

Memorandum

To: All Fellows, Affiliates, Associates and Correspondents of the Canadian Institute of Actuaries and Other Interested Parties

From: Charles C. McLeod, Chairperson
Actuarial Standards Board
Jacqueline Friedland, Chairperson
Designated Group

Date: December 10, 2009

Subject: **Final Standards of Practice – Practice-Specific Standards for Insurers (P&C Insurance) – Subsection 2250 Margin for Adverse Deviations**

Document 209123

INTRODUCTION

The attached final Standards of Practice were approved by the Actuarial Standards Board (ASB) on December 3, 2009.

A notice of intent on this subject was published on June 5, 2009, with a comment period ending on July 31, 2009 (<http://www.actuaries.ca/members/publications/2009/209050e.pdf>). An exposure draft was published on September 15, 2009 with a comment period ending on October 31, 2009 (<http://www.actuaries.ca/members/publications/2009/209087e.pdf>).

There are only minor changes in the final Standards of Practice from the exposure draft.

The attached Standards of Practice (subsections 2250 through 2270) replace Subsection 2250 Margin for Adverse Deviations of the existing Standards of Practice – Practice-Specific Standards for Insurers (P&C Insurance).

The Policy on Due Process for the Adoption of Standards of Practice was followed in the development of these final Standards of Practice.

BACKGROUND

Absence of Standards of Practice Related to Stochastic Analysis

As explained in the notice of intent, the current Standards of Practice for Property and Casualty (P&C) Insurance address margins for adverse deviations (MfAD) for deterministic analyses only. Paragraph 2250.01 of the current Standards of Practice states: “The standards in this subsection 2250 apply to the selection of a margin for adverse deviations in the assumptions for a valuation of policy liabilities by a single scenario valuation.” A growing number of insurers offering P&C types of coverage are using stochastic analyses, either in part or whole, for the determination of policy liabilities. In such situations, the MfAD is often selected based on confidence level analyses or conditional tail expectations. However, since this is not addressed in the current Standards of Practice, it is unclear as to whether or not the actuaries working with these organizations are in compliance with accepted actuarial practice in Canada.

MfAD for Investment Return Rates

Currently, the interest rate MfAD is determined on an additive basis as a deduction of 50 basis points to 200 basis points from the best estimate. We consider that the existing low end of the range (e.g., 50 basis points) could sometimes be inappropriate, as may currently be the case.

SUMMARY OF CHANGES

The final Standards of Practice clarify that the use of stochastic approaches for determining a MfAD is within accepted actuarial practice in Canada. Specifically, the attached final Standards of Practice provide separate guidance for the MfAD for deterministic and stochastic analyses of policy liabilities. The changes also include a reduction in the low margin for investment return rates from 50 basis points to 25 basis points and an increase in the high margin for claim development from 15% to 20%.

COMMENTS ON THE EXPOSURE DRAFT

Comments on the exposure draft were received from two individual Canadian Institute of Actuaries (CIA) members and one regulator.

The Designated Group reviewed and considered all comments prior to their unanimous decision to adopt the exposure draft without any revisions. The primary messages contained in the comments and the reactions of the Designated Group are summarized below.

Change in Claim Development Margin for Adverse Deviations from 15% to 20%

Two members expressed concern with the increase in the high margin for claim development from 15% to 20%. Specifically, they noted that an actuary has always had the option to use a higher MfAD if the situation justifies such a margin. One of those members was also concerned about the implications to current MfADs that were selected based on where the particular circumstances of an insurer fit in the continuum of low to high margin cases. The issue was raised regarding the implications to margins that are currently spread between 2.5% and 15% if, in future, they are to be spread instead between the new range of 2.5% to 20%.

The regulator, however, supported the change to 20% for the high margin. It believes the maximum (and minimum) margins proposed in the exposure draft are adequate and will provide greater flexibility to the actuary in his or her valuation work.

The Designated Group conducted a detailed review regarding existing practices of P&C actuaries to select MfAD outside of the 2.5% to 15% range as set out in the current Standards of Practice as well as the intent of the increase to 20%. While the Standards of Practice clearly permit P&C actuaries to select MfAD for claims development greater than 15%, very few do in practice. The intent of the increase to 20%, which was originally suggested by members of the CIA's Committee on Property and Casualty Insurance Financial Reporting and is supported by the regulator who provided comments, is to make it clearer to P&C actuaries that the selection of 20% in times of great uncertainty is acceptable. In unanimously agreeing to retain the high margin of 20%, the Designated Group confirmed the need to emphasize to membership that it is not expected

that the change will result in a shift of the entire portfolio of Canadian P&C policy liabilities; it is expected that the overall mean will remain virtually unchanged.

An educational note on MfAD, which the ASB understands is intended to be released by the CIA at the same time as the new Standard of Practice on MfAD, clearly describes the purpose of the increase in claim development high margin to 20% and provides examples of its use. The following is an excerpt from this Educational Note on MfAD.

“The intent of the increase in the high margin is to make clearer to P&C actuaries that selection of 20% in times of great uncertainty is acceptable. For example, it may be appropriate for an actuary to select a margin of 20% for the following:

Automobile insurance in a specific province that is undergoing significant change due to tort reform or legal challenge to recently introduced tort reform,

Introduction of a new line of business or operations in a new province for which there is limited relevant data from which to estimate policy liabilities,

Significant change expected in future claims due to an increase in retentions and limited data for estimating the effect of such a change,

Economic upheaval such as the financial crisis of the fall of 2008 and its effect on long-tail lines of insurance such as directors’ and officers’ liability.

The above examples are only intended to be illustrative of potential situations for which the actuary may choose to select a claims development margin greater than 15%. However, it is important to recognize that the above situations may not always necessitate a claims development margin greater than 15% and the decision will be based on the actuary’s assessment of the uncertainty around the mean estimate.

The change in the high margin from 15% to 20% was not intended to shift the margins for all P&C insurance. Many actuaries currently select between 10% and 15% for many of the longer-tail lines of P&C insurance. These claims development margins are selected based on a review of the numerous considerations underlying the actuary’s estimate of claim liabilities and premium liabilities. It is not expected that these margins would change simply due to the increase in the high margin. However, if there has been a notable change in the environment and in the actuary’s assessment of the various considerations that influence the selection of the margin for adverse deviations, then a change may be justified.”

Finally, the MfAD educational note does not refer to a continuum approach for the selection of MfAD based on a deterministic analysis. Instead, detailed lists of considerations are presented. The Designated Group recognizes that a continuum approach was used in the past; however, it is no longer part of the Standards of Practice nor the educational guidance contained in the MfAD educational note. In conclusion, the

Designated Group does not believe that an overall shift in margins will occur in the valuation of policy liabilities for Canadian P&C insurance companies as a result of an increase in the high margin from 15% to 20%.

Adoption of Separate Standards for Deterministic and Stochastic Analysis

One member expressed concern about the adoption of separate MfAD Standards for deterministic and stochastic analysis. This member is concerned that it may generate less confidence in CIA Standards of Practice and that the presence of two potential different MfADs raises the possibility of differing actuarial results.

On the other hand, the regulator expressed support for clarification of the Standards of Practice related to stochastic analyses. It commented that since a number of actuaries are already making use of stochastic models for the purpose of valuing policy liabilities, the clarifications in the exposure draft are reasonable. It also noted that for the regulator's use of third party work, established Standards of Practice are part of the guiding principles and oversight framework; the adherence to established Standards of Practice are essential to the relationship of trust with external resources. It concluded that the changes proposed will eliminate all doubt with respect to norms for stochastic modeling.

There was clear support expressed during the comment period for the NOI in support of stochastic analysis for the purpose of developing MfAD. Such support was also expressed during the CIA's Seminar for the Appointed Actuary in September 2009. The Designated Group unanimously decided to retain the three separate subsections (i.e., 2250, 2260, and 2270) as presented in the exposure draft.

EFFECTIVE DATE

The effective date of the final Standards of Practice is **December 31, 2009**.

EARLY IMPLEMENTATION

Early implementation of the Standards of Practice is allowed since the changes do not represent material differences from the existing Standards of Practice. The purpose of specifically adding a subsection on stochastic approaches for determining MfAD for P&C insurers is to clarify that such approaches are within accepted actuarial practice in Canada. Some P&C actuaries who have been using stochastic techniques for years have relied on the Standards of Practice for Life Insurers in the absence of P&C-Specific Standards of Practice. With respect to the reduction in the lower end of the range for investment return rates and the increase in the upper end of the range for claims development margin, existing Standards of Practice permit actuaries to select a MfAD that is outside of the specified range, if such selection can be justified.

CCM, JF