Enterprise Risk Captives
Regulation and Prospective Developments

Commitment Beyond Numbers

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About the Presenters

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Outline of Presentation

• Current Regulatory State

• Prospective Regulatory State

• Self-Regulation in the Actuarial Profession

• Actuarial best practices for pricing enterprise risks, commonly for Enterprise Risk Captives, aka “ERCs,” “Microcaptives,” “Small Captives,” “831(b) Captives”
1. **Credit Risk** - Amounts actually collected or collectible are less than those contractually due.

2. **Market Risk** - Movement in market rates or prices, such as interest rates, foreign exchange rates, or equity prices adversely affect the reported and/or market value of investments.

3. **Pricing/Underwriting Risk** - Pricing and underwriting practices are inadequate to provide for risks assumed.

4. **Reserving Risk** - Actual losses or other contractual payments reflected in reported reserves or other liabilities will be greater than estimated.

5. **Liquidity Risk** - Inability to meet contractual obligations as they become due because of an inability to liquidate assets or obtain adequate funding without incurring unacceptable losses.

6. **Operational Risk** - Operational problems such as inadequate information systems, breaches in internal controls, fraud, or unforeseen catastrophes will result in a disruption in business and financial loss.

7. **Legal Risk** - Non-conformance with laws, rules, regulations, prescribed practices or ethical standards in any jurisdiction in which the entity operates will result in a disruption in business and financial loss.

8. **Strategic Risk** - Inability to implement appropriate business plan, to make decisions, to allocate resources or to adapt to changes in the business environment will adversely affect competitive position and financial condition.

9. **Reputation Risk** - Negative publicity, whether true or not, causes a decline in the customer base, costly litigation, and/or revenue reductions.
Current Regulatory State - 10 Critical Risks

1. Valuation/Impairment of Complex or Subjectively Valued Invested Assets
2. Liquidity Considerations
3. Appropriateness of Investment Portfolio and Strategy
4. Appropriateness/Adequacy of Reinsurance Program
5. Reinsurance Reporting and Collectibility
6. Underwriting and Pricing Strategy/Quality
7. Reserve Data
8. Reserve Adequacy
9. Related Party/Holding Company Considerations
10. Capital Management
Prospective Regulatory State

• Looking forward there are three areas that State regulators will be focusing on:
  – Corporate Governance
  – Corporate Governance
  – Corporate Governance

• Increased focus on actuarial opinions regarding:
  – Risk Shifting
  – Risk Distribution
  – Premium Reasonableness
AAA Code of Professional Conduct

• Precept 1
  – An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession’s responsibility to the public and to **uphold the reputation of the actuarial profession**.

• Annotation 1-2
  – An Actuary shall not provide Actuarial Services for any Principal if the Actuary has reason to believe that such services may be used to violate or evade the Law or in a manner that would be detrimental to the **reputation of the actuarial profession**.
AAA Code of Professional Conduct (continued)

• Precept 13
  – An Actuary with knowledge of an apparent, unresolved, material violation of the Code by another Actuary should consider discussing the situation with the other Actuary and attempt to resolve the apparent violation. If such discussion is not attempted or is not successful, the Actuary shall disclose such violation to the appropriate counseling and discipline body of the profession, except where the disclosure would be contrary to Law or would divulge Confidential Information.
CAS Statement of Principles Regarding P/C Insurance Ratemaking

- Principle 1: A rate is an estimate of the expected value of future costs.

- Principle 2: A rate provides for all costs associated with the transfer of risk.

- Principle 3: A rate provides for the costs associated with an individual risk transfer.

- Principle 4: A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.
ASB Actuarial Standards of Practice – Ratemaking

- ASOP 41: Actuarial Communication
- ASOP 12: Risk Classification
- ASOP 13: Trending Procedures in Property/Casualty Insurance
- ASOP 23: Data Quality
- ASOP 25: Credibility Procedures
- ASOP 29: Expense Provisions in Property/Casualty Insurance Ratemaking
- ASOP 30: Treatment of Profit and Contingency Provisions and the Cost of Capital in Property/Casualty Insurance Ratemaking
- ASOP 38: Using Models Outside the Actuary’s Area of Expertise
- ASOP 39: Treatment of Catastrophe Losses in Property/Casualty Insurance Ratemaking
- ASOP 53: Estimating Future Costs for Prospective Property/Casualty Risk Transfer and Risk Retention
Experience vs Exposure Rating

- **Most Captives, Self Insureds, etc.**
  - +
  - Commercial Insurers - Overall

- **ERCs, New Entities**
  - +
  - Commercial Insurers - Policy Rating

**Experience Rating**
- Credible Loss Data

**Hybrid Rating**
- Some Loss Data

**Exposure Rating**
- No Loss Data
Exposure Rating Techniques

Utilizing Commercial Rating Plans

Methods Utilizing Other Data Sources

Most Specified Rating

Most Exposure Data Needed

Most Fundamental Rating

Usable with Minimum Exposure Data
Exposure Rating – Incorporating Experience

• Over time, complement exposure rating with emerging captive loss experience to the extent the loss experience is credible
  – Commercial rating plans vs. other approaches
• Risk loads and profit & contingency margins may be reduced as captive surplus increases
Simulation

• Useful for:
  – Confidence levels/risk margins
  – Risk transfer/risk distribution testing
  – Projections for high excess layers

• Be careful with:
  – Primary layer pricing
What is Simulation?

Actuarial Model
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What is Simulation?

Input Data / Assumptions → Simulation Model → Results
Simulation Example: High Excess Layer Pricing

• Available data:
  – Significant volume for primary layer

• Assumptions:
  – Based on fitting a model to underlying data

• Simulation:
  – Used to project excess layer based on information known about primary layer
Simulation Example: ERC Pricing

- Available data:
  - Little or none

- Assumptions:
  - Based on industry data, information from client, judgement

- Simulation:
  - Not enough info to judge whether assumptions are sound, but simulation model will build upon them anyway
Conclusions

- Actuarial profession has a robust system of self-regulation

- Actuaries need to consistently apply our framework of professional standards in emerging practice areas

- Captive regulatory environment will continue to move forward and improve
Questions
Join Us for the Next APEX Webinar

Thursday, June 20
2:00 p.m. ET
Registration is Open

State of the Medical Professional Liability Market
Final Notes

• We’d like your feedback and suggestions
  • Please complete our survey

• For copies of this APEX presentation
  • Visit the Resource Knowledge Center at Pinnacleactuaries.com
Thank You for Your Time and Attention

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