

## A Recent History of the Statement of Actuarial Opinion, Solvency Regulation in the United States and Changes in the Actuarial Profession

*Commitment Beyond Numbers*



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### Panelist – Joseph A. Herbers

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- Managing Principal at Pinnacle
- Member of CAS, AAA and CERA
- Past member and Chair AAA Committee on Property and Liability Financial Reporting (COPLFR) for 13 years
- Faculty for AAA Seminar on Effective Loss Reserve Opinions
- Appointed Actuary for 20+ companies in 2013
- Author of paper on Materiality and SAOs (2004)
- 29 years consulting experience



## Panelist – Mary D. Miller

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- Senior Consulting Actuary at Risk & Regulatory Consulting LLC
- Member of CAS and AAA, President-elect of AAA
- 2011 Robert J. Myers Award for Public Service
- Former Asst. Director, Ohio DOI
- Past member and Vice Chair of CASTF
- Past member of COPLFR
- Faculty for AAA Seminar on Effective Loss Reserve Opinions
- Past CAS VP & Board Member



## Outline of Presentation

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- CAS and Actuarial Profession in 1980s
- Evolution of Profession, Solvency Regulation and SAO
- Timeline of events impacting actuarial profession and solvency regulation
- Changes to SAO over time
- SMI / ORSA

## Timeline

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- *1979:* OPEC, Love Canal, Hostages in Iran
- *1980-81:* Superfund, First SAO, AAA Qualification Standards
- *Early 80s:* No significant public interface
- *Late 80s/Early 90s:* Rapid development in the actuarial profession
- *1996 – 2001:* Elevation of profession in the public eye
- *2002 – 2007:* Challenging Times
- *2008 – Present:* Evolution of new approach to Solvency Monitoring

## CAS and Actuarial Profession in early 80s

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- Less than 1,000 CAS Members (CAS office had one PT meeting planner and 2 FT employees) in 1983
- Six actuarial organizations (CAS, SOA, ASPA, CAPP, CIA and AAA)
- No ASB, ASOPs, ABCD
- No CAS Statements of Principles
- SEC Reserve Disclosures in 1984
- Only a few states had SAO requirement
- NAIC establishes CATF in 1985
- IASB formed in 1985

### **P/C Insurance Industry Backdrop**

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- Superfund passed in 1980, imposing \$B in costs retroactively
- 49 Insolvencies in 1985 (5x average over past 20 yrs.); 15 related to deficient loss reserves
- Cash flow underwriting rampant (21% prime rate in 1980 declines to 12% in 1984)
- Combined ratio of 118 in 1984
- State mandated rate rollbacks, higher guaranty fund assessments, proposals to repeal McCarran-Ferguson popular in 1986 – 1990
- Hard Market of 1994-95; public entities going bare

### **Task Force on Strengthening the Actuarial Profession**

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- Formed by Council of Presidents in June 1987
- Charge was to explore how to strengthen the profession and consider whether restructuring was needed
- Conclusions:
  - AAA needed to be reorganized
  - All member organizations should encourage membership to join AAA
  - AAA and CIA sole organizations to establish standards of practice / conduct discipline proceedings

### Developments in 1988 - 89

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- ASB established
- CAS promulgates Statement of Principles on Ratemaking, Reserving and Valuation
- AAA issues Qualification Standards for signing SAOs
- ASOP 9 (Documentation and Disclosure in Property and Casualty Insurance Ratemaking, Loss Reserving, and Valuations) was adopted, incorporating the Statements of Principles formally into a Standard of Practice
- NAIC overhauls Schedule P reporting format

### Developments come rapid fire in early 1990s

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- Federal scrutiny
- A. M. Best Insolvency studies in 1990 and 1992
- ASB adopts several ASOPs
- ABCD formed
- Hurricane Andrew
- Tax Reform Act
- RBC

## Federal Regulators & P/C Insurance Industry

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- High profile insolvencies in 1986 (Transit Casualty, Mission, Integrity) catch eye of Washington DC
- Best's Insolvency Study (1990)
- Dingell Report (February 1990)
  - "Incredibly, the GAO found that 35 states have not implemented the independent audit recommendations, and 33 states do not require actuarial certification of reserve adequacy."*
- State regulators require SAOs of all P/C companies in 1991

## 1992

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- Second Best's Insolvency Study
- Hurricane Andrew
  - Category 5*
  - Landfall in Homestead FL*
  - \$15.5 Billion Insured Losses*
  - Two lessons learned:*
    - Exposure concentration a significant risk factor
    - Need for more sophisticated modeling for CAT exposure
- COPLFR issues draft guidance and illustrative wording (i.e., inaugural Practice Note)

## 1994

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- Best's A&E Study (March 28, 1994)
  - Outstanding claims liabilities of \$132 billion (at NPV)
  - Defined “survival ratio”
  - “Like it or not, the P/C industry is on the hook”
- Tax Reform Act
  - Proration (taxation on a portion of otherwise tax-exempt income)
  - Revenue Offset (only 80% of change in unearned premium reserve is deductible)
  - Discounting of loss and LAE reserves for tax purposes (AFR, loss payout patterns, vintage year)
- Risk Based Capital

## RBC

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- P/C RBC model measures
  - Asset Risk (affiliates, other)
    - Credit risk, interest rate risk, market risk
  - Insurance Risk
    - Underwriting risk, reserves risk, NWP risk
  - Business Risk
  - Covariance
- Model Audit Rule
- Risk focused financial analysis
- Uniform statutory accounting practices/procedures

## 1996 - 2001

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- Public perception and credibility of actuaries elevated
- Expanded scope of SAO
- Equitas formed to runoff Lloyds/UK market claims
- Codification
- ASOP 36
- 9/11

## 1996

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- SAO must exclude Sch P penalty (i.e., excess of statutory over statement reserves)
- Disclosures regarding tabular vs. non-tabular discounting
- Equitas formed – designed (in part) to moderate uncertainty in reserve estimates



## 1997

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- New A&E disclosure in SAO
- Disclosure regarding company practice for accruing for reporting lag from pools & associations
- Extended comments required for significant types of losses and major risk factors that may materially affect the variability of reserves

## 1998

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- Codification exposed but not required until 2001
  - Removed Sch P penalty
  - Management must book its best estimate of loss and LAE reserves in total and by line
  - PDR applies in SAP
- Scope of SAO expanded to include UEPR for long duration contracts
- Changed ALAE/ULAE to DCC/A&O

## 1999

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- Scope of SAO expanded to include DD&R
  - As disclosed in Sch P Interrogatories
  - Loss reserves
  - Unearned premium reserves
  - Direct v Net
  - MPL only or all Professional liability?
- Y2K Disclosure

## 2000

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- ASOP 36 adopted
  - Range v Point Estimates
  - Materiality
  - RMAD Disclosure
  - Defined 5 (and only five) types of Opinions
  - Reliance on Others
- Electronic filing of SAO

## 2001

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- 9/11
- Scope of SAO expanded to include retroactive reinsurance reserves assumed
- Disclosure to insurance company BOD that actuarial report in support of SAO is available.
- New disclosures if Reliance on Another
- Disclosure regarding impact of terrorist attacks

## A Crisis of Confidence Emerges (2002 – 2007)

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- Sarbanes-Oxley (Section 404)
- S&P Report
- CRUSAP Report
- Morris Report
- Task Force on Actuarial Credibility

## 2003

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- S&P Article on “Insurance Actuaries – Crisis of Credibility”
  - *“Actuaries are signing off on reserves that turn out to be wildly inaccurate.”*
  - *“Whether by naïveté or knavery, the property/casualty industry's ongoing parade of reserving additions has undermined confidence in the estimates given by insurance actuaries.”*
- Fitch Special Report “Property/Casualty Insurance Reserves at Year-end 2002: Filling in the Hole — Slowly”
  - *“in many recent cases, reserving shortfalls are attributable to a failure in the actuarial process, as opposed to purposeful ‘cheating’ on the part of management.”*

## 2004 – A Year of Extensive Changes to SAO

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- Mandatory Exh A and Exh B
- Explicit RMAD disclosure required – Yes or No
- Disclose materiality standard used for the RMAD disclosure
- Disclose name/affiliation of person at Company upon which the Appointed Actuary relies upon for data
- Disclose difference between the actuary's indicated reserves and company held reserves
- Disclose reconciliation of the data used in the actuarial analysis to Schedule P
- Extended comments on unusual IRIS test ratios required
- New CATF Regulatory Guidance Memo - Bright Line Indicator
- New Data Testing Requirement for Auditors
- New SAO for CA WC

## 2005 – More Changes

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- New Actuarial Opinion Summary (AOS) document required
- Process for changing AA spelled out in detail
- AA provides formal Practice Note on RX testing for reinsurance contracts (new attestation requirement for RX)
- First AAA Reserve Opinion Seminar (Oct. 2005)
- First “Regulatory Guidance Memo”
  - Explicit RMAD statement
  - Basis for materiality standard
  - AA awareness of RX features in reinsurance contracts  
*note new COPLFR study on RX / introduces concept of ERD to public*
  - Meaningful discussion of factors leading to IRIS test results outside normal range

## More Bad News for Actuaries in 2005

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- Morris Report (UK) - Identified several serious problems facing actuarial profession:
  - Insularity in methods and approach;
  - Insufficient emphasis on the uncertainties inherent in long-term financial planning;
  - Insufficient transparency in actuarial advice;
  - Concern about reserving certain roles to actuaries; and,
  - Widespread perception that the actuarial profession had not responded as effectively or as fast as might have been expected to major changes in both demographics or economic conditions in the UK in the last decade or more.
- “Actuarial Profession at a crossroads in the UK”

## CAS becomes Introspective

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- Study causes of credibility gap
- Consider steps to enhance public understanding of SAO
- Restore confidence in profession
- Task Force on Actuarial Credibility report (May 2005):
  - Enhance transparency of actuarial findings by identifying differences between management's best estimate with that of AA
  - Enhance public's understanding of actuarial estimates
  - Enhance transparency of actuarial disclosures – change from prior year
  - Enhance quality of corporate governance – educate audit committees on roles and responsibilities of AA

## AAA Reserve Opinion Seminar (Introduction)

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- Why were we there in Oct. 2005?
- Actuaries are in the News
- High profile insolvencies related to adverse loss development
- Credibility of Actuary a fundamental problem
- SAO is a highly visible part of our work
- ABCD is not always the right solution
- AAA wants to help

## AAA & CRUSAP Report

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- Recommendations from Critical Review of U.S. Actuarial Profession Report (Dec. 2006; commissioned in May 2005)
  - Encourage individual actuaries to gain sufficient knowledge to speak out on actuarial elements of major public issues
  - Require active members of the actuarial profession to meet consistent continuing education requirements
  - Sponsor research to enhance the ability of the profession to meet the actuarial needs of the public
  - Establish a joint disciplinary process for the profession, independent of the individual actuarial organizations
  - Require training and demonstrated proficiency in communications skills as part of the basic education and qualification of actuaries
  - Establish consolidation of the U.S. actuarial profession as a goal of the profession

## Changes for 2006

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- Title Opinion Instructions rewritten
- Clarification that AOS is a separate document from SAO
- New CATF Guidance
  - Interpretive Opinion 02-21

### Minor Changes for 2007

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- SAO must be submitted electronically
- Figures in Exhibit B should be net unless otherwise indicated
- New disclosure regarding name, affiliation, credentials of AA and relationship to Company

### Qualifications Standards for Actuaries Issuing Statements of Actuarial Opinion in the U.S. (1/1/08)

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- *General Qualification Standard* – Continuing Education requirement of 30 hours annually that is “relevant to the subject of the SAOs that they issue.”
  - 3 hours must relate to Professionalism
  - 6 hours must involve organized activity
- *Specific Qualification Standards* – 15 hours annually; at least 6 of 15 hours must involve interaction with outside actuaries or other professionals.



## 2008 Changes

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- Clarification regarding intercompany pooling
  
- Regulatory Guidance Memo
  - Provide comments on new/unusual exposures
  - Coverage for Service Contracts
  - D&O Excess Coverages
  - Economic Conditions (coincident with meltdown of financial markets in 4<sup>th</sup> quarter of 2008)

## 2010

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- Sch. P Interrogatories amended to refer to MPL only
  
- Changes to Note 30 to Financial Statements relative to PDR
  - Disclose \$ amount
  - Disclose date of last review
  - Disclose whether or not investment income was considered
  
- Regulatory Guidance Memo
  - Proper documentation of Sch. P reconciliation
  
- AAA (COPLFR) document “An Overview for Audit Committee Members of P/C Insurers: Effective Use of Actuarial Expertise” added as Appendix to Practice Note

## 2011 Developments

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- Revised ASOP 36 – must disclose:
  - Intended users and intended purpose of the SAO
  - Stated basis of reserve presentation
  - Whether any material assumption or method was prescribed by law or regulation
  - Whether the actuary disclaims responsibility for any material assumption or method that originated from another source
  
- ASOP 9 repealed
  
- Include e-mail of AA in signature block of SAO

## 2011 (cont.)

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- Regulatory Guidance Memo offers suggestions on documentation in Actuarial Report
  - Expected Loss Ratios
  - Actuarial Judgment
  - Changes since prior year
  - Describe AA role in advising Company regarding carried reserves; manner in which Actuarial Report and/or findings is presented to Company BOD
  
- Practice Note adds suggested language regarding
  - Review date and Accounting Standard per ASOP 41
  - Reliance on Others per ASOP 36

## 2012 Changes

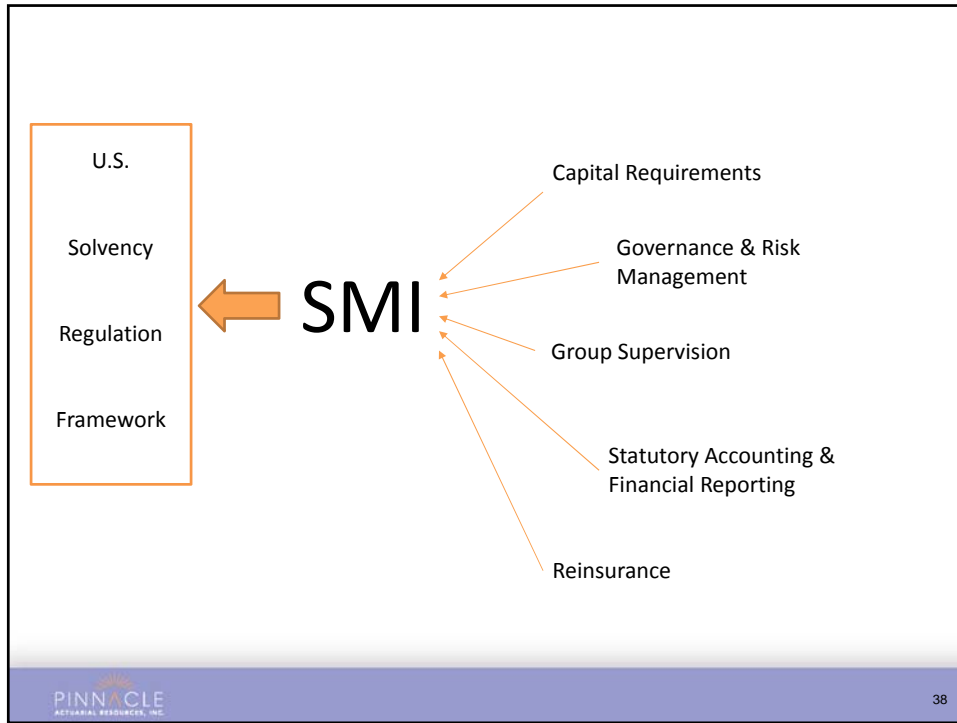
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- New disclosures regarding change in AA
  - Category of Opinion Issued
  - Wording of Opinion itself
- Define actuarial report
  - Amended to include BOD as intended audience
- Regulatory Guidance Memo
  - Guidance regarding Review Date
  - Expectations if errors found in AOS
- SAO Instructions amended to include disclosures from 2011 Regulatory Guidance Memo

## NAIC Solvency Modernization Initiative (SMI)

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- Recommend changes to SAP in light of international developments (IAIS Insurance Core Principle 16, IFRS, Solvency II)
- Balance goals of:
  - Transparency
  - Policyholder considerations for information
  - Disclosure
- Initial discussion of framework began in 2008
- Changes to RBC?
- Incorporate ERM into solvency monitoring



### U.S. Insurance Financial Solvency Core Principles

1. Regulatory Reporting, Disclosure & Transparency
2. Off-Site Monitoring & Analysis
3. On-Site Risk Focused Examinations
4. Reserves, Capital Adequacy and Solvency
5. Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities
6. Preventive and Corrective Measures, Including Enforcement
7. Exiting the Market and Receivership

## SMI – Actions by NAIC

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- Insurance Holding Company System Regulatory Act (Model #440)
- Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (Model #450)
- Risk Management and Own Risk and Solvency Assessment Model Act (#505)
- Own Risk and Solvency Assessment (ORSA) Guidance Manual
- Adoption of the Existing U.S. Corporate Governance Requirements
- Adoption of updates to the Standard Valuation Law (Model #820)
- NAIC adoption of revised reinsurance supervision:
  - Credit for Reinsurance Model Law (Model #785)
  - Credit for Reinsurance Model Regulation (Model #786)

## Capital Requirements

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- RBC has been around since 1994
- Formulas, factors and methodologies have evolved over past 20 years
- Calibrated to identify weakly capitalized companies
- Not designed to estimate economic target levels for capital
- RBC will remain in place as floor for triggering regulatory intervention
- Ongoing studies of risk factors in RBC
  - New CAT risk charge
  - Increase granularity of asset and investment risk charges
  - Refine credit risk charge for reinsurance recoverables
  - New Operation risk charge

## Governance and Risk Management

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- On-site examinations currently cover this
- ORSA tool essential in this step
- Adopted Own Risk Solvency Assessment Model Act (#505)
- ERM Education for Regulators

## Group Supervision

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- Group supervision currently performed under
  - Insurance Holding Company System Regulatory Act (#440)
  - Insurance Holding Company System Model Regulation with Reporting Forms & Instructions (#450)
- Windows & Walls approach
  - Enhance models and monitoring to provide clearer *windows* into group operation
  - Build upon existing *walls* providing solvency protection
- Group Solvency Issues (E) Working Group

## Statutory Accounting & Financial Reporting

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- Current system provides for consideration of changes to GAAP pronouncements
- Wait and see approach to developments in IASB/FASB Insurance Contracts projects
- Likewise SEC Decisions regarding IFRS

## Reinsurance

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- Amendments to the Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786)
- Financial Regulation Standards and Accreditation (F) Committee adopted revisions to the accreditation standard for reinsurance ceded reflecting key elements from revised Models #785 and #786
- Certification process for reinsurers (states retain authority to recognize certification)
- “Qualified jurisdictions”
- Certified reinsurer eligible for collateral reduction (reductions correspond to rating)

## ORSA is Coming

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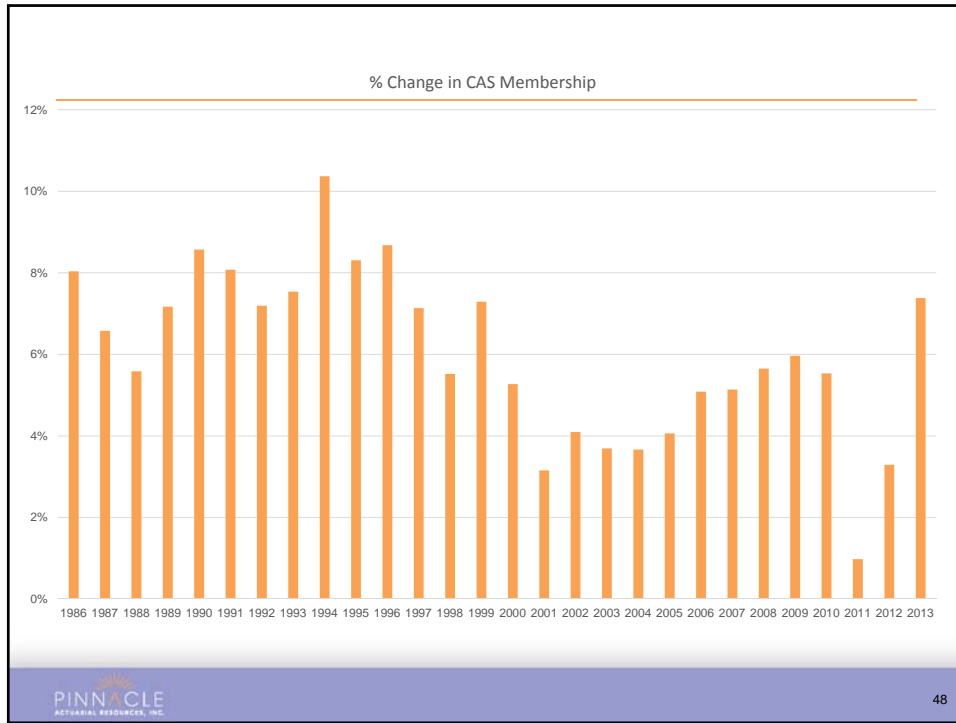
- Required of all insurers in New York
- ORSA Guidance Manual
  - Specify safety level and time horizon
- What's coming next?
  - Expanded AOS?
  - PDR Opinion?
  - Solvency Opinion?
  - More Rate Certification Opinions?

## Where will the Actuarial Profession Go?

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- Merger of SOA/CAS?
- New CAS Brand
- Will the AAA become stronger or weaker?
- Will each society have its own public interface?





## Thank You for Your Attention

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