Captive Insurance Regulation: Reserve Certification, Financial Examination and Their Relationship

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Agenda

- Statutory Actuarial Certification Requirements
- Statutory Examination Requirements
- Introduction to Risk Focused Exam Process
- Relationship between Actuary and Exam

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Actuarial Certification Requirements

- Credentials
- Filing Requirements
  - Actuarial Opinion
  - Actuarial Opinion Summary
- Exemptions
- Waiver

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Examination Requirements

- Timing Guidelines
- RRGs versus Pure Captives
- Statutory versus Accelerated
- Full Scope versus Target

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Purpose of Risk-Focused Examination Process

- Detect potential financial trouble
- Identify noncompliance with statutes and regulations
- Compile information for regulatory action
- Provide a clearer methodology for assessing residual risk and to explain how that assessment translates into establishing examination procedures
- Allow the assessment of risk management processes in addition to those that result in financial statement line item verifications
- Allow for the utilization of examination findings to establish, verify or revise regulatory priorities

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Risk-Focused Examination Process

Phase 1 – Understand The Company And Identify Key Functional Activities To Be Reviewed

Phase 2 – Identify And Assess Inherent Risk In Activities

Phase 3 – Identify And Evaluate Risk Mitigation Strategies (Controls)

Phase 4 – Determine Residual Risk

Phase 5 – Establish / Conduct Detail Examination Procedures

Phase 6 – Update Prioritization And Supervisory Plan

Phase 7 – Draft Examination Report And Management Letter

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Risk Assessment Matrix

Simplified Risk Assessment Matrix
Example Insurance Company

Phase 1	Phase 2						Phase 3			Phase 4			Phase 5	Phase 6	Phase7
1a-d	2a	2b	2c	2d	2e	2f	3a	3b	3c	4a	4b	4c	5	6	7
	Risk Identification		Inherent Risk Assessment				Risk Mitigation Strategy/Control Assessment			Residual Risk Assessment					
Sub-activities	Identified Risks	Branded Risk	Likelihood	Impact	Overall Inherent Risk Assessment		Risk Mitigation Strategy/Control	Evidence & Document Testing Controls	Overall Risk Mitigation Strategy/Control Assessment	Calculated Residual Risk	Judgmental Residual Risk	Overall Residual Risk Assessment	Examination Procedures/Findings	Prioritization Results Superivsory Plan	Report Findings & Management Letter Comments
Risks Other than Financial Reporting															
Financial Reporting Risks															

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Phase 1 – Understand The Company And Identify Key Functional Activities To Be Reviewed

Gather necessary information including:

- Actuarial opinion
- Independent loss reserve report

Conduct interviews including:

- Company Actuary

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Meet with the Company's Independent Actuaries

Considerations

- The materiality and risks (e.g., nature and type of business, loss development, reinsurance, etc.)
- The actuaries' professional qualifications, reputation and relationship with the insurer
- Any changes in methodology or assumptions
- The actuaries' interaction with the internal and external auditors

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Sample Interview Questions for the Actuary

Experience and Background

How has your professional experience and background prepared you to be the Chief Actuary for this company?

Duties and Responsibilities

Briefly describe your duties and responsibilities.
How does management establish objectives, and how is the achievement of those objectives monitored?
How is your performance evaluated? Is it based on the performance of the company?

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Sample Interview Questions for the Actuary

Reporting Structure

Describe the reporting structure of the actuarial function, including to whom you report, as well as those reporting to you.
Is there a reserving committee?
How is it organized and who are its members?
How are differences resolved?
Describe your interaction with the CFO/CEO/BOD.
Do you provide them with any specific reports?
Do the board/audit committee members demonstrate an understanding of the variability inherent in the reserves?

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Sample Interview Questions for the Actuary

Risk Mitigation Strategies (Internal Controls)

What controls are in place to ensure reserving guidelines are followed?
- Who determines which reserves will be booked in the financial statements quarterly and/or annually?
- Does the company book to the actuary's point estimate, or is there a monitored gap?

How often are full reserve analyses performed?
Is the actuarial opinion signed by a company actuary or a consultant?

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Sample Interview Questions for the Actuary

Risk Mitigation Strategies (Internal Controls) Continued

Does the company use commercial software or "homegrown" spreadsheets? What controls are in place to check for errors?
How are pricing and underwriting monitoring integrated into the reserving process?
Is there a peer review of the reserving actuary's work? If so, who performs it?
How much reliance does the appointed actuary place on the work of others?

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Sample Interview Questions for the Actuary

Risk Areas

- Have there been changes in the appointed actuary in recent years and, if so, how often have such changes occurred and why?

Corporate Strategy

- Give a general description of the company's reserving philosophy.

Explain what types of tools or reports you utilize to evaluate actuarial decisions.

Other Topics

What is the quality of the actuarial report, with respect to completeness and clarity of documentation?

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Phase 2 – Identify And Assess Inherent Risk In Activities

- Identifying the Risk*
- Identifying the Type of Risk
- Assessing the Inherent Risk

*Slides 17-22 focuses on risks that impact Actuarial activities

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Identifying the Risk

Other Than Financial Reporting Risks

- The board of directors is not involved in establishing and/or reviewing the insurer's overall reserving policy and methodology.
- The insurer is not following the reserving policy and methodology that has been adopted and reviewed by the board of directors.
- The insurer is not cancelling overdue policies in a timely manner, resulting in additional risk exposure.
- The insurer does not have a claims administration policy or the administration policy is not adequate or appropriate (i.e., not congruent with insurer risk tolerance).
- The insurer will not be able to accommodate increased utilization during a catastrophic event (e.g., disaster, terrorist attack, etc.).

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Identifying the Risk

Accumulation of Data For Reserving

- Claims data maintained by the insurer is not complete, accurate (including line of business classification) and properly cut off.
- The claims data utilized by the actuary to estimate reserves does not correspond to the data in the insurer's claims system and to the data in the insurer's accounting records.
- Loss adjustment expense data is not properly classified as defense and cost containment (DCC) or adjusting and other (AO).
- Reinsurance is not properly taken into account in accumulating claims data.
- Catastrophe (CAT) claims or mass tort claims data are not separately identified and evaluated from other claims.

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Identifying the Risk

Reserving Assumptions and Methodologies

- The assumptions and methodologies used by the insurer are not accurate and appropriate.
- Changes in the legal environment or changes in the insurer's underwriting, case reserving, or claims handling processes are not appropriately considered within the insurer's reserving assumptions and methodologies.

Performance of Reserve Calculations and Selection of Estimates

- The loss reserve computations are not performed correctly or the selected estimates are unreasonable.
- The computation of reinsurance credits within loss reserves are not performed correctly.
- The loss adjustment expense (LAE) estimates are not reasonable

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Identifying the Risk

Recording and Reporting of Loss Reserves

- Management books reserves that are materially different than the actuary's best estimate.
- Loss and loss adjustment expense reserves are not properly distributed amongst insurers in a pool.
- Loss and loss adjustment expense reserves are not properly reported and disclosed in the annual statement.

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Identifying the Risk

Premium Collection

- The insurer does not maintain an adequate premium deficiency reserve.

Unearned Premium

- Unearned premiums are not properly recorded.

Claim Settlement

- The insurer is not properly identifying and investigating fraudulent claims.
- Claims under Claims-Made liability policies are improperly accepted (or rejected) by the claims adjusters.

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Identifying the Risk

Case Reserves

- Initial case reserves are not established or reviewed in accordance with the insurer's standards.
- Case reserves are not updated accurately.
- The insurer is not properly recording case reserves (assumed or ceded) for contracts subject to reinsurance.

Ceding

- Ceded loss and LAE reserves are materially overstated.

Assuming

- The insurer is not including all assumed contracts in its financial statements.

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Identifying The Type Of Risk

- Credit
- Market
- Pricing/Underwriting
- Reserving
- Liquidity
- Operational
- Legal
- Strategic
- Reputational

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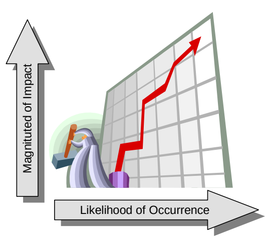
Assessing The Inherent Risk

- Likelihood of Occurrence
- Magnitude of Impact



Overall Inherent Risk Rating Scale

Likelihood of Occurrence	Magnitude of Impact			
	Threatening	Severe	Moderate	Immaterial
High	High	High	High	Moderate
Moderate-High	High	High	Moderate	Moderate
Moderate-Low	High	Moderate	Moderate	Low
Low	Moderate	Moderate	Low	Low

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Phase 3 – Identify And Evaluate Risk Mitigation Strategies (Controls)

- Identify Risk Mitigation Strategies
- Perform Tests of Controls
- Evaluate Risk Mitigation Strategies

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Phase 4 – Determine Residual Risk

Inherent Risk – Controls = Residual Risk

Inherent Risk	Strong Risk Controls	Moderate Risk Controls	Weak Risk Controls
High	Moderate or High	Moderate or High	High
Moderate	Low or Moderate	Moderate	Moderate
Low	Low	Low	Low

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Phase 5 – Establish / Conduct Detail Examination Procedures

High Residual Risk	Detail procedures required.
Moderate Residual Risk	Fewer detail procedures performed (i.e., tests of details of transactions), including more utilization of analytical procedures.
Low Residual Risk	Limited or no detail procedures performed, which may be limited to analytical procedures.

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Phase 6 – Update Prioritization And Supervisory Plan

- Examiner interfaces with analytical staff
- Analytical staff interfaces with captives based on examiners recommendations

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Phase 7 – Draft Examination Report And Management Letter

Examination Report

- Comments on financial statement items (comments concerning non-compliance or material changes to the financial statements).
- Summary of recommendations (company improvements in processes, activities and/or controls).

Management Letter

- State the issue using a concise statement of the problem identified;
- Provide commentary on the examiner's understanding on what caused or created this issue;
- Illustrate the effect of this issue including the materiality impact, and what impact it has had on the financial statements, the company's financial condition, or company operations;
- Provide information regarding the criteria that elevated this issue (i.e., non-compliance with statute);
- If appropriate, request response from the company on the noted issue.

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Scope of Exam

Included in the financial statements to this Report of Examination are actuarially determined estimates of certain reserve liabilities. The reserve estimates reported in the Company's Annual Statement were supported by a Statement of Actuarial Opinion by an actuary representing the Company. The reserves were reviewed for adequacy by Jayne Dough, ACAS, MAAA, from Actuarial Associates, Inc., consulting actuaries representing the State Department of Insurance.

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Body of Exam Report

Actuarial Opinion

The loss reserves, loss adjustment expense reserves, and unearned premium reserves were calculated by Jacques Deaux, FCAS, MAAA, associated with the firm Actuarial Consulting Firm. Mr. Deaux issued a statement of actuarial opinion that the amounts carried in the balance sheet on account of the actuarial items identified, are consistent with reserves computed in accordance with accepted actuarial standards and principals; make a reasonable provision for all unpaid loss and loss expense obligations of the company under the terms of its contracts and agreements; and met the requirements of the insurance laws of State. The identified actuarial items at December 31, 20XX, are:

Reserve for unpaid losses	$	$,$$$,$$$
Reserve for unpaid loss adjustment expenses	$	$$$,$$$
Reserve for unpaid losses - Direct and assumed	$	$,$$$,$$$
Reserve for unpaid loss adjustment expenses - Direct and assumed	$	$$$,$$$

The reserves were reviewed for adequacy by Jayne Dough, ACAS, MAAA, from Actuaries and Associates, Inc., consulting actuaries representing the State Department of Insurance.

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Example Report Comments

Losses and Loss Adjustment Expenses

The Company's reserves for losses and loss adjustment expenses were reviewed for the purpose of the examination, by John Doe, FCAS, MAAA, American Firm of Actuaries. Mr. Doe concluded the Company's reserves for losses and defense and cost containment expenses (also referred to as allocated loss adjustment expenses, or "ALAE") were understated in the amount of $$$$,$$$. Factors causing the differences include loss development factor selections, expected loss assumptions in the actuarial methods, trend assumptions and selection of ultimates from the methods employed. In determining the range of reasonable values, Mr. Doe also considered the Company's surplus and leverage (ratio of surplus to premium and reserves).

The balance of the total examination adjustment of $$$$,$$$ for losses and loss adjustment expenses, consisted of a reserve of $$$$,$$$ for adjusting and other expenses (also referred to as unallocated loss adjustment expenses, or "ULAE"). The Company prepays these expenses to Claims Administrator Inc., and did not report a reserve for ULAE. The examination determined the ULAE should be reported, in accordance with customary insurance accounting practices. One factor considered was the agreement between the Company and Claims Administrator Inc. did not specify they will administer the run-off of all claims in the event of termination of their contract. Another factor, consistent with the statutory treatment of prepaid ULAE, considers the credit risk to the Company for the possible inability of Claims Administrator Inc. to fulfill its obligations under its agreement with the Company.

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Example Report Comments

Reserve for Loss and Loss Adjustment Expenses

The Company books all actuarially estimated bulk and IBNR reserves as loss reserves, and does not allocate any of these reserves to defense and cost containment (DCC) or adjusting and other (AO) loss adjustment expense reserves. Bulk and IBNR reserves should be allocated to loss, DCC and AO reserves.

The Company did not book a reserve for unallocated loss adjustment expenses (ULAE). While ULAE is generally immaterial to the overall loss and allocated loss adjustment expense reserves but is a required element in accounting for total incurred loss and loss adjustment expenses.

Case Reserves for Losses and Allocated Loss Adjustment Expenses

Directly and indirectly through services providers such as outside defense attorneys and its subcontracted claims administrator, Claims Administrator Inc. administers substantially all aspects of the claims adjudication process, including the establishment of case reserves for reported losses. As part of the examination process, a sample of claim files was selected, with the objective of testing the statistical accuracy of the Company's claim data, including the case reserve estimates. This procedure disclosed inadequacies in the files related to an absence of an audit trail of the establishment, periodic review and changes in case reserve estimates, and documentation of the methods and reasoning used by Claims Administrator Inc. to arrive at the individual case loss and ALAE reserve estimates and any changes to the estimates.

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Example Report Comments

The Company did not specify a portion of their loss reserve for adjusting and other expenses (AO). While not considered material for the purposes of this examination, the NAIC Annual Statement Instructions require the Company to consider and post reserves for AO obligations. The Company utilizes XXXX for third-party claims administration. The fees paid to XXXX cover handling costs for the life of the claim (except there is an additional hourly appearance fee at trials and similar events). The NAIC Accounting Practices and Procedures Manual SSAP #55 Int 02-21 clarifies that the liability for unpaid loss adjustment expenses be established without consideration of prepayments made to third-party administrators.

The Company did not complete Parts 5 and 6 of Schedule P of the 2007 Annual Statement in accordance with NAIC Annual Statement Instructions regarding the recording of the development of claim counts and earned premiums.

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Management Letter Examples

The Company's reserves at year-end 20xx did not include a liability for unpaid adjusting and other ("A&O") expenses. The Department requires companies to record A&O expense reserves gross of any prepayments for adjusting services. With respect to pre-paid adjusting service fees, GAAP accounting would allow for an associated pre-paid asset to be recorded along with a credit worthiness analysis of the counterparty associated with the pre-paid asset.

The Company's reserves at year-end 20xx did not include an unearned premium reserve component applicable to the extended reporting benefits associated with the death, disability or retirement ("DD&R") of covered physicians. The Department requires companies to record DD&R reserves where coverage is provided, even if the coverage was not intended but under the contract as written the coverage was actually provided.

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References

Financial Condition Examiners Handbook. (2012). National Association of Insurance Commissioners.

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