RESERVING IN GENERAL INSURANCE BUSINESS IN INDIA AND ITS IMPLICATION

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Working out "adequate and appropriate" reserves is a very important aspect of the functioning of a general insurance co. It is essentially required for building up of accounts. Besides it is regulatory requirement also. Despite the fact that reserves constitute the single largest liability on the insurer's balance sheet, there is inadequate awareness, understanding and appreciation of the significance of these reserves and how a slight manipulation can distort the actual picture of the financial health of the company, both on short and long term basis. In fact the various stakeholders seldom examine the adequacy of the reserves critically. As for the personnel of insurance companies, especially those on the operations side, they consider reserves to be the domain of accounts department and hence not warranting their attention. If only they understand the importance and implication of adequacy / inadequacy of reserves, the exercise they carryout at the close of each financial year of working out claims o/s provision would be more meaningful and realistic. Besides an awareness and understanding of reserves by the various functional departments contributes to more informed and effective collaboration in achieving goals and improving overall result. It can help formulating strategies for u/w and claims at the local level also.

Insurance companies sell 'promise.' The promise to indemnify a loss on a future date arising out of a defined contingency. But as the saying goes, the promises are difficult to fulfill, more so if it is financial and you do not know the nature, extent and dimension of the promise you will be called upon to fulfill. Therefore an insurance company at any given point of time must be in a position to honour all its promises as can be foreseen reasonably. Creating adequate reserve is the means to achieve this goal. It is a fundamental principle of accounting to ensure matching of expenditures during the accounting period with the recognition of revenue for the same period. It essentially consist of bifurcating the premium representing the policy period into accounting period i.e. how much of premium to go for which accounting period. Reserving takes care of this need also. There are, therefore, basically two kinds of reserves.

i) Claims reserves
ii) Premium reserves

Let's now examine WHAT are reserves; WHY are they created and HOW they are created. Let us go into greater detail.

In simple terms, reserve is a sum of money to meet liability which has arisen in the current year but will be settled next financial year. The premium earned by an insurance company goes to fund the claim, meet the expenses of the underwriting and the cost of the capital employed. Thus the pricing and hence the premium earned must be sufficient to meet these ends. When an insurance policy incepts the insurer does not know whether this will result in a claim or not. If yes, then what would be the claims cost? It is for sure that some of the polices will result in claim and therefore the insurance company must account for liabilities for these claims in its balance sheet to reflect as accurately as possible the eventual claims cost. This constitutes what is called reserve / provision for outstanding claims. General insurance policies are very largely an yearly contract. This creates accounting problem in that the policy period and the accounting period are not the same. In order to match the revenue (premium) with the accounting period, there is in insurance the concept of the earned and unearned premium. The earned premium represents that portion of the premium which has been used up or earned at any particular time, say 31st March of the year (risk cover period) and consequently that portion of the premium that has not been used up will represent the unearned premium. It is set aside as a reserve and is that part of the gross premium which is to be allocated to the subsequent financial period.

In view of the above and as seen earlier, the reserves can be put in two categories namely; Claims Reserves and Premium reserves. Let us now examine them in more details.

i) Claims Reserve: As on the date of account finalization, this reserve represents an estimation, as accurately as possible, of the ultimate amount of claims and all costs relating to unpaid and anticipated claims. This would include estimate for

- Claims reported to the insurance company, registered there, liability worked out but settlement not effected.
- Claims reported to the insurance companies, registered there but liability not yet worked out.
- Claims incurred but not yet reported to the insurance companies in what are called IBNR claims. There is also a category of claims called IBNER – incurred but not enough reported. These may include orphan claims, prematurely closed / repudiated claims and such other claims where the provision is less than likely amount for which claim is likely to be settled.

Creating adequate claims reserve is necessary for the following reasons.

- At any point of time, the insurance company must be in a position to meet claims obligations. It is therefore necessary for them to have reliable estimate for these obligations as also reserve funds to meet them.
- Claims reserve help insurance companies properly recognize company’s future obligation & current cost.
- Insurance companies are regulated for solvency so that they will be able to pay claims in future. Therefore, claims reserve are required by insurance regulatory law.
- Claims reserves are like barometer. It helps insurance company to recognize the future problems and to take corrective actions in time. It provides picture of claims trends.
- Appropriate pricing is important for the survival of insurance companies. Claims reserve help them in this task and thereby help them in business planning. It

assists u/w in determining whether pricing is realistic or whether action is needed to improve result.

- Claims reserves help in determination of the profitability of insurance companies.
- Accurate reserving is important part of any good claims management philosophy.

Proper and adequate claims reserving is thus necessary. How under / over claims provision affects the financial position of an insurance company, we shall discuss at a later stage. At this point let’s see how claims reserve are made. Basically there are two ways of doing it.

- Individual reserving for each claims file by claims handling person
- Using statistical / actuarial methods (average / formula reserve)
- Each and every claims file is examined and based on the facts and figure of each case, an estimate is made by the claims handling person subjectively using his own judgment and experience for that class of claims. For this purpose, necessary information like surveyors opinion / report, nature and extent of injury, medical bills, other related documents are relied upon. There is no substitute for experience, business knowledge and analysis of individual files. A cushion for safety is generally added. Based on past and projected experience of a particular class of business and using statistical methods, the individual case reserves are modified also in line with the group experience. As the claims develops, the reserves need to be adjusted to reflect the latest position. The statistical method thus helps in addressing deficiencies in the individual case-estimate as also helps in validating case reserves. While it is easy to workout estimate for property claims, the same for liability / injury calls for more care and diligence.
- Rather than examining each and every individual claims files, statistical / actuarial methods are used by monitoring past claims experience and pattern to project future loss in what is called average or formula reserves. This method is usually applied to high frequency and low severity claims e.g. motor accidents. However these methods are based on certain assumptions and in a particular situation these must be met for the estimates to be realistic. With every passing year, more refinement can be brought about.
- IBNR / IBNER claims have their own peculiarities and pose problems in making estimates for them. Sometimes claims take time to be reported specially after a catastrophe or claims arising out of liability insurance. In such situation insurance companies do not know with accuracy the number of claims and corresponding outgoes (obligation) that will be generated. In liability claims, the claimants are not the insured. Prudence requires that insurance company keeps a reserve to take care of all such claims at any point of time.

IBNR reserves can only be assessed using statistical methods keeping in mind the past experience on this account and is generally worked out as percentage of net liability of o/s claims except aviation. The various statistical / actuarial methods for reserving are as under:

- Chain ladder method
- Cape code
- Bornhuetter–Fergusson (B-F) method

The chain ladder method is the oldest and the most popular method of projecting claims reserve. The other two methods are improvements over the chain ladder method by pooling in additional information (amount of premium). Simulation method using computers are also being developed for use. Based on the availability and accuracy of data, types of business, relevancy of the underlying assumption of the methods, the external bench marks, the actuary will decide which methods to use on in a given situation or whether statistical methods is to be used at all. How much reliance can we put in the reserves worked out by any one of these methods? The goal is, the outcome must not be very different from the one projected. We need to know with high probability the range within which our estimate will fall. Measuring reserve variability is done using bootstrap methodology. It helps to build an upper limit at an adequate confidence level.

- Premium reserves - These are of two kinds
    - Unearned premium reserve (UPR)
    - Unexpired risk reserved (URR)

In India, though, we only have URR. Insurance business is unique in the sense that the revenue (premium) is earned in advance, for obligation that may or may not take place in future. The general insurance policies being one year contract, there is a need to match the revenue (premium) over the policy period with that of the revenue over accounting period and therefore we need to have unearned premium reserve which are deferred income that represents the part of gross premium which corresponds with the subsequent financial period. This reserve should be able to take care of all anticipated costs needed to discharge the insurance company’s obligation w.r.t. its insurance policies incepted in the proceeding year except claims liabilities already incurred. Unearned premium reserves are provided basically as recognition of revenue.

At the end of the financial year, unearned premium reserves represent the aggregate of unearned premium in respect of all the policies calculated on daily basis (1/365). In practice, however, suitable statistical methods are used for this purpose. What if the reserve for unearned premium is not able to take care of the cost of remaining exposure already entered into? This is a distinct possibility if the products are under priced or there has been a catastrophe. In order to take care of such an eventuality, “unexpired Risk Reserve” is created. Appropriate statistical methods may be used for this purpose keeping past experience in mind. Where the actuary finds that the expected value of claims related expenses in a particular class of business attributable to the unexpired period of policies in force at the valuation date exceeds the unearned premium reserve an additional reserve for “unexpired risk” is to be provided. In the Indian context, it should be noted that regulatory requirements are only in respect of reserve for unexpired risk. It does not talk about unearned premium reserve. Ideally unexpired premium reserve together with premium deficiency reserve should constitute unexpired risk reserve. Premium deficiency reserve is the amount required (in addition to UPR) to provide for future risk already contracted.

As per IRDA regulation, 2000 on valuation of liabilities, the reserve for unexpired risks shall be, in respect of

i)	fire and miscellaneous business	- Not less than 50 %
ii)	Marine Cargo	- Not less than 50%
iii)	Marine hull	- Not less than 100%

Of the premium, net of reinsurance, received / receivable during the preceding twelve months. These incidentally are the allowable deductions under Schedule –I, IT Act, 1961. This practice thus appears to be more of a tax driven kind and does not in fact correctly represent the unexpired risk reserves. If it is presumed that risks are very evenly distributed over the entire 12 months of the year, then logically it can be presumed that on an average 50% should represent the UPR in the next year. Though there is no bar for providing more than 50%, generally companies, stick to the minimum requirement of 50%.

At this stage, it will now be appropriate to examine how the reserving impacts financial result of an insurance company. Both under and over provisioning affects the company's financial position. In very simple terms, the difference between asset and liability represents surplus, i.e.

Revenue (Income) – Expenditure = Surplus.

Understating the company's liability would amount to overstating the surplus, which will not be reflective of true picture. It will also result in avoidable extra tax paid and excess dividend to shareholders which was not really earned. Besides, reserves being integral part of premium rate making, inadequate reserves would lead to lower rates than is warranted which in turn would mean not only loss of revenue for the company but would also mean sustaining itself on uneconomical rates. It will only hasten the company's decline. Similarly over-reserving creates its own problem, besides being not true and fair. It will understate the company's financial position. This may also lead to price-increase which will have serious repercussion in a competitive market. Over provision may draw the attention of tax authorities / regulators. To summarize, it is important to have proper reserve to correctly reflect a company's financial position.

A few words about the discounting of reserves will not be out of place to discuss here. Reserve for life insurance have always been discounted for interest earned. Compared to life insurance the contract for general insurance are for short periods and hence reserves have traditionally been held undiscounted. However, since the amount involved is so huge, there is now a feeling that there should be discounting of reserves in general insurance also. With the liberalization and many more private players coming in the pictures there will be pressure from the shareholders on this as they would like to have more return on their shares / investments. No discounting of reserves in general insurance is being practiced in India. There is, however, distinct possibility for discounting of reserves for long tail liabilities claims.

Reserving should not be seen in isolation as a finance function to meet regulatory requirements and for building up accounts. It surely should not and must not end with the publication of annual balance sheet. Reserving can be used as a strategic tool for bringing about operational excellence. There are clear linkages between the loss forecasts and pricing of products, marketing, underwriting, claims management, reinsurance programme, etc. All key area of the company can benefit from the analysis of reserve and the process involved in building up the same. They can provide meaningful insight and can be used as analytic tool. Those of the insurance company who will make use of it will definitely have an edge over those who do not. Proper analysis of the reserves can help address such important concerns as:

- Adequacy of price to meet desired level of profitability and business target. Both high and low pricing over a period of time can have serious implication.
- Effectiveness of underwriting to know whether guidelines are being followed and whether they are producing desired results.
- Loss ratio – whether higher than the company’s price monitoring would indicate whether they compare favorably with other operators in the market.
- Whether type and quality of business has shifted significantly. If it was planned the effectiveness of such plan. e.g. Motor T.P. portfolio.
- Claims management – How effective is loss control measure (LCM)
    - Average time taken for settlement claims – whether corrective action required – whether claims staffing level needs change
    - Claims trend analysis –
- Reinsurance Programme – whether the programme benefits the reinsurance company more than the ceding company – what is the ceded experience
    - Whether retention level can be increased - It can be a tool in reinsurance pricing negotiation also.
- Marketing efforts – whether pricing, claims settlement process needs intervention to meet with the market requirements.

Reserve deficiencies may weaken a company’s balance sheet, limit its future growth which may ultimately results in some companies not being able to pay claims and yet other disputing the claims. There have been lot of instances of the insurance companies going ‘bust’ for inadequate reserving. Insurance companies are under pressure to show profit and to achieve this sometimes they resort to ‘under provisioning.’ But this short term remedy may have serious long term implications. The insolvency of insurance company has social and economic consequences. While the cause of insolvency may be many e.g. fraud, too rapid growth, failure of ceded reinsurer, catastrophic loss, etc. the most dominant factor is “inadequate reserves.” Therefore, in order to ensure the twin objective of prudent supervision and protection of consumers interest, IRDA has issued guidelines requiring the Appointed Actuary to certify the appropriateness of methods used for reserving and the adequacy of reserve.

In the light of the above, the following lessons can be learnt.

- Adequacy of reserve is important for reflecting the correct picture of the financial health of the company.
- An awareness and undertaking of reserves by other functional departments is important
- It makes sense to find other application of “reserve.”
- In the process of building reserves, the information gathered can be used for better claims management, marketing, underwriting, reinsurance programme, etc.
- Reserving can be a tool to achieve operational excellence.
- It can help us in taking strategic decision.

In public sector general insurance companies, the divisional offices are the basic accounting units and it will be a worthwhile exercise for divisional in-charges to analyze the reserves, compare the same with previous years and draw appropriate inferences and work out their own strategies to achieve corporate goals in their office at micro level. In fact as part of corporate strategy, divisional offices should be encouraged in this exercise. Through such exercise they will get meaningful insights in their own operations which will help them formulate sound strategies to achieve corporate goal in key areas. They will have the feeling of being part of the bigger picture - corporate strategy and its execution. They should know how the objective of their unit fit in with the objective of the organization as a whole.