Risk of Material Adverse Deviation - A Regulator Viewpoint

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Materiality and Risk of Material Adverse Deviation

What more can we possibly talk about?

Topics Covered
- Defining RMAD
- Regulator's view of RMAD
- Commonly cited risks
- Opinion and AOS Statistics
First, a few Definitions

- NAIC – National Association of Insurance Commissioners
- COPLFR - Committee on Property Liability Financial Reporting, subgroup of the American Academy of Actuaries
- Practice Note - Annual publication provided by COPLFR on Statements of Actuarial Opinion on Property and Casualty Loss Reserves

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Definitions

- Risk – the degree or probability of a loss
- Material – important or pertinent
- Adverse Deviation – amount of reserves (measured $ or %) that increase or develop over time.
Guidance on Materiality tends to be General

- ASOP 36
  - Uses phrases similar to “...likely to have a material effect”
  - There is no definition of material
- NAIC APP Manual, Preamble, Paragraph VI,
  - “is the item large enough for users of the information to be influenced by it?”
- SEC Staff Accounting Bulletin No. 99
  - Similar to above, but more earnings focused
  - Both “quantitative” and “qualitative” factors should be considered.

Risk of Material Adverse Deviation - Defined

- ASOP 36
  - The most important ASOP related to the Statutory Opinion.
  - Effective since 2001
  - Paragraph 3.3.3 requires disclosure,
    “When the actuary reasonably believes that there are significant risks and uncertainties that could result in material adverse deviation.”

Topics Covered

- Defining RMAD
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Why is RMAD Important for Opinion Writers?

The NAIC *Annual Statement Instructions* require the Appointed Actuary to:
- Identify the materiality standard and the basis for establishing this standard.
- Explicitly state whether or not there are significant risks and uncertainties that could result in MAD.
  - Is there Risk, Yes or No?
  - Additional answer in Exhibit B, Item 6.
- Provide discussion of RMAD in the Relevant Comments section
- If Yes to RMAD, describe major factors that could result in MAD.

Regulator View of Opinion

- Solvency of our insurers is the regulator’s primary focus and concern.
- Regulators are the PRIMARY users and intended audience of Opinions.
- There are other users of Opinions.

Regulator View

- While all regulators have the same goal of protecting consumers and focusing on insurer solvency, each has his/her own perception of Materiality...
- Does this element of perception make Appointed Actuaries less likely to conclude Yes?
Regulators that review Opinions include:

- Actuaries  
  - Duties vary by state
- Financial Examiners  
  - Onsite auditing staff
- Financial Analysts  
  - Desk audits of insurer financial statements

Regulator View of RMAD

- My view as an actuarial regulator may differ from non-actuarial regulators.
- Informal survey of financial examiners and financial analysts:
  - For RMAD, does an Actuary's Yes conclusion mean something different to you than a No conclusion?
  - If so, please explain.
- Responses were quite varied in their perception of RMAD

Regulator View of RMAD - Examples

- “I am definitely more on the alert when a company has such a risk. If a qualified professional with inside knowledge of a company states there is a MAD risk, I believe I should pay attention to his assertion and act accordingly.”
- “I would put more emphasis in determining if the company’s surplus can weather such a change in reserves.”
Regulator View of RMAD - Examples

• “I assume in order for an actuary to conclude yes to this question, that there must be some reasonable chance for it to occur, but to what level and degree, I am not sure.”

• “‘No’ means the actuary is confident or incompetent; ‘Yes’ means the actuary is leery of something or just in CYA mode.”

Regulator View of RMAD - Examples

• “So while yes or no are not explicit factors used in assigning priority, either one could be used as part of an argument to support a higher or lower priority than the explicit criteria.”

• “To me, a yes or no response needs to be put into context.”

Regulator View of RMAD - Examples

• “I would probably expect most, if not all opinions, to contain a ‘yes’ answer, because I think that most, if not all companies, face the risk of adverse development.”

• “Without identifying the risks considered, either answer could be misleading.”

• “The big problem or worry comes when there is no supporting paragraph or explanation that can alleviate an examiners fears or (hopefully) natural skepticism.”
**Regulator View - Takeaway**

- COPFLR Practice Note* says, “The disclosure of a significant risk of MAD generally can be viewed as a disclosure and not as a qualification.”
- Accompanying disclosure is a critical component of risk evaluation.

* Reference: 2009 Version, Appendix 2 - FAQ, Discussion 7

**Regulator View - Takeaway**

- Individual perception may always have some influence on the response to a particular situation.
- Proper way to evaluate RMAD:
  - Not as standalone disclosure
  - Consider with other relevant comment and explanation
- Regulators of all types generally understand its context

**Topics Covered**

- Defining RMAD
- Regulators view of RMAD
- Commonly cited risks
- Opinion and AOS Statistics
**Commonly Cited Risks**

- Reserve risk always has some level of inherent uncertainty.
- Regulators get most value from Company specific risks.
  - Already have knowledge about a company's business profile.
  - Broad, general statements do not apply.
- COPLFR Practice Note provides some good suggestions

**Commonly Cited Risks**

- What do Appointed Actuaries say in Opinions when there is a Risk of MAD?

**Commonly Cited Risks**

- Line of Business Risk
  - "Long tailed nature of coverages written"
  - "Long time period associated with closing Workers Compensation claims"
  - "Company writes significant volume of long-tailed, low-frequency, high-severity classes of business including Excess Casualty"
Commonly Cited Risks

- Asbestos, Environmental, Mass Tort Claims
  - “Significant exposure to A&E claims”
  - “Exposure to asbestos, environmental and other mass tort liabilities”
- Rapid Growth
  - “Significant growth in direct writings”
  - “Increase in gross and net earned premium for 2006 to 2008”

Commonly Cited Risks

- Changes in Claims...
  - “Changes in claims reserving practices for certain classes”
  - “ Noticed a trend of changes in key diagnostics”

Commonly Cited Risks

- New Company or Limited History
  - “Company commenced operations in 2004, so has limited historical data on which to project”
  - “Small volume of company data”
  - “Newness of company’s operations”
  - “Heavy reliance on use of judgment and external industry data creates an additional risk”
Topics Covered

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Opinion & AOS Statistics

- Who Signs Opinions?
- Type of Opinion
- Is there RMAD?
- Point, Range or Both?
- Position of Carried Reserves to Appointed Actuary Estimate

Who Signs Opinions?

- About 10% of CAS membership signs Opinions
- For year ending 2009, about 2,550 Opinions issued by 492 actuaries.
- Large handful of actuaries preparing a high number of Opinions
Who Signs Opinions?

Actuarial Credential
- Fellows 78%
- Associates 22%
- Other includes AAA members and non actuaries, approved by a few states

Who Signs Opinions?

Employment Status
- Consultants 68%
- Employees 32%
- Does the employment relationship influence RMAD conclusion?

Type of Opinion

Of the five recognized Opinion types:
- 98.8% Reasonable
- Not much change from prior years
  - Slightly more Excessive Opinions
  - Regulator(s) for companies receiving Inadequate Opinions very actively involved.
Is there RMAD?

Of valid responses from NAIC database:
- 31.2% Yes
- 67.4% No
- 1.4% n/a
- Steady ratio over time.

* 2005 and 2006 from multi-state sample; subsequent years from NAIC database

Is there RMAD?

Varying by Employment

* 2005 and 2006 from multi-state sample; subsequent years from NAIC database
Point, Range or Both?

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* Again, not much change since prior year
* Source: Multi-state sample of about 790 companies from six states

Carried vs Actuarial Estimate
Year End 2009

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Final Points on RMAD

- The Opinion’s intended audience is the domestic regulator, whose focus is insurer solvency.
- RMAD should be applicable and specific to the insurer.
- RMAD should be evaluated with other relevant comments and related disclosures.

Points for Appointed Actuaries to Consider

- Is my explanation of relevant comments sufficient?
- Can I provide an explanation of items considered and relevant discussion even if I conclude “No” to RMAD?
- Are there points within my range that could cause a material misstatement of reserves or cause a financial reporting ratio to be triggered?