

Casualty Actuaries of Greater New York

Corporate Governance and the Loss Reserving Process

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Opening Thoughts



Opening Thoughts

Top 5 ways to know your corporate governance needs a refresher:

5. The audit committee is comfortable that the reserves are reasonable because the presentation hand-outs were on color copies.
4. Written documentation supporting internal reserve analyses consists solely of the statement “*based on actuarial judgment*”.
3. “*Because they couldn’t reconcile the data!*” is the punch line to seventeen knee-slapping jokes within the actuarial department.
2. The reserve group meeting is so superficial that the conclusions are documented in the meeting’s “*nano-Minutes*”.
1. Company public disclosures provide the reader with assurance that the reserves are “*probably not outside the realm of possibility.*”

Opening Thoughts

What is "governance"?

- *n* . The act of developing and managing consistent, cohesive policies, processes and decision rights for a given area of responsibility.

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Our Observations

Section 1

Corporate Governance and the Loss Reserving Process

Defining a Best Practices Reserving Process

Our Observations

Raising the Bar on Reserving Controls

Sarbanes-Oxley - Four Years Later . . .

- Some companies embraced the concepts regarding a strong control environment,
while . . .
- Others have the minimum level of controls to accomplish the requirements for managements and external certifications
- Many companies lie somewhere between each of these ends of the spectrum

Raising the Bar on Reserving Controls

Benefits from having a strong control environment:

- Greater efficiency in operation
- Reduced risk of reserve misstatement
- Reduced likelihood of surprises
- Few or no deficiencies in controls
- More effective and more efficient external audit
- Smoother regulatory exam

Section 2

Corporate Governance and the Loss Reserving Process

Defining a Best Practices Reserving Process

Our Observations

Defining a Best Practices Reserving Process

Gold Standard

Key Elements of the P/C Reserving Process

1. Management and board involvement
2. Actuarial staffing and expertise
3. Data quality and reliability
4. General reserving approach and methodology
5. Documentation of reserving process
6. Use of external actuaries
7. Financial statement disclosures

Gold Standard Maturity Framework

- *1 = Minimal* - operating near or at the minimum level needed for management to complete their attestation (and an audit) in a timely manner.
- *2 = Developing* - reserving process not well standardized, significant changes – sometimes it is smooth, timely and efficient, other times it is not; numerous gaps and shortcuts exist.
- *3 = Accomplished* - reserving process is well standardized – generally smooth, efficient and timely; however, some gaps and shortcuts still exist.
- *4 = Optimal* - operating at the Gold Standard – a best practices process.

Assessment: management and board involvement

How committed is senior management to the actuarial reserving function?

- a. Personnel tends to be overwhelmed. Systems have outlived or outgrown their usefulness. Management tends to challenge actuarial results only when they are unfavorable.
- b. Typically, resources are moderately strained and there is room for systems improvement. Management challenges results at times – favorable or unfavorable – but is not consistent in its method and process.
- c. Resources are at acceptable levels in all but isolated spots. Management challenges results regularly and understands the process but does not get into details.
- d. Senior management regularly demonstrates its commitment by prioritizing and committing necessary personnel and systems resources. They understand and challenge reserving approaches, methods and key assumptions, as warranted.

Section 3

Corporate Governance and the Loss Reserving Process

Defining a Best Practices Reserving Process

Our Observations

Our Observations

Management and board involvement Characteristics of a strong control environment

Management's commitment to a strong control environment:

- Prioritize/commit necessary resources (staffing, systems)
- Minimize potential conflicts of interest (e.g., pricing/reserving)
- Understand/challenge reserve approach, methods, key assumptions
- Proactively monitor changes in estimates

The audit committee:

- Monitor/evaluate policies, principles and internal controls around reserve setting process and effectiveness of related disclosures
- Meet regularly with internal and external actuaries

Our Observations

Management and board involvement Industry observations

- Management oversight is generally strong; reserve committees are typically used. Personnel and systems are generally sufficient.
- Audit committee involvement is less consistent, and in many cases there is room for improved oversight; heavy reliance on management, information received is typically high-level summaries only.
- Large commercial/reinsurance companies have higher average ratings than personal lines companies.

Our Observations

Actuarial staffing and expertise

Characteristics of a strong control environment

- Appropriately credentialed actuaries who participate in continuing education
- Staffing levels are of sufficient quantity and quality
 - To allow for appropriate frequency of review
 - Proper level of expertise for the type of exposures
- Reserving personnel independent of Underwriting and Pricing personnel
- Chief Actuary/lead reserving actuary responsible for:
 - Internal actuarial reserving estimate
 - Presenting estimate and appropriate support to senior management

Our Observations

Actuarial staffing and expertise Industry observations

- Most companies are appropriately staffed.
- Lead actuary generally demonstrate ownership of results of the reserve estimates, and typically prepares a consistent standard quarterly package.
- Two common opportunities for improvement:
 - Separation of the pricing and reserving functions
 - Frequency of meetings and interactions between the lead reserving actuary and senior management.

Our Observations

Data quality and reliability

Characteristics of a strong control environment

- Loss/premium/other actuarial data is usable for reserving as captured and contained in the company's systems
- Limited or non-existent manual processing
- Data is available in a timely manner for actuarial review
- MGA/TPA interfaces are well controlled and monitored
- Data adjustments for FX and intercompany reinsurance are handled accurately and transparently

Our Observations

Data quality and reliability Industry observations

- Personal lines companies tend to have superior data quality as compared to commercial lines and reinsurance companies – much less manual processing
- Data systems at some commercial lines and reinsurance companies have limitations, requiring manual processes and resulting in data is not easily reconcilable to the financial statement.
- Companies generally have a relatively strong system in place for preparing current period metrics.

Our Observations

General reserving approach and methodology

Characteristics of a strong control environment

Frequency of Reviews

- Quarterly analysis without a quarterly lag for most exposures; more complex exposures might require lag with AvE for latest quarter.
- A&E, other non-traditional exposures – annual analysis with robust quarterly monitoring.

Gross vs. Net of Reinsurance

- Analyses completed concurrently
- Same depth of analysis for gross and net reserves

Use of Reasonableness Checks

- Loss ratios, IBNR/case, other metrics are standard outputs

Use of Software

- Standardized, well controlled, flexible reserving software
- Ad hoc spreadsheets are used sparingly and with appropriate controls

Our Observations

General Reserving Approach and methodology Characteristics of a strong control environment (continued)

Use of best methods available for the circumstances

- Method not based on ease of application
- Inferior methods not accepted long term as appropriate where there are data limitations

Regular input from with claims, underwriting, reinsurance, etc.

Information is shared among multiple locations, business units

- Broader/global approaches are used

Effective price monitoring

- Reserving actuaries team with pricing actuaries, underwriters to obtain appropriate price monitoring information

Our Observations

General Reserving Approach and methodology Industry observations

- Most companies apply appropriate methodologies in their analyses, receive reasonable balance of inputs from actuarial, underwriting, and claims departments.
- A common area where companies fall short is the rigor of the analysis of difficult-to-estimate liabilities, such as A&E, D&O and property catastrophes.
- Most large companies use reserving software to some capacity, although ad hoc spreadsheets are used when circumstances warrant the increased flexibility spreadsheets afford.

Our Observations

Documentation

Characteristics of a strong control environment

Comprehensive documentation of reserving process in a single report or location, including:

- Premium and loss data (reconciled to financial records)
- Actuarial estimates as applied to the data
- Schedules summarizing the actuarial estimates

Documentation also exists to demonstrate:

- Effectiveness of peer review
- The decision-making process for determining management's best estimate
- Evidence that management's best estimate equals amounts recorded in the financial statements
- Where recorded amounts differ from internal actuarial estimates, a record that qualitatively and quantitatively supports why management believes the recorded amount is better than the actuarial estimate

Our Observations

Documentation

Industry observations

- Our survey responses highlight the improvements to the documentation of the reserving process facilitated by the post-Sarbanes environment.
- Most companies have standardized documentation for the majority of their business. However, a strong majority of companies do not produce a consolidated stand-alone report.
- A common opportunity for potential improvement involves the support for recorded amounts in cases where such amounts differ from internal actuarial indications.

Our Observations

Use of external actuaries

Characteristics of a strong control environment

External actuaries can add value to the reserving process:

- May be considered more independent, objective
- Expertise/information not available to company e.g. non-traditional claims
- Differences between internal and external actuarial estimates can highlight areas for additional review
- Can provide insights based on a broad industry perspective
- Value in having the external actuary report to the board and/or audit committee

Our Observations

Use of external actuaries

Industry observations

- A clear majority of companies involve external actuaries annually, in particular for difficult-to-estimate liabilities – likely as a result of the post-Sarbanes environment.
- A common opportunity for improvement involves the documentation of reasons for differences in indications between the external actuaries and management.
- Another area of improvement regards the frequent meetings between third party actuaries such that a rapport is built and management regularly seeks advice.

Our Observations

Financial statement disclosures

Characteristics of a strong control environment

Disclosures are clear, understandable, and include:

- Management's process
- How management arrives at its best estimate
- Ranges/other metrics to provide transparency around uncertainty of estimates
- Explanation of prior period development, even if increases in one line or accident year offset reductions in another line or accident year
- Other information that would be useful e.g. global loss triangles for global insurance companies

Our Observations

Financial statement disclosures

Industry observations

- Actuaries are typically very involved in developing disclosures related to prior period development and preparing the related accident year and prior year metrics.
- Prior period development disclosures are generally clear quantitatively, but explanations could be improved.
- Opportunities for improvement involve the description of the reserving process and approach to selecting its best estimate, and providing greater insight via ranges / reserve variability.

Questions & Answers



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