CLRS Difficult Situations in Statements of Actuarial Opinion September 2010

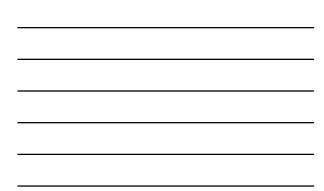
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Agenda

Types of Opinions Difficult Situations – Definitions and Mitigation Difficult Situations – Types and Examples

Types of Opinions Five Types of Opinions Opinion Types • Reasonable • Deficient or inadequate • Redundant or excessive • Qualified • No opinion • No opinion • Strist three opinion types based or the actuary's "range of reasonable estimates" • All opinion types can involve a difficult situation. • All opinion types can involve a difficult situation.



Types of Opinions

Range of Reasonable Estimates

- Confidence interval approach
- Margin (provision for adverse deviation)
- Scenario testing
- Results of several methods or set of assumptions
- Fixed percentages around a central estimate

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Types of Opinions

Reasonable Opinion

- Reserve is within the actuary's range of reasonable estimates
- Most opinions (For NAIC opinion, 99% for 2008)
- When is a reasonable opinion a potential difficult situation?
- Reserve at low end of the actuary's range
- Volatility of components of the reserve may define a large range
- Reserve high relative to surplus
- Track record of adverse development
- Recognition of the issue
- Disclosure and risk of material adverse deviation

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Types of Opinions

Deficient or Inadequate Opinion

Reserve is less than the minimum the actuary considers reasonable
 Below low end of the range of reasonable estimates

- NAIC and ASOP No. 36 require difference to be disclosed
- Rare (For NAIC opinions, 2 for 2008)
- More common for gross than for net
- Is this always a difficult situation?
- Often disagreement between management and actuary

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Types of Opinions

Is it a Reasonable or Deficient Opinion? Situations on the Bubble

- Difference in view or need more information on the following areas
- Changes in Operations
- New markets
- Optimistic assessment of re-underwriting
- Tort system changes
- Economic Environment Changes
- Low volume, immature data

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Types of Opinions

Whether a Reasonable or Deficient Opinion Consideration and Disclosures if on the Bubble

- Considerations
- Fact based approach
- Appropriate weight to management's interpretation
- Documentation of assertions by management
- Range considerations
- Adherence to actuarial standards and principles
- Disclosures
- Risk of material adverse deviation
- Surplus implications
- Viability of the company

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Types of Opinions

Redundant Opinion

- Reserve greater than maximum the opining actuary considers reasonable
- Above the actuary's range
- NAIC and ASOP 36 disclosure of the amount it exceeds the maximum
- Rare: 12 in 2008
- Why aren't there more?
- Conservatism to the range
- Knowledge and documentation of the variability of the particular reserve
- Sensitivity test

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Types of Opinions

Is It a Redundant or Reasonable Opinion? Situations on the Bubble

- Situations
- Run-off
- Significant surplus
- Highly volatile lines
- Complications
- Potential management of earnings
- Tax consequences

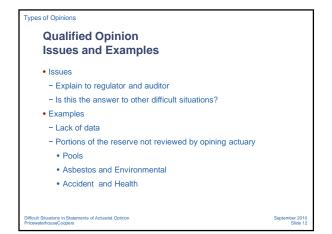
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Types of Opinions

Qualified Opinion

- Significant portions of reserve cannot be reasonably estimated
- Management still has a best estimate of these reserves
- Materiality considered before adding qualification
- The other portions of the reserves of the company can be estimated and have an opinion associated with them
- Rare: 10 in 2008
- Disclosures significant

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Types of Opinions No Opinion Actuary cannot reach a conclusion — Management still has a best estimate of these reserves Rare: 6 in 2008 Situations — Data limitations — New company — Lack of reliable analysis — Inability to make reasonable assumptions

- mability to make reasonable assumptions
- Lack of viability of the company

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Types of Opinions

No Opinion Issues

Issues

- Management's view
- Explain to regulator and auditor
- Is this the answer to other difficult situations?
- Disclosures Extensive
- Highly judgmental situation

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Difficult Situations

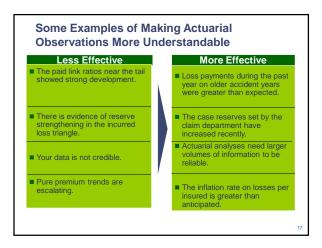
Statements of Actuarial Opinions What makes a Situation Difficult?

- Bearer of bad news
- Different perspectives of management and actuary
- Current versus prior view
- Timing Not enough time to react
- Inherent nature of loss reserves
- Dynamic and variable nature of reserves
- Imperfect data
- Assumptions and Judgments

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Frequently Encountered Difficult Situations

- Significant changes in estimates by the actuary
- Risk of material adverse deviation
- Low Surplus
- Actuarial Opinion Summary (AOS) adverse development trigger
- Reinsurance and risk transfer
- Changes in actuary

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Significant Changes in Estimate by the Actuary Common Causes

- Interpretations of changes in operations
- Emerging claims issues
- Changing development patterns
- Higher case reserves
- Lower loss payments
- Changes in tort system
- Lack of information about data trends
- Greater level of optimism by the Company

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Difficult Situations

Risk of Material Adverse Deviation An example

"In my opinion there is a risk of material adverse deviation...including uncertainties associated with the company's changing mix of business and operations,...liabilities relating to the Company's discontinued operations, potential reinsurance collectability issues and estimates of liability for the Company's A&E exposure."

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Low Surplus

When surplus is low:

- Reserves can be reasonable
- Reserves can be less volatile than typical
- Operations could have been stable in the past
- · Low materiality threshold causes virtually all risks to be significant
- Viability of the company is at stake. If control of the operation changes,
- much of the basis of the actuary's estimates is devalued because:
 - Claim handling may change
 - Claimants' perspectives may change
 - · Reinsurers may react differently

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Difficult Situations

AOS Adverse Development Disclosure Trigger

 Adverse development (at least five percent of surplus in at least three of last five years) triggers a discussion

- Awkward situation for actuary
- Development based on carried reserves
- Carried reserves may not have equaled actuary's prior estimate
- Appointed actuary may need to explain management's best estimate
- Awkward situation for Company
- Disclosure may be too transparent

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Difficult Situations

AOS Adverse Development Disclosure The Disclosure

- Fact based
- Identify
- Unanticipated loss emergence
- Position of prior held reserve in the range
- Detailed by line of business or other business segment
- Communication with principal
- Share drafts with management
- Allow for some collaboration

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Risk Transfer Issues

- Appointed Actuary not obligated to determine risk transfer
- Example: assume company cedes reinsurance using deposit accounting - Based on company assessment
- Disclosed by company in notes to financials
- Ceded reserves and therefore net reserves do not reflect this reinsurance
- Disclosure may be advisable
- Sample disclosure
- Several ceded reinsurance contracts were accounted for by the company under the deposit method of accounting. Ceded liabilities associated with these contracts are not recorded as ceded loss reserves and therefore are not within the scope of this opinion

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Difficult Situations

Reinsurance Issues

- Appointed Actuary not obligated to opine on the accounting treatment of reinsurance or other balance sheet items
- Example: assume company books ceded premiums on less sensitive reinsurance at provisional amounts
- Current reserve estimates imply additional premium will be due to reinsurer
- Opining actuary is able to calculate the amount of the additional premium
- Sample disclosure
- The company has accounted for certain of its ceded reinsurance arrangements, based on provisional ceded premiums paid. The results of my analysis imply that an additional \$x million of ceded premiums will be due to the reinsurer

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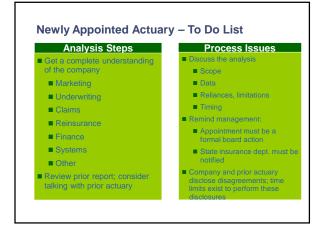
Difficult Situations

Changes in Actuary View point of New Actuary

- Prior actuary had disagreement with management
- Understand the circumstances
- Discuss with prior actuary
- Interact with the regulator
- · Level setting of estimates new and old actuary
- Location in the range
- Example: prior actuary considered reserves to be at mid-point of range: new actuary says low end
- Communication with all stakeholders
- Audit committee and management
- Regulator through actuarial report

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Changes in Actuary View point of Former Actuary

- Company required to send a letter to domiciliary commissioner stating reasons for change of actuary and areas of disagreement
- Company is required to send a copy of the its letter to the former actuary and ask the former actuary to write a letter confirming agreement with the company letter
- · New actuary is likely to contact former actuary
- Read Precept 10 of Code of Conduct for guidance as to how and when
 to respond to these requests

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Difficult Situations

Retracting and Reissuing an Opinion

• Opinion rendered in error

- Reliance on incorrect data or information
- Different opinion would have been issued with alternative data
- Limited time to make this determination
- Notifications and amended opinion required if error identified before balance sheet date of next opinion
- Appointed actuary to notify board or audit committee within 5 days
- Company to notify commissioner within 5 days (copy actuary)

- If needed, actuary notify commissioner

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An ounce of prevention is worth a pound of cure. Ben Franklin

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