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Guideline

Subject: Standards of Sound Business and Financial Practices -- Underwriting and Liability Management

No: F-8 **Date: February 1998**

A. PURPOSE

This guideline sets out the minimum policies and procedures that each company needs to have in place to prudently manage and control its underwriting and liability risks.

The nature of certain life and health insurance products involves commitments by the company to provide financial obligations and insurance coverage for extended periods of time. Emerging economic, medical and legal experience, as well as the developments within the enterprise and its changing ability to withstand risk requires ongoing review of its practices. Experience indicates that the quality of management of underwriting and liability risks goes hand in hand with financial soundness.

This guideline focuses on a company's responsibility for managing and controlling underwriting and liability risks. It is intended to cover all products issued, including life, health and annuities on either a group or individual basis. It is not intended to imply that these risks can be managed in isolation from the capital management, investment, product design and pricing, or marketing policy of the company.

B. DEFINITION

Underwriting and liability risk is the exposure to financial loss resulting from the selection and approval of risks to be insured, the adjudication of claims, and the management of contractual and non-contractual product options.

C. UNDERWRITING AND LIABILITY MANAGEMENT PROGRAM

Managing underwriting and liability risk is a fundamental component in the safe and sound management of a company. Sound underwriting and risk management involves understanding the risk and prudently managing the company's risk/reward relationship.

Although the particulars of underwriting and liability risk management will differ among companies depending upon the nature and the complexity of their products and the manner in which they are marketed and serviced, a comprehensive underwriting and risk management program requires:

C identifying when

- the company accepts insurance risks;
- material changes occur in insurance exposures for which underwriting, or limitation of risk is required;
- claims arise requiring approval;
- ongoing claim assessment is required; and
- the company's capacity to accept insurance risk changes in a material manner;

and developing policies to effectively manage and control them;

- developing, documenting and implementing effective processes for underwriting, for management of product options, and for adjudication of claims; and

- developing and implementing comprehensive procedures to effectively monitor and control the nature and characteristics of the insurance risks assumed, or claims approved.

Underwriting and Liability Risk Management Policies

The foundation of an effective underwriting and liability risk management program is the identification of the existing and potential risks inherent in a company's underwriting and liability management, and the maintenance of clearly defined policies, formally established in writing, that set out the underwriting and liability management philosophy of the institution and the parameters under which the risks are to be controlled.

Pressure for increased profitability, marketing considerations and technological advances have led to more innovative and creative products. The long term nature of certain products, the consequences of which are not be fully known at issue, represents a unique risk to the insurance industry. Each jurisdiction in which a company operates may have unique risk profile, culture, or legislation, which limits a company's freedom to investigate risk exposure, or manage claims. Understanding the risks attached to underwrite each product and to adjudicate claims permits the determination of aggregate exposures for control and reporting purposes.

Underwriting and liability policies establish the framework for accepting applicants and claimants, and reflect the company's culture, marketing strategy and capacity to accept insurance risk. To be effective, policies must be communicated in a timely fashion, be implemented through all levels of the organization by appropriate procedures and revised periodically in light of changing circumstances.

Underwriting and liability policies need to contain:

- an underwriting and liability philosophy governing the extent to which the company is willing to assume liability and claims risk;
- groups of individuals and/or other classifications which the company is prepared to underwrite, or is restricted from underwriting;
- the type of investigation required prior to claim approval and review;
- clearly defined and appropriate levels of delegation of approval; and
- sound and prudent underwriting concentration limits.

i) Underwriting and Liability Risk Philosophy

The underwriting and liability philosophy is a statement of principles that outlines a company's willingness to assume underwriting, product option, and claim risk in the context of its capacity to accept insurance risk. Such principles need to address the use of reinsurance and alternative approaches in the mitigation of such risks. The philosophy will vary with the nature and complexity of its business, the extent of the risk assumed, its ability to absorb losses and the minimum expected return acceptable for a specific level of risk.

ii) Underwriting Classification

The underwriting classifications which a company intends to utilize and prohibit would usually specify:

- the legal jurisdiction in which they will operate;
- the degree of disclosure required;
- the nature of the risk to be assumed;
- the product which is applicable;
- premium classifications;
- occupational characteristics;
- health characteristics;

- other coverage in effect; and
- other risk profiles on which the company may wish to place constraints.

iii) Claims Requirements

The claims requirements establish the degree of investigation required to accept, or reject a claim, and usually specify:

- the legal jurisdiction of the claim;
- the nature of insurance risk;
- the product which is applicable;
- the documentation and proof required; and
- the occupational, financial, contractual or health characteristics on which the company may accept or reject a claim.

iv) Contractual or Non-Contractual Product Options

Product options vary with the type of product. Individual insurance would normally address whether and on what terms the company would provide:

- reinstatements;
- settlement options;
- dividend options;
- policy replacements;
- products available under conversion or guaranteed insurance options; and
- other options made available to policyholders involving non-guaranteed terms.

Group insurance would normally address whether and on what terms the company would provide:

- alternative funding;

- cancellation and transfer of liabilities;
- reinstatement; and
- conversion or guaranteed insurance options for certificate holders.

v) Approval Authorities

Clearly defined and appropriate levels of authority for underwriting design and liability approval help to ensure that such decisions are prudent and acceptable, that the integrity and credibility of the process is fair, consistent and objective, and that the risk is acceptable given the expected return.

Approval limits may relate to size or:

- satisfaction that requirements regarding risk selection, claim approval, service and sales staff training, presentation and contract materials, meet requirements;
- satisfaction that systems and administrative procedures are in place; and
- satisfaction of corporate objectives.

Authorities may be absolute, incremental or a combination thereof and may also be individual, pooled or shared within a committee.

The delegation of authority needs to be clearly documented and should include:

- the authority being delegated;
- the officers or positions or committees to whom authority is being delegated;
- the ability of recipients to further delegate; and
- any restrictions.

The degree of authority delegated will depend on a number of variables, including:

- the company's risk philosophy and culture;
- degree of market responsiveness required;
- type of risk; and

- experience of underwriters or officers.

In particular, because of the authority and responsibility given to the appointed actuary or valuation actuary, his/her role in the approval process needs to be clearly defined.

vi) Underwriting and Liability Concentration Limits

Concentration occurs when a case being underwritten contains excessive exposure to:

- a geographic region;
- a type of product;
- a distribution system or facility;
- a single individual or group;
- a number of associated individuals or groups;
- an industry;
- a product;
- specific health characteristics; or
- any other specific risk profile.

Reinsurance is one method to minimize certain insurance risks. Diversification policies should:

- be stated clearly;
- include global goals for the business; and
- place limits on individuals and groups.

Underwriting and Liability Documentation

The company faces the risk of financial loss resulting from inappropriate risk selection and underwriting of risks, product options and/or inadequate claims management.

To minimize its exposure, the company must give proper consideration to, and conduct an assessment of, each insurance risk, change in product, or claim prior to acceptance, or disbursement of funds. Dimensions such as concentration, anti-selection, misrepresentation, adverse experience and reinsurance need to be considered.

The procedures reflecting these and other important considerations in underwriting and claims management need to be clearly documented. This documentation needs to address the maintenance and implementation of procedures necessary to maintain adequate safeguards within the underwriting, product, claims and reinsurance management processes.

Evaluating Insurance Risks and Claims

Each company should have an effective formal evaluation process that provides for an independent and objective assessment of insurance risks and claims. In this context, where circumstances dictate, companies should consider the formation of specialist groups. A strong independent process is an effective means of ensuring an appropriate analysis and review.

Underwriting and product option procedures should capture:

- the overall process of risk evaluation;
- the necessary criteria of risk evaluation;
- the proper process of acquiring evidence;
- the method of monitoring emerging experience;
- the use of reinsurance; and
- the controls in the process.

Claims management procedures should capture:

- the overall process of claims management;
- the required proof of claim;
- the criteria for claims investigation;
- the claims payment procedures and controls; and
- the reinsurer participation in the claims process.

Reinsurance management procedures should capture:

- the overall process of reinsurance management;
- the reinsurance limits and treaties for a given product;
- the procedures of risk cession;
- the reinsurance cash flows administration and controls; and
- satisfaction that the reinsurer is adequately capitalized.

The underwriting and liability management program should contain the necessary provisions for updating these procedures to ensure their consistency with emerging claims experience and other contingency, or regulatory developments.

Underwriting and Liability Monitoring and Control

Establishing adequate procedures to effectively monitor and control the underwriting, product options and claims function within established guidelines has been found to be an effective method of limiting the financial exposure for companies. The appointed actuary's report on the financial condition of the company provides an existing source for identification and monitoring of existing and potential exposures, as well as providing input as to the financial capacity of the organization to accept insurance risk.

Accordingly, a company needs to develop and implement comprehensive procedures and information systems to effectively monitor and control risk selection and claims approval. These procedures need to define prudent criteria for identifying and reporting potential problems, followed up with appropriate corrective action.

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