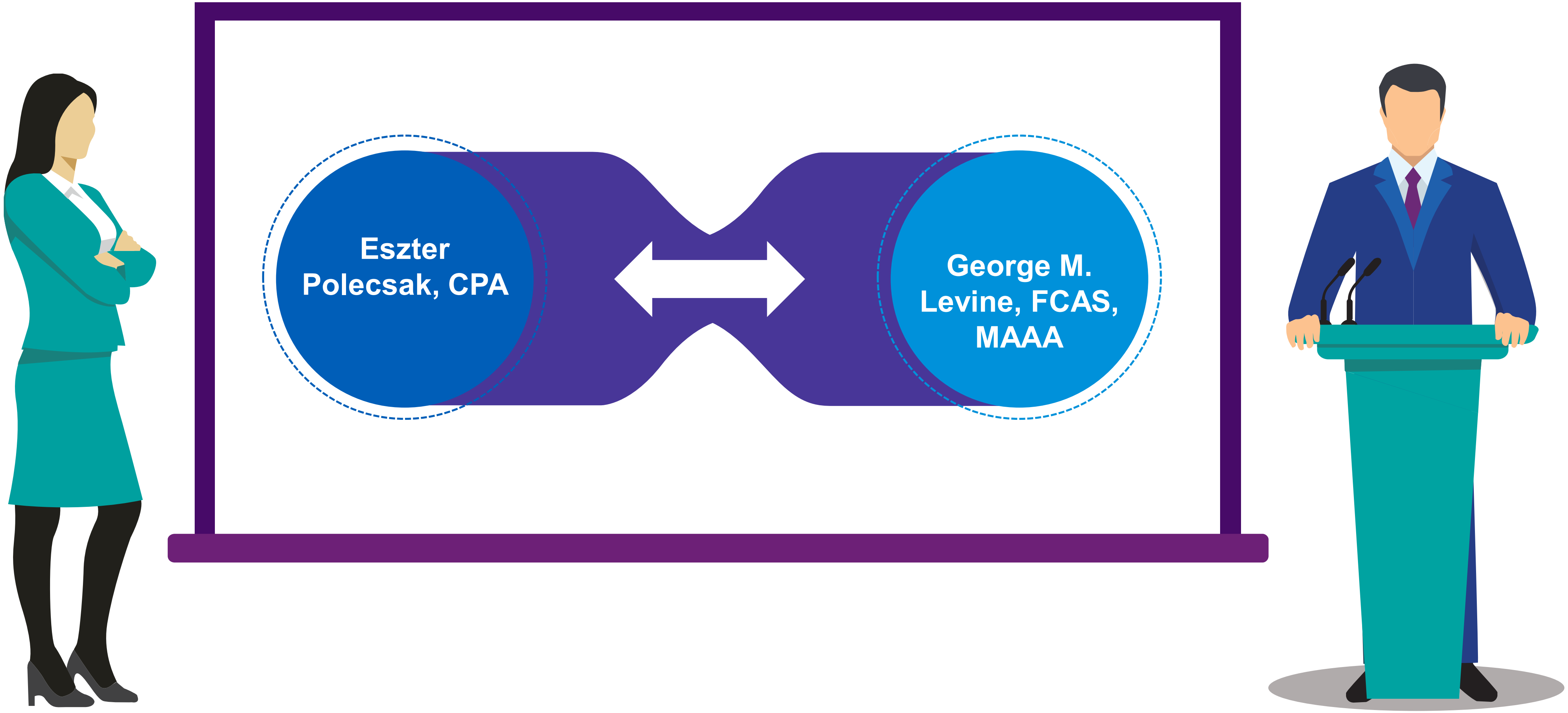
Reserving and financial reporting for non-insurance company entities

2021 Casualty loss reserve seminar

September 13, 2021

Speakers



Presentation learning objectives

In this Presentation, you will:

- Identify non-insurance entities that require actuarial support in estimating reserves (or “accruals” to accountants)
- Understand the differences in reserving requirements for these self-insured entities compared to insurance entities
- Be aware of the financial reporting requirements, which can vary by parent geography and ownership, and accounting guidance for these entities

Polling question #1

— How familiar are you with retained risk actuarial work and accounting provisions?

a. Very familiar—All of my work is for non-insurance companies
b. I do some, but mostly insurance companies
c. Familiar with retained risk, but limited hands on experience
d. What is retained risk?

Agenda

- Introduction—Retained risk overview
- Comparisons between retained risk and statutory insurance company requirements (throughout presentation) in red
- Primary resource: American Academy of Actuaries (“AAA”) retained risk practice note overview
  - Relevant accounting standards
  - Summary of accounting standards and implications of retained accruals
  - Roles of interaction between actuaries and auditors

Introduction

- Corporate entities typically retain significant amounts of risks that are similar to those commercially insured.
- P&C actuaries are often engaged to value the unpaid claim estimates associated with these exposures.
  - Retained Risk: “Accruals” vs. Insurance Company: Reserves
- The actuarial estimate may be recognized by the management of the entity as a liability for the entity’s obligations.

Introduction (continued)

— How these liabilities become part of an entity’s financial statements is governed by:
  - The applicable accounting standards for the type of entity
  - The type of exposure to loss
  - The domiciliary jurisdiction of the entity and its parent

Primary resource: Retained Risk (“RR”) practice note

— “Retained Property-Casualty Insurance Related Risk : Interaction of Actuarial Analysis and Accounting, Effective April 2018”
  - Developed by AAA’s Casualty Practice Council’s Committee on Property and Liability “COPLFR” work group
  - Is intended to provide information, and the interaction of accounting guidance with the relevant actuarial concepts for P&C actuaries on relevant actuarial and accounting issues where a perceived vacuum in literature exists
  - COPLFR’s Practice Note on Statements of Actuarial Opinion On Property and Casualty Loss Reserve (Insurance Company) vs. Retained Risk Practice Note (Retained Risk Entity)

RR Practice note overview

— Retained risk practice note <u>is not</u>:
  - A promulgation of the actuarial standards board
  - An actuarial standard of practice
  - Binding upon any actuary, and
  - Is not a definitive statement as to what constitutes generally accepted practice in the area under discussion.

— Retained risk practice note <u>does</u>:
  - provide information and guidance for area not often encountered by many actuaries

RR Practice note overview (continued)

—Describes:
- The various ways entities retain exposure to risk
- The various types of entities and the variation in the retained risk characteristics because the type of entity often determines the particular approach or applicable accounting treatment
- Common exposures that these various entities may retain
    - **Workers Compensation**
    - **Auto Liability / General Liability / Professional Liability / Liquor Liability**
    - **Property**
- Composed of 8 Chapters — A summary of chapters not discussed in this presentation is in the appendix

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RR Practice note overview (continued)

- Includes relevant accounting guidance that will apply to entities and exposures, the interaction of the accounting guidance with the relevant actuarial concepts, and the variation by type of entity
- Discusses the interaction between the actuary, accountants, third party administrators and risk managers/ internal attorneys
- Summarizes the applicable actuarial standards

Who are the non-insurance company entities that retain risk? (Chapter 2 of RR Practice Note)

— Characteristics — Entity must be large enough (actuarially)
— Private sector entities (privately held or publicly traded)
— Group programs
— Governmental entities
— Governmental groups and pools
— Government quasi-insurance programs
— Healthcare providers

When should an entity retaining risk engage an actuary?

- Statutory Insurance Company: NAIC Instructions, Appointed Actuary Requirement (COPLFR SAO Practice Note)
- Retained Risk (Self-Insured) Entity
  - Governance of organization
  - Competitive/Profitability concerns
  - External auditor decides based upon materiality — If material enough, auditor can recommend to the entity to engage an independent actuary
  - May be required by state self-insurance regulator (e.g. California Dept of Industrial Relations, Office of Self-Insurance Plans)
  - Education, experience, qualifications — Audit standards, no appointed actuary concept

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Polling question #2

—Which of the following is a non-insurance entity that retains risk?

a. Captive insurance company
b. A hospital with a $500,000 Deductible Retention
c. A group of automobile dealers that purchase insurance
d. A Fortune 500 Company that purchases insurance only

Chapter 6: Relevant accounting standards

—US Generally Accepted Accounting Principles (GAAP)

- FAS 5, now ASC 450 (SSAP No. 5 Liabilities, Contingencies, Impairment of Assets)
- FASB ASC 720-20 – Insurance costs
- FASB ASC 954-10-00 – Healthcare entities
- GASB 10

Note: US Statutory Accounting Principles (SSAP) govern Insurance Companies

—International Accounting (IFRS) requirements

- IFRS 7 and 19
- IAS 37

ASC 450-20 (FAS 5)—Accrual characteristics

— A contingency is “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.” The scope of ASC 450-20 specifically excludes the insurance-related transactions of insurance entities, which are covered by other accounting standards, but it is relevant to all entities that retain risk.

— An estimated loss from a loss contingency is recognized when:

  - a. Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
  - b. The amount of loss can be reasonably estimated.”

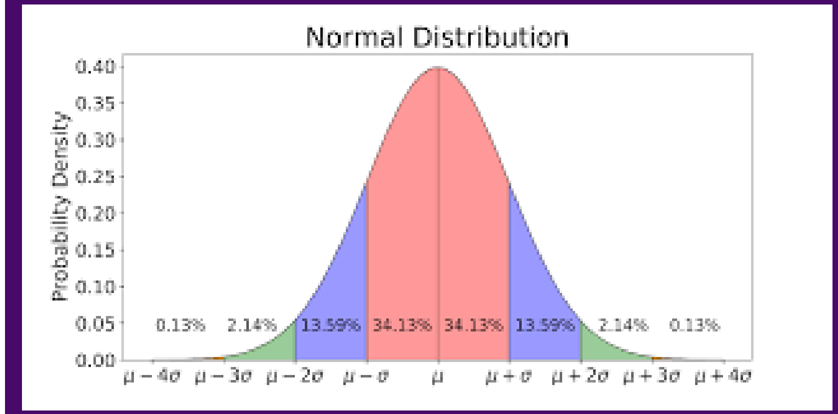
— Only accruals for past events are included in financial statements (in the US, catastrophes are not accrued for as losses before they occur; in European countries, some permit catastrophe accruals)

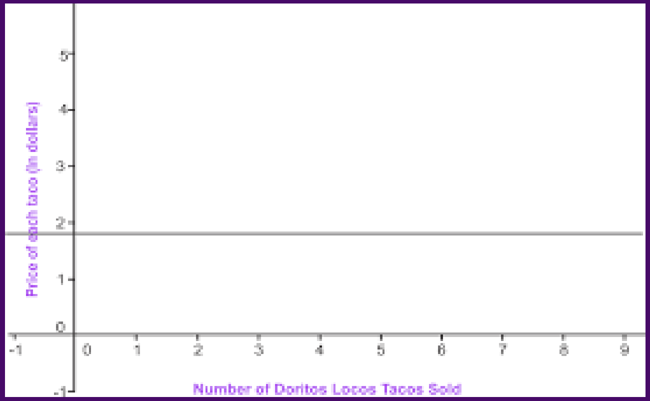
ASC 450-20 (FAS 5)—Measurement Criteria

"If some amount within **a range of loss** appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount."

Actuaries have a central estimate that is more likely (see first graph below)

Others may believe all the estimates are equally likely (see second graph)





Chapter 7: Roles and interactions of actuary, accountants and risk managers

Definitions of roles and responsibilities

Controls

Interaction with the external auditor

Actuarial report and presentation

Interaction with the internal accountants

Interaction of actuary with external auditor

- Concept of materiality
- Auditing standards:
  - AICPA standards (material non-significant accounts)
  - PCAOB standards
  - International Standards on Auditing (ISAs)
- Considerations for integrated audits
- Audit scoping, risk assessment process
- Critical accounting policies and estimates (management's responsibility)
- Critical audit matters (auditor, PCAOB opinion)

Interaction of actuary with external auditor (continued)

— Typical audit procedures
  - Inquiry with management and actuary
  - Perform walkthroughs and process understanding (testing the design and implementation and operating effectiveness of internal controls when selected or required)
  - Review the actuarial analysis and report (methods and assumptions) – with or without the involvement of the external auditors' independent actuary
  - Evaluation of the actuary used by management (knowledge, skills, ability and independence)
  - Select the substantive approach to test the estimate (accrual)
    — Test and evaluate the entity's process for developing the estimate
    — Develop an independent expectation for comparison to the entity's estimate

Interaction of actuary with external auditor (continued)

- Typical audit procedures, continued
  - Testing the completeness and accuracy of data used by the actuary (i.e. loss run, exposure data, policy amounts etc.)
  - Circulate legal confirmations with internal and external legal counsel(s)
  - Evaluate adjustments made to actuarially determined amounts (actuarial report vs. general ledger/ financial statements)
  - Evaluate management bias
  - Review the appropriateness of disclosures in the financial statements (estimation uncertainty)

Interaction of actuary with external auditor (continued)

- Timing of audit procedures
  - Financial statement date (period-end)
  - Interim
  - Rollforward procedures
  - Exceptions—a non-insurance entity audit can have a valuation date before year-end (i.e. 9/30), and no procedures are performed by the actuary due to materiality. For statutory insurance companies, using year-end data (12/31) is almost always performed
- Point estimate vs. range?
- Audit misstatements
- Control deficiencies

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Polling question #3

— What is your level of involvement in the external audit process?

a. Very involved—I work closely with the finance team on the data request received from the auditors and responding to questions
b. Some involvement during prior audits
c. Are we required to have an external audit?

Chapter 6: Summary of accounting standards where on the balance sheet? Discounting/Risk margin?

Accounting basis	Type of risk transfer	Balance sheet liability accrual	Balance sheet offsetting asset	Net result (liabilities minus assets)	Discounting /Risk margin
US GAAP Non-Insurer	Guaranteed cost	Usually none	Usually none	Nil	N/A
	Self-Insurance (SI)	Unlimited unpaid losses & ALAE	Expected excess recoveries	Unpaid losses & ALAE limited to SI retention	Optional/ No
	Large Deductible	Unlimited unpaid losses & ALAE	Expected excess recoveries	Unpaid losses & ALAE limited to deductible	Optional/ No
	Retro-Rated	**Unlimited unpaid losses & ALAE**	**Expected excess recoveries**	**Difference between ultimate retro premium and premiums paid to date**	**Optional/ No**
		+ expected loss sensitive premium adjustments other than losses (generally associated with unpaid limited loss)	**+ Difference between premiums paid to date and limited unpaid losses & ALAE**		
	Claims-made SI & Large Deductible	Unlimited unpaid losses & ALAE on an occurrence basis = report year plus tail	Expected excess recoveries on reported claims	Limited unpaid losses & ALAE on reported claims + unlimited IBNR	Optional/ No

Retro rated accrual example vs. Insurance company reserve estimate

Policy year	Limited ultimate losses	Variable expense factor	Limited ult. Losses and variable expenses	Fixed and excess expenses	Gross ultimate liability	Paid to date as of December 31, 2020	Total net undiscounted accruals
5/18-19	6,000	1.050	6,300	4,500	10,800	9,000	1,800
5/19-20	4,000	1.050	4,200	1,500	5,700	4,600	1,100
5/20-21 (Pro Rated, 7 months)	2,500	1.050	2,625	2,000	4,625	3,500	1,125
Total	**12,500**		**13,125**	**8,000**	**21,125**	**17,100**	**$4,025**

Note: The $17,100 Paid to Date could reflect large prepayments or deposits, incurred losses, variable expenses, and are much higher than the “paid losses and ALAE” from an insurance company review. With large prepayments, as noted in the retro policy, the accruals could be negative!

For insurance companies, ultimate losses less paid losses is the unpaid loss estimate formula generally.

Chapter 6: Summary of accounting standards

Accounting basis	Type of risk transfer	Balance sheet liability accrual	Balance sheet offsetting asset	Net result(liabilities minus assets)	Discounting /Risk margin
US-domiciled captive	Generally use US GAAP for insurance companies. Most captive domiciles have abbreviated statutory forms based on US GAAP for regulatory filings; exception: Risk retention groups file a standard statutory annual statement				Sometimes permitted by domicile
Governmental Entity (GASB)	Self-Insurance	Unpaid losses & ALAE limited to SI retention	None	Unpaid losses & ALAE limited to SI retention	Optional/ no
	Large Deductible	Unpaid losses & ALAE limited to deductible	None	Unpaid losses & ALAE limited to deductible	Optional/ no
	Retro-Rated	Difference between ultimate retro premium and premiums paid to date	None	Difference between ultimate retro premium and premiums paid to date	Optional/ no
	Claims-made SI & Large Deductible	Limited unpaid losses & ALAE on reported claims + unlimited on un-asserted claims	None	Limited unpaid losses & ALAE on reported claims + unlimited on un-asserted claims	Optional/ no

Chapter 6: Summary of accounting standards (continued)

Accounting basis	Type of risk transfer	Balance sheet liability accrual	Balance sheet offsetting asset	Net result(liabilities minus assets)	Discounting /Risk margin
International Accounting: Non-Insurer	Employee Benefits (including WC): short term	Net of expected insurance recoveries	None	Net of expected insurance recoveries	No/No
	Employee Benefits (including WC): long term	Net of expected insurance recoveries	None	Net of expected insurance recoveries	Required/ No
	Other than Employee Benefits	Unlimited loss and ALAE	Same as GAAP	Same as GAAP	Required/ permitted

Footnote: Per accounting standards accruing for expenses is optional; however, accruing for ALAE is usual practice.

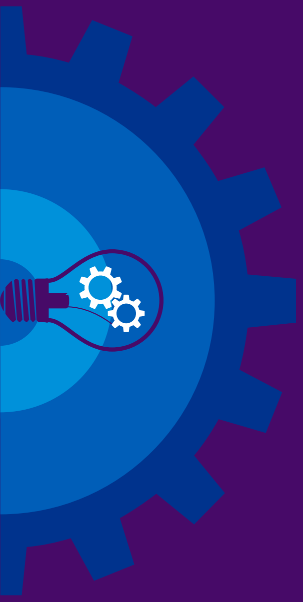
Chapter 1: What could Go wrong? Bankruptcy of insured entity vs. Insurer—By type of insurance

Type of risk transfer or type of entity	Insured entity goes bankrupt	Insurer goes bankrupt
Guaranteed cost	Commercial carrier still retains risk and pays claims.	Transferred to guaranty funds; possible cap on payments.
Retrospectively rated	Commercial carrier still retains risk and pays claims; commercial carrier has a creditor's claim for unpaid retro premiums.	Transferred to guaranty funds; possible cap on payments; liquidator may recover premium adjustments from insured.
Large deductibles	Commercial carrier still retains risk and pays claims; commercial carrier has a creditor's claim for unpaid deductibles.	Transferred to guaranty funds; possible cap on payments; liquidator may recover deductible payments from insured.
Self-insurers	Workers' compensation claims are transferred to a self-insurance guaranty fund if the state has one; other claimants become creditors.	
Captives	Captive insurer is usually an asset of the bankrupt entity; regulators will require that claims be paid before releasing any remaining funds.	If the captive covers the insured directly (e.g., a deductible reimbursement policy), it will be unaffected. If the captive reinsures the commercial insurer, it will be treated like any other insurer by the liquidator and may have to pay the full amount of reinsured claims even if the guaranty fund caps its claim payments.
Excess insurer	Excess carrier still retains risk and pays claims.	Excess losses transferred to guaranty funds; possible cap on payments; liquidator may recover premium balances from insured.

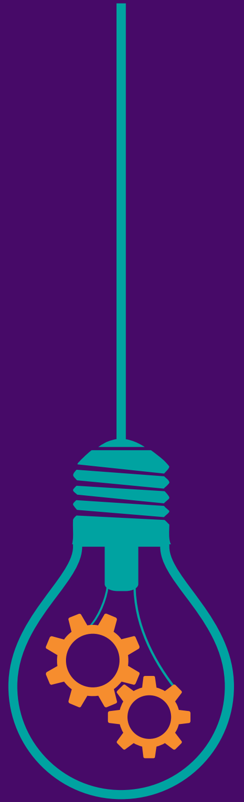
Appendix

Reserving and financial reporting for non-insurers

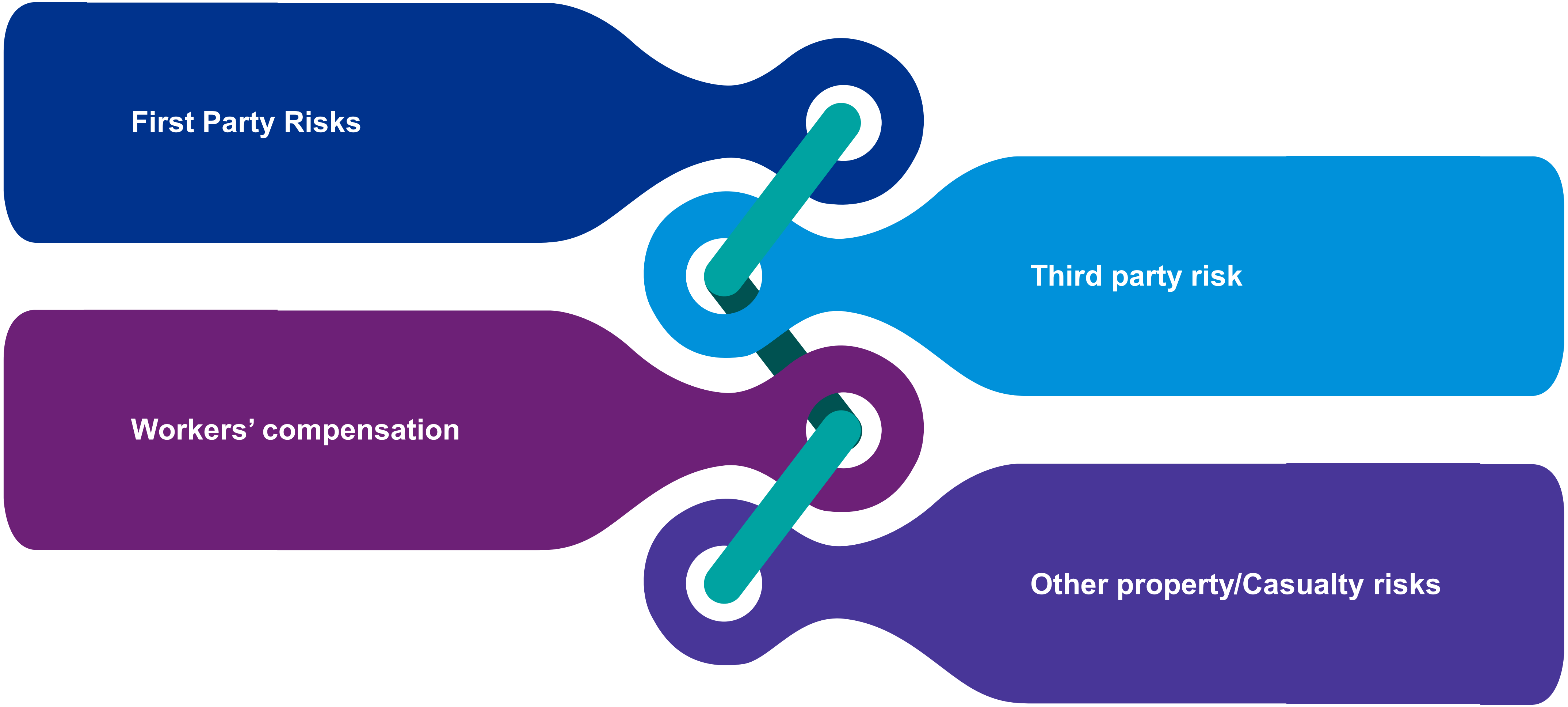
Chapter 1: Method of retaining risk and associated treatments



- Types of risk transfer
  - Guaranteed cost policies
  - Retrospectively rated policies
  - Self-insurance
  - Claims-made coverage
  - Captives
  - Trusts
- Risk transfer illustrated by bankruptcy



Chapter 3: Exposures and coverages



Chapter 4: Relevant actuarial concepts and considerations

- Intended purpose of the actuarial analysis
  - Adequacy of accruals for financial reporting
    - Key issues related to the presentation of indications
    - Key issues related to the comparison with recorded accruals
  - Internal financial reporting and cost allocation
  - Regulatory filing for a qualified self-insurance designation

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Concepts and considerations

Other considerations

Coverage or policy period

Key dates and interactions

Loss adjustment or claim adjustment expenses

Chapter 5: Applicable precepts and ASOPs

- Code of Professional Conduct
  - Precepts 3, 4, 8 and 10
- *ASOP No. 7* – Analysis of Life, Health or Property/Casualty Insurer Cash Flows
- *ASOP No. 13* – Trending Procedures in Property/Casualty Insurance
- *ASOP No. 20* – Discounting of Property/Casualty Unpaid Claims Estimates
- *ASOP No. 21* – Responding to or Assisting Auditors or Examiners in Connection with Financial Audits**, Financial Reviews, and Financial Examinations**

Chapter 5: Precepts and ASOPs

- *ASOP No. 23* – Data Quality
- *ASOP No. 36* – Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves
- *ASOP No. 38* – Models Outside the Actuary's Expertise
- *ASOP No. 41* – Actuarial Communications
- *ASOP No. 43* – Property/Casualty Unpaid Claim Estimates

Chapter 5: Precepts and ASOPs

ASOP No. 23 **– Data Quality**

ASOP No. 36 **– Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves**

ASOP No. 38 **– Models Outside the Actuary's Expertise**

ASOP No. 41 **– Actuarial Communications**

ASOP No. 43 **– Property/Casualty Unpaid Claim Estimates**

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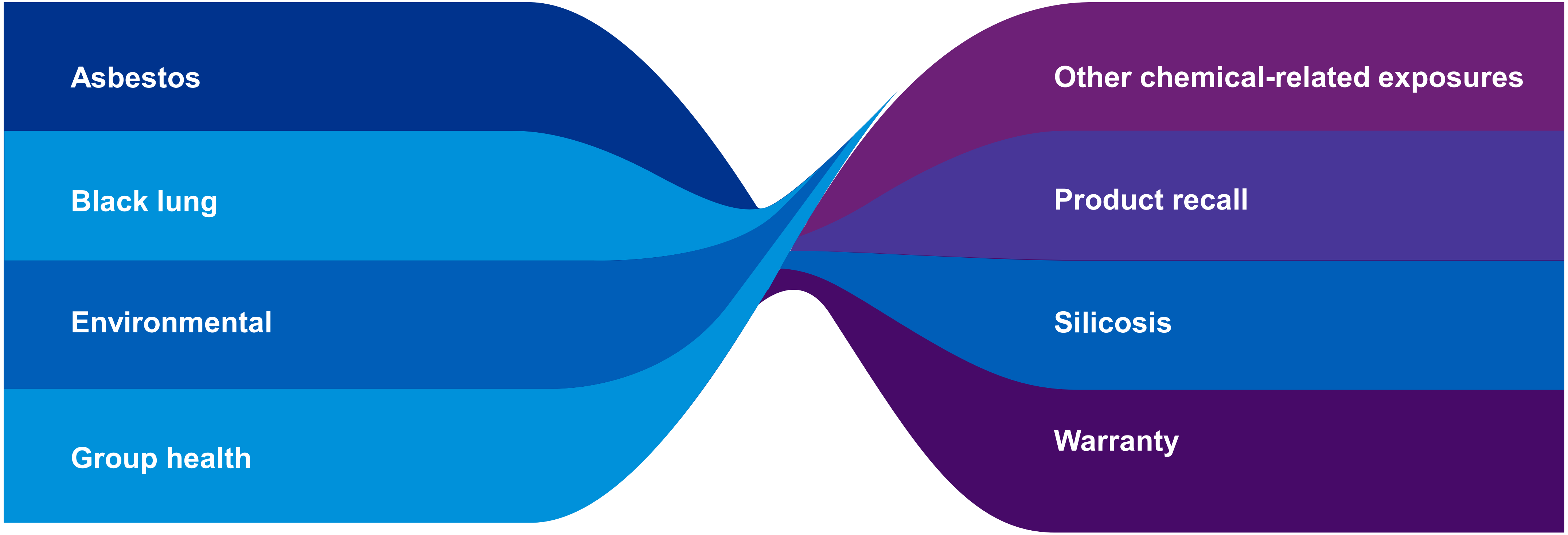
Chapter 8: Special situations and special treatments



Q&A

Reserving and financial reporting for non-insurers

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