APN 116: INCURRED BUT NOT REPORTED PROVISIONS - GUIDANCE FOR CALCULATING TECHNICAL PROVISIONS AND SOLVENCY CAPITAL REQUIREMENTS ON LIFE INSURANCE OBLIGATIONS

Classification

This Advisory Practice Note (**APN**) provides guidance for Members calculating or reviewing Life Insurance *Technical Provisions* and/or *Solvency Capital Requirements* under the Prudential Standards, regulations, directives and guidance notes, as required by the Insurance Act (2017).

Abstract

This APN outlines considerations with respect to Life Incurred But Not Reported (**IBNR**) provisions for Members calculating or reviewing life insurance *Technical Provisions* and *Solvency Capital Requirements* for regulatory reporting under the Prudential Standards required by the Insurance Act (2017).

Purpose

The purpose of this APN is to provide a guide to support *Members* of the Actuarial Society of South Africa in the allowance of IBNR provisions in the calculation of *TPs* and their treatment in the calculation of the Life Underwriting Risk Capital Requirement within the *SCR*.

Legislation or Authority

Insurance Act (2017) and Prudential Standards, regulations, directives and guidance notes.

Application

This applies to *Members* calculating or reviewing *Technical Provisions* and *Solvency Capital Requirements* for life insurance regulatory reporting under the Prudential Standards, regulations, directives and guidance notes required by the Insurance Act (2017). This applies to all life insurance business, including individual and group business.

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Status

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Definitions

BEL	Best Estimate Liabilities forming part of the Technical Provisions and calculated in accordance with the requirements in *FSI 2.2*;
BOF	Basic Own Funds;
FSI	Financial Soundness Standards for Insurers as issued by the *Prudential Authority*;
IBNR(s)	Incurred But Not Reported
Insurer	An entity licensed to conduct insurance business under the Insurance Act;
Insurance Act	Insurance Act (18 of 2017), including relevant amendments, Prudential Standards, regulations, *Prudential Authority* directives and guidance notes;
Member	A member of the Actuarial Society of South Africa as defined in the Code of Professional Conduct, or a member of another recognised actuarial association to whom this APN applies;
Prudential Authority or PA	The Prudential Authority established in terms of the Financial Sector Regulation Act (9 of 2017);
Prudential Standards	The Prudential Standards issued by the Prudential Authority as enabled by the Insurance Act;
Prospective reserving	Specific to this APN, this should be considered as all the reserves and/or methodologies included in the BEL, but excluding IBNR provisions and/or methodologies
SCR	The Solvency Capital Requirement of the Insurer as defined in the Prudential Standards; and
Standardised formula	The standardised formula of stresses and other required calculations as prescribed by the FSIs
TPs	Technical Provisions as defined in FSI 1.

1 Introduction

1.1 Background

The Prudential Standards are principles-based and as a result interpretations of some of the requirements contained in the Prudential Standards are subjective. Further to this, all the principles are not always explicitly laid out, which results in more room for interpretation. The treatment of IBNR provisions in the *SCR* calculation is one example.

The *PA* issued guidance on the SCR, "Guidance Note FSI GN 4, Calculation of the SCR Using the Standardised Formula" ("FSI GN 4"). Chapter 1 covers stressing IBNR provisions for Life Insurance Obligations.

Despite the existence of FSI GN 4, there are still areas that are open to interpretation.

This lack of clarity on the treatment of IBNR provisions in the *SCR* may lead to inconsistency of treatment across the market.

1.2 Scope

This note covers the treatment of IBNR provisions for Life Insurance Obligations, under the Framework for *FSIs* of the Prudential Standards for insurers writing life insurance business, including individual and group business.

Some of the recommended considerations set forward in this note may be applicable to other forms of provisions set up in terms of the larger outstanding claims provision ambit, as they may be exposed to the same uncertainty as pure IBNR provisions. The Member must therefore consider a broader definition of IBNR provisions to include other forms of outstanding claims provision, where appropriate, when considering this note.

2 A note on materiality

The size and therefore materiality of an IBNR provision will depend on, amongst other items, the product type, lapse rates, lapse business rules, premium collection approach, benefit types and claim procedures.

In most cases, an explicit IBNR provision is required. In some cases, the implicit allowance within prospective provisions may cover some of the provision for IBNR claims.

The size of the IBNR provision will impact any SCR arising from the risk exposures within the IBNR provision.

If the Member views an explicit IBNR provision or SCR component relating to IBNR provisions as not being material, the member should document the justification for this, any assumptions underlying this conclusion, estimated understatement of the SCR, and the circumstances where this view might change.

3 Allowance of IBNR provisions in the BEL

Members should determine appropriate IBNR provisions in the BEL. The following general considerations should be evaluated when deciding against allowing for IBNRs in the BEL:

- Whether reserves are implicitly included in the prospective discounted cashflow models (e.g., by building in explicit claim delays in cashflow projections). The objective of setting up a prospective discounted cashflow provision is different to that of IBNRs. The two provisions are in principle different and are intended to provide for separate sets of policies. If an overlap of the two provisions is presumed to be negating the need for explicitly allowing for an IBNR, it is recommended that this be investigated, and the sufficiency of the offset confirmed.

- If implicit or inherent prudence in other types of provisions is put forward to be sufficient to cover IBNRs, it is recommended that this be assessed and confirmed.

4 Allowance for IBNR in the SCR

4.1 Variability of amount and timing of cash flows arising from claims for which the IBNR was raised

An IBNR provision should be a best estimate of future claim and related expense payments in respect of past claim events, as at the date of calculation. The amount and timing of actual claims reported (and then ultimately paid) is uncertain. Therefore, the variability in actual claims incurred relative to the best estimate IBNR provision will be a source of change in BOF over time.

IBNR provision methodologies often include implicit assumptions. However, just because an assumption is implicit, does not mean that variability in that assumption (or variance between that assumption and experience) would not give rise to a change in BOF.

Most IBNR provision methodologies will include explicit or implicit assumptions related to the following:

- The number of claims incurred but not reported.
- The distribution of claim sizes for claims that have been incurred but not reported.
- The claims development pattern (i.e., the distribution of lag between a claim being incurred and reported)
- Claim repudiation rates (i.e., the percentage of claims that are not paid despite being lodged.)

Differences between any of these assumptions and actual experience will give rise to a change in BOF within the one-year time horizon of the SCR calculation.

4.2 IBNR stresses in the SCR are consistent with the SCR being a forward-looking approach

FSI 4, section 4.2 defines the SCR as being "forward-looking".

Even though IBNR claims were incurred before the valuation date, there is still uncertainty in the size and timing of future claim cash flows. Variability in actual claim cash flows will affect the BOF in the one-year horizon used in the calculation of the SCR.

Further, for non-life business, IBNRs are explicitly stressed and included in the SCR.

The FSIs do not explicitly exclude IBNR provisions from SCR stresses.

Therefore, the "forward-looking" principal of the SCR does not preclude the incorporation of IBNR stresses into the SCR, neither as a matter of principle nor in terms of the standardised formula.

4.3 Applying SCR stresses to the IBNR provisions

Without specific rules from the FSIs, stressing the IBNR could be done by either stressing the best estimate IBNR by the relevant SCR stress, or by stressing the underlying incidence rate. Members must decide the most appropriate approach given the IBNR methodology utilized and allowing for the principle of proportionality, where applicable.

4.4 The allowance of IBNRs in the *standardised formula* of the SCR

Given the risks of variability in BOF arising from IBNR provisions and actual experience, it is recommended that the SCR incorporate explicit allowances for IBNR by allowing for the following aspects:

- The member should apply those stresses that are consistent with the relevant risks contained within the IBNR provisions.

- The Life Underwriting risk module does not have a dedicated sub-module to allow for IBNRs, unlike the Non-life Underwriting risk module. The IBNR components for life insurance should follow the life underwriting sub modules for each relevant risk. Where material, interest rate risk should be included under market risk.
- An argument might be made that the incident rate type stresses as per the Mortality, Disability-Morbidity and Retrenchment risk sub-modules are not properly calibrated for the specific risks imposed by IBNRs.

  These sub-modules only allow for the risk of the number of claims being different to what is implied in the IBNRs, and even then, it may overstate this specific risk due to the claim incident rate being more certain for IBNR type claims.

  However, these risk modules do not capture other risks, such as statistical fluctuations over shorter periods as they focus on permanent changes.

It is therefore not immediately clear how much each risk will offset the other, and whether the *standardised formula* stresses in these sub-modules are sufficient or not when capturing the overall risk of an IBNR. It may therefore be appropriate to consider, in addition, a more detailed analysis of the risk and appropriateness of the *standardised formula* in the ORSA.

However, even if these risks are analysed in the ORSA, the argument that the *standardised formula* is not calibrated perfectly does not remove the need to comply with *standardised formula* and apply the stresses in a coherent manner to IBNRs.

Risk type	**Recommended approach to apply the relevant stress to IBNR provisions**
Mortality risk sub module	IBNR provisions should be stressed in the Mortality risk sub-module. The recommended method is to apply the prescribed stress of 15% to the best estimate IBNR provision.

Risk type	**Recommended approach to apply the relevant stress to IBNR provisions**
Disability-Morbidity risk sub module	IBNR provisions should be stressed in the Disability-Morbidity risk sub-module. For Lump Sum Disability, the recommended method is to apply a single prescribed stress of 25% to the best estimate IBNR provision. For Income Disability, the recommended method is to apply stresses for both incidence and termination risks: 1. Apply the prescribed stress of 25% to the best estimate IBNR provision. 2. Apply the 20% termination stress calibrated from a representative 0 duration claim in payment, or other approximation linked to the application of the prescribed stress to existing claims in payment. The aim should be to have a best estimate of the sensitivity to termination rates.
Longevity risk sub module	IBNR provisions should be stressed in the Longevity risk sub-module. Similar to the recommended treatment for income disability termination rates mentioned above, the percentage stress to apply to the IBNR provision will need to be calibrated off a model to translate the impact of a decreased mortality rate into an impact on the best estimate IBNR provision.
Retrenchment risk sub module	IBNR provisions should be stressed in the Retrenchment risk sub-modules. The recommended method is to apply the prescribed stress of 50% to the best estimate IBNR provision.
Lapse risk sub module	The Lapse risk sub-module would not be impacted by claims that were incurred before the valuation date and therefore it will generally not be appropriate to stress IBNRs in the lapse risk sub module. The IBNR provision should not be used to offset negative prospective provisions when calculating the lapse and mass lapse risks.

Risk type	Recommended approach to apply the relevant stress to IBNR provisions
Catastrophe risk sub module	The Catastrophe risk sub-module will generally not require IBNR provisions to be stressed. The catastrophe stress is intended to stress future incidence rates and would therefore have no impact on incurred claims before the valuation date.
Expense risk sub module	While IBNRs should cater for any material future claim related expenses, in practice it is common for life IBNR provisions not to include an allowance for expenses. In this case, no expense stress would be required in respect of the IBNR provision. If expenses are included in the IBNR provision, this amount should be stressed by applying at least the expense part of the stress, i.e. the 10% increase in expenses. Given the typical term of claim reporting delays, it is likely that the expense inflation component will not be material. However, the member should apply their mind to adequately allowing for expense stresses for any expenses included in the IBNR.
Interest rate risk sub module (market risk)	The typical discounted mean term of IBNR provisions is short. In many cases it will not be necessary to apply interest rate stresses to IBNR provisions, from a materiality point of view. However, the member should assess this and document the justification against applying interest rate stresses. For certain claim types (e.g. disability income) the IBNR provision should be sensitive to interest rates. The member should consider the specific nature of the claim in payment provision that will be created when the claim is reported, and evaluate the interest rate sensitivity of that claim provision. This would need to be done on an average basis since by virtue of being "unreported", the details of the claimant will not be known. This will likely require an appropriate approximation.

4.5 Non-standardised formula considerations

If a Member believes that the risks of the IBNRs are material enough and are not appropriately captured through the *standardised formula* approach, the Member could in addition to above:

- state this finding in their reporting on the QRT as part of the requirement to comment on why the regulatory capital model is an accurate reflection of the insurer's own risk profile, when the standardized formula is used to assess risks (GOI 3 paragraph 14.4a)

- consider, in addition to allowing for it through the *standardised formula*, allowing for the risk more appropriately in the ORSA and/or Economic Capital.

- consider applying for a partial or full internal model to capture the risks of the IBNRs more appropriately and better calibrated to the risks inherent in them.

5 Further considerations when dealing with Life IBNRs

5.1 Allowance for IBNRs in the simplifications to the life underwriting risk

Many of the Life Underwriting simplifications (i.e., Mortality Risk, Disability-Morbidity Risk, Life Catastrophe Risk and Retrenchment Risk) rely on a capital-at-risk (CaR) calculation to perform the simplified stresses. The CaR is defined at a high-level as the difference between the Sum Assured over the book of business less the BEL on the book of business. Normally when determining the Sum Assured across the book of business, the total sum assured in the in-force data file is used. However, the in-force book is overstated as at the valuation date due to claims that may already have incurred but not reported and may still be included in the in-force data file. Therefore, the BEL component should include the IBNR provisions to appropriately adjust for this overstatement.

Furthermore, it is recommended that the IBNR provisions should be stressed alongside the simplifications, in a manner detailed in section 4 above, and added to the stress determined under the simplifications. This is to ensure the risk of the IBNR provisions are captured appropriately as the simplifications do not allow for it.

5.2 The treatment of the IBNRs in the Surrender Value Gap (SVG) calculations

In contrast to the simplified stresses, considered above, it is advisable that the IBNRs should not be included in the BEL when determining the SVG or surrender strains in the prudential standards.

Attachment 4 of FSI 2.3 sets out the methodology to apply when determining the SVG. Specifically, part A, section 3 reads: "The SVG is calculated as the change in basic own funds following a selective mass lapse event, which is the lapse of all existing (in-force) business where there is a positive surrender strain.

It therefore follows that it is a mass lapse event that should determine the premise of the SVG calculation. In a mass lapse event, in most circumstances, the IBNR portion of the BEL would not fall away, while the remainder of the BEL may. The reason for this that the IBNR claims already took place before the mass lapse event and the insurer will still be liable to meet them regardless of the mass lapse event – it would only be the remainder of the in-force business that would lapse.