Institute and Faculty of Actuaries

Risk Alert
www.actuaries.org.uk
31 August 2022

RISK ALERT
The impact of high inflation on actuarial practice

KEY MESSAGE

Significant global economic pressures are taking measures of inflation to high levels which increases the risk of economic uncertainty and may affect actuarial practice. It is important that actuaries fully account, and carefully consider, the nature of the market conditions, how these are likely to rapidly change and how this affects their work.

Current inflation will impact the expectation of future inflation, the rationale for selections of methodologies used and the quantification of outcomes.

What are Risk Alerts?
A series of alerts drawing attention to specific issues where the IFoA asks Members (and others) to think carefully about the consequences of actions they are taking or not taking.

The information in the Risk Alert is published to support Members and to protect the public interest. The Risk Alert is not mandatory guidance.

This Alert is relevant for the following Members:

This Risk Alert is relevant for all Members, with a particular focus on actuaries involved in general and life insurance, and pensions. This is especially relevant for general insurance actuaries who are used to a low inflation environment and may need to make significant adjustments due to a period of stability changing.

Subject matter

It has been decades since actuaries have encountered widespread pressures of high inflation. In the last few months, this has continued to rapidly change as inflation is rising, affecting the price of goods and services globally which are vulnerable to the effects of inflation. The Bank of England recently raised interest rates to 1.75% on the 4 August 2022.

Inflation has been impacted by a variety of factors including Brexit, the COVID-19 pandemic, global reopening, and the ongoing war in Ukraine. Several measures are used by the UK Office for National Statistics (ONS) which include consumer price inflation (CPI), producer price inflation (PPI input and output) and the House Price Index.

Considerations for all Members

All Members, regardless of practice area, can consider and adjust their work by taking appropriate consideration of:

- expectations of future inflation and rationale for selections;
- different types of inflation, where relevant;
- the impact of the current high inflation environment on underlying methodologies (for example, where the methodology implicitly assumes past is representative of future); and
- the quantification of uncertainty (such as using scenario testing) to ensure the user of the work understands the potential range of plausible and possible outcomes. Where relevant to decision making, and to the extent that it is proportionate to do so, scenario testing (either quantitative or descriptive) and considering the outcome of scenarios of higher than currently expected inflation, expected inflation, and short-term deflation.

General insurance

It is important that general insurance reserving actuaries are aware of the market conditions when advising those making decisions on reserves. This includes carefully considering whether existing processes, assumptions and methodologies remain suitable and appropriately documenting any work that considers inflation.

The reserves constructed by general insurance companies often use variations of chain-ladder methods through the evolution of case reserves and payment streams, leading to the estimate of the total ultimate claim amounts and corresponding reserves.

Given the high inflation coming through on specific components of claims costs reaching double figures, there is a risk to the adequacy of both actuarial reserves and the underlying case estimates. General insurance actuaries may be less familiar with inflation and coping with this than other areas that focus on many longer-term outlooks.

Those working in general insurance may want to consider the following:

- claims inflation is an ongoing challenge for actuaries and their organisations in managing overall claim costs and setting appropriate levels of reserves to meet customer claims. Existing reserving methodologies and models may not reflect the increasing inflation pressures without adjustments, increasing the risk of under-reserving;

- there may be pressure from other stakeholders to limit any potential reserve increase;
- firms may face calls to hold and/or raise additional capital, restrictions on writing new business and/or insolvency in extreme cases. This could lead to non-payment or underpayment of valid claims; and
- general insurance reserving actuaries should carefully consider whether existing processes, assumptions and methodologies remain suitable and appropriately document any work concerning inflation.

Pensions and life insurance

Members working within the areas of pensions and life insurance may be faced with increased challenges in managing investments or hedging strategies for inflation-linked liabilities.

There may be an enhanced risk where actuaries cannot match underlying liabilities with a suitable asset or choose to adopt "delta-hedging" as an approximate matching technique. Both higher levels of inflation, and possible increased volatility, may mean that monitoring and re-balancing become expensive or problematic.

Those working in pensions and/or life insurance may wish to consider the following:

- retirement factors for deferred members may require to be reviewed to ensure that they are appropriate and consistent with preservation legislation;
- the need to consider any matching or mismatched exposure;
- the impact of any caps and collars on cashflows;
- possible member or political pressures to ignore caps or apply discretionary increases, especially where the cost of living is outstripping pension increases; and
- the likelihood of inflation causing underpinning biting in the future.

Professional obligations

Members are asked to be alert to the risks due to increasingly high inflation. Members must ensure they comply with their obligations under the Actuaries' Code ('the Code'), Actuarial Profession Standards (APSs) and, for actuaries carrying out UK technical actuarial work, the Technical Actuarial Standards (TASs) produced by the Financial Reporting Council.

Members are reminded of Principle 2 of the Code which states they must carry out work competently and with care and ensure that they have an appropriate level of relevant knowledge and skill to carry out a piece of work.

Principle 6.3 of the Code states that Members must take reasonable steps to ensure that any communication for which they are responsible or in which they have a significant involvement is accurate, not misleading, and contains an appropriate level of information. They should clearly explain the impact of current high inflation or investments and returns of products to clients, and proactively communicate appropriately to users. Where actuaries believe that data or products they are using are overestimating or overpromising returns, they should clearly flag these issues to the appropriate individuals or groups.

Further information and support

- Members with specific professional questions or concerns should send those to the regulation team at regulation@actuaries.org.uk. Members can also get support on ethical or technical issues through the Professional Support Service.

- The Prudential Regulation Authority (PRA) in the UK has ongoing interactions with general insurance firms in relation to reserving assumptions and methodologies. Members can refer to the publication of the PRA "Dear Chief Actuary" letters which contains feedback to industry.

- The UK Financial Conduct Authority (FCA) has a focus on customer outcomes representing fair value, as set out in the Consumer Duty rules.

- The UK Office of National Statistics (ONS) produce quarterly estimates to monitor the changes in prices charged for services provided to UK based customers. Further detail can be found on their website.