How to Avoid Malpractice Lawsuits

Casualty Loss reserve Seminar

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Boston, Massachusetts
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Professionalism

You can always count on Americans to

do the right thing —

after they've tried everything else.

Winston Churchill

(or maybe Abba Eban)

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The same with Actuaries.

Chap Cook

Professionalism

Darkness cannot drive out darkness;

only light can drive out the dark.

Dr. Martin Luther King, Jr.

(from "Strength to Love" 1963)

Professionalism

Light thinks it travels faster than anything, but it is wrong. No matter how fast light travels, it finds the darkness has always got there first, and is waiting for it.

Terry Pratchett

(from Reaper man 2005)

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Until the light drives it out!

(Chap Cook, here 2013)

Professionalism

Everything makes sense a bit at a time. But when you try to think of it all at once, it comes out wrong.

Terry Pratchett

(Only You Can Save Mankind, 1992)

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Guidance for Actuaries – when you combine what you think are reasonable assumptions, data, methods and models, but the result looks wrong, then it probably is wrong.

(Charlie Niles, a mentor, about 1968)

Professionalism: Is Someone watching? Company Actuaries

- Pricing – especially "actuary certified" filings
- Loss reserve studies (internal)
- Loss Reserve Reports to regulators or rating agencies
- Loss Reserves: Statutory Actuarial Opinions
- Lawyers may question fair treatment of customers

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Lawyers will always have copies of the Code of Professional Conduct and the relevant ASOPs.
You should follow them – or explain & support your deviation -- and be able to prove it.

Professionalism: Is Someone watching? Consultants: all of the above – *plus:*

- Pricing and reserve studies in broker submissions
- Insurance post-acquisition disputes involve loss reserves
- Liquidations and receiverships involve actuarial estimates
- Actuarial consultants are sometimes sued directly
- Actuaries may be engaged as expert witnesses

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Professionalism: Is Someone watching? The Plaintiff Attorneys are!!!

ASOPs are standards that are not prescriptive as to details

But if your work *cannot* be reconciled with the relevant ASOPs

And deviations are not explained ---

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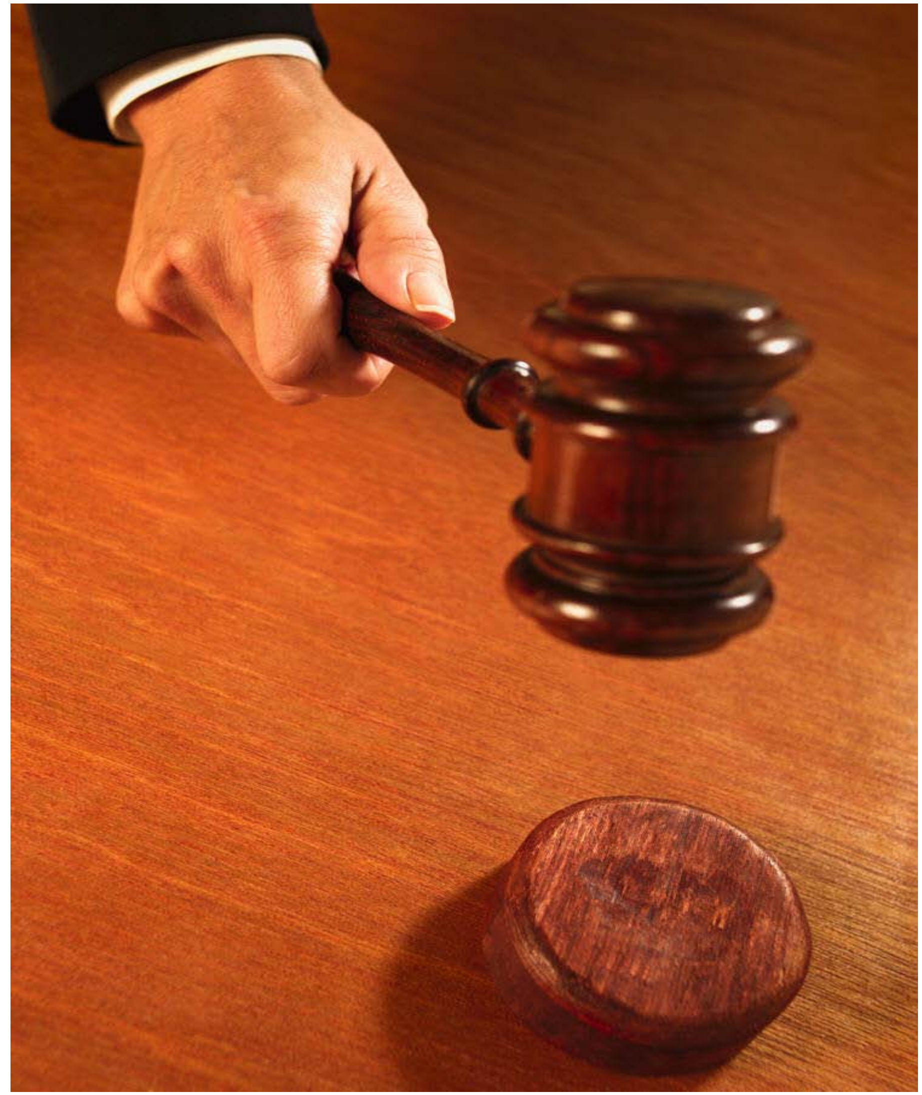

Sources of Non-Compliance

Why might your work appear non-compliant when viewed under a microscope 10 years later?

- ✓ Pressure by management, client, etc. (The Imperfect World We Live In)
- ✓ True mistakes – *even the best of us sometimes make them*
- ✓ Lack of time or budget; need to move on to next project/client
- ✓ Viewpoints change; people ask questions not easily anticipated at the time the work was done
- ✓ Variance simply did its thing and your good work on the central estimate was overrun by the tail of the distribution

The Imperfect World We Live In
Management Pressure

Sample Quotes

- "You need to be a ***team player***"
- "We ***can't afford*** to price it that high"
- "***Forget the tail***, it gets washed out by competition"
- "This is an ***important client***/quarter/year/result/etc."
- "Ignore that ***aberration*** - it won't happen again"

Source: Richard Fein, PhD, FCAS, MAAA CAGNY June, 2010

The Imperfect World We Live In
Cutting the Corners

- “I just take 3 year averages and use them -- can’t go wrong as it’s a time tested and utilized methodology”
- “There goes the bonus!”
- “My supervisor insists on looking at all my assumptions - rude and unprofessional.”
- “Guess what, my supervisor doesn’t look at any of my assumptions, unless the overall result is unexpected - no worries for me.”
- “The Auditor is challenging our results -- YIKES, you did what???”

Source: Richard Fein, PhD, FCAS, MAAA CAGNY June, 2010

The Imperfect World We Live In
Words Have Power

- “We can’t afford another hit to income this quarter/year”
- “This kills our earnings”
- “Just use the “tail” factors we developed in 19XX. We used them last year. We *always* use them.”
- “I used the loss ratios budgeted in the rates.”

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Case Example 1: Relying on Others

Accepting work for which You are not qualified

- CA was only fairly well familiar with warranties
- CA was NOT familiar with CLIP over a warranty fund
- The CLIP presented stated on its face that it was “Claims Made”
- The CLIP presented stated on its face that there “was no UEPR”
- The detailed text of the contract did not support “Claims Made” or “no UEPR”. In fact there were specific references to both:
    - premium refunds in case of cancellation, and
    - loss runoff after the policy period
- Rather than declining the job, CA sought expert opinion

Case 1:
Relying on Another Expert's Opinion

- There is little useful guidance in the ASOPs
- There is an issue of qualification and adequate expertise
- CA went to the Insurance Department of Domicile State for resolution of the inconsistency
  - Both General Counsel and Actuary confirmed that the CLIP *WAS* "Claims Made" and required no UEPR
- CA called the NAIC to confirm that "Claims Made" meant "No IBNR"

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- CA called the NAIC to confirm that "Claims Made" meant "No IBNR"
- When the bankruptcy *inevitably* happened –
- the Insurance Department (now acting as Receiver) sued CA anyway

Case 1: Key Principles and Guidelines

1. Code of Professional Conduct
2. US Qualification Standards
3. ASOPs
4. NAIC Annual Statement Instructions
5. AAA Practice Note by COPLFR:
   Statements of Actuarial Opinion on P&C Loss Reserves (year)
   This document includes #4 and expands on it
   It is priceless -- Never fail to use it!!
2. NAIC SSAPs 53 and 65

Case 1: The Code of Professional Conduct

PRECEPT 2. An Actuary shall perform Actuarial Services only when the Actuary is qualified to do so on the basis of basic and continuing education and experience, and only when the Actuary satisfies applicable qualification standards.

> ANNOTATION 2-1. It is the professional responsibility of an Actuary to observe applicable qualification standards that have been promulgated by a Recognized Actuarial Organization for the jurisdictions in which the Actuary renders Actuarial Services and to keep current regarding changes in these standards.
>
> ANNOTATION 2-2. The absence of applicable qualification standards for a particular type of assignment or for the jurisdictions in which an Actuary renders Actuarial Services does not relieve the Actuary of the responsibility to perform such Actuarial Services only when qualified to do so in accordance with this Precept.

Case 1: U.S. Qualification Standards

4.3 Emerging or Non-Traditional Areas of Actuarial Practice — As actuaries become engaged in emerging or non-traditional fields, it is likely that their expertise will be recognized and that they will be called upon to issue Statements of Actuarial Opinion in those areas.

An actuary practicing in an emerging or non-traditional practice area can satisfy the continuing education requirements by maintaining knowledge of applicable standards of practice, actuarial concepts, and techniques *relevant to the topic of the Statement* of Actuarial Opinion.

Case 1: Applicable ASOPs

1: Introductory Actuarial Standard of Practice

23: Data Quality

36: Statements of Actuarial Opinion Regarding P/C Reserves

41: Actuarial Communications

43: P/C Unpaid Claim Estimates

In this case, ASOPs are not very useful.

In most cases ASOPs provide good and relevant guidance.

In case like this one, the actuary must look to her own good judgment and to guidance from law, actuarial accounting or underwriting literature, or other sources.

In this particular case, relevant standards are from the NAIC.

NAIC Annual Statement Instructions

5. The OPINION paragraph should include a sentence that at least covers the points listed in the following illustration:

   "In my opinion, the amounts carried in Exhibit A on account of the items identified:

   A. Meet the requirements of the insurance laws of (state of domicile).

   B. Are computed in accordance with accepted actuarial standards and principles.

   C. Make a reasonable provision for all unpaid loss and loss expense obligations of the Company under the terms of its contracts and agreements."

   If the Scope includes material Unearned Premium Reserves for Long Duration Contracts, the Opinion should cover the following illustration:

   D. "Make a reasonable provision for the unearned premium reserves for long duration contracts of the Company under the terms of its contracts and agreements.

AAA Practice Note on Statements of Actuarial Opinion on P&C Loss Reserves.

Appendix 8 (in 2012)

Unearned Premium for Long Duration Contracts (excerpts)

While the primary focus of SCOPE Items 7 and 8 is extended warranty contracts, there are some companies writing other contracts with durations greater than 13 months with fixed premiums that the insurer cannot cancel, such as residual value contracts or directors' and officers' liability insurance. These may fall within the SCOPE of this section of the Instructions.

In 1995, the NAIC implemented an accounting rule establishing a methodology for determining a minimum level of unearned premium reserves for single or fixed premium policies with coverage periods of 13 months or greater. The rule applies to any reporting date prior to the expiration of the contracts. The rule for calculating the unearned premium reserve is composed of three tests to be applied individually by policy year for the three most recent policy years and in the aggregate for older policy years.

Case 1: NAIC SSAP 53

6. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of contracts shall be recognized in the statement of income, as earned premium, using either the daily pro-rata or monthly prorata methods as described in paragraph 7.

Certain statements provide for different methods of recognizing premium in the statement of operations for specific types of contracts. For contracts not separately identified in specific statements where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

Case 1: NAIC SSAP 65

Policies with Coverage Periods Equal to or in Excess of Thirteen Months

21. Some property and casualty insurance contracts are written for coverage periods that equal or exceed thirteen months. These contracts may be single premium or fixed premium policies, and generally are not subject to cancellation or premium modification by the reporting entity. The most common policies with such coverage periods are home warranty and mechanical breakdown policies. Accordingly, this guidance is primarily focused on home warranty and mechanical breakdown policies and does not apply to multiple year contracts comprised of single year policies each of which have separate premiums and annual aggregate deductibles.

22. Revenues are generally not received in proportion to the level of exposure or period of exposure. In order to recognize the economic results of the contract over the contract period, a liability shall be established for the estimated future policy benefits while taking into account estimated future premiums to be received. Unearned premiums shall be recorded in accordance with paragraphs 23 to 33 of this statement.

23. Paragraphs 24 to 33 shall apply to all direct and assumed contracts or policies ("contracts"), excluding financial guaranty contracts, mortgage guaranty contracts, and surety contracts, that fulfill both of the following conditions:

   a. The policy or contract term is greater than or equal to 13 months; and
   b. The reporting entity can neither cancel the contract, nor increase the premium during the policy or contract term.

24. At any reporting date prior to the expiration of the contracts, the reporting entity is required to establish an adequate unearned premium reserve, to be reported as the unearned premium reserve. For each of the three most recent policy years, the gross (i.e., direct plus assumed) unearned premium reserve shall be no less than the largest result of the three tests described in paragraphs 27 to 29. For years prior to the three most recent policy years, the gross unearned premium reserve shall be no less than the larger of the aggregate result of Test 1 or the aggregate result of Test 2 or the aggregate result of Test 3 taken over all of those policy years.

25.to 33. provide detailed instructions

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Case 2: Competent Work, Bad Result

- CA did reserve studies for an MGA
- Insurer relied on the CA's reserve studies
- Everything went south
- Insurer sued MGA and CA

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- In his deposition, CA had documentation of everything
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Case 3: Who Is Responsible?

- Another auto warranty case
- We were experts for two governments and three dealer groups
- Really big losses

Case 3: Who Is Responsible?

- Is the appointed actuary responsible for Loss Reserves?

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Case 3: Who Is Responsible?

- Is the appointed actuary responsible for Loss Reserves?
- What about Unearned Premium Reserves?

Case 3: Who Is Responsible?

- Is the appointed actuary responsible for Loss Reserves?
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Annual Statement Instructions: The OPINION paragraph should include a sentence that at least covers the points listed in the following illustration:

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- The company's Actuary is part of "Company Management".

Case 3: Who Is Responsible?

- Are the CFO and the Auditor responsible for Loss and UEP Reserves?

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- Are the CFO and the Auditor responsible for Loss and UEP Reserves?

Of course they are! They will both be held responsible for *any* financial problem.

"The CEO told me to" or

"I relied on the Actuary" (or anybody)

will be brushed off –

and considered evidence of their negligence –

by Receivers and by Lawyers

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Case 3: Who Is Responsible?

The Deputy Insurance Commissioner (and often Receiver) of a major state once told me:

[In every impaired insurer situation]

"it is the fiduciary duty of a Receiver to sue the Auditor, the Appointed Actuary and at least one member of company management."

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The Case Result

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- But due to a typo, they did Sum - of - the - years - digits *backwards*, so that premium earnings were accelerated instead of deferred
- The auditor missed it
- The Consulting Actuary didn't review UEPR at all --

  because the client told him not to

Case 3: Who Is Responsible? The Case Result

- OOPS! Sins of omission count, too
- The NAIC Actuarial Opinion Instructions do not require the actuary to opine on UEPR for long-term contracts *only if the client wants it done*
- The Cayman Islands government isn't an NAIC state --
  - But our compliant Actuary *represented* his opinion to the Cayman Islands regulators as an NAIC opinion
  - And was held to that standard

Case 3: Who Is Responsible?
The Case Result

- **Everybody was responsible!**

- Two big 4 accounting firms, the Consulting Actuary, insurer management, and two reinsurers (because they misrepresented the amount of risk transfer limitations to third parties) all contributed generously –

  when the receivers' attorneys described their case, passed the hat and mumbled about possible lawsuits

Case 4: Treating Customers Fairly

An Expert Actuary opposing credit scoring says:

- ✓ Consistent with the Risk Classification Statement of Principles, [the purpose of] risk classifications [is] …to be fair.
- ✓ If you do not update your credit score information *at every renewal,* then renewal rates and new business rates for similar risks will be different, violating ASOP 12 § 3.2.3 "Objectivity".
- ✓ Therefore failure to update your insurance credit scores with each renewal is unfair, a violation of the ASOP 12, Risk Classification Principles and state law requiring that rates shall not be unfairly discriminatory.

Case 4: Treating Customers Fairly
Applicable ASOPs

1: Introductory Actuarial Standard of Practice

12: Concerning Risk Classification

23: Data Quality

41: Actuarial Communications

And always keep in mind the Code – in this case

PRECEPT 1. An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession’s responsibility to the public and to uphold the reputation of the actuarial profession.

Case 4: Treating Customers Fairly ASOP 12 Guidance

3.2.3 **Objectivity—The actuary should select risk characteristics that are capable of being objectively determined.**

A risk characteristic is objectively determinable if it is based on readily verifiable observable facts that cannot be easily manipulated. For example, a risk classification of "blindness" is not objective, whereas a risk classification of "vision corrected to no better than 20/100" is objective.

Case 4: Treating Customers Fairly ASOP 12 Guidance

The insurer's expert counter-punched with section 3.2.4

3.2.4 **Practicality—The actuary's selection of a risk characteristic should reflect the tradeoffs between practical and other relevant considerations.**

Practical considerations that may be relevant include, but are not limited to, the cost, time, and effort needed to evaluate the risk characteristic, the ongoing cost of administration, the acceptability of the usage of the characteristic, and the potential usage of different characteristics that would produce equivalent results.

Case 4: Treating Customers Fairly ASOP 12 Guidance

3.2.3 **Objectivity—The actuary should select risk characteristics that are capable of being objectively determined.**

3.2.4 **Practicality—The actuary's selection of a risk characteristic should reflect the tradeoffs between practical and other relevant considerations.**

Close call – Are the two sections in conflict?

What do you think is correct? Why?

Closing Thoughts

Think about how your analysis and reports may look in retrospect – to adverse attorneys and actuaries.

Don't do work if you are not qualified to do it

Read the Code of Conduct, Principles and ASOPs

Document! Document! Document!

Get competent peer review

Closing Thoughts

Finally, step back and look at the whole job.

Would your mother be proud of the work you have done?

If not, why should a jury, judge or arbitrator?

SO FIX IT ALREADY!

Questions and Comments