



EXPLANATORY MEMORANDUM TO EXPOSURE DRAFT OF PROFESSIONAL STANDARD 300

VALUATIONS OF GENERAL INSURANCE CLAIMS

June 2009

A. About this Explanatory Memorandum

This Explanatory Memorandum has been prepared to assist Members in understanding, and responding to, proposed changes to PS 300.

B. Background

Professional Standard 300 – Valuations of General Insurance Claims (“PS 300”) was substantially amended in August 2007. Following its release, some issues were raised by members concerning the application of the revised standard. It was apparent from the issues raised that there had been unintended consequences flowing from the revised PS 300 and which it was desirable to address.

The General Insurance Practice Committee formed a PS 300 Working Group to undertake a review of the issues raised by some members. Recent regulatory changes by APRA to GPS 310 and GPS 311 regarding the preparation of Insurance Liability Valuation Reports reinforced the need for a review. The members of the PS 300 Working Group are:

Elaine Collins (Convenor)
Nick Allsop
Peter Hardy
Andrew Houltram
Blair Nicholls (alternating, where required, with Elaine Yang)
Adam Searle
Bruce Watson
Anne Peters (Institute representative)

Following the formation of the PS 300 Working Group, all members were invited – through media such as the General Insurance Practice Committee Newsletter, Actuary Australia and the Institute Information Bulletin – to provide comments on the August 2007 standard and raise any difficulties or issues members had experienced in applying the standard for further consideration.



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This input formed the basis of an Issues Brief released to members in August 2008. A series of 17 questions were posed, and member comment invited, on the following issues in particular with respect to PS 300:

- ▶ the scope and timing of the application of PS 300, as well as the documentation requirements;
- ▶ reliance on others;
- ▶ valuations in advance of balance date/post-balance date events; and
- ▶ reconciliations and comparisons.

A total of nine submissions were received. The PS 300 Working Group has found the submissions very useful in formulating this exposure draft and thanks members for their comments.

The balance of this Explanatory Memorandum provides, with respect to each of the above, a general description of the changes proposed as well as an overview of submitters comments in response to the Issues Brief.

C. Principal changes

C.1 Scope and timing of application of PS 300

As previously noted, there have been issues in practice as to the circumstances when a PS 300-compliant report is required and timing issues in respect of the use and delivery of a PS 300-compliant report.

One of the unintended consequences referred to above which the PS 300 Working Group has sought to address is the entities to which the standard applies. Accordingly, the definition of "General Insurance Claims" has been amended to make clearer the intended application of PS 300 to entities which have general insurance liabilities, but which are not necessarily classed as undertaking "Insurance Business" under the Act (this is consistent with the definition of "Entity").

More generally, there were diverse views among members on the issues of scope and timing, ranging from a very high level and 'light handed' general principles approach to a very prescriptive view. Ultimately, in developing the current exposure draft of the proposed amendments, the PS 300 Working Group took the view that:

- (a) it would be impracticable – and only likely to lead to inadvertent and unforeseeable errors of omission – to stipulate an enumerated list of situations in which a full PS 300-compliant report should be provided; and



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- (b) in many cases, it was appropriate to leave a decision as to the need for a PS 300-compliant report to the professional judgment of members, but that it was appropriate to ensure that there were fixed points in time where such a report would be provided.

Ultimately, the PS 300 Working Group approached this from a dual perspective:

- ▶ changing the scope of the application of PS 300 to all valuations of General Insurance Claims; *but*
- ▶ making it clear in the documentation requirements that, as a baseline, a Code-compliant report is required and, in the following particular circumstances, particular reporting obligations as stipulated in clause 5.1 of the proposed PS 300 (which remain similar to the August 2007 version):
 - where a valuation is intended to be used in an annual Regulatory Report (as now defined); or
 - where a valuation is intended to be used in connection with a change or transfer of ownership of liabilities for General Insurance Claims; or
 - where the Member forms a view, as a matter of judgment, that the circumstances surrounding or affecting the valuation warrant it.

In terms of the latter requirement, members' comments are sought on whether this provision should be predicated on another concept (for example, Materiality, the purpose of the Actuarial Report or the public interest) rather than a Member's judgment.

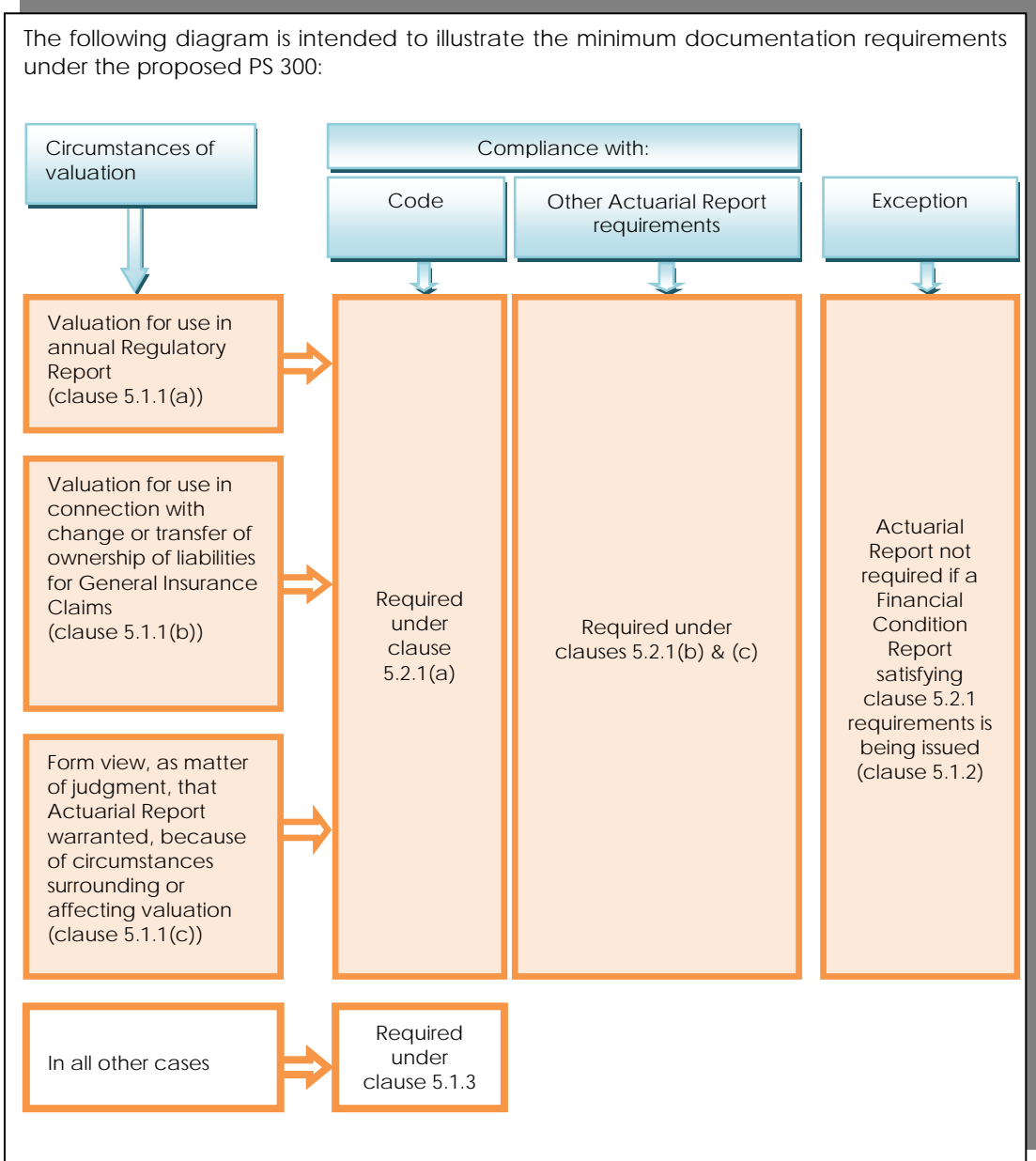
C.2 Documentation requirements

Clause 5 of the proposed standard introduces two levels of documentation requirements – a stricter level of requirements for more formal categories of work and a less strict set of requirements for the broader categories of work which are within the standard's scope.

The following diagram provides an illustration of the proposed documentation requirements, in order to assist members understand the proposed changes:



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C.3 Reliance on others

In the August 2008 Issues Brief, it was noted that APRA had released proposed Prudential Standard GPS 311 which, by its provisions, potentially created an issue for Institute member actuaries employed by an Australian-based general insurance company who have to rely on figures produced by overseas qualified actuaries or other persons. However, as noted, the issue of reliance on others was of more general relevance to the Institute’s membership.



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Broadly, submissions on the Issues Brief were largely in favour of:

- ▶ a consistent approach between reliance on other actuaries and reliance on other professionals;
- ▶ given that, ultimately, the actuary is responsible for the valuation, a level of discretion as to what level and type of verification of both the qualifications of the information provider and the information provided should be undertaken by the member;
- ▶ adopting a realistic and balanced approach to such reliance; and
- ▶ some degree of documentation of the reliance placed, verification steps undertaken and so forth.

As such, the PS 300 Working Group has proposed changes to the existing clause 5 of PS 300 (refer clauses 7.2 and 7.3 of the exposure draft), including:

- ▶ drawing a clearer distinction between those provisions dealing with reliance on others (including other Members) and any consequent limitations as a result of such reliance;
- ▶ adopting a more consistent approach between reliance on other Members and other professionals (including, but not limited to, overseas qualified actuaries); and
- ▶ making flexible and clearer provision as to verification and documentation in relation to any such reliance.

C.4 Valuations in advance of balance date

In the August 2008 Issues Brief, comments were invited with respect to addressing the relatively common industry practice for valuations to be performed in advance of the valuation date. Broadly, submitters considered that:

- ▶ existing clauses 7.1.5(b) and 8.2.2 were not too restrictive; and
- ▶ there should be more flexibility to allow a Member to use his or her own professional judgment, taking into account materiality.

Although submitters generally considered that post-balance date events should be addressed, there was not necessarily a consensus as to how to stipulate such.

As such, the PS 300 Working Group is proposing the following general changes to PS 300:



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General requirements:

- ▶ The substance of existing clause 7.1.5(b) has been relocated to what is now clause 11 (Valuation Estimates), as its content deals with both the issues of methodology and valuation and it is felt that this relocation is more appropriate; and
- ▶ the requirements in relation to events and valuations up to the valuation date remain largely unaffected, however greater clarity has attempted to be given by the use of the criteria "which changes lead to a Material change in the valuation result", rather than the somewhat ambiguous phrase "appropriately allow".

Post-valuation date events:

In respect of events after the valuation date, the proposed changes in clause 11.1.2 (clause 7.1.5(c) of the current PS 300) are intended to provide greater clarity as to members' obligations and the disclosure requirement and, in particular, are considered to operate in the public interest by making clear to the reader of an Actuarial Report the degree of impact of such events on the valuations contained in that report.

However, the criterion against which to assess which post-valuation date events need to be taken into account in an Actuarial Report has resulted in considerable debate. For example, in response to the Issues Brief:

- ▶ one submitter expressed concerns that the term 'extreme' could be interpreted differently by members. The PS 300 Working Group endeavoured to formulate a satisfactory definition, but without success; whilst
- ▶ other submitters focused on Materiality to valuation results as (at least one of) the relevant indicia. This approach has the benefit of using a term which is expressly dealt with in clause 4 of the proposed standard and would be consistent with the approach taken in the balance of the standard generally. However, the use of 'Material' could be argued as placing a more onerous burden on members than the term 'extreme' (although such burden may be ameliorated by the touchstones of practicability included in the proposed drafting).

As such, the PS 300 Working Group is particularly keen to receive members' further views on whether 'extreme' or 'Material' should be used as the relevant criterion.

C.5 Reconciliations and comparisons

Responses to the August 2008 issues brief indicated that:

- ▶ the existing PS 300 requirement is often impractical with respect to reconciliation of the prior review's premium liabilities with subsequent experience and the result of the current valuation;



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- ▶ taking into account the needs of users of Valuation Reports, the reconciliation of most relevance will be a reconciliation to the previous valuation undertaken at the most recent annual balance date (which is the existing requirement);
- ▶ reconciliations presented in PS 300-compliant reports do not always make it clear whether the previous liability estimate has been more or less than sufficient to provide for subsequent payments and any residual liability estimate; and
- ▶ the extent to which any reconciliation attribution is prescribed by PS 300 needs to strike a fair balance between providing at least a minimum level of detail, and allowing flexibility to provide information that, based on the judgment of the responsible Actuary, most usefully explains the amount to be reconciled.

Taking into account this feedback, the Exposure Draft:

- ▶ removes the explicit requirement for a premium liability reconciliation. The practical effect of the change is intended to be that, where an accident-year valuation is performed, PS 300 requires a reconciliation of the outstanding claims liability and, where an underwriting year basis applies, a reconciliation of insurance liabilities is required. This was the intention of the previous drafting of PS 300. Contrary requirements were unintended;
- ▶ retains the requirement for a reconciliation to the Previous Valuation (defined as the most recent annual balance date). This does not preclude an Actuary from also including reconciliations to other investigations;
- ▶ introduces the terms "reconciliation" and "attribution" to help clarify PS 300 requirements;
- ▶ explicitly defines the reconciliation to refer to the extent to which previous liability estimates have proved too high or too low to provide for subsequent payments and residual liability estimates. Though this has been made the explicit PS 300 requirement, the PS 300 Working Group is aware that Actuaries may sometimes regard it as preferable to present a reconciliation that takes the liability estimate at the previous review as the starting point, and have the liability estimate relating to the current balance date as the end-point. The Exposure Draft permits such a presentation, and it may indeed be the primary focus of a Valuation Report, provided the reconciliation as defined in the Exposure Draft is disclosed; and
- ▶ specifies attribution requirements in a way that aims to strike a balance between allowing flexibility of presentation, whilst also providing a minimum breakdown (as sought by a number of respondents).

D. Other changes

A number of other corrections and changes have been incorporated, including:



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- ▶ splitting the previous material on Materiality to allow for a new section (clause 4) so entitled. The intention in doing so is to make clearer that it is expected that, in doing any thing or making any decision in relation to PS 300, a Member will take Materiality into account. Inclusion of this provision at the outset is intended to eliminate duplicative drafting;
- ▶ including a new definition of 'Financial Condition Report';
- ▶ in terms of actual versus expected experience, making clear that the latter can relate to the most relevant valuation, rather than always the Previous Valuation (refer clause 6 in current version of PS 300; clause 8 in exposure draft);
- ▶ clarification that Group Two and Group Three Entities are catered for within the terms of the proposed standard;
- ▶ updating the background to reflect developments since the August 2007 issue of PS 300;
- ▶ correcting minor typographical errors; and
- ▶ changes to the commencement date clause.

The PS 300 Working Group also notes, in respect of the definition of "Replicating Portfolio" contained in clause 3 of the Exposure Draft (and referenced in clause 10.2.2 of the Exposure Draft), that this definition has not been reviewed or changed since the current version of PS 300. However, following the completion of other Institute projects considering a possible more universal cross-practice view of risk free discount rates, this definition may be reviewed further.

E. Consultation

The PS 300 Working Group would appreciate Members' views on the proposed changes to PS 300. Comments and views should be sent by the ***close of business on 15 July 2009*** to:

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