

1987 CASUALTY LOSS RESERVE SEMINAR

3C/6H - LOSS RESERVE CERTIFICATION STANDARDS

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**Panel: Douglas J. Collins, Consulting Actuary
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**William D. Hager, Commissioner of Insurance
State of Iowa**

**Recorder: Marlene D. Schustar, Sr. Actuarial Assistant
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WARREN COOPER: The one after, Bill Hager, has talked to us at lunch. Unfortunately there was a bit of a mix-up in the program. I originally asked Bill to be on this panel, knowing his background, particularly as general counsel of the Academy and the talks that he has given about professional matters and Congressional responsibilities over the years. Bob Nicholas then asked him to be the luncheon speaker and he agreed to do that but wanted to remain on the panel. I said, "Great, I want you on the panel, but in putting together the booklet they left him off. He is a full fledged panel member and has been so engaged for several months. He has gone down to get some photostats, we'll get everybody here together sooner or later. This is a very serious topic that we're discussing today. It's not something that any of us should take lightly. There is not very much known nor much publicity about the area of actuarial malpractice, but it is indeed out there. There are cases -- they're not getting very much play at the time. You did hear Bill say that he was considering in the case of one now defunct Iowa company, whether he should go after the loss reserve specialist. Just so, we ought to review what has been happening in the last very few years. New York, California, and New Jersey have for some years now required the submission of an opinion by a qualified loss reserve specialist. Last year New Jersey made theirs a lot sharper and put a lot more teeth in it; the others have followed suit. However, despite that we saw earlier this year, a major problem for New Jersey in the liquidation of Integrity of Paramus. They stated, I know perfectly well, having been the person that actually put the requirement in existence in New Jersey, that their statements had come in with an opinion by a qualified loss reserve specialist. New York has also required it for some years for their domestic companies. And yet during that time we saw Constellation, Ideal Mutual, The American Plan Companies, Union Indemnity, Dominion of New York and Midland all go into liquidation in the Empire State after they had been given clean opinions by a loss reserve specialist. California during this period has also made a requirement for an opinion, and yet very similarly we saw Califarm go under, only to be resuscitated in a different guise. But the grandfather of them all that is running just shocks throughout the whole industry is Mission Reinsurance, that has taken or will take other companies along with it which, of not the least, is our little New Jersey company of Integrity. They had 40% of their assets and its affiliated companies. The insurance department had no choice but to bring it under liquidation because there is very little likelihood that that reinsurance will ever be realized. We are talking about very serious matters throughout here, and those of us who are in the profession take it, at least I hope we all take it very, very seriously. Setting that rather glum note, we'll turn to our first speaker, who has just recently changed jobs and became one of us -- a consultant who is Stan Khury. Stan was for several years not too far from me out in Holmdel, but just recently he

has come to work for William M. Mercer, Inc. in New York and is building an actuarial consulting operation for Mercer.

STAN KHURY: Thank you Warren. I'm sorry for being late. I didn't have a chance to give Warren the introduction that I wanted, but I wanted the commercial and he already did it. The name of the firm I'm with is not William Mercer, Inc., it's a subsidiary of that firm and it's called Mercer-Future Cost Analysts; formerly known as Future Cost Analysts, headed by Fred Kilbourne.

I like to bid you a good afternoon. I welcome you to beautiful downtown Minneapolis. I would like to share with you a little discovery. It has nothing to do with the subject at hand, but permit me a little indiscretion here. I guess I'm typical in that I tend to find opportunities such as this very enticing. I look forward to them for 100 different reasons. But I always seem to run into a problem, and that is after all the preparation -- how do you bring a subject that is dry, serious, utterly humorless, and establish contact with the audience. After reflection I decided that the best way to do this is that you have to start with something utterly unserious. Without further ado I would like to share with you a letter that a freshman coed wrote home "Dear Mom and Dad: It has now been 3 months since I left for college. I had been remiss in not writing and I am very sorry for my thoughtlessness in not having written to you before. I will bring you up to date now, but before you read on, please sit down. You are not to read any further unless you are sitting down. I am getting along pretty well now. The skull fracture and the concussion I got when I jumped out of the window of my dormitory when it caught on fire shortly after my arrival, are pretty well healed now. I only spent two weeks in the hospital and now I can see almost normally. I get those sick headaches only about once a day. Fortunately the fire in the dormitory and my jump were witnessed by an attendant at the gas station near the dorm. He was the one that called the fire department and the ambulance. He also visited me at the hospital, and since I had no place to live because of the burned out dormitory, he was kind enough to invite me to share his apartment. It's really a basement room but it is kind of cute and quaint. He's a very fine boy and we have fallen deeply in love and are planning to get married. We haven't set the exact date yet but it will be before my pregnancy begins to show. Yes, mother and dad I am pregnant. I know how much you are looking forward to being grandparents, and I know you will welcome the baby and give it the same love, devotion, and tender care you gave me when I was a child. The reason for the delay in our marriage is that my boyfriend has some minor infection which prevents us from passing our pre-marital blood tests, and I carelessly caught it from him. This will soon clear up with penicillin injections I am taking

daily. I know you will welcome him into our family with open arms -- he's kind and although not well educated, he is ambitious. Although he is of a different race and religion than ours I know your tolerance will not permit you to be bothered by the fact that his skin color is not like ours. I am sure you will love him as I do. Now that I have brought you up to date I want to tell you that there was no dormitory fire. I do not have a concussion. I was not in the hospital. I am not pregnant. I'm not engaged. I do not have syphilis, and there is no tall good looking man in my life. However, I am getting a D in history, an F in calculus, and I wanted you to see these marks in the proper perspective.

The moral for me, I guess, is that there is life after loss reserve certification. We've got to keep that in mind and keep our perspective. Today I would then like to deal with the subject at hand structurally and would like to do it on two different planes. First of all, I would like to share with you some perspectives and observations on the loss reserve certification process. With that background I would like to move on to the second part, that is, describe the broad elements-- the road map to be followed by the loss reserve certifying actuary. You will note here the distinction between the person who calculates the reserves and the person that certifies. They can be the same but these are really two different functions. Those of you who work for an audit type firm will appreciate that difference. But in any event, I am assuming there is a difference and if you find my references roll from one function to another, it's kind of unintentional.

With respect to the first point I would like to ask you to look with me at any estimate of a future happening. Examples, look at weather forecasts, GNP estimates, stock market forecasts, psychic readings, longevity estimates of cancer patients, and thousands and thousands of other estimates of future happenings. I think you will agree that they are all subject to one ultimate test-- the test of time. In fact, if you wait long enough you will find out just how good that estimate was. Loss reserve estimates are no different. They are subject to the test of time. Unfortunately we don't have a time machine where we can sit and dial up a future year and see how good is this or that estimate. That just doesn't exist.

To illustrate this point further let me share with you what a surgeon does with a prospective patient for a quadruple bypass. Of course, the statements that the doctor can make can range all the way from "estimating that you will recover completely and return to perfect health" to "you will probably die on the operating table". What does the surgeon have to do here. The

client/patient wants assurance. The surgeon, first of all, does not guarantee the outcome of the operation. If he has statistics to point to in terms of "out of so many operations I've done so many have been a success" -- he'll point to those. If the medical procedure is generally successful he will point to that. On the other extreme the doctor can say -- "Well, I am current on all of the relevant technology, I have a great deal of experience with this procedure -- the facilities are terrific and we have great back up and so on and so forth." There is a representation here as to extreme ranges. On one end you have full statistical support. On the other hand, if you don't have the statistics and you have a 30% rate, what does a surgeon have to do. He has to speak of the process itself -- that the process will be the best that is available.

I would like to transplant this analogy, no pun intended, to the insurance problem -- loss reserve certification. Pretend the actuary is a surgeon and the patient is an insurance company or a self-insured plan. In order to assess the possible outcomes here we have two extremes again. On one extreme is if the practitioner turns in a credible performance year in and year out with a long track record, that person doesn't have to do much more than say this is the reserve and you will probably just take it. You really don't have to do a whole lot more. On the other hand, if there are a lot of environmental changes included in the historical data, for example, there is a new claim system in the company or in the self-insured plan, judicial decisions and external environment come in and change the ball game, and there are changes in the contract. What do you do? You have two extremes here again. One, you can refer to the track record, that has met the test of time. If you can't do that then you've got to look at the process. That is the kind of assurance the certifying actuary can give to the client.

I would like to make a brief digression for just a moment and talk about a side issue that tends to operate even though generally only implicitly. I think you'll recognize it immediately. That is, the purpose for which the reserve is being certified. If the purpose is to certify the normal quarterly or monthly update, then that's one thing. It affords great opportunity to recover from bad data, bad judgments, bad methods and so on. You're doing this job every quarter or every month. That's on one extreme. But if the certification is going to serve as a basis for an acquisition or as the basis for a major reinsurance treaty commutation negotiation, you're going to get only that one shot. Money is going to change hands based on what you say. I think that's a place where the actuary is particularly exposed. Again, I harken to Commissioner Hager's comments at lunch. I suppose one can say in a vacuum that under both circumstances (whether you're working on a regular updated

reserve or whether you're working on part of an acquisition), the answer should be the same. That is technically true, but I think, only in a vacuum. Reality is when you're dealing with an acquisition situation you have relatively zero chance of recovery. If you made a mistake -- you really have made a mistake. I think that will require a much greater degree of rigor in terms of the activity required by the certifying actuary.

With that digression aside, I would like to now shift to the second aspect of my comments. That is the broad elements of the road map to be followed by the certifying actuary. Let me first remind you that in this segment I'll not be dealing with the situation of the actuary with a great record. If the actuary has a great sustained record of hitting the mark every time. That's really not a problem, and we can go home and rest. The focus here is on the case where the certification of the process is really what is truly required. The same as the surgeon talking to the patient saying "these are the assurances I can give you about the process itself." The method that the certifying actuary should follow should consist of a review and assessment of three broad aspects of the process. One is the data; second is the analysis of the data; and third is the presentation of the results. Let me deal with each of those and I will briefly amplify them and hope that the question and answer period will give us a chance to develop them some more.

With respect to the data issue, I'd like to point out four aspects that the certifying actuary has to examine. One is the actuary has to be certain that the intrinsic data that is available is complete that it is the most complete set of intrinsic data that is available. This is an element of assurance that the actuary has to bring to the process. Second, there has to be assurance that the completeness of the relevant extrinsic data is present. In other words, you have looked at all the data that is relevant to the problem internally and all the data that is relevant to the problem externally. Third, is the quality of data issued. How good are the data you're using? How good is it in terms of the input? When a claim comes in how rapidly is it put into the system? What are the adjustments that have been made to the data by the systems people. And those of you who have dealt with systems people know enough not to assume that the number that went in is the same number that came out. By the time the programmers are done, the numbers change. And there are other elements of quality. Fourth and last, is a very important aspect of all the factors I mentioned earlier, deals with the influences operating on the data. I think the certifying actuary has to ascertain the types and degrees of influence the operational process has on the data. Let me give you an example. Suppose a company puts in a new claim system.

That immediately changes the basis of reporting. What are the structural changes, the changes in the coverage of the contract? History is based on one contract, the future may be based on another. What external pressures are present from the judicial environment? A precedent setting decision comes down that makes all of your history really irrelevant or creates the need for significant data modification. What are the reinsurance retention limits that are applicable to this particular company? Does that influence the reserve setting process? I suspect the answer is yes. To what degree? That's the job of the certifying actuary. You have four key elements of assurance a certifying actuary has to explore before he renders the data to be good data to do the work.

With respect to the analysis I would like to identify six different elements of assurance. I will skip through them quickly. The first one is the appropriateness of the adjustments made to the data to recognize the future conditions that are going to be applicable. What is the quality of that adjustment to the historical data? Second, are the methods that have been selected appropriate for the situation? If a paid loss development method is used on medical malpractice, you'd better look again. It just doesn't apply. For physical damage insurance, you can use some very crude systems to come up with very reliable estimates. Are the methods appropriate for the situation? Are the methods applied properly? If you have a scalpel are you trying to use it as if it is a meat axe? It is just as important that the proper method is applied properly. Another is the judgments that are applied. Are they rational or are they mystical? Again, I harken to what Commissioner Hager said at lunch. Where did that 4% come from? Some actuarial work that I have seen would say the answer is 5, 4, or 7. Is it rational? Does it have a foundation, or is it mystical? I think we have to endeavor as actuaries to avoid the mystical aspect because that gives us all a bad name. We just haven't yet got tp physics doing loss reserve certification. The next one is: has there been sufficient testing of reasonableness of the outcome. Again, versus industry -- what are the reserve levels being set vis-a-vis what the industry has that is available to look at? What is the pure premium versus the pure premium that underlies the loss reserve estimate? What kind of loss ratio does it produce? How does it compare versus history? You can just go on and on. There are reasonableness tests that the certifying actuary should observe in order to render the reserve estimates to be clean. Finally, has there been sufficient sensitivity testing conducted in the process? In other words, if an assumption is changed, what would the outcome be? These are 6 aspects that I think the certifying actuary should evaluate on route to pronouncing the reserves reasonable.

Finally, I would like to speak to the presentation element of the reserve certification work. I have five aspects listed to share with you. 1) Are the correct assumptions clearly spelled out? Does the client know? The client can be an insurance company or a one time client paying for a consulting service. Does the client understand the assumptions that have been made? 2) Are appropriate caveats provided so the client understands the limitations of the work that is being presented? For example, with respect to payability of reinsurance recoverable, Commissioner Hager mentioned that again in his luncheon address. Does this really affect your calculation? Does this affect your judgment? The variability aspects -- all of the caveats that surround the final judgment, have those been communicated to the client? Mind you the client may not like to hear some of that, but it is your duty, if you're going to certify those reserves to make sure that that client has the caveats. The third aspect on the presentation is the consistency between the numerical results and the qualitative statement. I've seen at least one piece of work where after many, many pages of calculations and tables and Lord knows what, and estimates range quite a bit; and then there's a very simple statement at the end that reserves are reasonable. I cannot accept this. You have to mention that the calculations that you performed did not produce conclusive answers. You just can't come out and say it is reasonable. The next item is the sensitivity of the results to change in the critical variables. For example, if you've made a judgment that the number should be 4 or 7 or what have you, does the client know the effect of this critical variable, if you were to assume 5 or 9? I believe the certifying actuary has a responsibility to see to it that the work does reflect some sensitivity testing. Finally, is the best probability statement included in the final work product. The best probability statement is an actual confidence interval: the answer is "x" plus or minus -- epsilon with probability "y". It is indeed a very rare situation that will give you enough history, enough data to be able to produce that statement. At the other extreme is a crystal ball. The question the certifying actuary must deal with -- does the best probability statement exist within this report that can be made?

With this background I would like to sum with a couple of random thoughts here. Maybe some of them are self evident truths. One is I would like to reaffirm that there is no clairvoyance available to the actuary. The temptation to say to a client that this is the answer is great. The practitioner must endeavor to avoid the reference to clairvoyance or any implication thereof. Another point is that a great job can be done on reserves and the estimate can be way off when the final results are in. That doesn't mean that it is a bad job. A great job can produce an answer that can miss the mark. The opposite of that -- a very poor job can accidentally hit the right answer. The test of time, while interesting, really doesn't give you very much to go

on. What is the quality of the job that was done on the reserves?

I'd like to share with you two very short stories as to what not to do. This is a company that insures professional liability. Its reserving procedures did not make use of paid data. One can understand that -- if you use paid data exclusively you're going to get in trouble with that. But they paid no attention to it-- their reserve methods were totally independent of that, and when the answer comes out they give it to their accountants to put on the books, and nobody bothered to check actually what was the cummulation paid losses for this particular accident year. The ultimate reserve estimate was less than the amount that was paid to date. The accountants, what did they do, they dutifully put a negative paid on the books. What kind of reserve job is this? I think it really strains the imagination. Another one that's kind of cute is the professional liability company that doesn't know how to set reserves. They don't want to invest in actuarial services so they do their own reserves. How do they do it? They're required to have a premium to surplus ratio of 3 to 1. They divide the premium by 3 and get surplus -- everything else that's left is reserves. From this I would like to quote a famous actuary who, when I related this story to her, said "well, this sounds like in answer to the question: what should the reserve be? The answer is how much money have you got?" I think that's a sobering thought. For a lot of insurance companies that is the answer -- what should the reserve be -- everything you've got.

WARREN COOPER: Thank you Stan. We'll save questions until we complete the session since we did get underway a little late, to make sure everybody gets a chance to say all the important things that need to be said today. When I first put this panel together I had tried to balance it out very nicely by having a regulator, a consultant, and a company person. I also want to note that while it is not listed in the program, Marlene Schustak from General Accident has agreed to be the recorder for this panel. I'm sure that when we get the records out and the transcripts, that you all will be very pleased with what she did. Our next speaker comes from Tillinghast/TPF&C. Doug Collins is in the Connecticut office and he is the quality control officer, peer review officer, what have you, in Tillinghast and has given this matter a tremendous amount of thought which he will now share with us.

DOUG COLLINS: I'd like to shift direction a little bit from looking at the client relationship with the outside world to the opinion letter itself. The main message I would like to get across is that I think the loss reserve opinions need a greater

amount of standardization if they are to be meaningful communication tools to the many regulators and accountants, and other people that rely on our opinions. There are an increasing number of states that require opinions and at the same time I think there is an increasing potential for misunderstanding about what those opinions are really saying.

I'd like to start by posing a hypothetical situation in which you are the reserve actuary or the qualified reserve specialist for a company and you've been asked to write an opinion. It doesn't matter if you are an internal employee or a consultant, but you've reached the point in your analysis where you've concluded what you think the best estimate of reserves is and you've got to write the opinion and decide what the opinion should actually say.

If you look around there are several sources of information regarding opinion wording. The NAIC, of course, has instructions to the annual statement which describe the required language and those instructions are utilized by most of the 18 states that require loss reserve opinions currently. You can also review the state reserving laws and the regulations and instructions requiring opinions in the various states. Finally, the American Academy guides include Recommendation 8, which speaks to our responsibilities as actuaries in certifying statutory opinions. Each of these sources of information tell you the standardized wording that should be included in a normal situation. They don't give you any guidance in what you should say if you're not in a standard situation.

You'll learn from these sources that there are as many as six different sections to the opinion itself. There's the opening where your qualifications are presented and your relationship to the company. Following that is the scope section that enumerates the exact loss reserves that you're providing your opinion on. Following that there is a section on data reliance which names the people that you've relied on for the accuracy of the data that you have used. There's the opinion itself which summarizes what you really think of the reserves. There's a section on change in assumptions, which is a disclosure if there's been any major change in assumptions from the previous year's opinion. Finally, there are a number of qualifications or limitations on your opinion that you might include in the letter.

Only by looking at other sample opinions, that would be the only way you could really find examples of wording that you should use in non-standard situations. For example, if you have problems with the data -- if you think the reserves are not reasonably

stated -- or if you think the opinion should be qualified in some way. Looking at samples, we'll tell you that you have a lot of flexibility in what you say in the opinion. It will not tell you anything about the facts underlying that particular opinion letter or whether those are relevant to the situation you're looking at. You'll come away knowing that you can use a lot of judgment, but on the other hand, the flexibility that you have in wording those opinions makes them a less effective communication tool.

I'd like to speak further about the three problem areas you might run into in writing a reserve opinion. Those areas are: determining what you should say if you think the data is insufficient -- determining if stated reserves are not reasonable and what you should write in that opinion -- and finally, the various types of qualifications and other limitations that you might include.

Briefly I'd like to talk about the data problems first. There are two basic types of data problems. There may be plenty of data available, but you may not believe it is reliable or accurate. Alternatively, there may be insufficient data available, either because the company is a new company or a start-up operation, or because there may be statistical credibility problems or because in some cases, it may not be reasonable to collect all the data that is relevant. Perhaps, you're dealing with a reinsurer and you can't go to all the ceding companies and get all of the information that would help you in your review.

Is it still possible to provide a clean opinion or an opinion that says your reserves are good and sufficient if you have problems with the data?

In the first situation, if you don't believe the data is reliable, I would have to say no, you should decline to write the opinion. I'm differentiating here between reliability and credibility. If the data is not believed to be reliable or accurate in some material aspect, I think I would refuse to issue an opinion. Alternatively, if the problem is a lack of statistical credibility, I think that the opinion could still be considered good and sufficient but there might be a caveat or qualification stating that some key assumptions could not be verified using the clients data but they are nevertheless consistent with the knowledge of the business being insured.

The next question is -- how do you decide when the company's reserves are good and sufficient? I'm assuming that for one

reason or another the held reserves are different from the reserve estimate that you've come up with. Either you actually weren't the person that set the reserves or perhaps you did some initial calculations and someone else had the ultimate responsibility for setting the booked reserves on the balance sheet. In either case I think if you are a reasonable person you would agree that there is some range of uncertainty about your estimate which would include the reasonable reserve level. You would not expect the booked reserves to be exactly the same as your estimate in order to consider them good and sufficient. How do you decide whether to consider reserves good and sufficient? Is there some magical percentage within which you consider reserves to be within an acceptable range of your number? I believe it would be very useful if we had more standardization in this regard. We could use a starting point in determining when reserves are good and sufficient.

There's no common definition of the terminology good and sufficient other than a brief paragraph in Interpretation 8(b), which primarily says you can use your judgment. There was an expansion of interpretation of 8(b) last year that was tabled primarily because of the formation of the Interim Actuarial Standards Board, and potentially the IASB will be considering that sometime in the near future. I believe even the expanded 8(b) which was distributed for comments doesn't go far enough in defining what we mean when we say "good and sufficient."

A very simplistic but practical standard that I've seen in a number of cases would be just to say reserves are good and sufficient if they are within 5% of your best estimate. We could call that the acceptable range. I'm defining this acceptable range as a fairly narrow band, and I don't mean to confuse it with the risk margin, which would certainly be a much larger number and would include all the variation in the assumptions that you've used.

A more comprehensive standard would be to calculate the risk margin and then base the acceptable range as a function of the total risk margin. Other financial measures might also be taken into account. Certainly the acceptable range should depend partly on its relationship to the total surplus of the company. The standard would also have to define the term best estimate. Perhaps it might include a discussion of the mean, the median, and the mode. This would give us guidance in terms of what the starting point would be in determining the acceptable range. The creation of standards such of this would be a tremendous aid to both the users of loss reserve opinions, and also the writers and signers of those opinions.

Getting back to the wording itself, if the booked reserves are not within an acceptable range, the opinion letter must include wording other than good and sufficient -- various possible wordings are possible. If reserves appear to be short one could say that reserves are optimistic. You could say they are not conservative -- you can say they're are reasonable but optimistic or variations on these terms. If reserves appear to be fat, similar wording questions arise as well as the more fundamental question about whether there should be more leeway on the conservative side compared to the optimistic side. Another issue that needs to be addressed is the disclosure of the amount of discrepancy. If booked reserves are outside of the acceptable range, I think the opinion should clearly state what the percentage difference is between booked reserves and the loss reserve specialists' best estimate. This would serve to explain fairly to the reader why reserves are not considered to be good and sufficient.

The final subject I would like to talk about is the various types of qualifications and limitations that appear in opinions. Some people might argue that if reserves are considered to be good and sufficient, and if there are no data qualifications, then the opinion should contain no other qualification of any kind. Others would argue that there are a number of caveats that need to be disclosed to the reader of reserve opinions. Either way you'll find little guidance from the literature on the subject. Clearly if two different actuaries reviewed the same book of reserves and came up with the exact same conclusion, they could still write vastly different clean opinions about those reserve levels.

What types of qualifications are being included in opinions?

Several attempt to clarify what is not being covered in the analysis, such as the fact that assets, their liquidity or timing of payment, have not been reviewed by the actuary. This is an area that is covered in Interpretation 8(b), which speaks to the fact that we are not required to include any mention of assets in our opinion, but nevertheless it's a qualification appears that appears quite often. Another is the contingent liability due to uncollectible reinsurance. Generally, we review reserves net of reinsurance and as a result quite often a qualification appears that says we have assumed this reinsurance is collectable. In other cases there might just be a general statement that all other balance sheet items have not been reviewed, that we've only reviewed the loss reserves themselves.

Other types of statements are really more disclosures than qualifications, such as the fact that reserves might be discounted or that there is a change in methods. The change of methods is an interesting one -- it's one of the few qualifications that is mentioned in the NAIC and the American Academy Guidelines. But it is one that is rarely seen, and I think perhaps that's because there really aren't any guidelines on when a change in methods from previous years is material and when it has to be disclosed.

Another qualification is a statement regarding the contingent nature of reserve estimates and their resulting uncertainty. This is a disclosure that's often seen in actuarial reports but not very often in opinions themselves.

Most all of these have their place in an opinion letter. There are certainly others that can be added to the list. I think it would be very useful if there were guidelines that could be written suggesting when and if it is appropriate to include various qualifications with examples of what the wording might be.

To summarize, I'd like to say if we could improve the consistency of our opinions through more detailed standards they would have more meaning to the various parties, regulators, accountants and other parties that rely on these opinions. These issues are really separate from the standards underlying the reserve calculations themselves. These standards are being worked on by the CAS as well as the IASB, but I am suggesting that reserve opinion standards could also be addressed in greater detail.

WARREN COOPER: Thank you Doug. Our last speaker has spoken to you within the hour, but he has greater information for us at this particular time. I don't think we need to reintroduce him. He's been introduced twice -- once by Pres Bassett and also by himself as to who he really is. I'll let you decide.

WILLIAM HAGER: Thank you Warren. Doug just finished talking about various issues that as an actuary or casualty reserve specialist, you ought to reflect on as you articulate the language you speak. I'm going to zero -- in on the liability that attaches to items and statements that are used in an opinion. To do that I have focused on the instructions set out in the NAIC Casualty blank, relating to opinions. What I'd like to do is go through each component part of that opinion and talk briefly about liability that comes to bear on each provision of the suggested language and the opinion as it is set out. Along

those lines I have a handout that I would like you to hold until I finish. In the handout I've set out the analysis I'm about to provide you. The reason I am holding it is because the handout relates to a comparable panel that we did a couple of years ago. The material is about 99% on point but some of the references have been updated, so don't be offended by that. We're talking about liability and a very serious instance of liability happened in my neighborhood just the other day that shows the relevance of malpractice. This guy called home at noon and the maid answered the phone and the guy said I would like to speak with my wife. The maid said that I'm sorry she is upstairs in bed with another man, and the guy says that's outrageous, that's just outrageous. I want you to get my gun and I want you to go up there and shoot both of them. The maid says okay -- the maid sets the phone down on the counter, and about a minute later the guy hears "bang, bang" over the phone. The maid comes back and says -- well I did it. I shot both of them. The guy says that's great -- over the years you have been an outstanding loyal domestic servant. I need one additional piece of assistance from you. I'd like for you to get rid of the evidence -- get rid of that gun. The maid says I've already done that -- I've thrown it in the swimming pool. He says swimming pool, swimming pool -- is this 548-3160? I didn't make it up, we lost some real nice people in the neighborhood. The point is to use care in specificity. I'm going to go through the annual statement, the directions that relate to that opinion. I want to take them one at a time and talk about liability. The first provision, according to the instructions, reads like this --

"For companies as required by its domiciliary Commissioner, there is to be submitted to the Commissioner as an addendum to the annual statement by April 1 of the subsequent year, a statement of a qualified loss reserve specialist setting forth his or her opinion relating to loss or loss adjustment expense reserves. A qualified loss reserve specialist, as used herein, means a member in good standing of the American Academy of Actuaries, or a person who otherwise has competency in loss reserve evaluation."

What's the relevance of that? The relevance is that in a liability situation, what we're talking about is an insurer who gets into an insolvency or something less, perhaps rehabilitation. Adequacy of reserves is the issue. Who do we join as defendants is the question? One of the questions to be answered when deciding who will be joined as defendants will be whether the qualified loss reserve specialist is somebody that shows competency as indicated herein. The Academy of Actuaries, for those of you who are affiliated with the Academy, has set out

the standards. The standards would be examined. If the individual did not in fact meet the standards you've got a prima facie case of liability. The Academy has standards as follows: Education and experience - A loss reserve specialist should be a FCAS or have mastered knowledge. It sets out a number of topical areas such as general mathematics, probability, statistics, numerical analysis, theory of interest, life contingencies, principles of economics and so on. Obviously the point is that when an individual signs their name indicating they are a member of the Academy, they are representing to the public, to the regulator, to the courts, to the liability system that they meet the educational component as set out in the professional standards. They also have certified that they meet the experience requirements. Experience requirements as set out in the Academy's Qualification Standards, requires at least 3 years of experience with the responsibility for overall reserve level; quantifying overall reserves; and perspective evaluation of the reasonableness of overall reserves. The point is that criteria will be examined with respect to an Academy member who indicates that they have requisite qualifications as required. Non-Academy members may qualify under the phrase that "someone otherwise who has competency." Obviously, if it's a underreserving insolvency situation by definition, both experience and education will be evaluated. The regulators will argue that an individual that has rendered an opinion fails to meet minimum experience in education requirement. I don't think anybody needs a hand calculator to get to that. Anyway, that's the first provision.

The second part of the NAIC instructions reads as follows:

"One or more additional paragraphs may be needed in individual cases if the specialist considers it necessary to state qualifications of his or her opinion or to explain some aspect of the annual statement which is not already sufficiently explained in the annual statement."

That language is pretty straightforward and Doug has indicated that the loss reserve specialist may qualify their opinion or the opinion should be qualified as needed. There is also authority in that language to explain other actuarial items. Items that are not the direct subject of the opinion rendered. My advice would be to simply to review all the other actuarial items in the annual statement which impact directly or indirectly on the reserves. If you have responsibility for them and you believe that they merit comment, this is certainly the opportunity.

The third component reads like this:

"For a company actuary the opening paragraph of the opinion should contain the following sentence: "I, (name and title of the specialist) am an officer or employee of named insurer and a member of the American Academy of Actuaries." For a consultant the opening paragraph of the opinion should contain the sentence "I (name and title of the consultant) am associated with the firm of *(name of firm), am a member of the American Academy of Actuaries and have been retained by (name of insurer) with regard to loss and loss adjustment expense reserves.

I think that No. 3 is pretty straightforward, just setting out the qualifications. The fourth component is for a person other than a member of the American Academy of Actuaries. The opening paragraph of the opinion should contain the following sentence:

"I am an officer/employee of the insurer and I have competency in loss reserving."

This is a very straightforward statement. This is a certification to the government, the state insurance departments, to the courts, to all people that ultimately rely on that opinion or in a fiduciary capacity with the insurer affected, that the person signing that blank has competency in loss reserving. There's another aberration of that, but that should be pretty straightforward. But again, the statement, representing to all the world that the person signing it has competency in loss reserving will decrease your liability if you have an insolvency, and you have inadequate reserves and there is a question of competency. It's going to come to the surface very quickly.

There is a fifth component from the NAIC language. The following are examples which are for illustrative purposes of language which would be included in the remainder of the Statement of Opinion.

"The illustrative language should be modified as needed to meet the circumstances of a particular case and

the specialists in any case should use language which clearly expresses his or her professional judgment."

Again, it is language for illustrative purposes. The directions and instructions encourage modifications as needed. If you utilize this specific language, it provides no protection in a liability situation if it is used in a situation where the suggested language has no application. It is very straightforward and the utilization of the language isn't going to provide any protective shield. Obviously, that language intended that the author of these opinions would modify it to suit the situation and use language which clearly expressed his or her judgment.

A sixth component should contain a sentence such as the following:

"I have examined the assumptions and methods used in determining reserves as listed below and as shown in the annual statement of the company as prepared for filing with the state regulatory officials -- the paragraph should list those items and amounts with respect to which the specialist is expressing an opinion, that should include but is not limited to ..."

What is the point? The point is that a critical component is the certification by the casualty loss reserve specialist that they have examined the assumptions and methods used in determining the reserves as indicated. That, from a legal standpoint, this statement requires the specialist not only to examine the underlying methods and assumptions, so there is a certification of the examination, but also to declare that the methods and assumptions used meet the task of being generally accepted sound loss reserving standards. Those that are interested from an Academy standpoint, in terms of determining whether the reserves that have been established, look at the methods and assumptions that have been utilized. Take a look at Opinion A(7), which defines generally accepted actuarial principles. This is where you go to formulate generally accepted actuarial principles and it is very straightforward. You go to professional standards as promulgated, the guidelines, the opinions, the recommendations, promulgations by the Interim Actuarial Standards Board. You go to the procedures of CAP, SOA, of the Casualty Actuarial Society of the American Academy of Actuaries. You go to articles. In the handout I have listed about 25 or 30 specific articles on

casualty actuarial loss reserving techniques. If I can find those, any one could find those and we'll argue that the techniques, the methods and assumptions that you've signed off on were in fact inappropriate, if inadequate reserves are in fact an issue in an insolvency situation. Again, insolvency is the only time that these kinds of things are going to be tested, so that's really the bottom line.

The next provision, reading from the NAIC Instructions:

"If a specialist has examined the underlying records and/or summaries the scope/paragraph should also include a sentence such as the following: 'my examination included such review of the assumptions and methods used and the underlying basic records and/or summaries in such tests and calculations as I consider necessary'".

I think that's pretty straightforward.

"If the specialist has not examined the underlying records or summaries but is relying upon those prepared by the companies ..."

That sets out some suggested language. The reliance provision, in my judgment, merits careful scrutiny. In reliance situations the specialist should carefully document his request to company officials for the records and summaries, and be the records and summaries actually provided by the insurer. The opinion should be qualified to delineate those materials upon which the specialist relied and those which he or someone under his direction controlled and personally examined. In addition, the specialist should refuse to sign the opinion if the company has failed to provide appropriate or adequate records or summaries following the appropriate request. Doug hit the nail on the head in my judgment. The specialist should also recognize that in law, even where company officers state that summaries accurately reflect under relying records, if those summaries should raise questions -- if a reasonable special looking at those records would say these records are deficient, there's a whole unit missing -- there's a block of material missing -- liability can still attach. For legal foundation take a look at the Equity Funding case. The court in the Equity Funding case held the accountants and actuaries liable based not on the fact that they knew of the fraud, but based on the fact that from the material they had - they should have known about the fraud. You don't escape liability even if company officers certify that everything they've given you is full and accurate if upon reviewing what is given to you, a reasonable person would have raised serious

questions. Where there is smoke there is fire. As a professional, of course, you are liable in those situations.

The opinion paragraph should include a sentence that covers at least the points listed in the following illustration.

"In my opinion, the amounts carried in the balance sheet on account of items identified above: (1) are computed in accordance with accepted loss reserving standards, (2) are based on factors relevant to policy provisions, (3) meet the requirements of the insurance law of a particular state, (4) make good provisions for all unpaid losses."

Here, of course, the specialist is offering his professional opinion that: (1) sound loss reserving standards have been utilized for both unpaid losses and reserves for unpaid loss adjustment expenses; and (2) that such reserve amounts are consistent with the coverage of the affected underlying policy, (3) the reserves are so determined with applicable state insurance codes. It is very straightforward.

Another provision which conclusions I think are self-evident, are as follows from the NAIC Annual Statement directions:

"If there has been any material or change in the assumptions and/or methods from those previous employed that change should be described in the Statement of Opinion by inserting a phrase.

There's a signed signature line -- it's straightforward. In terms of your liability exposure, as a loss reserve specialist, it is incredible on these opinions. You don't have to look far -- you don't even have to believe me, just talk with the people who have legal proceedings pending against them. Some suggestions to minimize your liability that won't go away are liabilities like the electric bill. It's one of those things that's part of doing business. First, carry malpractice insurance -- that should be pretty obvious. Second, qualify your opinion as often as needed. Third, carefully document your reliance on the insurers underlying records and summaries. Fourth, if you are relying on summaries and records provided by the insurer, challenge insurers who provide insufficient or questionable data. Do not sign an opinion based on such data. Fifth, examine the applicable statutory provisions of each state where the statement will be filed to assure the reserves are consistent with those provisions. The states have varying

reserving standards. Sixth, examine the underlying policies to assure that the related reserves are appropriate and give the coverage. Seventh, examine the methodologies and assumptions used for determining reserves and satisfy yourself with: 1) they meet the test of reasonableness, and 2) they are appropriate for the instance at question. Make sure you can qualify yourself as a quality loss reserve specialist. If you have and there are insolvency problems in reserves that are at the heart of the insolvency problem, guess what -- you'll be asked to prove your qualifications. Eighth, examine the actuarial item to the annual statement which have direct implication as to the reserves and make comments if you have reservations about any of those provisions. I could go on but it should be clear that liability is pretty straightforward -- it is predicated on that opinion. As everybody in this room knows those are very, very serious documents, each of which has a potential to come home in a big way. See I can be boring. Thank you.

WARREN COOPER: Thank you Bill. We now have time for some questions. As you are probably aware, all of these sessions are being taped. Unfortunately we do not have a microphone in the back of this room. If you have a reasonably simple question I will repeat it. If you have a very complex question which is beyond the scan of my ailing memory, I'll ask you to come forward to the microphone so we can get it on tape. Who has a question?

CHUCK McCLENAHAN, Coopers & Lybrand: The question is for Commissioner Hager and relates to something that he said at lunch relating to the obligation of the qualified loss reserve specialist to opine on the collectability of reinsurance. I guess I have two problems/questions with that. The first being a practical question -- how far do you go through cessions, retro cessions and pools? The second specific question to Commissioner Hager -- what do you do in the event that my firm decides that the "X Y Z" Insurance Company of West Branch Iowa, which is fully licensed by your state, and under no regulatory supervision or rehabilitation, we decide that those reserves are no good, and tell our clients that they are no longer admissible.

BILL HAGER: I thought I was going to get a difficult question-- no problem. Actually, when I made that statement, Chuck, I hadn't had an opportunity to finish my dessert, so I was just angry and that's why it all came out. I think when you think about the liability issue, forget about your specific job description or your assignment, just step back and look at the liability issue as it will, in fact, be looked at. The liability issue will be examined when you are in an insolvency situation. That's when what you did or did not do in the reserving process becomes an issue. It does not become an issue any other time--

ives a damn. Even if you're off, if the company is still solvent and doing well, nobody cares. Put yourself in that situation. I'm in that situation with respect to three insurance companies that are insolvent. We are in the business of maximizing assets we collect. That's the politics of it. In the State of Iowa, all of the property/casualty insurers pay the assessment and there is no offset. Dollar for dollar it comes right off their bottom line. Guess what -- we get tremendous encouragement -- some might say political pressure -- but I say we get tremendous encouragement to collect all of the cash we can. One of the areas of cash collection is bringing liability actions against anybody who even wavered during the time this company was in operation -- directors and officers, all of the consultants that service this company. That's straight reality -- you don't get a chance to vote on it. The question isn't whether you like it or not. Let's criticize the situation where the key reason for the downfall of the insurers is that the reinsurance was uncollectible. Let's assume that the loss reserve specialist was in six months before the insolvency. And let's assume that the word out on the street was that the reinsurer was very marginal. Let's assume that everybody in America knew that reinsurer was very marginal. We've got an opinion by the casualty loss reserve specialist saying that the reserves are adequate with no mention of reinsurance problems -- no statement about reinsurance problems. Yet, a reasonable person at that juncture in time, knew or, in the words of the Equity Funding case, should have known that there were problems. Well what the hell. I'll tell you that the loss reserve specialist is going to be scrutinized very carefully as a potential candidate to be a defendant in the asset collection liability actions. I think it is not fair -- I think your statement is that it's impossible to go through treaty, after treaty, after treaty. Nobody said this was an easy task. Nobody said these were easy times, it's very difficult. I don't know where to stop. But perhaps the general counsel for Coopers & Lybrand -- can you give us some suggestions on where to stop in terms of going through the treaties. My point is that if I were general counsel to a group that was issuing opinions in this area, we would talk a lot about reinsurance. And we would talk a lot about how those opinions ought to mention reinsurance. Perhaps, I'm dead wrong -- perhaps the U.S. Supreme Court won't give a damn about the fact that everybody in town knew the reinsurer was on the margin. Everybody in town knew that at the time the opinion was issued that those reinsurance receivables were uncollectible, maybe that was the case, but I don't think so.

MARK SOBEL, Touche Ross & Co.: I wasn't sure Bill if you were implying at lunch that if a consultant goes in and does a loss reserve or a particular company, and for one reason or another he was unable to opine on that company ... his analysis there's an

obligation placed upon a consultant to then say something to the regulators involved in the supervision of that company. It seems to me that clearly puts the consultant in jeopardy. I thought I heard you say at lunch that the degree of cooperation between the consultant and the regulator was something that was looked at very carefully and I wasn't sure if I was jumping to any conclusions here.

BILL HAGER: I guess the speech gave more people indigestion than I thought. First of all, recognize an obvious thing. I don't have any power to make law, and I don't make law -- courts and legislatures do. What we're talking about here are facts that perhaps, in my judgment, lend themselves to the potential for liability. If you get dragged into these insolvency liability actions, those of you that have been around know that the costs of litigation are tremendous. Attempting to avoid being dragged in is certainly worthwhile. I'm familiar with the fact that casualty actuaries are frequently invited to look at the reserves, perhaps not give an opinion; perhaps give an oral opinion; perhaps give an opinion that is unconnected to any certification for any NAIC annual statement purpose. There's nothing inappropriate about doing that; about not issuing any kind of formal opinions. I don't see any liability there. What I was really getting at in my luncheon speech and if I remember I didn't get a chance to finish my steak so I didn't have much protein in my bloodstream at the time I was talking. But what I was really getting at is in the event that through your consulting activity with a particular insurer you come away with a sense that something illegal is going on. You come away with a sense that a serious coverup is going on. You come away with a sense that management in fact is going to coverup the inadequacy of the reserve. I think you're at the point that if I were a consultant I'd at least get on the phone and talk with the general counsel of your consulting firm and explain it to them, and then make your decision. Those are tough calls and I'm not in a position to set out the law but I am in a position to tell you the kinds of considerations that go into the formula about who becomes a defendant and who doesn't become a defendant. It's a touchy thing and your general counsel will probably hem and haw for a while and will probably do some research. Thank you.

JEFF ENGLANDER, Ernst & Whinney: I have a question for Doug. Getting back to the wording of certification. Let's assume you've been asked to certify a company's reserves and the company has got an extremely volatile book of business so you set about your work and run a variety of projection techniques and develop what you believe is the best estimate and a range and due to the variability in that company book that range might be quite low. You may have a difference between the casualty reserve and your best estimate but the casualty reserve is in your range. Let's say for argument sake that it's not that large a company so the

difference from the high or from even the best estimate indicates that the company can be bankrupt or approaching some form of indemnity. Do you feel that any kind of disclosure or unqualification is warranted, even though it was within your range?

ANSWER: I think you have an obligation to make a disclosure depending on whether the reserves are outside of your acceptable range. I believe the range you just described is more like the risk margin -- it's a wider range than what I would consider to be the acceptable range. Clearly, I would say if it's outside of the acceptable range then you need to disclose it. Certainly if the difference was a significant portion of surplus or at least equal to surplus, that would require disclosure of it. The Academy Guideline Recommendation No. 8 says that if the perceived inadequacy is greater than surplus, then you're required to disclose that. I'd certainly agree with them and I think the standard should be a lot tighter than that. Clearly, if the inadequacy is a significant percentage of surplus, I would think it should be disclosed.

MARTIN CARUS, New York Ins. Dept.: The answer to your question in New York would be yes, you would have to inform us. As an independent certified public accountant, Regulation 110 would require you to make that notification to the Department. That becomes ticklish. There could be an expansion of that. Frequently the independent certifier is performing a dual function, and it's not clearly divisible whether you're certifying the reserves as being completely divorced from your actions as being the certifier of the statement.

MARK SOBEL: Does 110 apply if he is acting simply as an actuary as opposed to an auditor?

MARTIN CARUS: So far the Department regulations don't address that -- they are not applicable strictly to consultants but in terms of independent certified public accountants, they are. In terms of your comment Chuck concerning what responsibilities you have to have in determining the collectability of reinsurance. You have to understand that in many jurisdictions the superintendent or commissioner is dealing with two hats. He's the liquidator and the regulator. As regulator he may say the company is a licensee, and therefore the reinsurance is good. But as a liquidator he has a responsibility to his security funds, and if he doesn't take the appropriate steps into making the most collection that he can, he's going to have to answer in his fiduciary capacity as the liquidator. He's frequently wearing two hats -- on one end he's telling everybody I have to

allow credit for this reinsurer, on the other hand, he's going to say but you should have known he was broke.

WARREN COOPER: We did get started late, and we've ended up our time. I apologize for that but the panelist will all be present at the rest of the meeting, and if you have any heart weary questions that must be answered, I'm sure they will be very happy to oblige you. Can we get a show of appreciation for our panelists?