

Today's Topic

Re-write of the September 2007 edition of
the American Academy of Actuaries publication
“An Overview for P/C Insurers’ Audit Committees:
Effective Use of Actuarial Loss Reserves Expertise”

Purpose of this publication

- The new publication can be found at [http://actuary.org/files/AC Policy Overview Dec 2014.pdf](http://actuary.org/files/AC_Policy_Overview_Dec_2014.pdf)
- The 2007 publication (and the 2014 publication) is intended for audit committees of insurance companies.

Background on Audit Committees

- The charter of an audit committee – examples from a Google search:
- The Chubb Corporation “The audit committee is ... to assist the Board in its oversight of a) the integrity of the financial statements... e) the effectiveness of the Corporation’s internal control over financial reporting
- Erie Indemnity Company “The Audit Committee ... shall assist the Board in overseeing 1) the integrity of the financial statements ... 5) the systems of control over financial reporting.
- FHM Insurance “The ... Audit Committee ... is to assist the Board ... by reviewing the financial reports provided by the Company to any government body ... [and] to monitor the Company’s financial reporting ...and internal control system.

Who Is Responsible for This Document

- COPLFR (Committee on Property Liability Financial Reporting) is the American Academy of Actuaries committee which is responsible for this “Overview for ... Audit Committees...” publication. COPLFR typically meets four times a year. At the March 2013 COPLFR meeting, we discussed whether to update this publication.
- At the June 2013 meeting, it was decided to update that 2007 document. We then established a subgroup to do the re-write.

Members of the Subgroup

- Members of the re-write subgroup were:
- Lisa Slotznick -- Managing Director/PWC
- Ralph Blanchard III – Vice President & Actuary/Travelers
- Mary Frances Miller – Senior Actuary/Select Actuarial Services
- John Pierce – President of John Pierce Consulting Actuary
- Lauren Pachman – staff attorney at AAA
- Dale Ogden – President of Dale F. Ogden & Associates

The Re-Writing Process – from March 2013 to December 2014

- Discussion March 2013 to June 2013
- Subgroup meetings (all by conference call) from July 2013 to September 2014
- During that time, there was rewriting of sections of the document by individual members of the subgroup.
- We also shared a draft of the revised publication with past and present audit committee members.
- September -October 2014 Peer review by selected AAA members; October-November 2014 Legal review by AAA lawyers
- Publication of new document in December 2014

Motivation for the Rewriting

- Reasons for re-write
 1. Recognize that some things have changed since 2007 (e.g. Medical Malpractice reserves)
 2. Reduce emphasis on calculation of benchmarks and other detail work by audit committee
 3. Discuss additional topics – reinsurance; data quality
 4. Discuss “undue management influence” on reserving actuary

One Minor Constraint

- One constraint – the revised document should be no longer than the September 2007 edition, which was 12 pages long.

Remove Outdated References

- 2007 document talked about “large loss reserve decreases for personal lines in the mid-1990s” and “Large loss reserve increases relating to professional ... liability lines”
- New document removes/revises these and other outdated examples

De-Emphasize Detail Work by Audit Committee

- The 2007 edition suggests that audit committee members check “various ratios of quantities, such as ... IBNR losses to case reserves and/or number-of-claims-closed to number-of-claims-reported at successive points in time”.
- The 2014 edition moves away from suggesting detailed calculations of this type

Reinsurance

- **Ceded Reinsurance**

Much of the focus on recorded loss reserves is on a net of reinsurance basis, or those reserves after the impact of reinsurance cessions. However, those loss reserves that are expected to be ceded under reinsurance agreements are also estimates. The reasonableness of both the estimated cessions, and, perhaps more importantly, the collectability of such cessions, are matters for board/audit committee oversight, as overstatement of ceded reinsurance or failure to collect such cessions has caused adverse impacts to financial statements and has even caused insurer insolvencies in the past.

The Statement of Actuarial Opinion requires the opining actuary to have a separate view on both gross loss reserves (i.e., before the impact of such cessions), and net loss reserves. As such, the board/audit committee should expect the appointed actuary to be conversant in this area. Issues that the audit committee might consider querying include:

- Possible concentrations by reinsurer
- Financial strength ratings of current reinsurers
- The policy regarding required financial strength for possible future reinsurers
- Reliability/variability of the ceded reserve estimates underlying the recorded reserves

Data Quality

- **Data Quality and the Impact on Loss Reserve Uncertainty**

The actuarial analysis process is highly dependent upon data quality, which is often determined by each company's systems and processes for collecting, storing, and making available its historical data relative to losses, exposures, and premiums. Due to the evolving data processing environment, some companies have a blend of historical systems that provide the data used by the reserving actuary. In addition, for companies that have undergone a series of mergers in the past, the systems of each of the legacy companies may not be fully integrated.

The level of controls and granularity of the information around these systems can lead to concerns about the quality of the data used by the actuary or may hamper the efficiency of certain levels of detailed review. Limitations posed by less than perfect data may introduce new uncertainties to the estimation process.

Even in the absence of these legacy system issues, data quality problems at a company can impact the reliability of the actuary's projections. For this reason, the actuary is required to review the data for reasonableness and consistency .

The actuary will have a view related to the degree of uncertainty that any data issues add to the process. The audit committee should consider making inquiries if this is a concern for a particular company.

Governance (Control) Structure

- the new edition includes an enhanced list of Governance (Control) Structures for loss reserves
- 2007 edition discusses “Segregation of duties” – having separate pricing and reserving actuaries -- and “Use of reserve committees”.
- 2014 edition has a long section on Governance Structures, and discusses not only “Segregation of Duties” and “Use of Reserve Committees” – but several other items including the “Report from the Appointed Actuary” and “Replacement of Appointed Actuary”

Disagreement Letter

- Replacement of Appointed Actuary -- The 2014 edition states “Whenever an appointed actuary is replaced, the NAIC requires both the company and the outgoing appointed actuary to provide letters to the domiciliary state regulator discussing any disagreements over loss and LAE reserves during the last 24 months.”
- The 2007 edition did not mention this topic at all.
- What is the “disagreement letter” and why the audit committee (and you) should care?

Undue Management Influence

- 2007 edition did not include much, if anything, on “undue management influence”
- 2014 edition includes a relatively detailed section on this topic, at the very end of the document. (Why did we include it at the end?)

Undue Management Influence

- Executive Session with Actuaries

Members of boards of directors or audit committees should consider meeting in executive session with the appointed actuary and potentially other actuaries significantly involved during the reporting process. Including the audit firm actuary in the audit committee's executive session with the audit firm is also beneficial. Such executive sessions are particularly of value where management may have exercised undue influence on the reserve estimation process. While such undue influence is uncommon, its potential is a key focus of regulators, as it has been a factor in a number of past insolvencies. Possible signs of undue management influence that could be identified during executive session include (in increasing order of severity):

- The actuary is not provided with comprehensive information on emerging problem areas (e.g., newer coverages with adverse experience).
- Information is provided late to the actuary, leaving inadequate time for analysis.
- The actuary is denied access to certain individuals at the company.
- Management makes clear to the actuary that his/her continued employment is contingent upon agreement with management's reserve estimates.
- The opening actuary is replaced, and the new actuary immediately agrees with management's position

More on Undue Management Influence

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