

Loss Reserving And The Law: What Every Actuary Needs To Know

*CAS Casualty Loss Reserve Seminar
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Types Of Claims

- Common Law Claims
 - Fraud
 - Negligence
 - Aiding & Abetting Breach of Fiduciary Duty
 - Professional Malpractice
 - Breach of Contract
- State Statutory Law
 - California Business Act
- Federal Statutory Law
 - Securities Act of 1933
 - Securities Exchange Act of 1934

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Parties

- Plaintiffs
 - Liquidators
 - Rehabilitators
 - Investors
 - Corporations & Joint Ventures
- Defendants
 - Insurance/Reinsurance Companies
 - Officers and Directors
 - Auditors
 - Actuarial Firms
 - *Mostly Not Individual Actuaries*

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Focus On Loss Reserves

- Largest liability of insurance and reinsurance companies is based on an estimate of accrued claim payment obligations
- Stated value of the company depends on the quality of the estimate
- Risk of over-estimation
 - Competitive disadvantage
- Risk of under-estimation
 - Reserve strengthening
- Perceived earnings manipulation leads to litigation

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Estimation Is Extremely Conjectural

“Indeed, the Complaint’s allegations of falsity in the initial estimate are negated by the fact that insurance reserves established for losses that have been incurred but not reported to an insurance company are, by their very nature, extremely conjectural and may need adjustment as time passes”

Coronel v. Quanta Capital Holdings Ltd.,
No. 07-Civ-1405, 2009 WL 174656 (S.D.N.Y. Jan. 26, 2009)

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Estimation Is Subjective

“Thus, loss reserves were ‘only estimates,’ as estimating loss reserves was a difficult and complex process involving many variables and subjective judgments.”

Coronel v. Quanta Capital Holdings Ltd.,
No. 02-Civ-1405, 2009 WL 174656 (S.D.N.Y. Jan. 26, 2009)

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History Is An Imperfect Guide

"[H]istory may be an imperfect guide to the future, particularly with regard to casualty risks. The incidence of claims may increase, and inflation may lead to unexpectedly high losses per claim. Even the conservative B-F method relies on assumptions as to future events and conditions, that, if wrong, will lead to substantial errors in the final estimate.... Consequently, regardless of the actuarial method used, the preparation of, and reliance upon a net worth calculation in a balance sheet for a casualty risk reinsurer is based in large part upon informed guesswork."

Delta Holdings, Inc. v. National Distillers & Chemical Corp.,
945 F.2d 1226 (2d Cir. 1991)

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Business Judgment Errors Are Not Actionable

"Plaintiffs' repeated assertions that management failed to maintain adequate loss reserves ... are criticisms of Defendants' business judgment and management of SCA, not fraudulent misrepresentations."

In re Security Capital Assurance, Ltd. Securities Litigation,
07-Civ-11086, 2010 WL 1372688 (S.D.N.Y. March 31, 2010)

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"Puffery" Is Not Actionable

"Plaintiffs' allegations that SCA made material misrepresentations when it referred to its underwriting approach as 'disciplined' and 'conservative' ... are classic examples of puffery."

In re Security Capital Assurance, Ltd. Securities Litigation,
07-Civ-11086, 2010 WL 1372688 (S.D.N.Y. March 31, 2010)

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Fraud By Hindsight Is Not Actionable

“The relevant inquiry ... is not whether the estimate disclosed in the offering documents later turned out to be correct, but rather whether the facts alleged in the Complaint evince that the Company knew or had reason to believe, at the time the Prospectus and Registration Statement were filed, that the statement was untrue.”

Coronel v. Quanta Capital Holdings Ltd.,
No. 02-Civ-1405, 2009 WL 174656 (S.D.N.Y. Jan. 26, 2009)

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“Catastrophic” Judgments & Settlements

Alaska Retirement Management Board Settles Lawsuit Against Former Pension Actuary Half-a-billion dollar payment likely the largest on record nationally

On June 10, 2010, Alaska Attorney General Dan Sullivan announced that the Alaska Retirement Management Board (ARM Board) has settled the lawsuit against its former actuary, Mercer, regarding claims of professional malpractice, breach of contract and unfair trade practices in advising the state on management of the Alaska Public Employees’ Retirement System (PERS) and the State of Alaska Teachers’ Retirement System (TRS), which face billions of dollars in unfunded liabilities.

The unfunded liabilities were caused by stock market declines, significant increases in health care costs and, as alleged by the ARM Board, Mercer’s negligence.

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Some Case Examples

- *Thabault v. Chait and Pricewaterhouse Coopers LLC*
- *PMA Capital Corporation Securities Litigation*
- *Converium Holding AG Securities Litigation*

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Thabault v. PricewaterhouseCoopers

- Claim
 - Professional malpractice
- Parties
 - Plaintiff - Receiver of failed casualty insurer
 - Defendant - Independent auditor of failed insurer
- Wrongdoing Alleged
 - Negligent issuance of clean audit opinion with knowledge that financial statements materially understated reserves
 - But for negligence, insurer would not have continued to write policies which resulted in its ultimate failure
- Result
 - Jury verdict for \$182.9 million

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In re PMA Capital Corp. Securities Litigation

- Claim
 - Class action alleging securities fraud
- Parties
 - Plaintiffs – Class of purchasers of PMS stock
 - Defendants – Reinsurance company and its executive officers
- Wrongdoing Alleged
 - Falsely represented that company carried sufficient loss reserves
 - Net loss reserves increased by more than \$300 million after independent review of reserves
- Result
 - Settled for \$15 million after motion to dismiss denied

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Converium Securities Litigation

- Claim
 - Class action alleging securities fraud
- Plaintiff
 - Purchasers of Converium securities (2001-2004)
- Wrongdoing Alleged
 - Falsely represented that company carried sufficient loss reserves
 - Duped independent actuarial consultant
 - Artificially inflated securities price
- Result
 - Claims settled for \$84.6 million after extensive discovery

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Issues For Reserving Actuaries

- Comply With Actuarial Standards
 - Know your ASOPs and follow them
- Document Your Work
 - Actuarial method
 - Actuarial assumptions
 - Actuarial approach
 - Ranges and point estimates
- Be Consistent In Your Approach
 - Deviations documented and explained
- Communications With Management
 - Clarity

Issues For Management

- "Best Estimate"
 - Tie to objective, verifiable criteria
- Ranges
 - Book consistently within the range
- Process
 - Allow independent meetings between actuaries and outside directors
- Systems
 - Develop robust systems that minimize human error and manual adjustment
- Disclosures
 - Consider robust disclosures

Issues For Independent Consultants

- Scope of Work
 - Clearly define
- Information Requirements
 - Understand what information the client has (and does not have)
 - Make clear what information you require and why
 - Make clear what information you do not require and why
- Drafts
 - Mark appropriately and discard when done
- Process
 - Be prepared to defend the normal give and take

Questions?

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