A PUBLIC POLICY OVERVIEW

An Overview for P/C Insurers' Audit Committees: Effective Use of Actuarial Loss Reserves Expertise

December 2014

American Academy of Actuaries
Committee on Property and Liability
Financial Reporting

American Academy *of* Actuaries

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Developed by the Committee on Property & Liability Financial Reporting of the American Academy of Actuaries

AMERICAN ACADEMY *of* ACTUARIES

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Revised from 2007 publication, *An Overview for Audit Committee Members of P/C Insurers: Effective Use of Actuarial Expertise*

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This document[1] is intended to provide members of boards of directors and audit committees of property/casualty insurance companies with a more complete understanding of the information and assistance that actuarial professionals can provide as such board/committee members perform their financial reporting oversight roles.

Summary

The reliability of financial statements for property/casualty insurance companies depends significantly on the accuracy of the recorded liabilities for unpaid claims, commonly referred to as "loss reserves." Unlike most balance-sheet liabilities common to other industries, the loss reserves of a property/casualty insurer are only estimates, not fixed known amounts. These estimates are based on the work of actuaries.

Loss reserve estimates are often subject to significant uncertainties. At times, property/casualty insurers have announced significant loss reserve increases for reasons that include but are not limited to: high growth in new business lines (where the company did not have preexisting experience), the impact of major court cases, unanticipated increases in loss trends (such as sustained higher trends in medical costs and utilization), asbestos litigation, and construction defect claims. For some companies, such loss reserve increases are large enough to impair their financial condition; for others, reported profitability is affected. Significant loss reserve decreases can also occur, e.g., due to declining auto claim frequency during a recession.

Property/casualty insurance companies' boards of directors and audit committees have a fiduciary responsibility and regulators' expectation for overseeing the financial reporting process. Since loss reserves are crucial to property/casualty insurers' financial statements, audit committees and boards of directors are advised to have direct discussions with their actuarial professionals to obtain a better understanding of the loss reserve estimation process and the policies related to that process. These discussions, via both periodic presentations and special workshops, help to increase boards of directors and audit committee members' appreciation for the uncertainty inherent in loss reserve estimates.

This document begins with a background on loss reserves and the roles of actuaries in setting them, followed by a discussion of oversight function considerations related to those reserves.

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[1] The considerations contained herein are based on broad generalizations and are not intended to describe or establish actuarial standards of practice or requirements. The information presented is intended to reflect a large percentage of property/casualty insurers. Within the property/casualty insurance industry, there is wide diversity of actuarial practice. Each company and each situation must be evaluated on the basis of its own circumstances.

This document is offered primarily for members of audit committees and boards of directors of property/casualty insurers subject to regulation by the members of the National Association of Insurance Commissioners (NAIC). While most of the considerations apply as well to other insurance entities, including non-U.S. insurance companies, captive insurance companies, corporate self-insurers, etc., some of the references contained herein are specific to the NAIC's requirements regarding the recording of loss reserves in insurers' financial statements.

Background on Loss Reserves and Roles of Actuaries in Setting Them

Property/Casualty Insurance Loss Reserves

A property/casualty insurance policy is a promise to pay claims related to covered, or insured, events. Usually, covered events take place during the time the policy is in effect (e.g., auto accident, injury, or loss of property as a result of a loss covered under the terms of the policy). In some cases, the insurance company is not presented with a claim or demand for payment by the insured or a third party until years after the covered event has occurred. It can take many years for a claim, once made, to be investigated and settled.

When these claims are eventually settled, the insurance company must have the resources to pay the claim in accordance with the policy provisions. Therefore, until all claims are resolved and the related amounts are paid, insurance accounting rules require the insurer to establish a "loss reserve" as a liability on the company's balance sheet. (These loss reserves include a provision for loss adjustment expenses[2] (LAE) or settlement costs.) The loss reserve is based on the company management's best estimate of the amounts that will be paid in the future for losses and loss adjustment expenses related to claims arising from past events (i.e., events on or prior to the accounting "as of" date) pursuant to policies sold, whether or not all claims have been reported at that time.

The duration and the uncertainty of the claims-settlement process necessitate that loss reserves be based on estimates. A property/casualty insurer's loss reserves are typically the company's largest balance-sheet liability by a wide margin and its greatest source of financial statement uncertainty. Loss reserves can be difficult to estimate, and the amounts ultimately paid may be far less than, or greater than, amounts previously estimated.

A conclusion that prior years' loss reserves need to be revised, based on current facts and circumstances, affects both the company's reported surplus and its income during the period in which that conclusion is reached. As such, changes in loss reserve estimates have consequences both for the financial condition of the company and for its perceived ongoing operating profitability. It is therefore important that loss reserves be set as accurately as possible.

Role of Actuaries in the Reserving Process

Actuaries typically play an integral role in the loss-reserving process. The actuarial role is generally provided by one or more of the following sources:

- *Internal Actuaries* – Many insurance companies employ actuaries to aid in setting loss reserves. Typically an internal actuary provides periodic analyses of loss reserves and assist management in understanding underlying claim trends, the judgments and assumptions used in the analyses, and any material risk factors that might affect the loss reserves. The internal actuary may also lead presentations regarding estimated loss reserves to boards of directors and audit committees.

[2] LAE are discussed in greater detail in Actuarial Standard of Practice No. 43, *Property/Casualty Unpaid Claim Estimates*, promulgated by the Actuarial Standards Board (ASB), which can be found at http://www.actuarialstandardsboard.org/pdf/asops/asop043_159.pdf.

- *Audit Firms* – Often, insurance companies' external audit firms will assign actuaries to their engagement teams. The audit firms' actuaries evaluate the reasonableness of the recorded amounts. To assist them in this evaluation, they may develop an alternative point estimate and/or "range of reasonable estimates"[3] of the loss reserves. This range is usually much narrower than a range of possible outcomes, and it is intended to provide an independent view of whether the recorded loss reserve amounts are reasonable in light of the available information.

- *Consulting Actuaries* – Consulting actuaries may be engaged to take on the actuarial role in setting loss reserves (as described in the *Internal Actuaries* discussion above). Some companies also engage third-party actuarial consultants to perform independent analyses of the loss reserves. Such analyses can encompass the entire claim population or can be limited to some unusual or especially difficult to estimate portion of the exposures. The detailed analyses performed by consulting actuaries often include independent methodologies, judgments, and assumptions.

The boards of directors of all U.S.-domiciled insurers are also required to appoint a qualified actuary, or "appointed actuary," to render an opinion on the recorded loss reserves for the regulatory (or "statutory") year-end financial statements. This opinion is based on specifications described by the National Association of Insurance Commissioners (NAIC), and is contained in a formal, public document called the *Statement of Actuarial Opinion* (SAO).[4] The SAO is an important tool used by insurance regulators to assess insurer solvency. In addition to the actuarial opinion on the reasonableness of the recorded loss reserves, the SAO contains informative disclosures regarding the factors affecting the variability of the loss reserves and the appointed actuary's view as to whether there is a risk of "material adverse deviation[5]" from the recorded estimate.

Oversight Function Considerations – Loss Reserve Estimates

The following are some of the major considerations for those providing an oversight function on recorded loss reserves.

- Unavoidable use of judgment – input from multiple disciplines
- How actuarial estimates are considered
- Extensive public (and private) disclosure
- Loss reserve variability and uncertainty
- Data quality and the impact on loss reserve uncertainty
- Context of the reserves
- Ceded reinsurance
- Governance (control) structure underlying loss reserves

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[3] The term "range of reasonable estimates" is defined and described later in the section labeled "Loss Reserve Variability and Uncertainty." The term is also discussed in a 2008 Academy paper, "P/C Actuarial Communication on Reserves Ranges and Variability of Unpaid Claim Estimates," available at http://www.actuary.org/files/range_sept08.4.pdf/range_sept08.4.pdf.

[4] In the United States, the SAO is prepared at the legal entity level, i.e., for each individual insurance company within a group rather than for the consolidated group of companies. (See the NAIC's Regulatory Guidance for Annual Statement Instructions for Property/Casualty Actuarial Opinions, available at http://www.naic.org/committees_c_catf.htm

[5] The SAO instructions require the appointed actuary to disclose their materiality standard"

Unavoidable Use of Judgment – Input from Multiple Disciplines

As mentioned above, loss reserves are only estimates of the ultimate amounts payable and are not known with certainty. The amounts that will eventually be paid will be the result of numerous investigations, settlement negotiations, jury trials, court decisions, (possibly) contract interpretations, and other items not knowable with certainty in advance. Hence the use of judgment in the estimation process is inevitable.

The basis for these estimates is "past experience adjusted for current trends, and any other factors that would modify past experience."[6] This estimation process is often led by actuaries and requires the input of others from multiple disciplines. Those providing input typically include the claims department, legal counsel, underwriting, and relevant business units, with the final decision on the estimate to book being the responsibility of company management. That said, actuarial input is vital to management's process, as the actuarial estimates typically consider and incorporate input from all involved disciplines.

Members of audit committees and boards of directors benefit from understanding the significant judgments and assumptions incorporated into the loss reserve estimates that are made by management and by the actuary. The significance of this understanding can extend beyond loss reserves, as the findings or observations that inform those judgments may also provide valuable input to decisions regarding pricing or marketing plans.

How Actuarial Estimates Are Considered

Actuarial estimates are not necessarily adopted by management as the booked loss reserves, as company management may record an amount that differs from the actuary's estimate. In such cases, members of audit committees and boards of directors should understand the differences between the actuarial and management estimates. In particular, members of audit committees and boards of directors may request management to provide clarity through answers to the following questions:

- Does management's process typically result in differences between the actuary's estimates and the recorded amounts, and, if so, why?
- How do management's estimates compare to a range of estimates that may be developed by the actuary?
- Has due diligence been performed to identify the potential impact, if any, on the loss reserve estimates of any significant recent changes in the company's operations (e.g., claims, underwriting, reinsurance)?
- If such changes exist, what adjustments or other considerations are made (by management and/or the actuary) to reflect the potential impact of the changes on the estimates of loss reserves?

Extensive Public (and Private) Disclosure

The loss reserves recorded by a U.S. property/casualty insurer are subject to extensive public and private disclosure, allowing many parties to view and potentially form their own view of the insurer's estimates.

[6] 2014 NAIC Accounting Practices & Procedures Manual – Statement of Statutory Accounting Practices (SSAP) No. 55, paragraph 10.

The Securities and Exchange Commission (SEC) requires each publicly-traded U.S. property/casualty insurance company to include a loss reserve development table as part of its annual Form 10-K filing. This table provides a comparison of the company's consolidated loss reserves (claim liabilities) recorded at each of the past 10 year-ends to updated estimates, including the most recent estimate, of those same liabilities. Additional (largely) qualitative disclosures are also required regarding loss reserves and related risk factors. These disclosures include information on the reasonably likely variation in the insurer's loss reserves and the effect of that variation on the financial condition of the company. The disclosures also contain explanation of the source of any recent changes in prior loss reserve estimates. In addition to the disclosures within the SEC filings, many public companies issue press releases and hold investor conference calls that incorporate information related to loss reserves.

For U.S. property/casualty insurers, a summary of similar loss development information is provided in Schedule P, Part 2 – Summary (Schedule P) of the NAIC Statutory Annual Statement, which is filed by each individual insurance company for regulatory purposes. Schedule P shows the annual development of ultimate losses and *Defense and Cost Containment loss adjustment expense* (DCC LAE) for each of the past 10 coverage years (often referred to as "accident years").

Both the SEC disclosures and the NAIC Schedule P filings provide 10 years of history showing the accuracy of management's loss reserve decisions over time. These schedules are used by analysts and other users[7] to assess the reliability of a company's current reserving practices and the accuracy of the balance sheet estimates relative to those of its competitors.

Members of audit committees and boards of directors can request the company actuary to provide the following information with regard to these disclosures:

- The specific reasons for past years' revisions to loss reserve estimates, including the lines of business, programs, and years affected.
- A comparison to industry trends for the same coverages during the same period.
- A comparison to the reserve activity of the company's closest competitors for the same coverages during the same period.

Besides the public SAO mentioned above, in which the appointed actuary is required by state law or regulation[8], to opine on the reasonableness of recorded loss reserves, the appointed actuary is also required to provide a private disclosure (the Actuarial Opinion Summary, or AOS) to insurance regulators every year. The private report discloses the actuary's estimate or range of estimates relative to management's recorded loss reserve estimates, and, where applicable, the causes of recent significant adverse reserve development. The appointed actuary documents the analysis underlying the SAO and AOS in the detailed Actuarial Report[9], which is made available to the insurance regulator upon request. The board or audit committee may wish to receive its own copy every year of the SAO and AOS (a relatively short document).

[7] The list of other users includes the Internal Revenue Service (IRS). The Schedule P filings are the basis for the loss reserve tax deduction under current tax losses, with the IRS and tax courts also making use of actuarial analyses in evaluating the reasonableness of these deductions. See *Acuity v. IRS* tax court decision, "T.C. Memo. 2013-209."

[8] Theses state laws or regulations are based on an NAIC model law on the topic of P&C insurer loss reserve opinions by appointed actuaries.

[9] The Actuarial Report is required and defined by the SAO instructions, and its purpose is to document the SAO findings.

Loss Reserve Variability and Uncertainty

The management of a U.S. P/C insurer is required to include an analysis of variability and uncertainty in the loss reserve estimation process.[10] Actuaries are uniquely qualified to provide insights into the potential for this variability and uncertainty.

Estimating loss reserves involves predicting future loss payments based on historical and current information and knowledge, as well as judgment about future conditions. Actuaries typically employ several methods to estimate loss reserves in a given situation and may consider multiple reasonable assumptions regarding future conditions when applying the methods. The actuary may develop a "range of reasonable estimates"[11] of loss reserves based on various combinations of these methods and assumptions. This range is typically developed by the Appointed Actuary to assist in creating an opinion on the reasonableness of the recorded loss reserves. The range of reasonable estimates is not a broad range of potential outcomes; rather, it is a narrower range of estimates that the actuary considers to be appropriate for the carried reserve.

While the range of reasonable estimates may encompass multiple reasonable assumptions about future conditions, it typically will not include the possibility of sudden shifts in the statutory, judicial, and economic-reserving environments, nor will it include major unexpected changes in company operations. Nevertheless, such shifts can and do occur.

As part of the actuarial opinion, the actuary reports on events and circumstances that pose a significant risk to the company and that would result in a material adverse deviation from the carried reserves. Such events and circumstances could be systemic to the company's segment of the insurance industry or particular to the company. Historic examples of systemic events and circumstances include changes in the legal environment that led to significant asbestos and environmental losses long after policies had expired or the rapid unexpected inflation that led to mispricing and initial under-reserving in workers' compensation in the late 1990s. Systemic changes can be positive as well: medical professional liability lines, in addition to experiencing rapid increases, have also seen rapid decreases in claims costs (neither of which were reflected in the initial reserves). Examples of significant internal risks include mispricing of a block of business or, for smaller companies, even the emergence of more than the expected number of large losses. For some companies, particularly very large personal lines carriers, the risk of material adverse deviation in the carried reserves might be remote, while other companies could be subject to reserve deviation risk so great that the difference between the high and low ends of the actuary's range of reasonable estimates is material.

Members of audit committees and boards of directors should seek to understand the significant risks that threaten reserve development outside of the current range of estimates, both in terms of their potential magnitude and the actuary's estimation of the likelihood of such events. Strong oversight should include frank discussions of such risks among the parties responsible for estimating and recording the loss reserves with the audit committee or board of directors.

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[10] 2014 NAIC Accounting Practices & Procedures Manual, SSAP No. 55, paragraph 12: "Management … shall include an analysis of the amount of variability in the estimate".
[11] As pointed out in footnote 3, this term is also discussed in http://www.actuary.org/files/range_sept08.4.pdf/range_sept08.4.pdf.

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[12].

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.

Context of the Reserves

Loss reserving issues and variability can vary drastically across product lines and companies within the insurance industry. Hence, members of audit committees and boards of directors will benefit in their oversight function from being aware of the context underlying the reserve estimates, including the company's areas of concentration, recent industry trends in those areas, and material developments within the company that might affect the estimation process. Knowing this context can help them ask more probing questions of management and the appointed actuary regarding the recorded loss reserve and associated risks.

Information they may want to obtain from senior management and/or the appointed actuary could include:

- The breakdown of the company's loss reserves by coverage or product line.
- Recent industry trends in those product lines (with regard to profitability, underwriting, claims, and reserving issues).
- Whether there have been any recent changes in the company's experience in those lines vis-à-vis profitability, claim handling, or reserve development.
- Major risk factors in the reserving for those lines.
- Whether competitors are experiencing the same risk factors, recent changes, etc., that the company has seen.
- The causes of recent changes in reserve estimates (favorable or unfavorable).
- Whether competitors have cited similar causes.
- Questions about the reserves raised by major outside stakeholders, including regulators, rating agencies, and, where relevant, investors or investment analysts.

[12] This is a requirement of both Actuarial Standard of Practice No. 23 – Data Quality, as well as the SAO instructions.

The feedback received should be consistent with (or at least not contradictory to) information available from publicly available sources, such as trade publications, competitor SEC filings, and investor analyst reports.

<u>Ceded Reinsurance</u>

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

<u>Governance (Control) Structure Underlying Loss Reserves</u>

Any material balance sheet estimate needs to have a strong governance process and system of controls supporting it, and the loss reserve estimate is no exception. The following are some of the typical controls, both internal and external, that exist for loss reserve estimates. The board/audit committee member might want to be familiar with the extent to which these controls exist or are followed for the insurance company.

<u>Internal Controls</u>

- *Segregation of duties.* While input from those responsible for pricing or developing business (e.g., underwriters, pricing actuaries) is often very useful to the loss reserving process, objectivity typically improves when different people perform the primary reserving and pricing roles. The perspectives provided by the pricing and reserving functions are often different, with the pricing function focusing on the profitability of current and future business. By contrast, the reserving function focuses on the potential outcomes connected with business written in the past (sometimes even in markets that the company has since left). As such, the reserving function acts to some extent as an early warning test or report card on past pricing and/or underwriting performance. This creates a potential conflict of interest when the same people perform both functions. Where resources do not allow separate staffing of these two functions, audit committee members should be aware of the potential conflict of interest that arises from the same people performing both functions.

- *Use of reserve committees*. Some insurance companies have reserve committees or an equivalent oversight management group, often organized at one or more management segment level(s) (e.g., legal entity, line of business, region). The committee might include the segment's executive management, the segment's internal reserving actuary or actuarial consultant, and heads of key operating functions (e.g., claims, underwriting, marketing).

Having a reserve committee does not ensure objectivity, and members of audit committees and boards of directors may wish to inquire further to determine its effectiveness. The extent to which a reserve committee improves objectivity is partly a function of the quality and efforts of the reserve committee members. Members of audit committees and boards of directors should learn the identities and qualifications of reserve committee members. The audit committee and board of directors may find value in meeting separately with the lead actuary to obtain the actuary's view of the reserve committee's effectiveness and may also find value in obtaining certain summary information from the reserve committee meetings on a regular basis.

- *Internal audit*. Larger insurance companies typically have an internal audit function that includes in its scope the loss reserve process. This internal audit function can include testing of data quality used in the loss reserve analysis and monitoring any in-house reserving actuaries' compliance with professional practice standards.

- *Actuarial peer review*. Many actuarial firms and in-house actuarial departments have implemented peer review programs to provide an additional set of eyes on professional work product.

- *Report from the Appointed Actuary*. Each statutory insurer's appointed actuary is legally required to report to the board or audit committee each year on the items within the scope of the actuary's loss reserve opinion. Many of these are in-person, allowing for immediate response to questions the board/audit committee may have.

<u>External Controls</u>

- *External Audit*. As loss reserve estimates have a material impact on earnings and technical solvency, external auditors of public companies typically include a review of these estimates in every reporting cycle (although more attention may be paid to this issue at year-end than for interim periods). Many insurers' boards/audit committees include discussions with their external auditors on a regular basis in their agendas.
- *Attestations.* Through its Model Audit rule, the NAIC requires larger insurers to provide an attestation regarding the operating effectiveness of its control structure. This control structure will include controls related to the loss reserving process. For public companies, the Sarbanes-Oxley Act of 2002 requires not only internal attestations, but an attestation by the independent auditors related to controls. An audit committee or board may seek reports related to how well the controls are operating and request specific information related to the controls on actuarial processes in particular.
- *Financial Examinations by Insurance Regulators.* State insurance laws require each insurer to undergo a financial exam by the state at least once every three to five years. A review of previously-recorded loss reserves is a key part of this exam, with that review performed by either insurance departments or external actuarial consultants working on behalf of the insurance departments. As part of these exams, the state's examiners inquire about the oversight of the board and audit committees into the loss reserving process, indicating that the expectations of the regulators includes a strong awareness and involvement in oversight of the loss reserves.

- *Replacement of Appointed Actuary.* 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. These disagreement letters are not public information, but audit committees benefit from review of these letters whenever an appointed actuary is replaced.

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 opining actuary is replaced, and the new actuary immediately agrees with management's position.

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Loss reserves are a major part of an insurer's reported balance sheet, subject to public (and private) disclosure and review, and, by their nature, require the use of judgment. As such, oversight of such reserves is a material part of the board or audit committee's responsibility. Actuarial input in this oversight process is inevitable and invaluable. This issue brief attempts to aid in audit committees' and boards of directors' understanding of the issues and resources related to this important oversight function.