

2005 Casualty Loss Reserve Seminar

Session 7:

Atypical Circumstances in Statements of Actuarial Opinion on P&C Loss Reserves: Professional Considerations and Sample Wordings

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This document is incomplete without the accompanying discussion; it is confidential and intended solely for the information and benefit of the immediate recipient hereof.

Introduction

- Statements of Actuarial Opinion (SAO) are an important manifestation of actuarial work
 - Present actuarial conclusions
- Focus on required SAO attached to financial statements
- US Statutory framework
 - However, underlying considerations applicable elsewhere as well
- Wordings based on our interpretation
 - Other wordings reasonable
 - Based on appointed actuary's interpretation of the principles applicable to the particular situation

Relevant Standards and Principles

- Obvious
 - Annual Statement Instructions
 - ASOP #36
 - ASOP #9, #41
 - Practice Note provides additional guidance
- But don't forget...
 - ASOP #20, #23
 - Code Of Conduct
 - Statement of Principles
 - Other

ASOP #36

- The most important ASOP related to SAO
 - Definitions
 - Uncertainty
 - Range of reasonable estimates
 - Significant risk of material adverse deviation
 - Important factor in most atypical circumstances and SAOs

- Additional emphasis beginning with 2004 opinions
 - NAIC instructions incorporate portions of ASOP #36
 - Comment on significant risk of material adverse deviation (RMAD) required
 - Disclosure of materiality standard required

Reasonable Reserves

- ASOP #36: Reasonable Reserve is
 - A reserve that falls within “... a range of estimates that could be produced by appropriate actuarial methods or alternative sets of assumptions that the actuary judges to be reasonable”
- “Reasonable” does not mean:
 - “Prudent,” “proper,” “adequate,” or other terms
 - Does not depend on the solvency of the company
- These considerations imply some judgments beyond estimation of reserves
 - Best handled with additional disclosures

Key Considerations

- Purpose of the opinion
- Knowledgeable user
- No guarantee
- Materiality
- Focus on loss reserves
 - However, some financial analysis required
 - Some limited review of other balance sheet and income statement items necessary

Purpose of the Opinion

- Solvency monitoring
- SAO needs to
 - Opine on held reserves
 - Disclose relevant issues
 - Flag material issues/risks

Knowledgeable Users

- Regulators
- Can presume knowledge of
 - Key industry considerations
 - Insurance accounting
 - The Company

Materiality

- General approach is to consider how user will be influenced
 - An item is material if it would change the user's interpretation of the situation
- Depends on the context
 - Solvency monitoring - might imply a standard based on surplus
 - Actuarial appraisal – might imply a standard based on net income or net worth
- Involves qualitative and quantitative considerations

Atypical Situations

- Financially Weak or Insolvent Company
- Reserve Leverage
- Reinsurance Collectibility Concerns
- Exceptional Values on IRIS Tests
- Unquantifiable Situation
- Change in Operations, Data availability
- Non-Tabular Discounting
- Significant Claim
- Uncertainty

Implications

- Atypical situations usually involve
 - Disclosure of risks and uncertainties
 - Modified opinion section language
- The SAO should inform the reader of the consequences of
 - The reserve
 - Uncertainty inherent in the reserve

Financially Weak or Insolvent Company

- Definitions may include
 - Negative surplus
 - Surplus below some key indicator, such as a Risk Based Capital (RBC) threshold
 - Positions within range of reasonable estimates would cause low or negative surplus
- Implications
 - Solvency monitoring
 - Effect on indications
 - Viability of the Company
 - Ability to express an opinion

Financially Weak or Insolvent Company – Solvency Monitoring

- Reasonably expected fluctuations in reserves may cause material changes in surplus
 - Large percentage of surplus
 - Cross key solvency monitoring threshold
- Requires disclosure of significant risk of material adverse deviation. e.g.,

*The Company's carried reserves are within a reasonable range, however **other points within the range would cause surplus to be below zero**. Therefore I believe that there are significant risks and uncertainties that could result in material adverse deviation in the loss and loss adjustment expense reserves, possibly by amounts exceeding surplus.*

Financially Weak or Insolvent Company – Viability of the Company

- Viability of the Company
 - Implicit assumption in most actuarial analyses
 - Negative or low surplus casts significant doubt on this assumption
 - May be caused by reasonably expected fluctuation
- Disclosure example:

*The financial condition of the Company creates an additional risk factor. My analysis of reserves implicitly assumes the Company is viable. **If it is not viable (e.g., due to developments such as regulatory actions, inability to meet claim payments, etc.), reserves may be affected in ways that cannot be quantified at this time.***

Financially Weak or Insolvent Company – Ability to Express an Opinion

- Implications
 - Reserves may be reasonable based on assumption of viability
 - However, uncertainty regarding viability may make it impossible to express an opinion
 - “No Opinion” opinion should be considered
- Opinion wording example:

Because of the uncertainties noted above I cannot express an opinion on the carried loss and loss adjustment expense reserves.

Reserve Leverage

- Reasonably expected reserve fluctuations may be material
- Disclosures may be required, even if viability not threatened. e.g.,

*The Company's reserves are large in relation to surplus. As a result, **reasonably expected fluctuations of actual versus expected results may be material to surplus.** Consequently, I believe that there are significant risks and uncertainties that could result in material adverse deviation in the loss and loss adjustment expense reserves. In consideration of the use of this opinion for purposes of solvency monitoring, I consider \$Y, calculated as X% of surplus to be material for this Company.*

Reinsurance Collectibility Concerns

- Accounting rules and applicable law govern cessions that are recorded
 - Not the actuary's role
- The actuary needs to evaluate the consequences of cessions
- Issues could include
 - Cessions to troubled reinsurers
 - Disputes with reinsurers

Reinsurance Collectibility Concerns (Cont'd)

- If material, disclosure required. e.g.,

*As noted above, the Company cedes an amount of loss and loss adjustment expense reserves that is material to (or exceeds) its surplus to a troubled reinsurer. **While the probability of failure to collect the full amount of the ceded reserves from this reinsurer is unknown, it is more than remote.** Therefore I believe that there are significant risks and uncertainties that could result in material adverse deviation in the loss and loss adjustment expense reserves. In consideration of the use of this opinion for purposes of solvency monitoring, I consider \$Y, calculated as X% of surplus to be material for this Company.*

Exceptional Values on IRIS Tests

- Required Disclosure
- 2004: Extended comments in the Actuarial Report will be required
- Key considerations
 - Prior year carried reserves vs current evaluation
 - Implicit assumption is that test result is predictive of future changes in current reserve
 - If current reserves are reasonable, irrelevance of failed test must be explained

Exceptional Values on IRIS Tests – One and Two-Year Reserve Development (Tests 10, 11)

- Causes may include
 - Adverse development on prior years
 - Change to inter-company reinsurance arrangements
- Possible disclosure:

The Company shows an exceptional value for IRIS Test 10, One Year Reserve Development to Surplus. The exceptional value on Test 10 is due to significant adverse development during the most recent calendar year related to reserves for [asbestos, pollution, construction defect, reinsurance assumed] losses. The associated parameters in my analysis of the loss and loss adjustment expense reserves have been modified accordingly. Therefore, I do not believe that this test indicates a deficiency in the current reserves.

Exceptional Values on IRIS Tests – Estimated Current Reserve Deficiency (Test 12)

- Measures “required” reserves to premium ratio based on prior years ratios
 - Uses developed reserves for prior years
- Causes may include
 - Rate level activity
 - Change in mix of business
 - Change in inter-company reinsurance arrangements
 - Other
- Not caused by adverse development on prior years’ reserves
 - Test based on current estimates

Unquantifiable Situation

- Developing legal proceedings
- Exposure may be negligible or highly significant
- Reserves may be reasonable, but uncertainty much greater than usual
- Disclosure should be considered

Change in Operations, Data

- Changes might include
 - Policy terms
 - Lines or exposures written
 - Claims
 - Underwriting
- Change increases uncertainty of estimates
 - Wider range of reasonable estimates
- Disclosure may be required. e.g.,
*I have identified additional risk factors as the **lack of detailed statistical information for some of the Company's segments of business, and recent changes in the claim handling and case reserving practices of the Company.** The potential impact of these risk factors is unknown at this time*

Non-Tabular Discounting

- Use requires special permission of domiciliary state
 - Disclosed in Notes to Financials
- SAO guidance in ASOP #36 and #20
 - Required comment
 - Disclose basis
 - Disclose amount
 - Disclose if interest rate not included in opinion
- Should also disclose how reflected
 - Contra-liability
 - Reflected in carried reserves

Non-Tabular Discounting (Cont'd)

- Possible disclosure:

*With the **permission** of the (state) Department of Insurance, the Company reflects in the details of write-ins section of the Liabilities, Surplus and Other Funds page a **contra-liability** for the discount related to its net loss and loss adjustment expense reserves based on an **actuarially determined payment pattern and a Y% interest rate**. I am not expressing an opinion on this rate. The amount of discount is \$X.*

Significant Claim

- Possibility of one claim that is large in relation to total reserves
- Situations include
 - Company in runoff
 - New company
 - Low frequency/high severity coverage

- Example:

*The Company wrote liability coverages with policy limits that are large in relation to reserves. **Consequently, it is possible that a single claim could occur that would represent a high percentage of reserves.** This situation represents a risk factor that exposes the Company's loss and loss adjustment expense reserves to variability.*