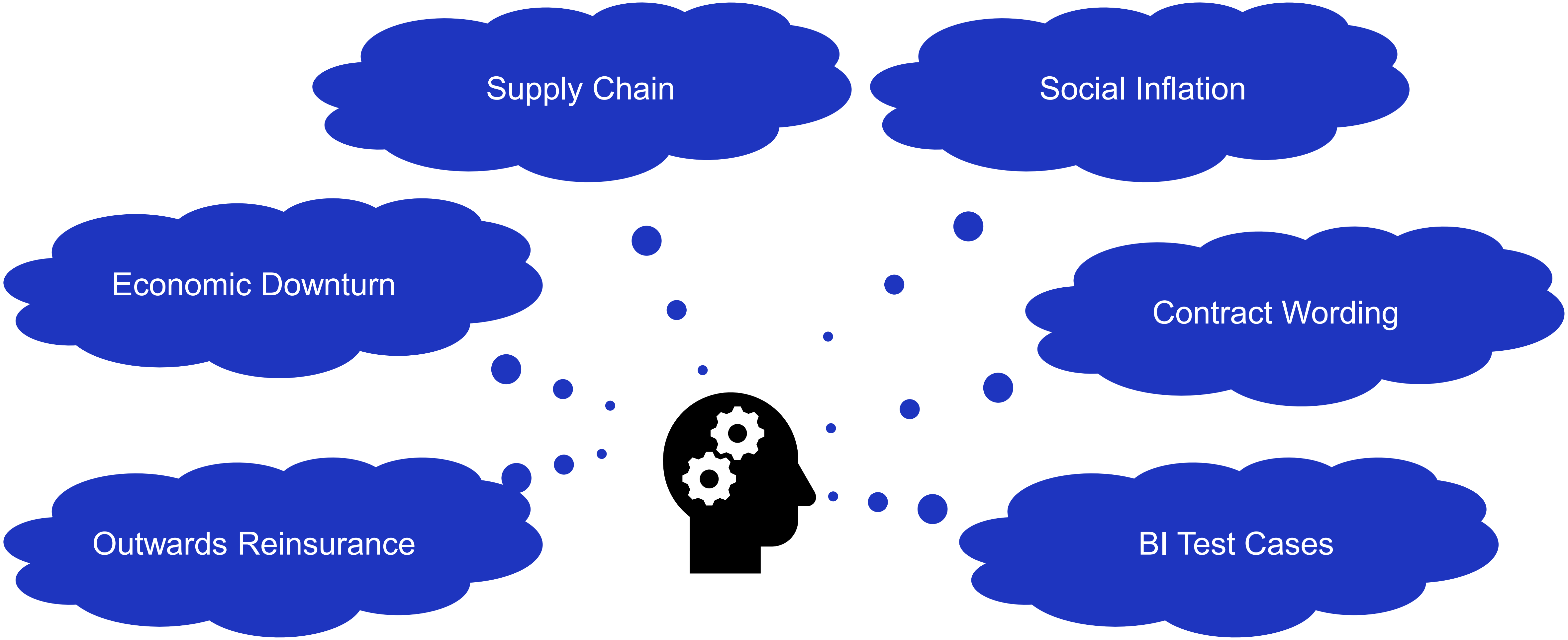


Figures use FX rates at time of reporting   Percentages may not sum to 100% due to rounding

- **Gross loss estimates relatively stable since 2020 Q4**
- Decrease observed in ultimate gross loss estimates (from £6.2bn at 2020 Q4 to £5.8bn at 2021 Q2)
- IBNR proportion of loss is decreasing as proportion of loss that is paid claims increases
  - As percentage of total gross loss;
    - **Paid Claims +18%** (20% - 38%)
    - **Outstanding claims -3%** (13% - 10%)
    - **IBNR -14%** (67% - 53%)

COVID-19 Current Uncertainties

Loss estimates remain stable but there are still some areas of uncertainty



Cyber

How are actuaries dealing with a class within a constantly changing landscape?

- The question of how actuaries reserve/price/parameterise a capital model for classes with minimal data and a constantly changing risk profile is epitomised by the Cyber class.
- This class has seen rapid growth at Lloyds over the last 10 years, and incurred heavy losses in recent years, particularly in 2019.
- The class has been a focus of oversight activity at Lloyd's
  - The Performance Management team have conducted a Cyber thematic review this year (see highlights on the following slide)
  - Cyber will be a focus area for MRC this year with both capital and reserving to carry out thematic reviews into Cyber risk and reserving methodologies used by the market over the coming months. The aim of these reviews is twofold – oversight on the one hand but also sharing good practices with the market on the other hand.
- We will work with CALM working groups on this – please get involved

Cyber

A class with significant uncertainty given the changing landscape

GWP has more than doubled over the last 5 years

Since 2019 there has been a significant uptick in the number of ransomware attacks

There has been a **145%** increase in incidents in the US in 2020 vs 2019

Across the market, syndicates on the whole have missed their plan every year since 2018

Poor performance has been experienced globally – no longer limited to US/UK risks

Can standard actuarial projection techniques be used?

What is the underlying exposure?

Observed inflationary trends on both frequency and severity?

How have key assumptions been validated?

Inflation, Covid-19 and Cyber

A summary of key questions to consider

Inflation

- Can inflation allowances be quantified (and appropriately validated)?
- Have inflation allowances taken emerging trends into account (explicitly)?
- Have you got an inflation framework, i.e. a consistent view on inflation across teams?

Covid-19

- What assumptions have been used to estimate Outwards RI recoveries and what is the level of certainty surrounding these assumptions?
- How are other impacts currently affecting the external environment such as inflation and supply chain issues affecting Covid-19 (and other) reserves?
- Have Syndicate specific exposures been appropriately allowed for, e.g. pandemic exclusions and exposure to BI test cases?

Cyber

- Is uncertainty appropriately understood and how is it allowed for within reserving and capital?
- Have key assumptions been validated and clearly communicated?

Summary

Key Takeaways

1. With the current changing landscape you are key in challenging the loss ratio selections
   - Have all the key assumptions underpinning them (such as inflation) been assessed and validated

2. You are required to ensure risks to your business are appropriately considered and allowed for
   - Capital in the context of risk profile
   - Historical deviations from plan loss ratio
   - Reserve projections compared to actual experience
   - Best estimate reserving process deficiencies

3. You should be comfortable that uncertainty been assessed holistically and relevant updated information has been presented to you (and other key stakeholders) to opine on appropriateness of reserves and capital
   - COVID-19
   - Cyber
   - Casualty classes

Questions & Comments

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