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Statement of Actuarial Opinion Changes Boost Industry Health

By Joseph A. Herbers, ACAS, MAAA

New requirements to the Statement of Actuarial Opinion (SAO) significantly change the roles and responsibilities of actuaries and the insurance companies on which they opine.

The SAO is an opinion by a qualified actuary as to whether the reserves held by an insurer adequately provide for its outstanding claims liabilities. The SAO is required to be filed with an insurance company's annual statement, which is the primary information source for regulatory review of an insurer's financial position.

In addition, there is an important change to the Annual Statement Instructions generally. That is, there is a new attestation requirement for risk transfer in reinsurance contracts that may have a bearing on SAOs in 2005.

Designed to improve adherence to actuarial standards, provide more organized and complete information to the regulator and increase disclosure in critical areas, the SAO changes were developed by the Casualty Actuary Task Force (CATF) of the National Association of Insurance Commissioners (NAIC). The task force is charged with making periodic changes to the form and content to the SAO as part of its Annual Statement Instructions to help regulators fulfill their statutory obligations.

Changes made to the 2005 requirements are the culmination of adjustments that have evolved over the past several years. Specifically, the 2005 SAO changes introduce:

- New documentation called the Actuarial Opinion Summary (AOS)
- A process for changing the Appointed Actuary
- New regulatory guidance

New AOS Document

The NAIC Annual Statement Instructions require a new document, called the Actuarial Opinion Summary, be provided by the Appointed Actuary. The AOS is designed to give regulators more information and disclosures earlier in the process of reviewing insurer financial information. In effect, the AOS is a summary of the primary conclusions of the actuarial report supporting the SAO. The AOS will allow a regulator to triage insurers into different categories in order to set their plans for financial exams in 2006.

Important Statement of Actuarial Opinion
DEADLINES

Annual Statement/Statement of Actuarial Opinion, *due* ***March 1, 2006***
Actuarial Opinion Summary, *due* ***March 15, 2006***
Actuarial Report, *due* ***May 1, 2006***

About the Author

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Mr. Herbers is a Principal and founding member of Pinnacle Actuarial Resources, Inc., in the Bloomington, Illinois, office. He holds a Bachelor's Degree in Mathematics from the University of Missouri. He has more than 20 years of consulting experience and 25 years experience in the insurance industry.

Mr. Herbers is an Associate of the Casualty Actuarial Society and a member of the American Academy of Actuaries. He is a long-term member of the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries, and has been an active volunteer member of the Casualty Actuarial Society.

Mr. Herbers currently serves as the Appointed Actuary for nineteen U.S. domiciled property/casualty insurance companies and has prepared formal Statements of Actuarial Opinion over the course of his 20 years as a consultant. In addition, he provides Statements of Actuarial Opinion for dozens of self-insurance clients and captive insurance companies.

Mr. Herbers has given presentations on Statements of Actuarial Opinion to a variety of audiences including regulators, auditors and practicing actuaries. He also is the author of a professional paper for the Casualty Actuarial Society titled 'Materiality and Statements of Actuarial Opinion' in 2002.

Prior to 2005, regulators had to make a special request for the actuarial report supporting the SAO and too often faced roadblocks in obtaining that document. The Annual Statement Instructions state the carrier "must make the report available for regulatory inspection" but it did not require the company to actually send a copy of the report to the regulator.

The AOS is an addition to two documents typically prepared by the Appointed Actuary. The first document is the formal SAO itself, which is sent both electronically and in hard copy format; the insurer generally attaches it to the inside front cover of the Annual Statement and includes it in electronic filings. The second document is the Actuarial Report, which presents a narrative and all the detailed exhibits and rationale to support the conclusions in the SAO. The Actuarial Report must be finalized and made available to the insurer by May 1.

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The new AOS document must be signed and dated by the Appointed Actuary who signed the SAO. The AOS must also include at least five elements. They are:

- The Appointed Actuary's range of reasonable estimates for loss and loss adjustment expense reserves, net and gross of reinsurance
- The Appointed Actuary's point estimates for loss and loss adjustment expense reserves, net and gross of reinsurance
- The insurance company's recorded loss and loss adjustment expense reserves, net and gross of reinsurance
- The difference between the company's carried reserves and the Appointed Actuary's point estimate and/or range of reasonable estimates, net and gross of reinsurance
- Explicit description of the reserve elements or major contributory management decisions where there has been one-year adverse development in excess of 5% of surplus, as measured by Schedule P, Part 2 Summary, in at least three of the past five calendar years

Range and point estimate requirements are shown separately because some actuaries develop a range of reasonable reserves to support the SAO while others develop a point estimate and subject the difference between held and actuarially indicated reserves to measures of tolerance. Either is acceptable and neither form is mandatory either by regulation or professional standards. However, actuaries are increasingly evolving towards presenting results using ranges as they consider the disclosure of significant risk of material adverse deviation.

Confidentiality Requirements

The Annual Statement Instructions state that the AOS contains significant proprietary information; it should be held confidential and is not intended for public inspection. This is in contrast to the SAO, which is a publicly available document.

The NAIC drafted a model law (separate from the Annual Statement Instructions), that protects the confidentiality of the AOS and the Actuarial Report. Called the NAIC Property and Casualty Actuarial Opinion Model Law, it also shields the Appointed Actuary from liability for the SAO from parties other than the regulator and the company, except in cases of fraud or willful misconduct.

The model law is expected to become an NAIC accreditation standard, but the process of getting it enacted in states is expected to take several years. In the meantime, insurers are required by the Annual Statement Instructions to submit the AOS to the domiciliary state if that state has passed the model law or can guarantee confidentiality in some other manner. In addition, states other than the domiciliary state may request the AOS if that state can guarantee confidentiality. Therefore, actuaries may want to prepare the AOS as part of developing the opinion in case a non-domiciliary state requests the AOS after receiving the opinion. Actuaries may consult the American Academy of Actuaries' law manual or contact regulators for further information.

In those domiciliary states where confidentiality is protected (either by the model law or perhaps by the laws governing Financial Examinations), the AOS is due March 15. The AOS will also be submitted to non-domiciliary states upon request provided that the requesting state can demonstrate its commitment to preserve document confidentiality.

Regulators are currently able to review the actuarial report underlying the SAO within two weeks of request. Normally, the actuarial report provides them with pertinent information about insurance company operations that influence reserves. With the new AOS, regulators will not have to wait to get critical information that will eventually be embodied in the actuarial report. Furthermore, this AOS will be provided automatically and

will not necessitate a special request and two-week waiting period.

Changing the Appointed Actuary

The process for replacing the Appointed Actuary, according to the 2005 changes, is similar to the process currently in effect for replacing the independent auditor. This requires submission of letters from the company and the actuary regarding any disagreements concerning matters within the scope of the actuary's opinion. Additionally, the timeframe for notification to the domiciliary commissioner after action by the company's Board of Directors has been shortened from within 30 days to within 5 days. An additional 10 days is allowed for the submission of the letters regarding any disagreements.

The impact of this change should be negligible - changes in the Appointed Actuary arising from fee considerations or job changes are common. The impact on an insurance company that did have significant disagreements with its former Appointed Actuary, however, may be more significant. Depending on circumstances surrounding the change, the carrier could expect closer regulatory scrutiny.

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New Regulatory Guidance

The Casualty Actuarial Task Force has significantly expanded guidance for 2005 requirements. The more important additions to the guidance include the:

- Expectation that the Opinion paragraph must **explicitly** state which of the five types of opinion (Reasonable, Inadequate/Deficient, Excessive/Redundant, Qualified or No Opinion) is being rendered
- Identification of the materiality standard and the basis of selection by the Appointed Actuary
- Expectation that the Appointed Actuary has sufficient awareness of the background information and disclosures regarding risk transfer in reinsurance agreements in order to provide an informed opinion on net reserves
- Discussion of unusual ratios for the Insurance Regulatory Information System (IRIS) Tests 10 – 12. These tests relate to loss development statistics for prior years and a test of current reserve adequacy. In discussions regarding unusual IRIS Test ratios, the Appointed Actuary must provide reasonable insight and explanation to the company-specific factors that caused the result, rather than using boiler-plate language such as, "the company strengthened reserves."
- Expectation that the Actuarial Report supporting the SAO will include an exhibit that compares the Appointed Actuary's conclusions to the carried amounts (both net and gross) in the Annual Statement.

Risk Transfer Attestation Requirement

A new Annual Statement Instructions (but not specific to the SAO) requirement in 2005 is an attestation by the insurance company's CEO and CFO identifying the risk transfer in its reinsurance contracts. Specifically, the attestation is an affirmative statement that there are no side agreements and that risk transfer has occurred.

In addition, there are numerous new disclosures. These disclosures require the company to report contract terms and management objectives of any finite reinsurance agreement that effectively alters policyholders' surplus by more than three percent or that represents more than three percent of ceded premium or losses. There is also additional Interrogatory that has been added to the SAO for 2005. (see sidebar on back page)

The definitive guidance regarding evaluation of risk transfer is provided in Statement of Statutory Accounting Procedures SSAP 62 – Property and Casualty Reinsurance in the NAIC Accounting Practices and Procedures Manual. Pinnacle believes that the attestation relates to the risk transfer characteristics of all reinsurance contracts entered into after 1994 used as credit for reinsurance in the Annual Statement. Accompanying the attestation should be an indication of the economic intent and risk transfer analysis for all contracts except those where risk transfer is "reasonably self-evident."

The scope of the SAO does not include an evaluation of risk transfer nor an assessment of the appropriateness of the accounting treatment on the reinsurance contracts of a company. However, opining on the carried net reserves calls for knowledge of the ceded program and related reinsurance agreements.

The NAIC Annual Statement Instructions advise the actuary on several actions for gathering background information. The NAIC has recently approved additional disclosures from the company in the Annual Statement Interrogatories regarding reinsurance and risk transfer. The Appointed Actuary is expected to have sufficient awareness of the background information and disclosures to provide an informed opinion. This background

information will not reveal every possible question regarding reinsurance. It does have the potential to identify inconsistencies that deserve clarity prior to reaching a conclusion. The Relevant Comments section regarding reinsurance in the SAO should reflect the actuary's approach. Further detail and documentation of the company's reinsurance program should be included in the Actuarial Report.

Many questions remain about this new 2005 requirement, including:

- What are the responsibilities of the Appointed Actuary for reviewing the risk transfer process?
- How should actuaries appropriately approach a risk transfer analysis?
- What does "reasonably self-evident" mean for risk transfers and when would the exemption apply?

Pinnacle believes that the primary responsibility for determining the amount of risk transfer in any reinsurance contract is ultimately an accounting concern. However, actuaries can provide valuable insight to managing that process.

Actuarial guidance for assisting in this process can be found in a recent document authored by the Risk Transfer Subgroup of the American Academy of Actuaries Committee on Property and Liability Financial Reporting: Risk Transfer In P&C Reinsurance: Report to the Casualty Actuarial Task Force of the National Association of Insurance Commissioners.

The document provides the results of a survey of current industry practices regarding risk transfer and alternative approaches to the evaluation of risk transfer. Another Academy document, Reinsurance Attestation Supplement 20-1: Risk Transfer Testing, directly addresses the attestation requirement. Both documents can be found at the American Academy of Actuaries website, www.actuary.org.

Conclusion

New requirements made by the NAIC to the Statement of Actuarial Opinion empower regulators to make more timely and informed decisions regarding insurer solvency. The requirements continue to allow actuarial flexibility while protecting confidentiality of certain company-specific information. These new requirements bolster support for the financial health of the insurance industry, which will benefit the industry, its customers and the public at large.

Look Out for New Interrogatory 9

New Interrogatory 9 is a new 2005 Annual Statement requirement that will receive a lot of attention from regulators looking closely at reinsurance transactions. The specific language for New Interrogatory 9 is below:

9.1 If (i) underwriting result of contract(s), ceded premium, or ceded reserves exceeds 3% of prior year-end policyholders surplus and (ii) if accounted for contract(s) as reinsurance (as opposed to deposit), disclose if:

(a) long-term (> 2 years), non-cancelable treaties
(b) cancellation provision that triggers an obligation to enter into a new reinsurance contract
(c) aggregate stop-loss reinsurance coverages
(d) unilateral right of either party to commute
(e) reporting or payment of losses less than quarterly
(f) payment schedule, accumulating retentions from multiple years, or any features designed to delay reimbursement to the ceding entity

9.2 (a) Disclose if the written premium ceded by the reporting entity and its affiliates under a contract (or series of contracts with affiliated reinsurers) represents 50% or more of the direct plus assumed premium written by the reinsurer

(b) Disclose if 25% or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates

9.3 If "Yes" to 9.1 or 9.2, provide
(a) summary of contract terms;
(b) brief discussion of management's principal objectives; and
(c) aggregate impact on balance sheet and income statement

9.4 Disclose if the accounting (i.e., reinsurance versus deposit) for any contract is different under Generally Accepted Accounting Principles and Statutory Accounting Principles

9.5 If 9.4=Yes, explain why the accounting treatment is different