ACTUARIAL STANDARDS BOARD

● EXPOSURE DRAFT ●

Proposed Revision of
Actuarial Standard
of Practice
No. 30

Profit Margins and Contingency Provisions in Property/Casualty Risk Transfer and Risk Retention

Comment Deadline:
November 1, 2024

Developed by the
ASOP No. 30 Task Force of the
Casualty Committee of the
Actuarial Standards Board

Approved for Exposure by the
Actuarial Standards Board
June 2024

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TO: Members of Actuarial Organizations Governed by the Standards of Practice of the Actuarial Standards Board and Other Persons Interested in Profit Margins and Contingency Provisions in Property/Casualty Risk Transfer and Risk Retention

FROM: Actuarial Standards Board (ASB)

SUBJECT: Actuarial Standard of Practice No. 30

This document contains the exposure draft of a proposed revision of ASOP No. 30, now titled *Profit Margins and Contingency Provisions in Property/Casualty Risk Transfer and Risk Retention*. Please review this exposure draft and give the ASB the benefit of your comments and suggestions. Each written comment letter or email received by the comment deadline will receive consideration by the drafting committee and the ASB.

The ASB appreciates comments and suggestions on all areas of this proposed standard. The ASB requests comments be provided using the Comments Template that can be found here and submitted electronically to **comments@actuary.org**. Include the phrase "ASOP No.30 COMMENTS" in the subject line of your message. Also, please indicate in the template whether your comments are being submitted on your own behalf or on behalf of a company.

The ASB posts all signed comments received on its website to encourage transparency and dialogue. Comments received after the deadline may not be considered. Anonymous comments will not be considered by the ASB nor posted on the website. Comments will be posted in the order that they are received. The ASB disclaims any responsibility for the content of the comments, which are solely the responsibility of those who submit them.

For more information on the exposure process, please see the ASB Procedures Manual.

Deadline for receipt of comments: **November 1, 2024**

History of the Standard

The current standard took effect in July 1997 and was updated for deviation language in May 2011. While the scope of the current standard includes risk retention (self-insurance), the purpose focuses on estimating the cost of capital and evaluating underwriting profit and contingency provisions. The current standard distinguishes contingency provisions from profit provisions. Sections 3.1–3.6 provide guidance on profit provisions for risk transfer between unrelated entities (insurer and insured), with all estimates of future costs based on expected future values, and where an underwriting profit provision, expected investment income from insurance operations, and expected investment income on capital will separately contribute to the insurer's total return on capital. This distinction between underwriting income and investment income evolved historically in U.S. statutory financial reporting for property and casualty insurers and is commonly used when a given state's rating laws or regulations are applicable.

State rate regulation typically does not apply to property and casualty coverage provided by reinsurers, excess or surplus lines insurers, self-insurance arrangements, or captive insurers. Certain pools, associations, or government entities provide specialized property and casualty coverage using rates that may or may not be regulated. The current standard acknowledges that "evaluation of whether the cost of capital is appropriately recognized does not necessarily require these distinctions." To perform actuarial services in such other circumstances, including treatment of profit margins, risk margins, or contingency provisions, an actuary must apply judgment more broadly than the current guidance in ASOP No. 30.

In addition, actuarial modeling techniques have evolved significantly since the standard took effect, and it is now common in some contexts to include explicit or implicit risk margins in the future cost estimation process. ASOP No. 30 currently requires the actuary to use expected future values for every component of an actuarially determined rate. If the actuary uses a different intended measure to meet legal or regulatory requirements, the actuary should "disclose any material difference between the rate so developed and the actuarially determined rate to the client or employer." ASOP No. 53, *Estimating Future Costs for Prospective Property/Casualty Risk Transfer and Risk Retention*, which took effect in 2018, directs the actuary to determine the intended measure of the future cost estimate based on the purpose or use of the estimate and disclose the intended measure in an appropriate actuarial communication.

This proposed revision of ASOP No. 30 allows ASOP No. 53 to govern with respect to appropriate intended measures.

<u>Notable Changes from the Existing Standard</u>

Notable changes from the existing standard are summarized below. Notable changes do not include changes made to improve readability, clarity, or consistency.

1. In section 1.2, the scope was broadened from estimating the cost of capital and evaluating the underwriting profit and contingency provisions to developing overall profit margins and contingency provisions.

2. In section 2, definitions of profit margin, risk margin, risk retention, and risk transfer were added, and several definitions were deleted. In addition, the difference between a profit margin and a contingency provision was clarified.

3. Sections 2.5 and 3.3 make it clear that guidance regarding development, review, or evaluation of underwriting profit provisions is included in the larger context of overall profit margins.

4. Section 3.3 clarifies that the profit margin may be reflected in multiple components of the future cost estimate, including in risk margins in the provisions for loss and loss adjustment expenses, in other risk margins, and in the underwriting profit provision.

5. In section 3.3, the guidance clarifies that the cost of capital is to be taken into account when developing the profit margin.

6. In section 3.3.5, references to ASOPs No. 7, *Analysis of Life, Health, or Property/Casualty Insurer Cash Flows*, and No. 20, *Discounting of Property/Casualty Claim Estimates,* were added for guidance when selecting appropriate investment income assumptions.

7. In section 3.4, guidance regarding reliance on another party was added.

8. In section 3.5, the documentation section was updated to coordinate with ASOP No. 41 rather than the repealed ASOP No. 9.

9. Section 4 was expanded to align with the new guidance in section 3.

Request for Comments

The ASB appreciates comments and suggestions on all areas of this proposed standard submitted through the Comments Template. Rationale and recommended wording for any suggested changes would be helpful.

In addition, the ASB would like to draw the readers' attention to the following questions:

1. Are the distinctions and relationships among contingency provision, risk margin, underwriting profit margin, and profit margin clear? If not, please explain and suggest language.

2. In the context of a contingency provision (both in the definition in section 2.2 and the guidance in section 3.2), is the difference between modeled expected losses and actual expected losses clear? If not, please explain and suggest language.

3. Is the level of disclosure required appropriate?

The ASB voted in June 2024 to approve this draft for exposure.

The Actuarial Standards Board (ASB) sets standards for appropriate actuarial practice in the United States through the development and promulgation of Actuarial Standards of Practice (ASOPs). These ASOPs describe the procedures an actuary should follow when performing actuarial services and identify what the actuary should disclose when communicating the results of those services.

EXPOSURE DRAFT—June 2024

PROPOSED REVISION OF
ACTUARIAL STANDARD OF PRACTICE NO. 30

PROFIT MARGINS AND CONTINGENCY PROVISIONS IN PROPERTY/CASUALTY RISK TRANSFER AND RISK RETENTION

STANDARD OF PRACTICE

Section 1. Purpose, Scope, Cross References, and Effective Date

1.1 Purpose—This actuarial standard of practice (ASOP or standard) provides guidance to actuaries when performing actuarial services with respect to developing or reviewing **profit margins** and **contingency provisions** that are included in future cost estimates for all forms of property/casualty **risk transfer** and **risk retention**.

1.2 Scope—This standard applies to actuaries when performing actuarial services with respect to developing or reviewing **profit margins** and **contingency provisions** that are included in future cost estimates for all forms of prospective property/casualty **risk transfer** and **risk retention**.

ASOP No. 53, *Estimating Future Costs for Prospective Property/Casualty Risk Transfer and Risk Retention*, ASOP No. 7, *Analysis of Life, Health, or Property/ Casualty Insurer Cash Flows,* and ASOP No. 20, *Discounting of Property/Casualty Claim Estimates,* provide guidance that may be helpful to the actuary when developing or reviewing **profit margins** and **contingency provisions** and the **cost of capital** associated with future cost estimates for prospective property/casualty **risk transfer** and **risk retention**.

If the actuary determines that the guidance in this standard conflicts with ASOP Nos. 7, 20, or 53, this standard governs.

If the actuary determines that the guidance in this standard conflicts with an ASOP that applies to all practice areas, this standard governs.

If the actuary is performing actuarial services that involve reviewing **profit margins** and **contingency provisions**, the actuary should follow the guidance in this standard to the extent practicable within the scope of the actuary's assignment.

If a conflict exists between this standard and applicable law (statutes, regulations, and other legally binding authority), the actuary should comply with applicable law. If the actuary departs from the guidance set forth in this standard in order to comply with applicable law, or for any other reason the actuary deems appropriate, the actuary should refer to section 4.

1.3 Cross References—When this standard refers to the provisions of other documents, the reference includes the referenced documents as they may be amended or restated in the future, and any successor to them, by whatever name called. If any amended or restated document differs materially from the originally referenced document, the actuary should follow the guidance in this standard to the extent it is applicable and appropriate.

1.4 Effective Date—This standard is effective for future cost estimates developed or reviewed on or after four months after adoption by the Actuarial Standards Board.

Section 2. Definitions

The terms below are defined for use in this standard and appear in bold throughout the ASOP. The actuary should also refer to ASOP No. 1, *Introductory Actuarial Standard of Practice*, for definitions and discussions of common terms, which do not appear in bold in this standard.

2.1 Capital—The funds intended to assure payment of obligations from **risk transfer** or **risk retention**, in excess of the funds backing the liabilities.

2.2 Contingency Provision—A provision for the difference between the actuary's modeled expected losses and the actual expected losses that cannot be eliminated by changes in other components of the ratemaking process. A **contingency provision** is a component of the expected losses and is therefore not expected to be earned as profit.

2.3 Cost of Capital—The rate of return that **capital** could be expected to earn in alternative investments of equivalent risk; also known as opportunity cost.

2.4 Investment Income—Proceeds (other than the return of principal) derived from the investment of assets, minus investment expenses.

2.5 Profit Margin—The difference between all expected cash inflows and all expected cash outflows in the future cost estimate of the **risk transfer** or **risk retention**. The **profit margin** is also equal to the **underwriting profit margin**, plus the provision for **investment income**, less expected income taxes, plus any **risk margins** in the future cost estimate. **Profit margin** is also known as total return.

2.6 Risk Margin—A provision that reflects the risk that future cash flows will deviate from expected cash flows associated with a **risk transfer** or **risk retention**. A **risk margin** is typically not a component of the expected losses and is therefore expected to be earned as profit. A **risk margin** may be implicit or explicit. A **risk margin** is sometimes referred to as a risk load.

2.7 Risk Retention—A risk-management and risk-control strategy for the assessment, management, or financing of retained risk associated with the specific coverage. Examples of **risk retention** include individual and group self-insurance, and large deductible programs.

2.8 Risk Transfer—A risk-management and risk-control strategy, involving legally binding agreements, that shifts responsibility from one party to another or indemnifies one party by another party for the financial obligations associated with the coverage. Examples of **risk transfer** include insurance, reinsurance, and loss portfolio transfers.

2.9 Underwriting Profit Margin—An explicit provision for profit in the future cost estimate. An **underwriting profit margin** may be referred to as an underwriting profit provision in certain contexts.

Section 3. Analysis of Issues and Recommended Practices

3.1 Overview—**Profit margins**, **contingency provisions**, and the **cost of capital** are used by actuaries when developing or reviewing future cost estimates for property/casualty **risk transfer** or **risk retention**. The **profit margin** includes the provision for the **cost of capital**. A **contingency provision**, if appropriate, is a component of the expected losses and is not part of the **profit margin**.

3.2 Contingency Provision—If the actuary reasonably believes that there is a material difference between the modeled expected losses and the actual expected losses that cannot practicably be eliminated by changes in other components of the future cost estimate process, the actuary should include a **contingency provision** in the future cost estimate. For example, in the event the modeled expected losses do not adequately capture the tail of the loss distribution, a **contingency provision** may be appropriate.

3.3 Profit Margin—The actuary should include an appropriate **profit margin** in the future cost estimate associated with the **risk retention** or **risk transfer**. When providing for the **profit margin**, the actuary should take into account the relationship between risk and return, the **cost of capital**, the intended measure for the future cost estimate, and characteristics of the **risk transfer** or **risk retention**. These characteristics may include insurance risk, investment risk, inflation risk, and regulatory risk, as well as diversification, debt structure, leverage, reinsurance, market structure, and other relevant aspects of the social, economic, and legal environments.

3.3.1 Development of the Profit Margin—When developing the **profit margin**, the actuary may use any appropriate method that is consistent with the guidance in this standard and should take into account the following as appropriate:

a. the intended use of the future cost estimate;

b. the structure of the **risk transfer** or **risk retention**, including features such as deductibles, limits, insured response behaviors (such as take-up rates and persistency), dividend or return of premium plans, or reinsurance;

c. the type of entity that is accepting the **risk transfer** or retaining the risk, such as a commercial insurance company, government insurance program, risk pool, or self-insurance program; a for-profit vs. nonprofit entity; or a publicly traded vs. privately held entity;

d. the amount of **capital**, whether available, allocated, or notional;

e. the risk tolerance of the entity that is accepting the **risk transfer** or retaining the risk;

f. the legal and regulatory environment; and

g. any **risk margins** included in the overall calculation.

3.3.2 Profit Margin Components—The actuary should ensure that the total **profit margin** is appropriate for the intended use. When doing so, the actuary should identify and evaluate the components of the **profit margin** included in the future cost estimate, including any explicit or implicit **risk margins**, the **underwriting profit margin**, expected **investment income** and expected income taxes.

3.3.3 Benchmarking Cost of Capital—When the actuary uses **cost of capital** to develop the **profit margin**, the actuary may benchmark against other entities or industries. When doing so, the actuary should make any necessary adjustments so that the **costs of capital** developed under different accounting rules can be properly compared.

3.3.4 Use of Projected Future Costs—When developing **cost of capital**, **investment income**, income taxes, cash flows, leverage factors, and other assumptions used for the **profit margin**, the actuary should base estimates on projected future costs relating to the prospective period of time to which the future cost estimate applies, which may differ from historical costs.

3.3.5 Investment Income—When developing the **profit margin**, the actuary should take into account both **investment income** from the cash flows related to the **risk transfer** or **risk retention** and **investment income** on any **capital** supporting the transaction. The actuary should refer to ASOP Nos. 7 and 20 for guidance in selecting appropriate **investment income** assumptions.

3.3.6 Income Taxes—When developing the **profit margin**, the actuary should take into account the effect of income taxes.

3.3.7 Use of Basis—The actuary may use any appropriate basis to present the **profit margin** or its components, such as a percentage of **capital**, a percentage of assets, or a percentage of premium.

3.4 Reliance on Another Party—When relying on another party and thereby disclaiming responsibility

a. for data and other information relevant to the use of data, the actuary should refer to ASOP No. 23, *Data Quality*.

b. for a model, the actuary should refer to ASOP No. 56, *Modeling*.

c. for assumptions and methods prescribed by another party, the actuary should review the assumption or method for reasonableness and consistency to the extent practicable and appropriate within the scope of the actuary's assignment.

d. for assumptions and methods not prescribed by another party, or for any other item not addressed above, the actuary should review the item for reasonableness and consistency to the extent practicable and appropriate within the scope of the actuary's assignment. In addition, the actuary should be reasonably satisfied that the reliance is appropriate, taking into account the following, as applicable:

1. when the other party is an actuary, whether the actuary knows that the other party is appropriately qualified and has followed applicable ASOPs;

2. whether the actuary knows that the other party has expertise in the applicable field;

3. whether the actuary knows the other party's stated purpose for the item and the extent to which it is consistent with the actuary's intended purpose; and

4. whether the actuary knows of differences of opinion within the other party's field of expertise that are material to the actuary's use of the item.

3.5 Documentation—The actuary should prepare and retain documentation to support compliance with the requirements of section 3 and the disclosure requirements of section 4. The actuary should prepare such documentation in a form such that another actuary qualified in the same practice area could assess the reasonableness of the actuary's work. The amount, form, and detail of such documentation should be based on the professional judgment of the actuary and may vary with the complexity and purpose of the actuarial services. In addition, the actuary should refer to ASOP No. 41, *Actuarial Communications*, for guidance related to the retention of file material other than that which is to be disclosed under section 4.

Section 4. Communications and Disclosures

4.1 Required Disclosures in an Actuarial Report—When issuing an actuarial report, the actuary should refer to ASOP Nos. 7, 20, 23, 41, 53, and 56. In addition, the actuary should disclose the following in such actuarial reports:

a. a description of and the rationale for any **contingency provision** (section 3.2);

b. the intended use of the future cost estimate (section 3.3.1);

c. the methodology and assumptions used in determining the **profit margin** (section 3.3, 3.3.1, 3.3.2, and 3.3.4);

d. any **investment income** assumptions reflected in the **profit margin** (section 3.3.5);

e. any income tax assumptions reflected in the **profit margin** (section 3.3.6);

f. the basis or bases for the **profit margin** or its components (section 3.3.7); and

g. any reliance on information provided by another party (section 3.4).

4.2 Additional Disclosures in an Actuarial Report—The actuary also should include disclosures in an actuarial report in accordance with ASOP No. 41 for any of the following circumstances:

a. if any material assumption or method was prescribed by applicable law;

b. if the actuary states reliance on other sources and thereby disclaims responsibility for any material assumption or method selected by a party other than the actuary; or

c. if in the actuary's professional judgment, the actuary has deviated materially from the guidance of this standard.

4.3 Confidential Information—Nothing in this standard is intended to require the actuary to disclose confidential information.

Appendix

Background and Current Practices

Note: This appendix is provided for informational purposes and is not part of the standard of practice.

Background

Historical Procedures—Until the 1970s, it was common practice to include in rate calculations a standard underwriting profit and contingency provision of 2.5% for workers compensation insurance and 5% for other property/casualty lines of insurance (6% for some property lines). These provisions did not explicitly reflect investment income, since there was general agreement at the time that these standard provisions implicitly reflected investment income and insurance risk in a reasonable fashion. However, economic and structural changes in the insurance industry over time began to lead to the explicit recognition of investment income in calculating insurance rates.

In 1997, ASOP No. 30 was adopted to address a number of considerations that arise in the development of profit provisions and separate contingencies provisions:

1. how to measure risk and reflect it in the underwriting profit provision;

2. how or whether to measure any systematic variation from expected losses and reflect it in the contingency provision;

3. which accounting rules should be used to measure insurance returns and to compare them with returns in other industries;

4. how or whether to allocate investment income and capital; and

5. how to relate underwriting profit provisions in rates to the cost of capital.

The growth of risk financing mechanisms that are alternatives to rate regulated insurance, such as risk retention, captive insurance, pools, and associations, have required different approaches. Available capital, risk tolerance, and risk financing goals differ significantly across the spectrum of risk-transfer and risk-retention mechanisms.

Role of Capital—The primary role of capital in risk transfer and risk retention is to assure payment of future costs, over and above those funds backing the liabilities.

Capital has a value, even if the capital is notional, and its use has a cost. The cost is the expected return the capital could earn in alternative investments of equivalent risk. Judicial decisions dealing with the cost of capital and profit margins (see, for example, *Federal Power Commission* *v. Hope Natural Gas*, 320 U.S. 591 [1944]) provide background and definitions for the determination of the cost of capital in a regulatory setting. Outside a regulatory setting, the determination of the amount and return on capital is influenced by the type of risk transfer or risk retention and the goals and risk tolerance of the entity receiving or retaining the risk.

Role of the Profit Margin—The profit margin, which may be reflected in various components of the future cost estimate, provides the risk taker with an expected total return.

Role of the Contingency Provision—A common assumption underlying property/casualty insurance ratemaking is that the modeled expected losses included in the rate calculations will equal the actual expected losses. If not, then this difference may be incorporated in the future cost estimate by including a contingency provision.

Current Practices

A method commonly used to develop or test the profit margin in insurance rates is to estimate the cost of capital and translate that cost into a profit margin. Profit margins can also be developed using models that do not directly relate the cost of capital to the profit margin. A profit margin may or may not include an explicit underwriting profit margin. This is particularly true, for example, in funding studies that are targeted to provide funding at a specified percentile of the loss distribution, which reflects a risk margin as a component of the profit margin.

A contingency provision may be included in the future cost estimate, for example, when the modeled expected losses do not adequately capture the tail of the loss distribution in the future cost estimate, resulting in a high level of uncertainty around the actual expected losses.