

Company-specific risk factors for SAO users

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**DIFP**
Department of Insurance,
Financial Institutions &
Professional Registration


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Three parts of the RMAD disclosure

1A. Describe company-specific risk factors. <i>"The Appointed Actuary should include an explanatory paragraph to describe the major factors, combination of factors or particular conditions underlying the risks and uncertainties the Appointed Actuary considers relevant" (2017 NAIC Instructions).</i>	1B. Select materiality standard. <i>"An item or a combination of related items is material if its omission or misstatement could influence a decision of an intended user. When evaluating materiality, the actuary should consider the purposes of the actuary's work and how the actuary anticipates it will be used by intended users" (ASOP 1).</i>
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2. Make RMAD conclusion.
"The Appointed Actuary should explicitly state whether or not he or she reasonably believes that there are significant risks and uncertainties that could result in material adverse deviation" (2017 NAIC Instructions).

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My objectives

- Provide assurance that regulators read the risk factor disclosures in the SAO and find them valuable.
- Show how the disclosures are used in regulatory analysis and exams.
- Understand the challenges appointed actuaries face in writing the disclosures.
- Give some advice.

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What we consider in our review

- 1. Are there new risks in this year's SAO?
- 2. Have any risks been removed?



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What we consider in our review

- 3. How can we use other sources to inform our view of the risks mentioned in the SAO?

- Actuarial report and AOS
- Schedule P
- Notes to Financial Statements
- MD&A
- ORSA summary report
- 10-K
- Financial exams and analysis
- Rating agency reports



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What we consider in our review

- 3. How can we use other sources to inform our view of the risks mentioned in the SAO?

- | | |
|-------------------------------|-------------------|
| Actuarial report and AOS | Appointed actuary |
| Schedule P | |
| Notes to Financial Statements | |
| MD&A | Company |
| ORSA summary report | |
| 10-K | |
| Financial exams and analysis | Regulators |
| Rating agency reports | Rating agencies |



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What we consider in our review

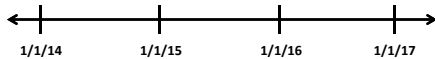
4. How can we use the risk factor disclosures?

Financial analyst - Prepare or edit the Insurer Profile Summary - Pose follow-up questions to company management	Financial examiner - Write C-level interview questions - Build the risk matrix - Prioritize exam work
Regulatory actuary - Review or construct diagnostics - Recommend areas of focus for exam team and examination actuary	Examination actuary - Write appointed actuary interview questions - Choose areas of focus when reviewing actuarial report

Using the risk factor disclosures



P&C carrier undergoing a financial exam covering the period from 1/1/14 to 1/1/17



Using the risk factor disclosures

In 2016 SAO: "I have identified the major company-specific risk factor as an initiative in the claims department, introduced in the second quarter of 2015, to close claims sooner. The claims initiative has increased the claims settlement rate and reduces the predictive power of paid loss development factors selected using historical data."

Using the risk factor disclosures

More details in appointed actuary's year-end 2016 report on:

- Annual December meetings with management during which claims department initiatives are discussed
- Review of claim closure diagnostics
- Addition of paid Berquist-Sherman methodology to year-end 2016 analysis



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Using the risk factor disclosures

Financial analyst edited Insurer Profile Summary.

Reserving:

- [The appointed actuary cited as a risk factor in his SAO a recently-introduced effort in the claims department to close claims sooner. The appointed actuary responded to this change in his 2016 analysis by incorporating an additional projection methodology.](#)
- The appointed actuary concluded that there was a risk of material adverse deviation in the carried reserves.
- Reserve development has been favorable in each of the past five calendar years, and the carried reserves have been about 5% above the appointed actuary's central estimate in each of these years.

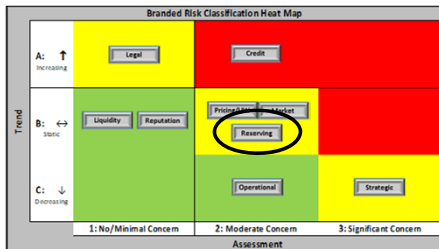
No/Minimal Concern	Moderate Concern	Significant Concern	Trend
	Claims department change which reduces the value of historical data; risk is mitigated by the incorporation of an additional reserving technique		↑
- Company's reserving procedures - Appointed actuary's analysis			↔
Overall Reserving Assessment: Moderate		Overall Trend:	↔



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Using the risk factor disclosures

Financial analyst edited Insurer Profile Summary.



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Using the risk factor disclosures

Examination actuary described his review of the added methodology in his report.

V. Review of Methodology

In response to an increase in the rate of claims settlement, the appointed actuary reduced the reliance on the paid loss development method and incorporated a paid Berquist-Sherman technique into his analysis. We reviewed the application of this technique and the selected parameters and found them to be reasonable. For all accident years in total, the ultimate loss based on the Berquist-Sherman method is 6% lower than the ultimate loss based on the paid loss development method. The effect is concentrated in the most recent two accident years...



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What do regulators find useful?

Question I posed to other regulators on a July 2018 call of the NAIC's AOWG: *What type of company-specific risk factor disclosures have you found particularly valuable in your SAO reviews?*

Some responses:

- Changes in case reserving methodology
- Changes in claims handling procedures
- Retirements or turnover in claims staff
- Differences between the company's risk profile and that of the average industry player (e.g., workers' compensation writer that focuses on high-risk industries).
- Recent changes in exposure (e.g., auto writer changing its target market from preferred to non-standard).

Regulators are interested in risks that increase the uncertainty in the appointed actuary's estimates and therefore could cause material adverse deviation in the carried reserves.



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Discussion question

Opinion writers, what challenges do you face in writing the risk factor section of your SAOs?

- Knowing which risk factors are valuable to the users of the SAO?
- Understanding how the SAO will be used?
- Deciding how much information to include?
- Deciding what to put in the public SAO versus the confidential AOS and report?
- Determining a threshold for adding or removing risks?
- Obtaining information on risk factors from management?



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Advice for appointed actuaries

- Keep up the good work. Most SAOs contain an appropriate discussion of company-specific risk factors.
- If there aren't any company-specific risk factors, disclose this in the SAO.
- Include risk factors in the SAO even if there are mitigating effects that blunt the impact (e.g., the addition of a method that responds to a claims handling change).
- Include risk factors in the SAO even if the RMAD conclusion is negative, pursuant to an *Instructions* change that took effect at year-end 2014.
- Consider providing additional information in the confidential report and Actuarial Opinion Summary.





Appendix



From 2017 SAO Instructions

6. The Appointed Actuary must provide RELEVANT COMMENT paragraphs to address the following topics of regulatory importance.

A. Company-Specific Risk Factors

The Appointed Actuary should include an explanatory paragraph to describe the major factors, combination of factors or particular conditions underlying the risks and uncertainties the Appointed Actuary considers relevant. The explanatory paragraph should not include general, broad statements about risks and uncertainties due to economic changes, judicial decisions, regulatory actions, political or social forces, etc., nor is the Appointed Actuary required to include an exhaustive list of all potential sources of risks and uncertainties.



From 2017 SAO Instructions

6. The Appointed Actuary must provide RELEVANT COMMENT paragraphs to address the following topics of regulatory importance.

B. Risk of Material Adverse Deviation

The Appointed Actuary must provide specific RELEVANT COMMENT paragraphs to address the risk of material adverse deviation. The Appointed Actuary must identify the materiality standard and the basis for establishing this standard. The materiality standard must also be disclosed in U.S. dollars in Exhibit B: Disclosures. The Appointed Actuary should explicitly state whether or not he or she reasonably believes that there are significant risks and uncertainties that could result in material adverse deviation. This determination is also to be disclosed in Exhibit B.



From ASOP No. 36, Section 4.2

e. If the actuary reasonably believes that there are significant risks and uncertainties that could result in material adverse deviation, an explanatory paragraph should be included in the statement of actuarial opinion. (See sections 3.6 and 3.9 for guidance on evaluating materiality and adverse deviation.) The explanatory paragraph should contain the amount of adverse deviation that the actuary judges to be material with respect to the statement of actuarial opinion, and a description of the major factors or particular conditions underlying risks and uncertainties that the actuary believes could result in material adverse deviation. The actuary is not required to include in the explanatory paragraph general, broad statements about risks and uncertainties due to economic changes, judicial decisions, regulatory actions, political or social forces, etc., nor is the actuary required to include an exhaustive list of all potential sources of risks and uncertainties.

Note that ASOP No. 36 only requires a discussion of risk factors if the actuary believes there's a risk of material adverse deviation. Since year-end 2014, the SAO Instructions have required a discussion of risk factors regardless of the RMAD conclusion.



From 2017 Regulatory Guidance

H. Risk of Material Adverse Deviation

The Relevant Comments paragraphs on the Risk of Material Adverse Deviation (MAD or RMAD) are particularly useful to regulators. The first two RMAD comments below respond to questions that Appointed Actuaries have posed to regulators. The second two stem from regulators' reviews of Actuarial Opinions.

1. No company-specific risk factors – The Appointed Actuary is asked to discuss company-specific risk factors regardless of the RMAD conclusion. If the Appointed Actuary does not believe that there are any company-specific risk factors, the Appointed Actuary should state that.
2. Mitigating factors – Regulators generally expect Appointed Actuaries to comment on significant company specific risk factors that exist prior to the company's application of controls or use of mitigation techniques. The company's risk management behaviors may, however, affect the Appointed Actuary's conclusion on whether there is a significant risk of MAD.



Glossary

- **Actuarial Opinion (C) Working Group (AOWG):** An NAIC working group of the Casualty Actuarial and Statistical (C) Task Force which edits the SAO section of the Annual Statement Instructions
- **Branded risk classifications:** Risk categories promulgated by the NAIC and used by DOI financial analysts. There are nine branded risks: credit, legal, liquidity, market, operational, pricing/underwriting, reputation, reserving, and strategic.
- **COPLFR:** The Committee on Property and Liability Financial Reporting, a committee of the American Academy of Actuaries that prepares the annual practice note on P&C SAOs
- **DOI:** Department of Insurance
- **Insurer Profile Summary:** Regulatory document maintained by the DOI's financial analyst for the legal entity which describes the exposure of the entity to the various branded risks



Glossary

- **National Association of Insurance Commissioners (NAIC).** The U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight.
- **Regulatory Guidance document:** A document prepared by the NAIC Actuarial Opinion (C) Working Group which supplements the NAIC Annual Statement Instructions – Property/Casualty (Instructions) in an effort to provide clarity and timely guidance to companies and appointed actuaries regarding regulatory expectations on the actuarial opinion
- **Risk assessment matrix:** Financial examination tool used to document the risks associated with the insurer's key activities and summarize the conclusions from the examination's testing procedures



Glossary

- **RMAD:** Risk of Material Adverse Deviation. The appointed actuary is asked to state in the SAO whether or not he or she reasonably believes that there are significant risks and uncertainties that could result in material adverse deviation.
- **SAO:** Statement of Actuarial Opinion, a supplement to the annual statement prepared by a qualified actuary which sets forth his or her opinion related to the reserves within the scope of the SAO.
- **SAO Instructions:** The section of the NAIC's *Annual Statement Instructions* – Property/Casualty that describes the requirements of the actuarial opinion