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ISSUE BRIEF

AMERICAN ACADEMY of ACTUARIES

Actuarial Opinions in Property/Casualty Insurance

Each year, property/casualty insurance companies are required by statute to file financial statements with insurance regulatory authorities. Because the financial statements of insurance companies are highly complex, and key issues and risk factors affecting their financial condition are not always readily apparent, insurance laws require that along with the financial statement, the insurance company must provide a "Statement of Actuarial Opinion" (SAO) prepared by its "Appointed Actuary." A primary purpose of the SAO is to present the Appointed Actuary's opinion regarding the reasonableness of the loss reserves reflected on the insurance company's balance sheet.

Recent reports from A. M. Best, an insurance rating agency, and Standard & Poors have cast doubt on the industry's loss reserve adequacy. A number of large property/casualty insurance companies have been in the news announcing material reserve increases, due to numerous causes including asbestos litigation, increased claims against contractors related to defective construction, large medical malpractice awards, alleged property damage caused by toxic mold, and terrorism losses. High profile, non-insurance corporate failures such as Enron, WorldCom, and others have heightened public scrutiny of financial statements for all industries. These failures contributed to passage of The Sarbanes-Oxley Act of 2002, which focuses on financial accounting standards, and on ways to produce more accurate disclosure of the true financial condition of public and non-public companies.

These developments have resulted in increased scrutiny by regulators and the public of the published financial reports of insurance companies, and increased attention to the SAO and the role of the actuary. This Issue Brief is intended to clarify the purpose of the SAO, and to highlight its value and intended use as a tool for the evaluation of—but not a guarantee of—insurance company solvency.

Members of the Committee on Property and Liability Financial Reporting who participated in revising this issue brief include: Andrea Sweeny, FCAS, FCA, MAAA, Chairperson; Robert Wainscott, FCAS, MAAA Vice Chairperson; Nancy Watkins, FCAS, MAAA Vice Chairperson; Scott Anderson, FCAS, MAAA; Lisa Besman, FCAS, MAAA; Robert Eramo, ACAS, MAAA; Edward Ford, FCAS, MAAA; Thomas Ghezzi, FCAS, MAAA; Holmes Gwynn, ACAS, MAAA; Joseph Herbers, ACAS, MAAA; Mary Miller, FCAS, MAAA; Jay Morrow, FCAS, MAAA; Marc Oberholtzer, FCAS, MAAA; Dale Ogden, ACAS, ASA, MAAA; Wade Overgaard, FCAS, MAAA; Marc Pearl, FCAS, MAAA; Thomas Schadler, FCAS, MAAA; James Votta, FCAS, MAAA; Scott P. Weinstein, FCAS, MAAA; Theodore Zubulake, FCAS, MAAA.

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Property/Casualty Insurance Loss Reserves

To understand the purpose of the SAO and what it can and cannot do, it is necessary to understand the nature of property/casualty insurance loss liabilities. The insurance policy is a promise to pay claims related to covered, or insured, events. Usually, covered events are those that take place during the time the policy is in effect (e.g., an auto accident, injury or loss of property due to defective product or faulty construction). In many cases, it is not until years after the covered event has occurred that the insurance company is notified of the claim. For example, bodily injury from exposures such as asbestos, pharmaceuticals or airborne contaminants may not be discovered for years or even decades after the exposure. Even after a claim is filed, the adjudication of the circumstances of the event, and the determination of negligence and damages, often involve complex legal theories that can take many years to resolve.

When these issues are eventually settled, the insurance company must have the resources to pay the claims related to its coverage. Therefore, in the interim, insurance accounting rules require that the insurance company set aside funds to cover the eventual cost of incurred claims and the cost of handling such claims (i.e., loss adjustment expenses). These funds (or "loss reserves") are established as a liability on the insurance company's balance sheet, and are ultimately used in the future to pay the claims that have occurred as of the current financial statement date. Loss reserves include amounts for claims as of the financial reporting date that have been reported or are known as well as an amount for claims that have occurred but have not been reported and are not known.

The time lags and uncertainties involved in the claims settlement process make it necessary for loss reserves to be based on estimates. A property/casualty insurance company's loss reserves usually represent the company's largest liability, and the greatest source of financial uncertainty on its balance sheet.

Role of the Appointed Actuary

Each year, every regulated property/casualty insurance company (with a few exceptions) is required to file a SAO on its loss reserves prepared by an Appointed Actuary. The Appointed Actuary must meet prescribed qualification standards and follow standards of practice. The qualification standards require education and experience in the area of loss reserving, and additionally, satisfaction of continuing education requirements.

A primary purpose of the SAO is for the Appointed Actuary to opine on the reasonableness of the insurance company's loss reserves at a certain date based on the information known at that date. The SAO is based on a combination of quantitative and qualitative information.

- In using quantitative information, the actuary analyzes patterns and trends in past claims data to construct models of the claim process and estimate the expected future claim payments, based on patterns present in the past available claim data. Such estimates may, in fact, prove to either overstate or understate the insurance company's claims liabilities over time as actual experience emerges. To get reserves "exactly" right, one would have to predict the future exactly.

- In using qualitative information, the actuary incorporates knowledge of the coverages offered by the insurance company, experience in matters affecting the frequency and severity of claims, and judgment to interpret the usefulness of past claims experience to project the insurance company's obligations to pay claims in the future.

Based on that information, the actuary produces estimates of the amount of future claims settlements in the aggregate, and compares the estimates to the loss reserves carried by the insurance company. The actuary issues a SAO stating whether or not the reserves are reasonable, and highlighting aspects of the insurance company's reserves that deserve particular regulatory attention and monitoring.

Uncertainty

There are sources of significant uncertainty affecting loss reserves, including changes to the legal, social and economic environment. Courts continuously interpret policy terms and expand or restrict the coverage provided by the insurance company's policies. Claimants' attitudes regarding filing insurance claims change, and the economic environment changes over time, making the incidence of claims more or less likely, and their settlement more or less costly than in the past. Further, there may be significant changes in the nature and quality of the underlying business. Since the effect of these sorts of changes cannot be precisely understood at the time the SAO is issued, estimating future loss payments is a highly uncertain exercise.

Another source of uncertainty is that no two time periods are ever identical, which makes the past claims history less than 100% predictive of future claims potential. As with all forecasts of future events, it is not possible to guarantee the accuracy of the actuary's estimates of the eventual cost of claims. Variations in experience from time period to time period make it necessary to think in terms of a range of possible outcomes as opposed to concluding that any given outcome will occur.

Why Estimates Change Over Time

As time passes and the legal environment changes, the actuary's assumptions regarding which claims are covered by the insurance company's policy and which claims are not covered also change. The actuary applies the current interpretation of legal precedents in each analysis. As courts and others change the scope of coverage of insurance company's policies, the actuary's estimates change accordingly.

Another reason why the actuary's estimates change over time is that new information is constantly being obtained that sheds light on the ultimate cost of claims. Over time, the volume of claims experience becomes more mature and reliable as claims are settled. This process generally provides the actuary with better information than was available in the past on which to estimate future losses. This new information increases the understanding of the ultimate resolution of prior claims, and provides greater insights into the actual underlying patterns of claim frequency and severity.

Use of Statement of Actuarial Opinion

The purpose of the SAO is to assist regulators in monitoring the reasonableness of reserves of insurance companies. It is prepared for a specified purpose, for use by a specified audience, and is governed by a rigorous base of actuarial standards and guidelines designed to enhance its quality and usefulness to regulators. The SAO provides insurance regulators with a rigorous annual review and discussion of the most significant liability on the insurance company's balance sheet using the information available at the time.

The SAO is focused predominately on loss reserve estimates. Certain other important solvency issues, such as the valuation of assets and adherence to accounting standards, are within the purview of other professionals (insurance department examiners, independent auditors, etc.).

In addition to providing the Appointed Actuary's opinion on the reasonableness of the insurance company's loss reserves, the SAO highlights the key factors known at the time the SAO is issued that appear to pose the greatest risk that the liability estimates may change in the future. Examples of risk factors that may be identified by the actuary include possible concerns about the collectibility of the insurance company's reinsurance, exposure to asbestos litigation, and the effect of the September 11 terrorist attacks. The eventual outcomes of these types of situations have proven especially difficult to estimate. The actual risk factors identified vary among insurance companies and over time as issues emerge and are resolved.

Conclusion

Since loss reserves are generally the largest liability on an insurance company's balance sheet, the SAO is an important tool in the monitoring of an insurance company's financial condition in an uncertain environment. Its focus on loss reserves and disclosure of known significant risk factors improves the information available to the regulator to consider areas of concern and take appropriate action. Although the SAO is not a guarantee that the financial condition reported by property/casualty insurance companies will prove accurate in all cases, it helps to identify the potential risks and uncertainties faced by insurance companies with respect to loss reserves.

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