

REGULATORY GUIDANCE  
On Property and Casualty Statutory Statements of Actuarial Opinion  
For the Year 2007

Prepared by the NAIC's  
Casualty Actuarial Task Force

### **Introduction**

The Casualty Actuarial Task Force (CATF) of the NAIC believes that the Statement of Actuarial Opinion (Opinion) is a valuable tool in serving the regulatory mission of protecting consumers. This Regulatory Guidance document supplements the NAIC's *Annual Statement Instructions Property and Casualty (Instructions)* in an effort to provide clarity and timely guidance to companies and Appointed Actuaries regarding regulatory expectations with respect to the Opinion.

An Appointed Actuary has a responsibility to know and understand both the *Instructions* and the expectations of regulators. One expectation of regulators clearly presented in the *Instructions* is that the Opinion and the supporting report and work papers should be consistent with appropriate Actuarial Standards of Practice (ASOP), including *but not limited to* ASOPs Nos. 9, 23, and 36. While the Actuarial Standards Board may be considering a repeal of ASOP No. 9, many regulators oppose this repeal, viewing it as a clear reduction in the standards expected in an actuarial work product. Regardless of any action by the Actuarial Standards Board, regulators expect that all opinions and the supporting reports continue to meet the standard of ASOP No. 9.

This CATF guidance supplements the *Instructions* to promote having specific characteristics of the company addressed in the Opinion. The CATF consciously avoids illustrative language in the *Instructions* as much as possible and encourages all actuaries to use whatever language they feel is appropriate to clearly convey their opinion *and* thought processes in reaching conclusions on a specific company. While the majority of Opinions address these interests, a good number of Appointed Actuaries continue to submit highly generic opinions, nearly indistinguishable other than for the dollar values presented in the Scope and the disclosures. The CATF believes such Opinions provide little value, reduce the credibility of the individual actuary, and fail to meet the expectations of professional standards.

### **Paragraph 1: Appointment, Definitions and Exemptions**

Paragraph 1 is unchanged for year-end 2007. Paragraph 1 is directed to company management and involves the interests of regulators when a change in Appointed Actuary is made. While this is a responsibility of the company, the CATF expects that an actuary considering a new assignment is aware of the requirement and will request similar information from the company and the former Appointed Actuary in order to make an informed decision about taking the assignment.

Both management and a potential Appointed Actuary should also be mindful of the following:

- **Timely feedback.** The CATF encourages management to seek feedback from a “qualified actuary” *prior to* management’s decision on establishing carried reserves. This allows management to make an informed decision with the benefit of actuarial analysis. It also helps to avoid a difficult situation in which management is committed to a decision that results in pressure on the actuary to “stretch” the range of reasonable reserve estimates.
- **Reporting to the Board or Audit Committee.** The actuary is required to report to the Board. This may be done in a form of the actuary’s choosing. The CATF strongly encourages the Appointed Actuary to present his or her analysis in person so that the risks and uncertainties that underlie the exposures can be adequately conveyed and discussed. As the actuarial profession makes advances in reserve methodology, such as stochastic simulation, a single deterministic indication would not be appropriate for many companies. While management is limited to single values on lines 1 and 3 of the Liability Page, the Board should be made aware of the actuary’s opinion regarding the risk of material adverse deviation, the sources of that risk, and what amount of adverse deviation the actuary judges to be material.

## **Paragraph 2: Structure of the Opinion**

Paragraph 2 is unchanged for 2007. It succinctly presents the four primary pieces of the Opinion. The CATF expects that Opinions will be presented in this order, with each section clearly marked.

## **Paragraph 3: Identification**

Paragraph 3 is unchanged for 2007. An individual meeting the credential requirements of a “qualified actuary” should not require further guidance here.

## **Paragraph 4: Scope**

Paragraph 4 has no substantive changes for 2007. Editorial changes relate to specific items in the exhibits. Exhibit A provides a clear picture of what items are to be opined on by the actuary. Note that guidance for the Exhibit B disclosure items is discussed in Paragraph 6.

The CATF continues to call attention to two items of interest to regulators that pertain to the Scope of the Opinion:

1. Coverage for Service Contracts. Regulators in several states have encountered threats to solvency involving companies that provide coverage for service contracts (automobiles, appliances, etc.). Due to wide variation in state laws, this type of product may or may not be regulated or treated as insurance. Insurance may only come into play as excess coverage for contractual liability. The insurer and the Appointed Actuary often have no underlying data on loss experience absorbed by the policyholder. When losses break through the retention, they can be catastrophic for the insurer, particularly a specialty writer or a risk retention group with concentration in this exposure. ASOP No. 36, section 3.5, the CAS Statement of Principles on Loss and Loss Adjustment Expense Reserves, and other actuarial literature address the relevance of exposure to the reserve actuary’s work. The CATF expects the actuary to understand the exposure associated with the Opinion to be issued. That understanding can be disclosed in the Opinion with a Relevant Comment regarding what the actuary believes to be the financial condition of the obligor(s) for the service contracts and/or the adequacy of any reserve funds the obligor holds for payment of claims under service contracts covered by the insurer.
2. Prepaid loss adjustment expenses. According to Interpretation 02-21 in Appendix B of the NAIC’s Accounting Practices & Procedures Manual, the liability for unpaid loss adjustment expenses should be established regardless of any pre-payments made to third-party administrators (TPA), management companies, or other entities. The values should be recorded as loss adjustment expense reserves throughout the Annual Statement and not recorded as a write-in. Appointed Actuaries should be aware of any such arrangements, incorporate this consideration into his or her analysis, and include appropriate disclosures in the Actuarial Report.

The Scope paragraph also requires specific disclosure of the name, affiliation/title and relation to the Company of the individual upon whom the Appointed Actuary relied for preparation of the data. The CATF expects the actuary to identify at most one or two senior officials who are responsible for integrity of the actuarial data. These individuals should be officers of the regulated entity. They should not be individuals who merely constructed the data triangles, unless they also have broader responsibilities, such as authority for maintaining a data repository that the Appointed Actuary can rely on when claiming that his or her work is consistent with ASOP No. 23 and ASOP No. 9. In some cases, the Appointed Actuary, if a senior officer of the company, may be the individual who holds this responsibility.

NOTE: The CATF recognizes that the Appointed Actuary may receive data from a TPA or similar organization that provides service to the regulated entity. If such a relationship exists, it is informative to identify it here. However, the TPA is not the regulated entity. Regulators expect the Appointed Actuary’s disclosure to always include the senior official(s) of the regulated entity responsible for integrity of the data.

## **Paragraph 5: Opinion**

Paragraph 5 has no substantive change for 2007, but there are editorial changes related to specific items in Exhibit B regarding the type of opinion rendered. The CATF expects points C and D of the Opinion Paragraph to be the full and complete expression of the Appointed Actuary’s conclusion on the type of opinion rendered. Regulators will presume that the Opinion conclusion will apply to both the Net and the Direct and Assumed Reserves. If the actuary reaches different conclusions, the actuary should use whatever language is appropriate to clearly convey a complete Opinion. If faced with this situation, the actuary should prepare exhibit entries to reflect the opinion on the Net reserves. Narrative comments can be sufficient to describe any differences with respect to the Direct and Assumed opinion.

Reliance on the opinion of another actuary is addressed in ASOP No. 36. Such reliance does not extend to subordinates or colleagues of the Appointed Actuary. The Appointed Actuary is expected to review the work of his or her subordinates or colleagues and accept responsibility for that work. If the Appointed Actuary is unable to do that, the Opinion should be issued as Qualified or as No Opinion.

### **Paragraph 6: Relevant Comments**

Paragraph 6 is unchanged for 2007. As the CATF considers the Relevant Comments of the Appointed Actuary to be the most valuable information in the Opinion, it is this section that calls for considerable guidance from regulators. Relevant Comments provide the context for the regulator to interpret the Opinion and to understand the actuary's reasoning and judgment.

#### **Risk of Material Adverse Deviation (RMAD)**

The regulator considers comments related to RMAD to be one of the most important parts of the Opinion. The *Instructions* require the Appointed Actuary to:

- 1) Identify the materiality standard,
- 2) Identify the basis, or rationale, for establishing this standard,
- 3) **Explicitly** state whether or not he or she believes that there are significant risks and uncertainties that could result in MAD, and
- 4) If such risk exists, the actuary should describe the major factors or particular conditions underlying the risks and uncertainties that the actuary reasonably believes could result in MAD. (Note that the actuary is encouraged to comment on the risks and other factors considered even when no RMAD is judged to exist.)

The actuary's comments regarding RMAD should be consistent with the disclosure in Exhibit B, item 6. If the actuary concludes that the Risk of Material Adverse Deviation is present, the CATF expects the supporting report to clearly address each of the risk factors identified with descriptive and quantitative information on alternate outcomes that would drive adverse development beyond the selected materiality threshold. This information will be useful to both regulators and the Board in understanding the actuary's comments on this issue.

The CATF recognizes the importance of the individual actuary's judgment in determining what is and is not material in the case of each individual insurance company's financial position. Accordingly, we have chosen to not specify in the *Instructions* a specific standard or set of standards to be followed by actuaries issuing Opinions. The CATF expects to see comments that address specific characteristics of the company and why those characteristics led the actuary to judge that the selected amount is material OR why those characteristics contribute to the actuary's conclusion that material adverse deviation is or is not a significant risk.

However, the CATF does recognize the value in identifying a simple "rule of thumb" or benchmark materiality standard, especially for cases involving the actuary for a group of companies or actuaries who are members of a consulting firm. However, the benchmark should only be a **starting point**. While consistency in approach can be desirable, regulators expect the Appointed Actuary to consider the relevant and unique characteristics of each company. Regulators have noted a particular practice that can be characterized as "cookie cutter" Opinions. That is, companies with widely different exposures, claims management, historical reserve adequacy, leverage ratios, and capital positions are issued nearly identical Actuarial Opinions with identical risk factors and materiality standards by the same actuary or consulting firm.

Note that regulatory actuaries have generally observed a more thorough consideration and discussion of RMAD and relevant comments within Statements of Actuarial Opinion over the past two to three years. Appointed Actuaries should remember that regulators expect to be the primary audience of Opinions and more disclosure is often better for this audience. The improved discussion is viewed positively by regulators and the CATF expects this trend to continue.

The CATF emphasizes that the main focus of the regulatory audience is solvency. As such, the Appointed Actuary should consider the materiality standard's relation to the company's risk based capital position. For example, a materiality standard of 10% of surplus would not be appropriate for a company where a reserve development of 10% of surplus would cause the company to fall below the authorized control level risk-based capital.

#### **Other Situations**

The first focus of regulatory evaluation is the net position of the company. The Appointed Actuary should address adverse deviation in net reserves when determining the standard to be disclosed in item 1 in Exhibit B. In most cases, a focus on the

net position will provide sufficient information for the regulator regarding the risks in the direct and assumed position as well. However, a situation that presents a challenge for both writers and readers of Opinions involves the materiality standard for a company that has zero net reserves due to a pooling arrangement or a 100 percent reinsurance cession (usually to an affiliate). In other words, how is material adverse deviation or any adverse deviation for that matter judged for a company that has no net reserves?

For a “zero net company”, it is common to examine the financial strength of the reinsurer. Thus, materiality considerations may encompass the quality of the reinsurer. As such, the Appointed Actuary should discuss the relevant comments outlined in the Reinsurance section of Paragraph 6. In this case, because the materiality standard was necessarily judged on a qualitative as opposed to a traditional quantitative basis, it is acceptable to put an amount of \$0 in Exhibit B and include relevant discussion. Other standards are certainly appropriate and should be supported with relevant discussion.

Another situation that may present a challenge is the choice of a materiality standard for pooled companies. The Appointed Actuary is reminded that each statutory entity is required to have a separate Opinion and, therefore, its own materiality standard. Where there are no unusual circumstances to consider, it may be acceptable to determine a standard for the entire pool and assign each member their proportionate share of the total. It is **not** appropriate to use the entire amount of the materiality threshold for the pool as the standard for each individual pool member.

The Appointed Actuary may certainly choose other reasonable measures, such as the amount of reserve cession that would have to be deemed uncollectible in order for the financial condition of the company to be compromised. Or perhaps the actuary may wish to evaluate materiality on both a direct and assumed and a net level. If this approach is chosen, two materiality standards could be presented along with relevant discussion.

The *Instructions* are clear in stating that the RMAD explanatory paragraph should not include general broad statements about risks and uncertainties due to economic changes, political forces, etc. – conditions that could apply to nearly all companies in any situation. When considering the inclusion of risk disclosures in the Opinion, the actuary should take into account the likelihood of the event occurring. Risks and uncertainties may include items such as the uncertainty in the tail factors or the need to use industry benchmarks. Risk factors may also include a carried reserve at the low end of the actuary’s range, assumptions regarding expected future emergence that are not consistent with history, and assumptions based on management representations of operational change that are not accompanied by objective documentation to support an expected impact (e.g. a recent underwriting initiative; a change in claim handling practices; price firming, etc). SSAP 55 confers on management both the right and the obligation to record its best estimate of reserves. The CATF expects that the Appointed Actuary will disclose risks and uncertainties such as those described above, *even when the carried reserve is within the actuary’s reasonable range*.

#### Other Disclosures

This section covers a variety of items of interest to regulators. Some of these items may not be applicable to a particular company. In certain cases, the actuary may rely on management representations that a particular exposure or practice is or is not present. Such reliances can be reasonable, but the supporting Actuarial Report should include documentation to identify the specific individuals relied on and description of additional efforts, if any, to validate the representations when reliance on those representations has influenced the actuary’s indications or conclusions.

#### Reinsurance

Recent industry developments regarding the appropriate treatment of reinsurance have elevated the attention given to this disclosure. The Scope of the Opinion does not include an evaluation of risk transfer or 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 what agreements are accounted for as reinsurance. The *Instructions* advise the actuary on a number of actions in gathering background information.

Beginning in 2005, additional reinsurance and risk transfer disclosures were required in the Property/Casualty Annual Statement Interrogatories. The CATF expects that the Appointed Actuary has sufficient awareness of the background information and disclosures in order to provide an informed Opinion. This background information can be used to potentially identify inconsistencies that deserve clarity prior to forming a conclusion. The Relevant Comments on reinsurance should cite the approach used by the actuary. Further detail and documentation should be included in the Actuarial Report.

#### IRIS Ratios

A single unusual IRIS ratio does not generate regulatory action. It does, however, call for relevant comment in the Opinion. The CATF expects comments on unusual results for the NAIC IRIS tests for One-Year Reserve Development to Surplus, Two-Year Reserve Development to Surplus and Estimated Current Reserve Deficiency to Surplus which identify the specific

exposure segments that contributed to the situation and (when applicable) what new information occurred since the prior valuation that contributed to the adverse development. The CATF considers it insufficient to attribute an unusual reserve development ratio to reserve strengthening alone and expects relevant comment on an unusual ratio to provide reasonable insight as to the company specific factors that caused the result. Detailed documentation should be included in the Actuarial Report to support comments in the Opinion.

### **Paragraph 7: The Actuarial Report**

Paragraph 7 is unchanged for 2007. The importance of this paragraph is the reliance by regulators on the professionalism of a “qualified actuary”. The Report is a statutory requirement prepared for the benefit of state regulators and thus should focus on regulatory concerns. The Report should be available in a timely manner and meet the definition of an Actuarial Report provided in ASOP No. 9: “A document, or other presentation, prepared as a formal means of conveying the actuary’s professional conclusions and recommendations, of recording and communicating the methods and procedures, and of ensuring that the parties addressed are aware of the significance of the actuary’s opinion or findings.”

Exhibits alone rarely convey professional conclusions and recommendations or the significance of the actuary’s opinion or findings. A narrative section should provide clearly worded information so that readers are able to appreciate the significance of the actuary’s findings and conclusions, the uncertainty in the estimates, and any differences between the actuary’s estimates and the carried reserves. Sources of assumptions should be clearly supported. The CATF has identified three notable weaknesses in the documentation of many actuarial reports.

1. **Expected Loss Ratios.** Methodologies that rely on an expected loss ratio may well be the most suitable in a given situation. When using these methodologies, particularly in a long tailed line with high premium volume, the CATF expects the documentation to include recognition of pricing and underwriting information in the recent years. Historical loss ratio indications have little value if rate actions, credit adjustments or program revisions have affected premium adequacy or inadequacy. Without documentation to demonstrate the validity of the selection, the expected loss ratio is of questionable value.
2. **Actuarial Judgment.** The use of this phrase in a report, in either the narrative comments or in exhibits, should be evaluated. Is there sufficient descriptive rationale to provide meaningful context for this term? Use of the term “actuarial judgment” does not replace proper explanation. The impact of alternate selections (see Expected Loss Ratios) should be considered. When the impact is high and no further documentation is provided, a reviewer might question the value of the analysis or wonder if the selections were made to manipulate the outcome.
3. **The Statutory Entity.** The Report serves to support an Opinion for a statutory entity. As a result, the Report should address reserve estimates that relate directly to that statutory entity.

In addition, the CATF supports the recommendation of the Task Force on Actuarial Credibility that the Actuarial Report contain an exhibit that summarizes changes in the Appointed Actuary’s estimates from the prior analysis, with extended discussion of significant factors underlying the change. The Task Force made this recommendation to improve the transparency of disclosures in actuarial work.

The CATF recognizes that company line of business definitions may be more meaningful than annual statement line of business definitions. These classifications should be clearly addressed and documented within the Report. The Actuarial Report must also include an exhibit that compares the actuary’s conclusions to the carried amounts (both net and direct and assumed) in the company’s Annual Statement. In addition, the Report shall include a reconciliation illustrating any differences between the data used in the actuary’s analysis and the amounts presented in Schedule P of the Annual Statement. The actuary should address the reasons for any significant differences in order to reduce questions regarding data integrity.

The CATF recognizes that the majority of the work supporting an Opinion may be done with data received prior to year-end and “rolled forward” to 12/31/20xx. By reviewing the Report the regulator should be able to clearly identify why the actuary made changes in the ultimate loss selections and how those changes were incorporated into the final estimates. A list of final selections without supporting documentation is not sufficient.

The CATF believes that regulators should be able to rely on the Report as an alternative to developing their own independent estimates. The Actuarial Report should not be merely a collection of data triangles with little or no rationale provided. A well-prepared and documented Actuarial Report that is consistent with the spirit of ASOP No. 9 can provide a foundation for efficient reserve evaluation within a statutory examination. This provides benefits to the examination process and potential cost-savings to the company.

**Paragraph 8: Signature**

Paragraph 8 is unchanged for 2007.

**Paragraph 9: Notice regarding Errors**

Paragraph 9 is unchanged for 2007.

**Exhibits A and B**

Effective with year-end 2007 reporting, each company is required to submit Exhibits A and B in electronic data capture format. Appointed Actuaries should refer to the *Instructions* and prepare exhibits matching this format to aid the Company in accurately populating the electronic submission.