AIM

Draft Capital Reserves Policy

Dated 2 Dec 2019

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Background and Purpose

The purpose of this document is to outline a Capital Reserve Policy for AIM and to develop a framework around a target level of capital reserves.

It is intended as a live document that will change over time.

Principles

The following principles are being put forward:

- A defined capital reserve target range is required for a number of reasons including to protect against volatility and to provide more flexibility
- Capital reserves are considered to be the amount by which assets exceed liabilities (liabilities are inclusive of actuarial reserves)
- The setting of the capital reserve target range is to be considered using a risk-based approach

Nature of AIM

AIM has numerous specific features that need to be considered in terms of managing reserves. These include:

Feature	Considerations
Ownership	The mutual is Member-owned and as such consideration needs to be given to any excess amounts
Discretionary Mutual	Claims are discretionary and as such claim payments can be made that might not be covered by reinsurance
Regulation	AIM is not regulated by the PRA as it is a discretionary/hybrid mutual. However because AIM organises XOL insurance for the members it is regulated by the FCA. As AIM operates as an Appointed Representative of Regis it is regulated via Regis rather than being directly regulated. The FCA regulation relates primarily to the conduct of business and does not relate to capital requirements which are regulated by the PRA
Reinsurance	AIM is heavily reinsured. This caps the downside risk but also means greater considerations around counterparty risk Reinsurance is currently charged as a percentage of contributions which reduces the exposure to mismatches between contribution and reinsurance rates.

These factors give AIM a considerable degree of flexibility in managing capital reserves over time and this can be seen by reserve levels that have been managed in the past.

Risk Based Capital

The last 20 years has seen the insurance industry move to a more risk-based approach to regulatory capital (i.e. free reserves). Solvency II is a risk-based approach that came into effect on 1 January 2016, implemented by the PRA. Solvency II applies to all insurers with gross premium income exceeding €5m or gross technical provisions in excess of €25m. Solvency II has continued to be refined over the years, each time with the intention of better reflecting the individual risk profile of an insurer.

This approach attempts to calculate minimum regulatory capital requirements on a basis that reflects the different risks faced by different insurers. A simple way to think of it is the sum of different amounts of capital for insurance, investment, asset, concentration and operational risk reduced by a diversification factor to allow for the fact it would not all go wrong at the same time.

Risk-based capital replaced more simplistic calculations of regulatory capital requirements such as a percentage of net premiums and/or outstanding claims.

Risks to AIM

The financial risks to AIM can be grouped under the following broad headings:

Protection Risk

This is the risk of claims volatility or an aggregation of claims resulting in worse than expected claims experience. It includes:

- underwriting risk – the current year outcome being worse than expected
- outstanding claims risk – net outstanding claims being worse than expected

This covers:

- Claims and/or market driven volatility
- Risk gap between claims budget and XCA attached

Asset Risk

This is the risk of assets reducing in value. This includes

- Investments
- Counterparty reinsurance risk – risk of default of the reinsurer

Commercial Risk

This is the risks associated with interaction with Members and the broader market place. It includes:

- Loss of Members
- Retaining or Gaining new Members
- Payment of Discretionary Claims beyond budget (and not under reinsurance)
- Business developments – blue sky or otherwise
- Flexibility to retain more risk

Operational Risk

This is the risks associated with day to day running of the business.

Approach to Capital Reserves Levels

The table on the next page looks at each of the risk outlined, touches on the mitigants in place and considers either the 1 in 20-year downside risk for each element or amount of capital that might be required. An aggregated approach has been taken with no allowance for diversification between the risks.

It suggests, based on current figures, a target range of between £929k and £1,394K, with the individual elements comprising the base £929K with an additional 50% loading to allow future flexibility for business decisions and risk retention options.

Capital Reserves by Type of Risk

	Mitigation / Management	1 in 20 Outcomes	Approach	Quantum
Protection Risk				
Underwriting Risk	Robust pricing approach Use of reinsurance	2019/20 claims budget is as follows Before XCA – 1.29M After XCA – 1.1M	Net budget strain at 1:20 with benefit of the XCA	0K
Outstanding Claims Risk	Internal actuary 75th percentile adequacy Prior year reinsurances	As at 31 July 2019 Current provision is 3.364M 95th percentile[1] would be 3.940M	Additional strain above the current provision if a 1:20 (95th) outcome	576K
Asset Risk				
Reinsurance Recoveries	Monitoring and management	At 1:20 - no impaired recoveries However, failure would have big impact	5% of the outstanding RI receivable including IBNR and profit commission	49K
Growth Assets	Conservative approach	At 1:20 there could be a significant fall in value of growth assets	10% of growth assets	151K
Commercial Risk				
Change in Membership	Careful management of relationships which are quite "sticky"	Membership stable but both losses and gains can have big impact	Larger of 10% gross contributions from largest three members and 5% of total gross contributions	143K
Discretionary Claims	Clear processes/consideration	Board decision rather than probabilistic	Decide on appropriate amount	10K
Biz Dev / Flexibility	Considered decision process	Strategy dependent. Ideal is to have sufficient reserves when needs arises	Target a multiple of reserve to give flexibility	Additional 50% of total
Operational Risk				
Day to Day Operations	Clear processes/consideration	1:20 is business as usual	No explicit reserve held	-

Notes:

1 . 95th Percentile is calculated by increasing the Outstanding claims and IBNR by 10%

Calculation of Capital Reserves

The nature of the calculation above means that the target capital reserve will change regularly. It makes sense to establish a target level and revisit annually unless there are any events during the year to consider re-calculation. Such events might include:

- Change in investment strategy
- Significant claims activity
- Mid-period change in reinsurers (including concerns about their security) or reinsurance strategy
- Commercial discussions which may impact capital reserves

An annual calculation could be undertaken supported by a quarterly statement regarding the projected reserve position and its position relative to the targeted ranges.

Working to a Target Capital Reserve

The capital reserve position will fluctuate. The position should be managed over time and impact the behaviours adopted. For simplicity, the following suggests actions required at different stages (the pound amount assumed is £0.93M with a 50% loading giving a target range to £1.40M)

	Range	**Response**
Strong	150% - 250% (1.4M – 2M)	Considered return of reserves (e.g. distribution, discounting, etc.) Consider lower annual average surplus target Investigate alternative reinsurance or investment strategies
Target	100% - 150% (0.93M – 1.4M)	Business as usual Maintain annual average surplus target
Below Target	50% - 100% (0.5M – 0.93M)	Ensure a clear path back to the Target range Look to achieve surplus on a one-year basis
Weak	< 50% (<0.5M)	Adopt a strategy aimed at returning to Target range Agree target surplus for next period Consider tools to change risk profile (e.g. additional RI)

Clearly the capital reserves in AIM change over time, but so does the target capital position if there are changes in the reinsurance structure, investment strategy or membership profile (i.e. a change in the risk profile will change a risk-based target capital range). The impact that decision making will have on both the level of capital reserves, but also the Target range needs to be considered carefully and this is discussed further below.

Impact on Target Capital Reserves

AIM has known risks that are carefully managed via risk register and mitigation. In addition it is appropriate to hold a target level of capital reserves both in relation to these risks and to be able to take advantage of opportunities.

This section focuses on various risks and the impact they would have on the target level of capital reserves. The intention is to understand the sensitivities and provide a basis that will help with decision making. The base case is the calculated target of £0.93M (giving a range of £0.93M to £1.4M). The current position is 143% (i.e. £1.33m members funds in the balance sheet divided by the base £0.93m) of the Target. The Target and position can be updated and will be reported regularly to the Finance and Audit Committee.

Risk	Change	Impact on Target	% Target
Protection (Underwriting)	No Cross-Class Aggregate	+183K	119%
Protection (Outstanding Claims Risk)	All years breach the aggregate	+359K	103%
Asset (Growth Assets)	All Investments drop by 35% instead of 10%	+378K	102%
Asset (Growth Assets)	Move to 100% cash	-151K	171%

The above shows that the target capital reserve will change with changes in the risk profile. A set target range of £0.93M to £1.4M can be established but needs to be revised when there are changes in the risk profile. It also means that, particularly when in a strong position, there is more flexibility around decision making with regard to reinsurance and investments.

Return of Reserves/Distribution of Surplus

When reserves are greater than 150% of target it may be deemed appropriate to make a return of reserves to member/owners. This may also be the case where reserves are between 100% and 150% of target, particularly if reserves are generally increasing over time. Reserves may be returned in different ways – for example via offsetting against contribution levels in the following year or making a distribution directly to members.

In terms of determining:-

- whether to make a return of reserves
- the level to be returned if it is decided to make a return
- how to make the return (e.g. for distribution of surplus which years to make the distribution from)

there are a number of key considerations including:-

- current level of surplus v target range (see above)
- general trend in relation to annual surplus, and in particular the most recent year's surplus

- the level of surplus attributable to each underwriting year and the exposure of each underwriting year to future reduction in surplus
- marketing considerations e.g. which members will benefit (bearing in mind that the surplus for a given underwriting year must be distributed in accordance with the contribution of each member to that underwriting year).