The Actuary’s Role in Captive Regulation

Commitment Beyond Numbers

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About the Presenters

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• CAS Board of Directors, 2016-2017
• Captive Review Captive Power 50, 2017
About the Presenters

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- Tennessee Department of Commerce & Insurance
- **Education and Designations**
  - Boston University, LL.M. (Tax) (2016)
  - University of Tennessee, J.D. (2002)
- **Activities and Awards**
  - ICCIE Board Member, 2016-present
  - Nashville Bar Foundation Fellow, 2016
  - Navy and Marine Corps Achievement Medal (3 awards)
  - Military Outstanding Volunteer Service Medal
Overview

• Introductions
• Background
• Captive Applications/Business Plan Changes
  – Funding Studies
  – Pro Forma Financial Statements
  – Challenges of Low Frequency-High Severity or Non-Traditional Coverages
• Financial Exams
  – Reserve Analyses
  – Statements of Actuarial Opinion
  – Risk-Focused Exams
Forming a Captive Insurance Company

• Three ways to buy a suit:
  – Bespoke
  – Made-to-Measure
  – Ready-to-Wear
Forming a Captive Insurance Company

• Select the captive team
  ➢ Manager
  ➢ Attorney
  ➢ Actuary
  ➢ Accountant
  ➢ Banker

• Initial feasibility study
Forming a Captive Insurance Company

- Choose a domicile
  - Onshore vs. offshore?
  - Where is parent or insured located?
  - Where is the risk?
  - Where are the key service providers?
  - Where is the best fit?
    - Permitted structures
    - Coverages allowed
    - Credit for reinsurance/pooling
    - Domicile reputation
    - Level of scrutiny/oversight
Forming a Captive Insurance Company

• Prepare and File Captive Application
  – Charter/Articles of Organization
  – Bylaws
  – Domicile application form
  – Feasibility study from approved actuary
  – Biographical affidavits from officers, managers and/or directors

• Secure initial capital in restricted account
Forming a Captive Insurance Company

• Prepare a Detailed Plan of Operations:
  – Overview of related party insured’s history and purpose for forming a captive, expertise of officers and directors
  – Explanation of risks to be insured
  – Information about any fronting company
  – Expected net annual premium income
  – Reinsurance
  – Loss prevention and safety program
  – Loss experience for past five years and projections for next five years
  – Financial projections (both “expected” and “worst-case”)
Forming a Captive Insurance Company

- Schematic Diagram

- Any other relevant information
Forming a Captive Insurance Company

• Oversight Documents
  – Executed agreement between owner and captive manager
  – Executed agreement with audit firm
  – Executed agreement with actuarial firm
  – Sample policy form
  – Minutes and resolutions of any board meetings
  – Executed reinsurance/pooling agreements
  – Statement of Investment Policy
  – Code of ethics and certificates of acknowledgement.
  – Conflict of interest policy and owner’s certificate of acknowledgement
Forming a Captive Insurance Company

• What Happens Next?
  – Review by captive domicile analyst
    • Independent actuarial review
  – Meeting between owner and regulator
  – Issuance of captive license
Forming a Captive Insurance Company

• Annual Statement Filing
  – Summary of balance sheet, insurance transactions
  – Other documents as required by domicile
  – Premium tax/annual fee payment

• Annual Audit

• Business Plan Changes
  – If the plan of operation as outlined in the formation has changed, regulator approval may be required.

• Examination (3 to 5 years)
Forming a Captive Insurance Company

• Show me the $$$ issues
  – Loan backs
  – Investments
    • Investments in related parties
  – Letters of credit
  – Surplus notes
  – Parental guarantee
  – Recapitalizations
  – Dividends
Captive Regulators and Actuaries

• U.S. captive insurance regulators typically retain one or more actuarial consultants to support their efforts

• Why?
  – Expertise
  – Cost
  – Amount of work involved

• Some insurance departments leverage staff actuaries or a combination of both

• Costs are often a pass-through to captive or captive manager

• The best relationships have high levels of communication and interaction
Code of Conduct – Precept 4

• PRECEPT 4. An Actuary who issues an Actuarial Communication shall take appropriate steps to ensure that the Actuarial Communication is clear and appropriate to the circumstances and its intended audience and satisfies applicable standards of practice.
“(A)n actuarial report should identify the data, assumptions, and methods used by the actuary with sufficient clarity that another actuary qualified in the same practice area could make an objective appraisal of the reasonableness of the actuary’s work as presented in the actuary’s report.”

Note: Section 3.1 “The requirements of this standard should be applied to the cumulative communications with respect to each specific engagement ...”

Equally applicable to internal peer review processes for actuarial staffs
Resources - 2005 AAA Discussion Paper

AMERICAN ACADEMY OF ACTUARIES

Council on Professionalism

PEER REVIEW

Concepts on Professionalism

Discussion Paper

Prepared by

Committee on Professional Responsibility
Council on Professionalism

PEER REVIEW

Concepts on Improving Professionalism

Discussion Paper

Prepared by

Committee on Professional Responsibility
Two Extremes

Simple

Complex

External Peer Review
- Maximize Value
- Qualified Actuary
- Independent
- Focused on Material Risks
- Rigorous Process

The approach should also be appropriate for the scale and complexity of the risk.
Non-Actuary “Read-Through” - Weaknesses

• Typically not trained actuaries
• Often only cursory reviews
• May have preconceived notions
• Independence from auditor, regulator or original “principal,” etc.
• Potential inability to deal with complex, intricate or subtle actuarial issues/flaws
Independent Actuarial Analysis - Weaknesses

- Time constraints?
- Expense (especially on smaller programs)
- Is incremental value worth the cost?
- Hard to fully incorporate unique issues/operational changes as thoroughly as original work product within constraints
- Much of the time, the actuarial work product is reasonable and the second analysis is largely unnecessary
Captive Application/Plan Change - Funding

- Actuarially reasonable standard still applies
  - Not excessive, inadequate or unfairly discriminatory
  - Different emphasis than admitted carriers
- Primary emphasis is solvency
- Remember peer review requirements
  - Data
    - Is there insured data?
    - Are the benchmarks appropriate?
  - Methods
    - What is the basis for the rates and premiums?
  - Assumptions
    - Are they assuming superior risk selection to an existing company?
    - Are assumptions overly optimistic or pessimistic?
Captive Application/Plan Change - Funding

• Other considerations
• Expenses – Are appropriate adjustments made for the expense of the captive (compared to commercial insurer)?
• Market comparable – Is the pricing consistent with what the insurer would pay for the coverage in the traditional market? If not, why? (e.g. broader form)
• Consistent with existing coverage – For differences in conditions or deductible reimbursement policies, does the relationship to existing coverages make sense?
• Other reasonableness tests
  – Premium to revenue or other exposure (e.g. payroll)
  – Premium to coverage limit (e.g. return period, rate-on-line)
Captive Application/Plan Change – Pro Formas

• Adverse scenario – Is it reasonable?
• Capitalization – Is the capital sufficient to withstand a reasonable amount of adverse development?
• Reinsurance – Does the reinsurance program offer sufficient protection for the captive? Is the reinsurer reputable?
• Expenses – Are the provisions reasonable and documented?
• Discounting – Is there any? Is the approach reasonable?
• Cash flows – Are the claims payment patterns reasonable?
• Risk margins – Are the explicit and implicit risk margins reasonable?
• Tax treatment – Is an 831(b) election assumed?
• Are unique accounting issues (e.g. premium earning) addressed?
Captive Application/Plan Change – Other Issues

• Financial strength of the parent – If something goes wrong, will the parent be willing/able to step in?

• Outstanding questions
  – Is the actuary responsible for assessing risk transfer?
  – Is the actuary responsible for assessing risk distribution?
  – Is the actuary responsible for identifying rates/premiums that are excessive?
  – How does the actuary interact with the regulator if there are other “reputational risk” concerns?
Enterprise Risk Captives

• Funding
  – By definition, less insured data
    • Still need to document data, methods and assumptions
  – Increased reliance on
    • Market Comparable
    • Reasonable
    • Expense and Risk Margin Adjustments

• Pro formas
  – Does the captive have the ability to pay claims?
    • Often have capitalization issues relative to limits
  – Impact and treatment of reinsurance facilities
  – Does the captive demonstrate risk transfer?
Captive Financial Examinations – External Review

• For most captives, domiciles find that an external peer review by their staff or consulting actuary is sufficient

• Elements of external peer review
  – Form
  – Contents
  – Professional

• Exceptions
  – Risk retention groups
  – Large or complex captives
  – Captives experiencing financial difficulties

• Does not preclude the regulatory actuary from testing specific assumptions or doing a complete analysis as needed
Components of Peer Review - Form

- Is the client identified?
- Is the actuary responsible for the report identified?
- Is the project scope clearly defined?
- Is the work product clear?
- Are the text and tables well organized?
- Is the report complete?
Components of Peer Review - Contents

- Are the assumptions/methods specified?
- Are the assumptions and methods reasonable for the assignment?
- Are the data sources appropriate?
- Are the calculations correct?
- Are the findings reasonable and adequately supported by the analysis?
- Are any reliances and limitations appropriate and clearly delineated?
- Is the potential variability of results adequately discussed?
External Peer Review – Content Problems

- Inappropriate benchmarks (e.g. loss costs, LDFs)
- Inappropriate methods/assumptions (e.g. Lognormal CVs)
- Incorrect interpretation of coverage (e.g. PCFs)
- Unrealistic results (e.g. collateral reserves > SIR, 75%<Central)
- Lack of adequate support (filings, captive applications)
- Improper recognition of operational changes
- Insufficient data/credibility
- Data reconciliation problems
- Unique risks – extended warranty, credit
- Unique reserving issues
  - Death, Disability & Retirement Extended Reporting
  - Premium Deficiency Reserves
  - Long Duration Contracts
External Peer Review – Professionalism Issues

- Inconsistent with state law (e.g. IL SRP, credit)
- Inconsistent with accounting standards (e.g. PDR, GASB 10 and 30)
- Inconsistent with practice note (e.g. DD&R, long duration contracts, reinsurance collectability)
- Inconsistent with state law (e.g. DC captives) or other domicile (e.g. Bermuda)
- Many professionalism issues lead to material content issues or disclosure issues for interested parties
Captive Financial Exam – Independent Review

• Allows regulatory actuary to
  – Organize data differently
  – Use different loss development methods
  – Use different assumptions (e.g. a priori losses, trends, loss development factors)
  – Use different benchmarks
  – Make different adjustments for changes due to:
    • Operational changes
    • Legislative or judicial changes
    • Changes in claims handling
    • Other factors influencing loss reporting, reserving and settlement
    • Frequency trends and/or
    • Severity trends
Captive Financial Exam – Risk-Focused Exams

• Typically restricted to large, complex insurers
  – Premium or surplus threshold
• Some domiciles extend to all insurers
  – Approach should match scale and complexity of the parent
• Limited applicability to captives
  – Will this change in the future?
• Some large RRGs have had risk-focused exams
Risk-Focused Exams - Approach

- Phases 1 & 2 – What are the company’s areas of risk?
- Phase 3 – What controls do they have in place to address them?
- Phase 4 – What is the amount of residual risk after the controls?
- Phase 5 – Test areas where residual risk is considered “High” or “Moderate”
- Phases 6 & 7 – Update Supervision Plan and Draft Examination Report
Risk-Focused Exams – Critical Risk Categories

- Valuation/Impairment of Complex or Subjectively Valued Invested Assets
- Liquidity
- Investment Portfolio
- Reinsurance Program
- Reinsurance Reporting and Collectability
- Underwriting and Pricing
- Reserve Data
- Reserve Adequacy
- Related Party/Holding Company
- Capital Management
Conclusion

• Actuaries are a key element of captive regulators’ approach to ensuring the solvency of the captives they oversee
• Captive regulatory actuaries can be involved in both ratemaking and loss reserving work
• Rigorous external peer review approaches can be an excellent solution to match the scale and complexity of many captive regulatory needs
• Communication between the regulatory team
Questions
Join Us for the Next APEX Webinar

Actuarial Standards of Practice Update

Join Pinnacle Consulting Actuaries Laura Maxwell and John Wade as they discuss the impact of recent changes to ASOPs 21 and 23, proposed changes to ASOP 17, and proposed property/casualty ASOPs.

Thursday, December 14
2:00 p.m. ET
Registration is Open
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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