保險業監管局
Insurance Authority

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22 February 2024 **BY EMAIL**

To: Chief Executive of authorized insurers
carrying on general insurance business excluding marine
mutual insurers and captive insurers

Dear Sirs,

Valuation of General Insurance Liabilities

In light of the upcoming introduction of Risk-based Capital ("RBC") regime, the associated proposed changes to the regulatory returns and GL9[1], we issue this circular to set out the Insurance Authority ("IA")'s expectation on insurers with respect to the valuation of general insurance liabilities ("reserves") and to provide additional clarity on the IA's on-going supervision approach in this regard.

The reserving function plays a critical role within an insurer, in particular in the following two aspects:

(i) *Financial aspect:* The reserving process involves understanding the insurer's latest claims experience and business actions to value the reserves appropriately, and the reserving results would form a key component of the insurer's balance sheet and impacts its profit and loss account.

(ii) *Business aspect:* The reserving results would influence the latest underwriting profitability, and serve as important feedback to management's discussions over any product pricing, business planning decisions or taking remedial actions as necessary. This forms a key part of the company's reserving and product pricing control cycle ("Control Cycle").

Over the past years, there were instances where the IA observed inadequate reserving of certain insurers. With the aim of strengthening insurers' Control Cycle, the IA has proposed updates on relevant requirements which have been communicated to insurers in various separate workstreams. We hereby summarize the major updates and highlight the IA's expectations relating to valuation of reserves to senior management's[2] and Certifying Actuary ("CA")'s[3] attention:

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[1] GL9 is the Guideline on Actuarial Review of Insurance Liabilities in respect of Employees' Compensation and Motor Insurance Businesses. Draft of the revised GL9 "Guideline on Actuarial Review of Insurance Liabilities in respect of General Business" was released in March 2023 post industry consultation.

[2] Please refer to section 2.1(g) of GL10 for definition. It shall include, but not limited to, Chief Executive, Chief Financial Officer/key person in financial control function and Head of Actuarial Function/key person in actuarial function.

[3] Certifying Actuary is the actuary defined under section 15AAA(1)(c) or 15AAA(1)(d) of the Insurance Ordinance (Cap. 41) upon the commencement of the Insurance (Amendment) Ordinance 2023.

(i) The scope of the actuarial report under GL9 will extend from employees' compensation and motor insurance business to all classes of general business.

(ii) Best estimates[4] and risk margins shall be presented separately in future regulatory reporting.

(iii) The proposed revised GL9 strives to enhance the accountability of the CA and the usability of the actuarial report. Among other new requirements, the CA will be required to illustrate and comment on prior year development ("PYD") and current year experience in a standardized manner in the actuarial report to facilitate senior management's understanding of the insurer's underwriting performance, where:

a. PYD represents a deterioration or improvement in the best estimate reserve estimation for claims which had already occurred prior to the previous year-end. It can serve as a key indicator of reserve adequacy. The IA would closely monitor insurers' PYD trend on an ongoing basis with a general expectation that the chance of reserve strengthening versus release shall be roughly equal; and

b. Current year result presents the performance for the latest cohort year[5]. It can be used to compare with the company's business plan, base case projections used within ORSA stress and scenario testing and feedback into technical pricing, underwriting actions and future business planning as part of the insurer's Control Cycle. Senior management shall ensure the consistency of assumptions used in the aforementioned plan or projections with the reserving results.

(iv) The regulatory returns on financial year underwriting result under the future RBC regime will also separate current year result from prior year result to bring transparency to all stakeholders.

(v) Senior management shall also take note of the potential increased sensitivity that the premium liabilities may bring to the company's solvency position under the future RBC regime[6], as it directly impacts the company's net asset value according to the new Valuation Rules. As such, heightened focus should be placed on it when reviewing the actuarial report prepared under the proposed revised GL9. The IA would expect the CA to clearly state the key assumptions made in estimating the premium liabilities, recognize the materiality and sensitivity of the assumptions and provide sufficient justifications on material changes with supporting evidence such as current year loss ratio, changes of business profile and economic changes, etc.

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[4] Best estimate reserves in this letter refer to undiscounted case reserve and IBNR.

[5] Cohort Year could refer to accident year, underwriting year or other depending on the actuarial analysis.

[6] Under existing rules, premium liabilities are the higher of unearned premium reserve and unexpired risk reserve. Only unexpired risk reserve will be considered as premium liabilities under the proposed Insurance (Valuation and Capital) Rules (Cap. 41R) ("Valuation Rules").

It is the responsibility of the CA to ascertain relevant information that is material to the valuation of reserves, and provide appropriate challenge to senior management's view of the reserves. In particular, where the insurer is experiencing significant changes (e.g. growth in market share, launch of new product or premium rate reduction) that pose an increased risk of failure in the Control Cycle, the CA should disclose such findings and make appropriate judgements on risk grouping, methodology selection and assumption setting, etc. In the event where the CA believes that the company's claims operation is not functioning to the expected standard, the CA should also disclose such in the actuarial report and make appropriate assumptions to compensate for the deficiencies.

In order to allow the CA to discharge his/her duties properly, senior management should provide necessary support to the CA, by ensuring claims reserves being adequately and timely made, keeping the CA abreast of business developments and giving the CA access to data and people as deemed necessary.

If an insurer is considered to be at risk of inadequate reserves, the IA, as part of its ongoing supervision, would take necessary regulatory actions to scrutinize the insurer's reserves such as peer review, thematic on-site inspection and additional claims or business reporting. Please also be reminded that the responsibility to maintain adequate reserves lies with both the senior management and the CA, and failure to do so will result in fitness-and-properness implications.

We trust that this circular will be a useful reminder to your company and your CA as Hong Kong moves towards the new regulatory regime. Having a proper Control Cycle is not only paramount to the business sustainability of individual insurers, but also helps ensure sustainability of the market in the long run.

Yours faithfully,

MM Lee
Head of General Business (Acting)
Insurance Authority