Adopted: October 14, 2008

REGULATORY GUIDANCE
On Property and Casualty Statutory Statements of Actuarial Opinion
For the Year 2008

Prepared by the NAIC's
Casualty Actuarial and Statistical Task Force

## Introduction

The Casualty Actuarial and Statistical Task Force (CASTF) 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, 36 and 43. While the Actuarial Standards Board may have been considering a repeal of ASOP No. 9 that action has been deferred. 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 Actuarial Reports continue to meet the standard of ASOP No. 9.

The CASTF consciously avoids illustrative language in the *Instructions* 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 company with reference to specific characteristics of that company in both the Opinion and the supporting report.

## Paragraph 1: Appointment, Definitions, Exemptions, and Special Requirements for Pooled Companies

Paragraphs 1, 1A, and 1B are unchanged for year-end 2008 and paragraph 1C has been added. 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 CASTF 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 CASTF encourages management to seek feedback from a "qualified actuary" *prior to* management's decision on establishing carried reserves. This allows

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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 CASTF strongly encourages the Appointed Actuary to present his or her analysis in person so that the risks and uncertainties that underlie the exposures and the significance of the actuary's findings 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 1C: Special Requirements for Pooled Companies**

Paragraph 1C applies only to those situations where there is an inter-company pooling agreement in which the lead company retains 100% of the pooled reserves and the other members of the pool retain 0%. In this situation, the Schedule P of the 0% companies is blank, rendering an Opinion on non-existent values virtually useless to the regulator. Thus the actuary is directed to prepare an Opinion on the Pool which is to be filed with the Annual Statement of each of the pooled companies. Exhibits A and B should reflect values specific to the individual company and Exhibits A and B of the Pool should be filed as an addendum to the Opinions of the 0% companies. This will allow for proper data submission for each company in the Pool while accommodating the greatest distribution of the relevant values for the Pool. The *Instructions* include specific answers for the Exhibit B questions regarding materiality and the risk of material adverse deviation. Again, this section **only applies to the case where there is one lead company in an intercompany pool that retains 100% of the pooled reserves and the remainder of the companies are 0% retaining members of the pool.**

**Paragraph 2: Structure of the Opinion**

Paragraph 2 is unchanged for 2008. It succinctly presents the four primary pieces of the Opinion.

**Paragraph 3: Identification**

Paragraph 3 is unchanged for 2008.

**Paragraph 4: Scope**

Paragraph 4 is unchanged for 2008. Editorial changes relate to 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 CASTF calls attention to two items of interest to regulators that pertain to the Scope of the Opinion:

1. **Exposure** -- An Opinion on the reasonability of the carried reserves should reflect consideration and evaluation of more than just loss history. ASOP No. 36 section 3.5.2 calls for the actuary to give attention to "exposures that are new or unusual and that are likely to be insufficiently reflected in the experience data or in the assumptions used to estimate loss and loss adjustment expense reserves." 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 CASTF expects the actuary to probe and understand the exposure associated with the Opinion to be issued. Areas of particular interest to regulators include:
   - Coverage for Service Contracts: 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.
   - D&O and XS Coverages: For any coverage with extended emergence patterns regulators expect that the actuary's analysis will demonstrate attention to factors that influence the underlying exposure and potential for claims subject to the coverage provided.
   - Economic Conditions: A number of Opinions identify various economic conditions as risk factors. With the current strains on the economy, and housing markets in particular, regulators expect the Appointed Actuary of a company that faces such risks to attempt to quantify those risks in the analysis. Mere disclaimers are insufficient. Actuaries should consider the potential for premium deficiencies, particularly in long duration contracts such as mortgage or financial guaranty products. The actuary may include the Premium Deficiency Reserve in Exhibit A and comment accordingly within the Opinion. The CASTF advises actuaries to contact the regulator of domicile for further guidance on expected disclosure.

   The understanding can be disclosed in the Opinion with Relevant Comment regarding what the actuary believes to be the financial condition of the obligor(s) for service contracts, the coverages subject to increased activity within the policyholder's retention, and the emerging risk factors. These are examples of what regulators expect the actuary to address as "specific characteristics of the company".

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,

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incorporate this consideration into his or her analysis, and include appropriate disclosures in the Opinion and the Actuarial Report.

The Scope paragraph also requires disclosure of the individual upon whom the Appointed Actuary relied for preparation of the data.
NOTE: The CASTF recognizes that the Appointed Actuary may receive data from a TPA, accounting firm or similar organization that provides service to the regulated entity. If such a relationship exists, it is informative to identify it here. However, any third party or firm 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 is unchanged for 2008. The CASTF 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 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.

**Paragraph 6: Relevant Comments**

Paragraph 6 is unchanged for 2008. The CASTF considers the relevant comments of the Appointed Actuary to be the most valuable information in the Opinion. 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 *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 CASTF expects the supporting Actuarial 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

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selected materiality threshold. This information will be useful to both regulators and the Board in understanding the actuary's comments on this issue.

Other Situations

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 *Instructions* are clear in stating that the RMAD explanatory paragraph should not include general broad statements about unspecified risks and uncertainties 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. *Specified* contemporary risks such as subprime mortgage exposure or declining real estate values may be relevant to the extent that they can be significant and directly related to adverse deviation.

Other Disclosures

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 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

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.

IRIS Ratios

The CASTF 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.

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**Paragraph 7: The Actuarial Report**

Paragraph 7 is unchanged for 2008. The CASTF believes that the *Instructions* and ASOP No. 9 provide the best guidance to actuaries regarding the Actuarial Report and supporting documentation.
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 CASTF has identified two 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 CASTF expects the documentation to include recognition of pricing and underwriting information in the recent years, loss costs, and loss inflation. 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 phrase "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.

In addition, the CASTF 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 CASTF 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 required reconciliation should illustrate 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 CASTF 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.

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The CASTF believes that regulators should be able to rely on the Report as an alternative to developing their own independent estimates. 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 2008. The CASTF requests that actuaries include an email address.

**Paragraph 9: Notice regarding Errors**

Paragraph 9 is unchanged for 2008.

**Exhibits A and B**

The reference to "Data Capture Format" merely means electronic filing. This allows for mechanical queries on demographic information and financial data. Appointed Actuaries should refer to the *Instructions* and prepare exhibits to aid the Company in accurately populating the electronic submission.

Special Note on Exhibit B, Question 6. Some actuaries have commented to regulators that the wording of the question implies a probability conclusion. That is not the regulatory intention. The question intends to mirror the disclosure in the Relevant Comments regarding your conclusion as to significant risks and uncertainties that could result in material adverse deviation. Actuaries should respond with this guidance in mind.