

Casualty Loss Reserve Seminar

Corporate Governance and the Loss Reserving Process

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Opening Thoughts

What is "governance"?

- *n* . The act of developing and managing consistent, cohesive policies, processes and decision rights for a given area of responsibility.

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Our Observations

Section 1

Corporate Governance and the Loss Reserving Process

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Our Observations

Raising the Bar on Reserving Controls

Sarbanes-Oxley - Four Years Later . . .

- Some companies embraced the concepts regarding a strong control environment,
while . . .
- Others have the minimum level of controls to accomplish the requirements for managements and external certifications
- Many companies lie somewhere between each of these ends of the spectrum

Raising the Bar on Reserving Controls

Benefits from having a strong control environment:

- Greater efficiency in operation
- Reduced risk of reserve misstatement
- Reduced likelihood of surprises
- Few or no deficiencies in controls
- More effective and more efficient external audit
- Smoother regulatory exam

Raising the Bar on Reserving Controls

Concerns with operating at the minimum level of controls:

- Reduced efficiency in operation
- Increased risk of reserve misstatement
- Increased likelihood and frequency of surprises
- Several deficiencies in controls
- Inefficient external audit – time spent debating and assessing deficiencies
- Less efficient regulatory exam

Section Two

Corporate Governance and the Loss Reserving Process

Defining a Best Practices Reserving Process

Our Observations

Key Elements of the P/C Reserving Process

1. Management and board involvement
2. Actuarial staffing and expertise
3. Data quality and reliability
4. General reserving approach (frequency of reviews, level of detail, gross vs. net, etc.)
5. Reserving methodology
6. Documentation of reserving process
7. Use of external actuaries
8. Financial statement disclosures

Maturity Framework

- *1 = Minimal* - operating near or at the minimum level needed for management to complete their attestation (and an audit) in a timely manner.
- *2 = Developing* - reserving process not well standardized, significant changes – sometimes it is smooth, timely and efficient, other times it is not; numerous gaps and shortcuts exist.
- *3 = Accomplished* - reserving process is well standardized – generally smooth, efficient and timely; however, some gaps and shortcuts still exist.
- *4 = Optimal* - operating at the Gold Standard – a best practices process.

Management and Board Involvement

Characteristics of a strong control environment

Management's commitment to a strong control environment:

- Prioritize/commit necessary resources (staffing, systems)
- Minimize potential conflicts of interest (e.g., pricing/reserving)
- Understand/challenge reserve approach, methods, key assumptions
- Proactively monitor changes in estimates

The audit committee:

- Monitor/evaluate policies, principles and internal controls around reserve setting process and effectiveness of related disclosures
- Meet regularly with internal and external actuaries

Actuarial Staffing and Expertise

Characteristics of a strong control environment

Best practice companies have these qualities:

- Appropriately credentialed actuaries who participate in continuing education
- Staffing levels are of sufficient quantity and quality
 - To allow for appropriate frequency of review
 - Proper level of expertise for the type of exposures
- Reserving personnel independent of Underwriting and Pricing personnel
- Chief Actuary/lead reserving actuary responsible for:
 - Internal actuarial reserving estimate
 - Presenting estimate and appropriate support to senior management

Data Quality and Reliability

Characteristics of a strong control environment

Themes consistent with a strong control environment:

- Loss/premium/other actuarial data is usable for reserving as captured and contained in the company's systems
- Limited or non-existent manual processing
- Data is available in a timely manner for actuarial review
- MGA/TPA interfaces are well controlled and monitored
- Data adjustments for FX and intercompany reinsurance are handled accurately and transparently

General Reserving Approach

Characteristics of a strong control environment

Frequency of Reviews

- Quarterly analysis without a quarterly lag for most exposures; more complex exposures might require lag with AvE for latest quarter.
- A&E, other non-traditional exposures – annual analysis with robust quarterly monitoring.

Gross vs. Net of Reinsurance

- Analyses completed concurrently
- Same depth of analysis for gross and net reserves

Use of Reasonableness Checks

- Loss ratios, IBNR/case, other metrics are standard outputs

Use of Software

- Standardized, well controlled, flexible reserving software
- Ad hoc spreadsheets are used sparingly and with appropriate controls

Defining a Best Practices Reserving Process

Reserving Methodology

Characteristics of a strong control environment

Use of best methods available for the circumstances

- Method not based on ease of application
- Inferior methods not accepted long term as appropriate where there are data limitations

Regular input from with claims, underwriting, reinsurance, etc.

Information is shared among multiple locations, business units

- Broader/global approaches are used

Effective price monitoring

- Reserving actuaries team with pricing actuaries, underwriters to obtain appropriate price monitoring information

Documentation

Characteristics of a strong control environment

Comprehensive documentation of reserving process in a single report or location, including:

- Premium and loss data (reconciled to financial records)
- Actuarial estimates as applied to the data
- Schedules summarizing the actuarial estimates

Documentation also exists to demonstrate:

- Effectiveness of peer review
- The decision-making process for determining management's best estimate
- Evidence that management's best estimate equals amounts recorded in the financial statements
- Where recorded amounts differ from internal actuarial estimates, a record that qualitatively and quantitatively supports why management believes the recorded amount is better than the actuarial estimate

Use of External Actuaries

Characteristics of a strong control environment

External actuaries can add value to the reserving process

- May be considered more independent, objective
- Expertise/information not available to company e.g. non-traditional claims
- Differences between internal and external actuarial estimates can highlight areas for additional review
- Can provide insights based on a broad industry perspective
- Value in having the external actuary report to the board and/or audit committee

Financial Statement Disclosures

Characteristics of a strong control environment

Disclosures are clear, understandable, and include:

- Management's process
- How management arrives at its best estimate
- Ranges/other metrics to provide transparency around uncertainty of estimates
- Explanation of prior period development, even if increases in one line or accident year offset reductions in another line or accident year
- Other information that would be useful e.g. global loss triangles for global insurance companies

Section Three

Corporate Governance and the Loss Reserving Process

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Our Observations

Key Findings from Our Internal Survey

Management and Board Involvement

- Management's oversight of the reserving process is generally strong; audit committee involvement is less consistent, and in many cases there is room for improved oversight

Actuarial Staffing and Expertise

- Most companies are appropriately staffed; two common areas for improvement: separation of pricing and reserving functions, which we believe improves objectivity, and frequency of meetings and interaction between lead reserving actuaries and senior management

Data Quality

- Personal and smaller commercial lines companies tend to have much better data quality than larger commercial lines and reinsurance companies.

Key Findings from Our Internal Survey, continued

Reserving Approach/Methodology

- Most companies apply appropriate methods, and have a reserving process that has a reasonable balance of inputs from actuarial, underwriting, and claims departments
- Common areas where companies fall short of Optimal include the frequency of reviews, as many companies do not perform full reviews each quarter, and the rigor of the approach to difficult-to-estimate liabilities, such as A&E, D&O and property catastrophes

Documentation

- Vast improvements in the post-Sarbanes environment
- A common area of potential improvement involves support for the recorded amounts in cases where such amounts differ from internal actuarial indications

Key Findings from Our Internal Survey, continued

Use of External Actuaries

- A clear majority of companies involve external actuaries annually, in particular for difficult-to-estimate liabilities, as part of its corporate governance of reserves, a result of a trend toward greater use of third party actuaries in the post-Sarbanes environment
- A common area of improvement involves documentation of the reasons for differences in views between the external actuaries and management and management's consideration of such differences in the reserve setting process

Disclosures

- Actuaries are typically very involved in developing reserve disclosures
- Areas for improvement: description of the reserving process, in particular management's approach to selecting its best estimate, and providing greater insight via ranges or other metrics on reserve variability

Discussion



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