



Company-Specific Risk Factor Disclosures

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September 16, 2021

About the Presenters

- Fellow of the Casualty Actuarial Society (CAS)
- Illinois State University
- 24 years of experience, primarily in commercial lines
- Reserving studies for:
 - Insurance companies (SAO and financial exams)
 - Captive insurance companies
 - Self-insured entities
- Extensive experience reviewing industry financial statement data and associated trends
- Experience in workers' compensation, liability lines, medical professional liability and commercial automobile

Erich A. Brandt
 Senior Consulting Actuary
 Pinnacle Actuarial Resources



About the Presenters

- Fellow of the CAS
- Associate in Risk Management (ARM)
- B.A. Mathematics – Carthage College
- 20 years of experience, primarily in commercial lines
- Reserving studies for:
 - Insurance companies (SAO and financial exams)
 - Captive insurance companies
 - Self-insured entities
 - Public entities
- Funding recommendations for emerging coverages
- Experience reviewing industry financial statement data and associated trends
- Risk margin modeling

Gregory W. Fears Jr.
 Consulting Actuary
 Pinnacle Actuarial Resources



About the Presenters

- Certified Public Accountant
- B.A. Business – University of Vermont
- 20 years of experience, primarily in insurance
- Client base includes:
 - Insurance companies
 - Captive insurance companies
 - Self-insured entities
 - Public entities
- Annual audit of financial statements
- Tax preparation
- Internal controls review and reports

Carolyn H. Rice, CPA
 Partner
 Johnson Lambert LLP



Agenda – Learning Objectives



Risk of Material Adverse Deviation (RMAD) background & Statement of Actuarial Opinion (SAO) location



Materiality threshold, basis, yes/no



Significant risk factors – historical perspective



COVID-19 risk factor



How does the auditor utilize materiality



Auditor response to emerging risk factors

RMAD Background and SAO Location

RMAD: Sources for Guidance

			
American Academy of Actuaries SAO Practice Note	NAIC Property and Casualty SAO Instructions Actuarial Opinion Working Group Guidance	American Academy of Actuaries Discussion Paper prepared by the Task Force on Materiality	Actuarial Literature • For example: Materiality and ASOP No. 36: Considerations for the Practicing Actuary – CAS Committee on Valuation, Finance and Investments

Relevant Comments Disclosures

Materiality standard	Major risk factors or considerations underlying the significant risks and uncertainties	Risk of material adverse deviation	Anticipated salvage and subrogation
Discounting	Voluntary and/or involuntary underwriting pools and associations	A&E liabilities	Retroactive, financial & uncollectable reinsurance
IRIS ratios	Changes in methods and assumptions	Extended reporting reserves	UPR for Long duration contracts

NAIC Statement of Actuarial Opinion (SAO)

Risk of Material Adverse Deviation (RMAD) paragraph identifies:

- Significant risks or uncertainties that could result in a material adverse deviation (in the actuary's opinion, yes/no)
- Threshold for the RMAD – amount in \$US
- Basis for the threshold
- Major risk factors or considerations underlying the significant risks and uncertainties

RMAD Location and Requirements

Statement of Actuarial Opinion (SAO)

- Explanatory paragraph to describe major risk factors
 - 2013: "If such risk exists", include
 - 2014: include regardless of yes/no disclosure
 - 2015 - 2020: no significant changes



Do not include:

- General, broad statements about risks and uncertainties due to economic changes, judicial decisions, regulatory actions, political or social forces
- Exhaustive list of all potential sources of risks and uncertainties



Explicitly state Yes or No whether the actuary reasonably believes there are significant risks and uncertainties that could result in material adverse deviation

*Source – 2013 - 2020 Practice Note on P&C SAOs by American Academy of Actuaries COPLFR

RMAD Location and 2020 Requirements (cont.)

Statement of Actuarial Opinion (SAO)

Exhibit B: Disclosures

- Risk of Material Adverse Deviation
 - #5: Materiality standard in \$US
 - #6: Are there significant risks that could result in material adverse deviation?
 - Yes / No / NA

*Source – 2020 Practice Note on P&C SAOs by American Academy of Actuaries COPLFR

Materiality Threshold, Basis, Yes/No

Materiality



Whether or not something matters



Does something need to be considered?

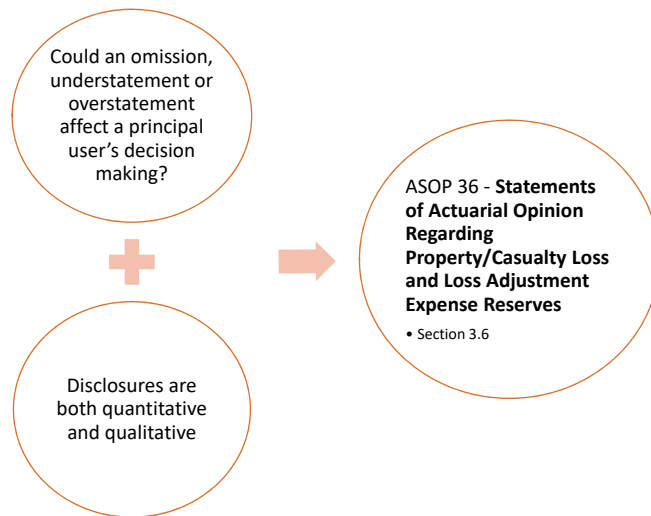


Can be defined qualitatively or quantitatively

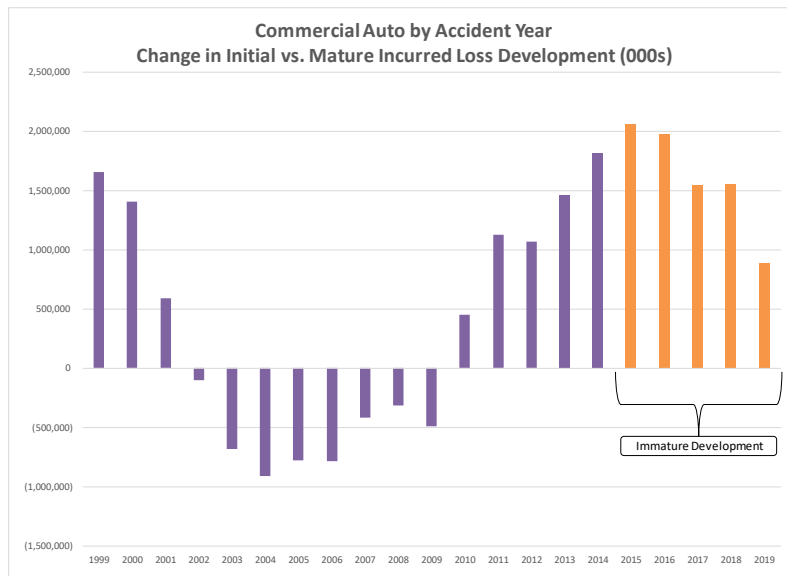
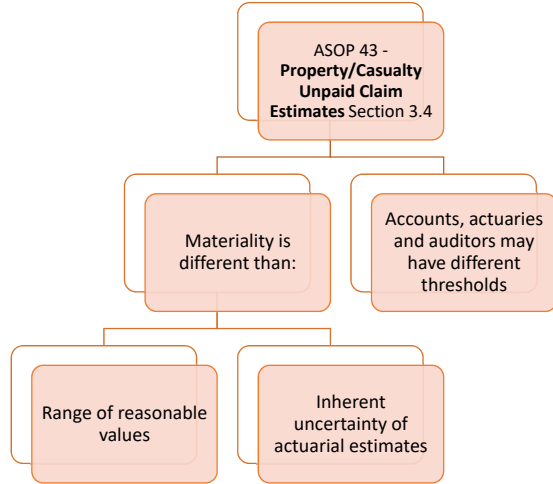


User perspective is a key element

Materiality - SAO



Materiality and Reserves



1-Year Reserve Development by Accident Year by Coverage for Total US P/C Industry

Acc Yr	CAL	CMP	MPL-CM	OL-OCC	OL-CM	FG/MG*	Subtotal	All Lines		All Lines
								Total	WC	Excl. WC
Prior	(38,263)	350,514	15,663	1,855,541	(210,161)	849,289	2,822,583	718,428	(1,281,549)	1,999,977
2011	(6,519)	(11,740)	101,926	36,471	(103,204)		16,934	(383,729)	(285,068)	(98,661)
2012	(30,244)	(25,693)	58,156	(89,986)	2,465		(85,302)	(534,008)	(207,221)	(326,787)
2013	(11,723)	(4,864)	(20,635)	(82,712)	(82,817)		(202,751)	(666,480)	(293,027)	(373,453)
2014	7,588	(28,336)	(61,442)	(37,589)	(104,600)		(224,379)	(479,877)	(471,497)	(8,380)
2015	77,419	(33,398)	(14,016)	392,953	(124,956)		298,002	(593,956)	(714,934)	120,978
2016	148,185	(21,019)	6,266	520,508	89,921		743,861	(263,429)	(940,577)	677,148
2017	330,019	112,112	36,799	259,654	119,060		857,644	(2,131,453)	(965,534)	(1,165,919)
2018	716,432	16,321	70,743	550,482	345,804		1,699,782	(1,515,250)	(1,015,155)	(500,095)
2019	887,960	150,786	92,225	258,014	513,610	(47,476)	1,855,119	(1,482,979)	(679,704)	(803,275)
Totals	2,080,854	504,683	285,685	3,663,336	445,122	801,813	7,781,493	(7,332,733)	(6,854,266)	(478,467)

*Short Tail Line of Business, Prior includes CY development on AY 2018 & Prior (values in thousands)



RMAD Paragraph Observations – Basis

Companies often list multiple options for the RMAD basis before specifying why they chose a particular measure

Selecting the lowest and highest threshold were both observed, as well as selections within their range of options

Focus on selecting a particular measure in relation to risk-based capital adequacy levels

Some actuaries listed options for their RMAD threshold and chose the minimum so long as it was less than the reduction that would lead to Company Action Level Risk Based Capital (RBC)

Most companies included purpose and intended use

Narrative included for the purpose of solvency monitoring or regulatory review/oversight

Referenced ASOP No. 36

Specific RMAD Paragraph Disclosures – Yes/No RMAD

Gross vs. Net:

- “Although I believe that the risk of material adverse deviation in the net reserves is remote, I believe that significant risks and uncertainties exist that could result in future direct and assumed paid amounts exceeding the amounts provided for in the reserves by more than the materiality standard.”

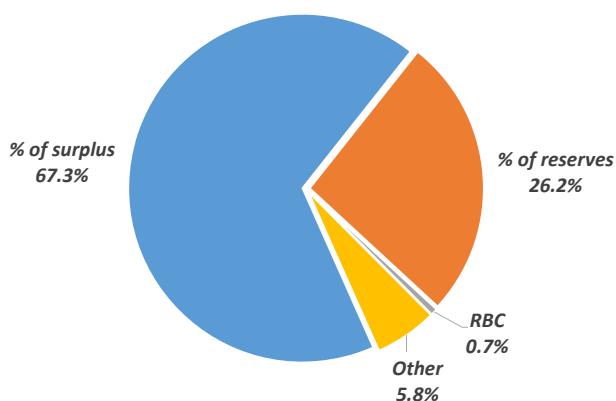
Justification for selection:

- “While individually, these factors do not present a risk of material adverse deviation, it is possible that a combination of factors could occur, resulting in material adverse deviation.”

Justification for selection:

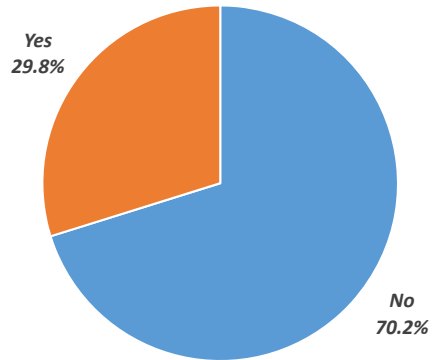
- “... factors contributing to loss cost volatility include jury awards, “social inflation,” medical inflation, tort reforms, court interpretations of coverage, etc. In my opinion, the uncertainty around future loss cost trends, loss development patterns and latent mass tort exposures, especially for the occurrence casualty classes, creates a significant risk of a material deviation ...”

2019 SAO Review: Materiality Threshold Basis

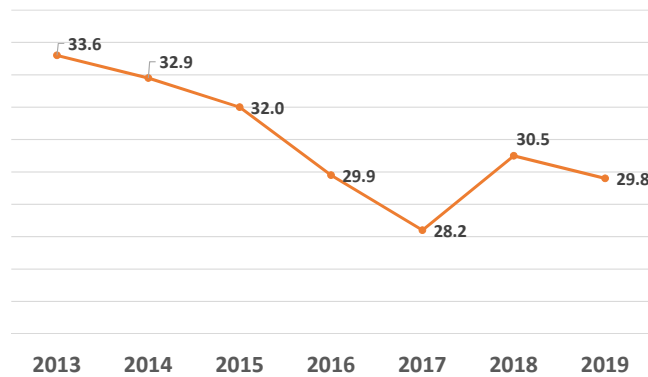


2019 SAO Review: RMAD Disclosures

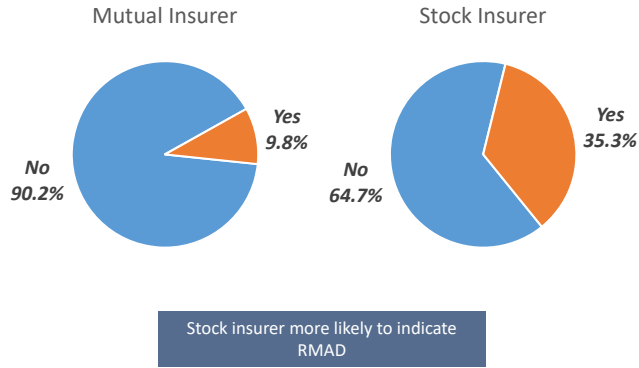
Is there a risk of material adverse deviation?



Trends in Disclosures – Affirmative RMAD

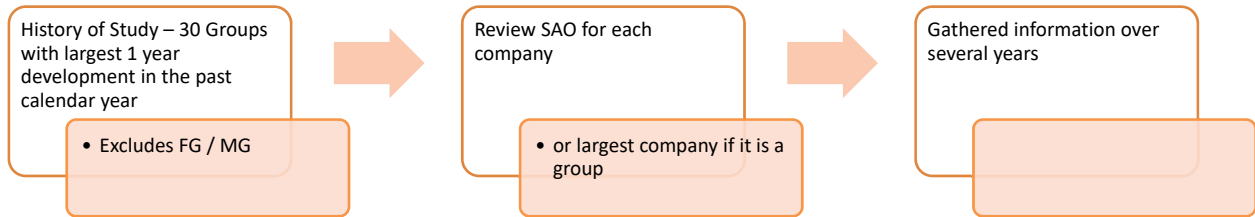


RMAD Disclosures by Organizational Form



Significant Risk Factors – Historical Perspective

Top 30 Analysis



Major Risk Factors – Top 30 Number of Disclosures

RMAD Major Risk Factors*	SAO Year									
	2012	2013	2014	2015	2016	2017	2018	2019	2020	
COVID-19	-	-	-	-	-	-	-	-	-	21
Asbestos/A&E/Environmental Combination	6	7	10	5	6	4	6	12	10	
Claims Department Changes (handling, settlement or reserving)	5	5	6	4	7	3	6	5	7	
Long tail Coverage / Line of Business	3	4	2	1	13	2	5	10	7	
Uncertainty	1	2	7	5	1	6	6	-	4	
Inflation	-	-	3	5	3	1	2	7	7	
Rapid growth	1	4	-	3	3	3	7	4	3	
Other Mass Tort exposure	-	2	5	5	3	2	2	3	3	
New Line of Business (lack of historical experience)	-	1	2	2	5	4	3	3	2	
Construction defect exposure	2	2	3	2	2	1	4	3	-	
Catastrophe exposure	-	-	1	1	2	3	5	3	2	
Workers Compensation Insurance	2	4	2	1	2	2	1	1	2	
Change in Economy	1	1	6	2	2	1	1	1	1	
Lack of historical experience	-	3	1	1	4	1	-	2	2	
Excess Coverage	-	-	-	3	1	1	-	8	1	
Excess Casualty or Liability Exposure	2	-	3	1	1	1	4	-	1	
Reinsurance Collectability	2	1	3	1	-	1	1	1	2	
Court/judicial decision recent or pending	-	1	-	3	2	3	1	-	-	
Sexual Abuse and Molestation (SAM)	-	-	-	-	-	-	-	4	2	
Total Risk Factors Listed	41	53	70	57	67	50	69	96	117	

*Top 30 Groups with highest 1 year adverse development - Sch P, Part 2

Specific RMAD Paragraph – Risk Factors

Asbestos & Environmental:

- “Estimation of liabilities for these claims is unusually difficult due to the extreme latency of claim activity, issues related to allocation of claims costs (including defense costs) across policy years and insurers, and the potential for coverage disputes with insured and other insurers (regarding allocation of such costs). Therefore, any estimation of these liabilities is subject to significantly greater than normal variation and uncertainty.”

- “The Company has executed a significant transformation of its business over the past several years... these changes include diversification into new Specialty Commercial lines of business and geographical expansion, a complete overhaul of Claims handling processes, staff, and controls, and significant changes in Underwriting.”

Specific RMAD Paragraph – Risk Factors



“The Company writes long-tailed casualty lines of business, including product liability, general liability, professional liability, excess liability, and umbrella, which are exposed to societal trends impacting claim frequency and severity including social inflation.”



“Recently high levels of social inflation have made litigation outcomes increasingly unpredictable... Further there has been a sharp increase in security class action lawsuits in recent years, impacting the D&O segment.”



“Opioids litigation is in early stages. Critical issues such as unknown defendant damages, allocation of claims costs (including defense costs) and coverage disputes have yet to be resolved by the judicial system... Several states have enacted legislation extending statutes of limitation and reviving reporting windows associated with SAM allegations. These legislative changes could have a significant impact on the reporting of SAM claims in the future”

D&O - Directors & Officers Liability
SAM - Sexual Abuse and Molestation

Specific RMAD Paragraph - Risk Factors

• “The Company recently experienced changes in its case reserve levels due to the implementation of a new case reserving model. This model is used for physicians professional liability indemnity and allows the Company to derive case reserves via algorithm, rather than rely on the judgement of claim managers.”

Claims Handling,
Settlement,
Reserving



• “Claims operational changes that impact case reserve adequacy or settlement rates.”

Claims Handling,
Settlement,
Reserving



• “Claims handling changes in the Guidewire claim management system during the first half of 2016 contributed to the uncertainty in the reserve estimate.”

Claims Handling,
Settlement,
Reserving



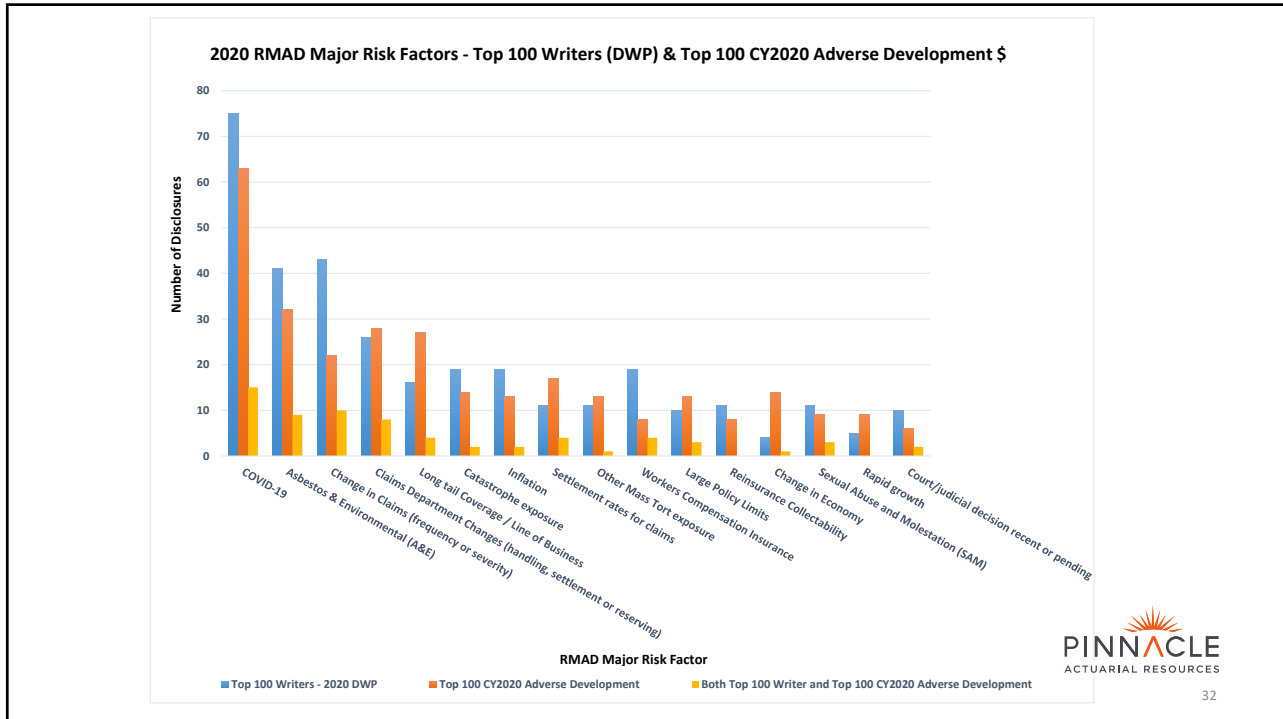
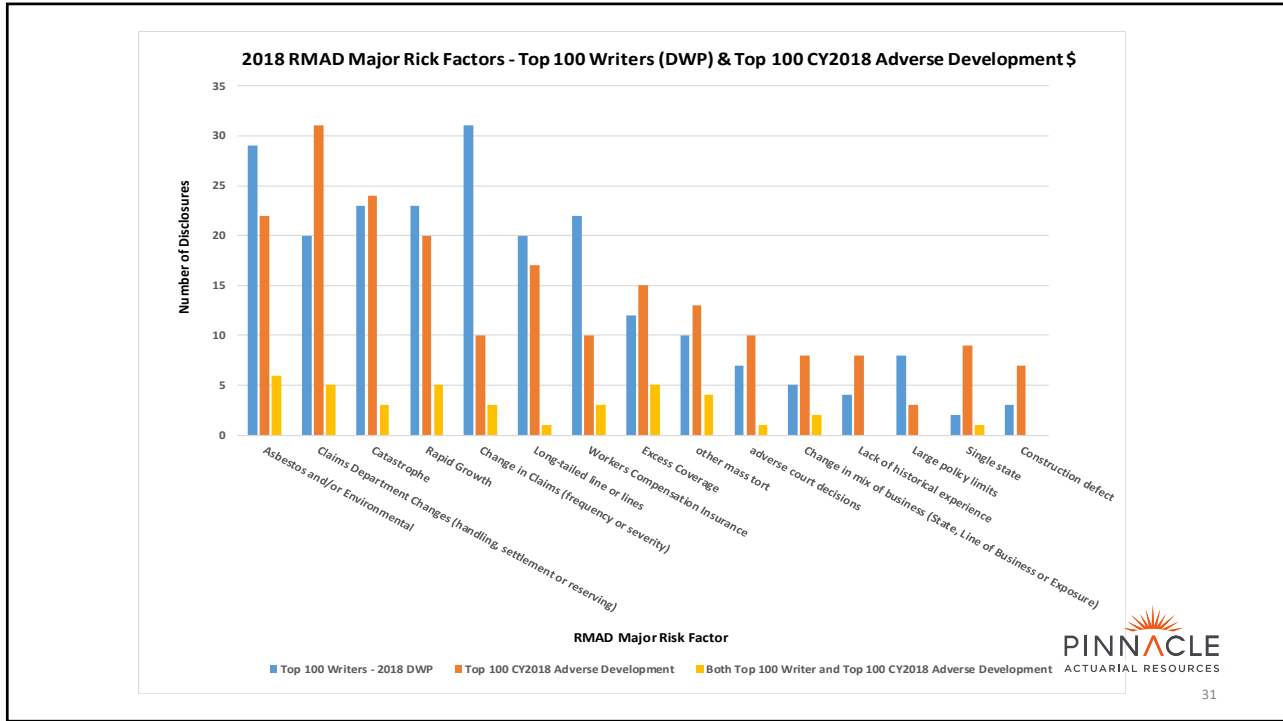
Specific RMAD Paragraph - Risk Factors

State Specific, Geographic or Line of Business Concentration

“... the Company began to experience adverse development ... Sources of this development were identified as New York construction business, in particular claims made under general liability policies using the New York Labor Law 240 and 241 which allow injured workers to sue the jobsite owner or general contractor for their injuries rather than accept workers’ compensation benefits (labor law claims).”

“A high concentration of business in Florida, combined with the unfavorable claims environment in Florida, characterized by high costs associated with assignment of policyholder benefits to water remediation contractors, increases in policyholder demands related to roof repairs, significant attorney representation and “companion claims” resulting from Hurricane Irma.”

“Reinsurance of high excess layers, umbrella and excess casualty business, and asbestos. These risk factors may not individually result in material adverse deviation but could combine to do so.”



COVID-19 Risk Factor



American Academy of Actuaries P/C Practice Note 2020 – COVID-19 Guidance

Section 5.7 COVID-19 Considerations

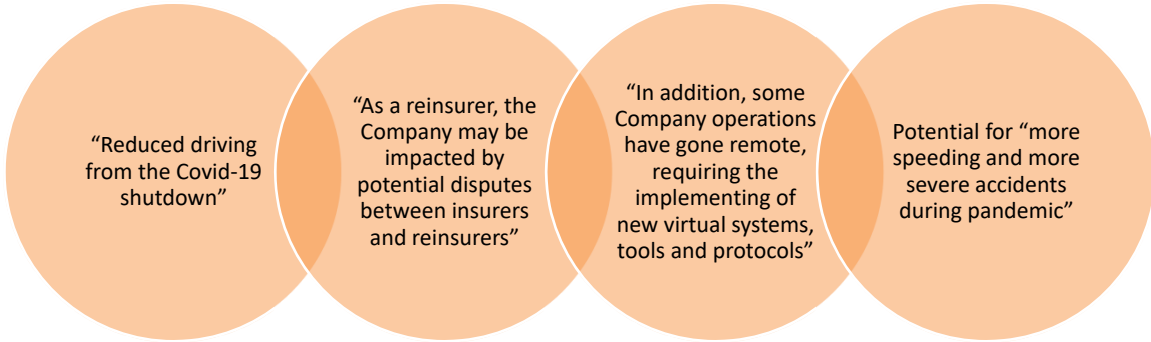
- Relevant Comments section of SAO
- “If the impact on reserves is significant”
 - Premium refunds (if material); also disclosed in Note 21a
 - WC presumptive benefits
 - Actuarial loss data (delays in the court system)
 - Change in exposure assumptions

Other resources:

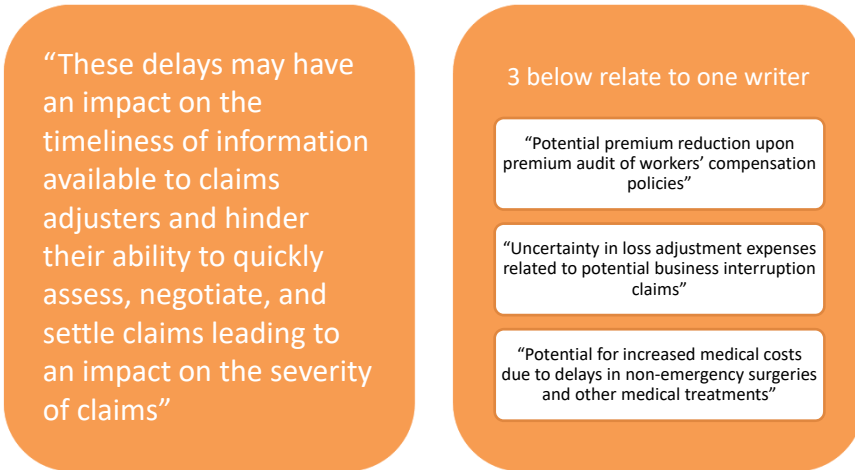
- AAA repository of COVID-19 resources
- COPLFR FAQ regarding COVID-19
- NAIC SAPWG

Keep COVID-19 in mind for multiple areas in SAO

Sample Language – Risk Factors



Sample Language – Risk Factors



Sample Language – Relevant Comments



“During 2020, the company has been exposed to extraordinary risk factors due to COVID-19 and the resulting close of economic, judicial and medical processes which increase the uncertainty inherent in the Company’s loss and loss adjustment expense reserves.”

“We have considered the direct impacts to loss premium reserves, claims patterns and loss trends, as well as indirect impacts such as claims handling delays.”



Specific COVID Disclosures - Methodology

Change to loss development patterns

Change to salvage and subrogation development assumptions

- Think amounts will be realized, just delayed

Reliance on ultimate loss estimate from internal department

Mitigating or ignoring impact of most recent development factor on estimates

Specific COVID Disclosures – Methodology - Language

“In my analysis, I have incorporated estimated adjustments to our actuarial assumptions in consideration of the effects of the pandemic.”

“For auto liability, I adjusted projected initial expected loss ratios for accident year 2020 to reflect an expected reduction in loss cost trends during COVID-19.”

“Loss frequency for all auto lines in total have been reduced by approximately 22% for the full year. The reduction ranged anywhere from 20% to 50% by month. ...These changes to frequency cause changes in the average accident date. We have addressed this by augmenting our analysis with accident month data. (PPAL)”

Auditor’s Perspective

Auditors Materiality

Objective of materiality for financial statement reporting purposes

Financial statements are fairly presented

Free from material misstatement individually or in the aggregate that would influence the judgment made by a reasonable user based on the financial statements

Measurement of Materiality

Auditor uses many quantitative and qualitative measures to establish materiality, no prescribed %

Factors to consider in evaluating materiality could include:

- Knowledge of business and economic drivers
- Understand the FS presentation process and accounts

Auditor's Materiality

Auditors Materiality

Concept of materiality

- Applied by the auditor both in planning and performing the audit
- Evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements
- In forming the opinion in the auditor's report

Levels of Materiality

FS Materiality

Performance

Threshold for Trivial Items

Auditor's Reliance on Actuaries

Auditors Reliance on Actuaries

Auditor Guidance – Auditing Standards

AU – C 500 “Managements Specialist”
 AU – C 600 “Auditors Specialist”

Specialist – “An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.”

Auditor Responsibilities



Competence, Capabilities, and Objectivity



Obtaining an Understanding of the Work



Evaluating the Appropriateness of the Work

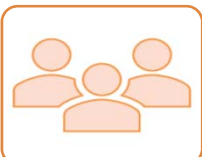
Competence, Capabilities, and Objectivity



Personal experience with previous work of that specialist



Discussions with specialist



Discussions with others who are familiar with that specialist's work

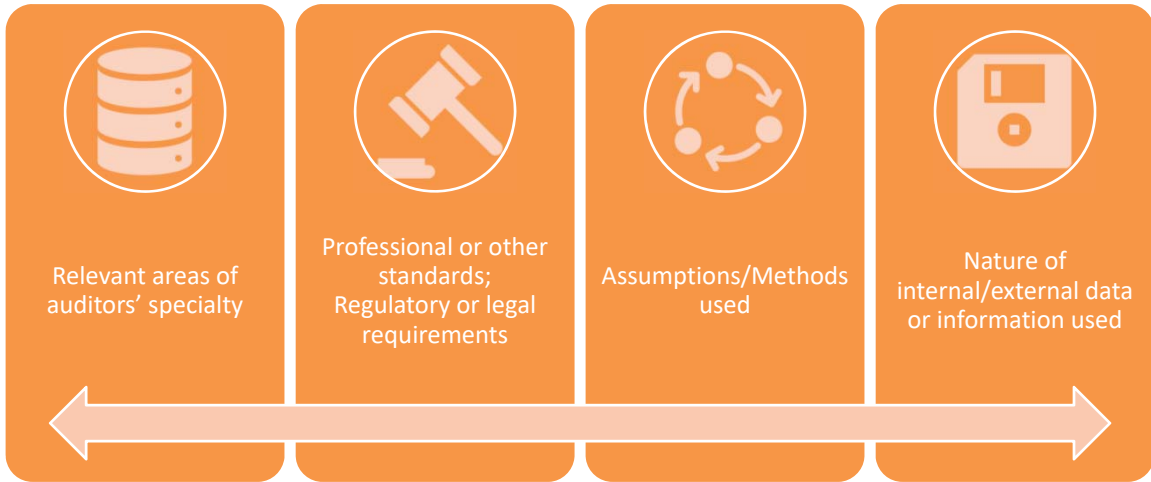


Understanding of specialist's qualifications

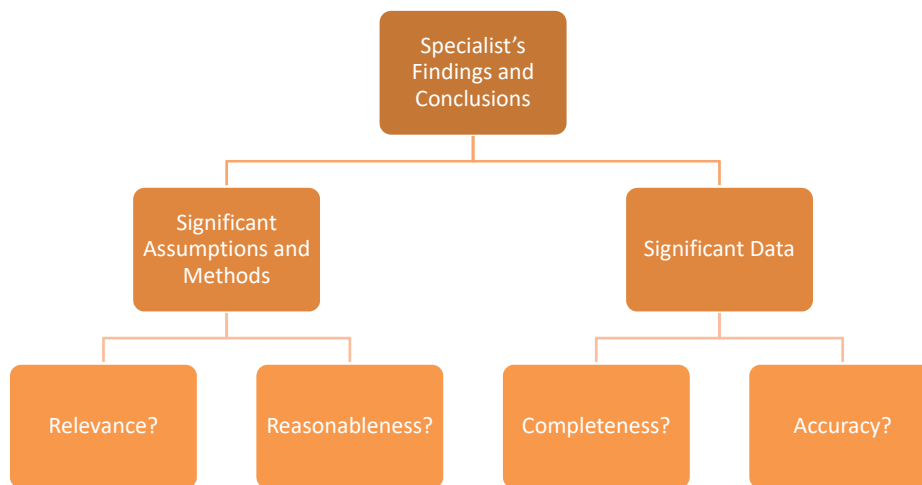


An auditor's specialist, if any, that assists the auditor in obtaining sufficient appropriate audit evidence

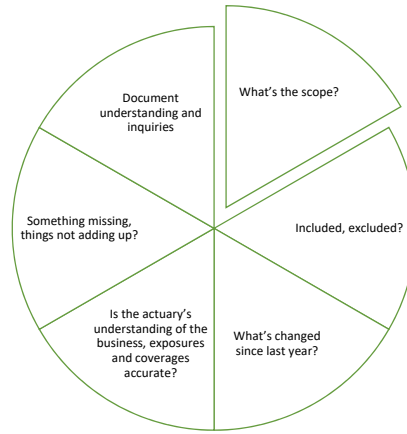
Obtaining an Understanding of the Work



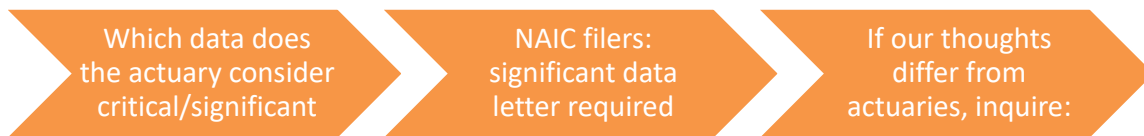
Evaluating the Appropriateness of the Work



Understanding the Scope of Services



Understanding of Data Used

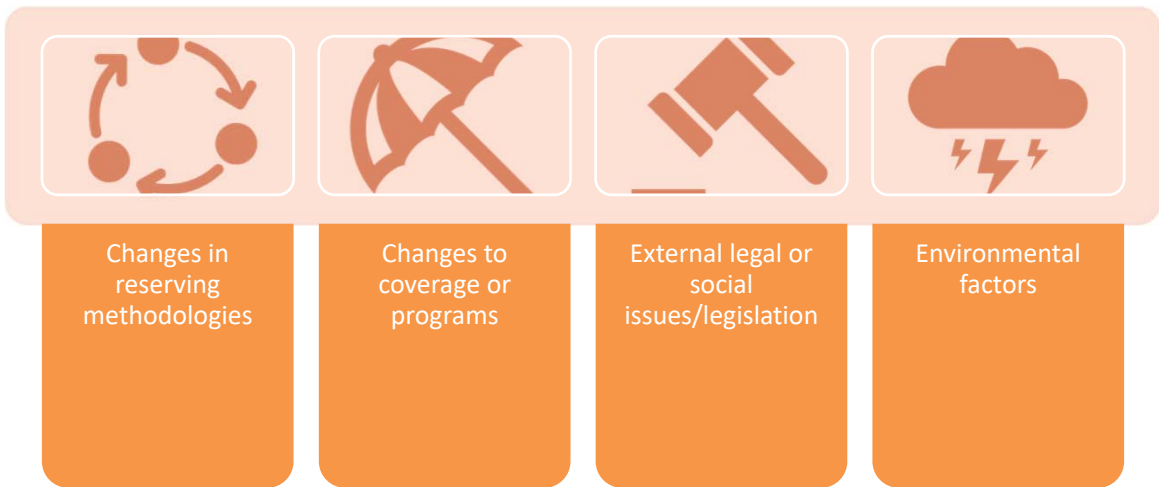


- We are required to test data we deem significant to the estimate we are auditing
- Why included? How did they use?
- Document if we still do not consider something significant
- Document critical/significant data, how we tested the data
- Any emerging risks identified

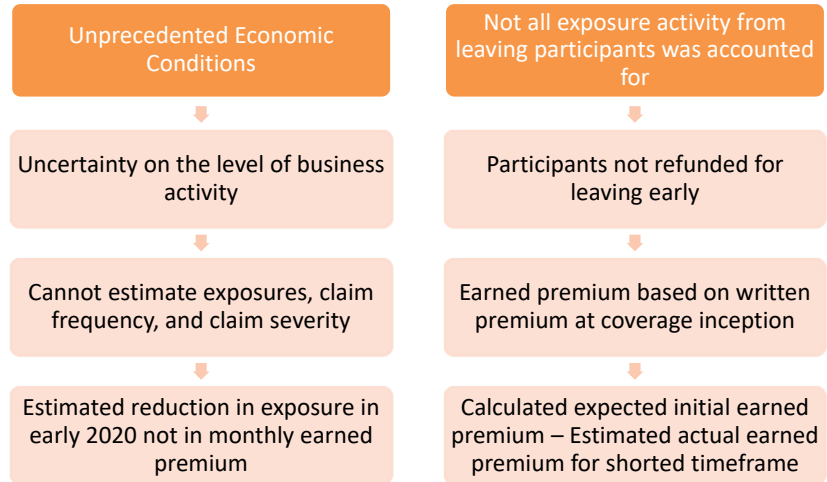
Auditor's Response to Emerging Risk Factors



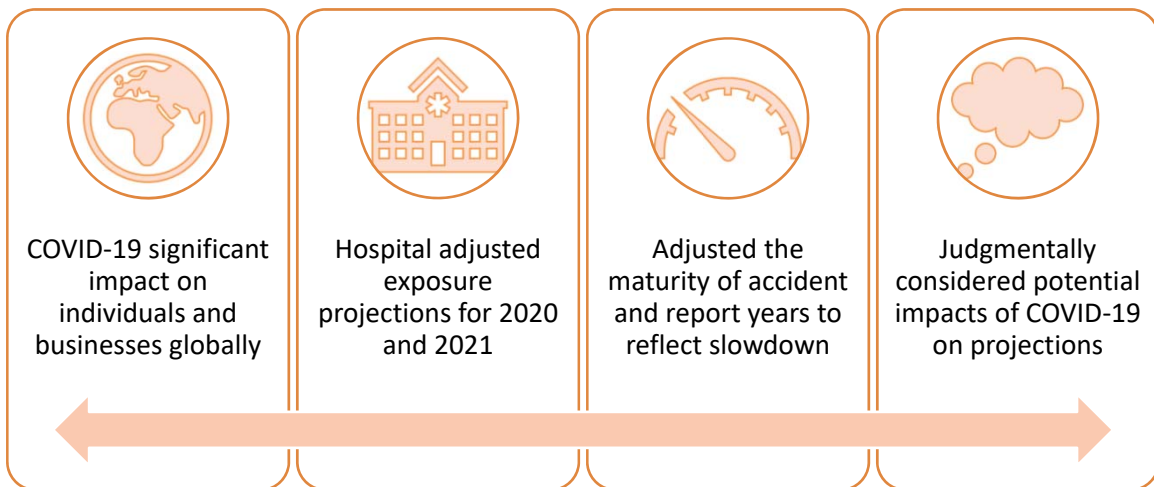
Auditors Response to Emerging Risk Factors



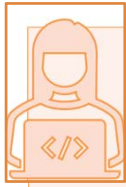
COVID 19 –Travel Restrictions



COVID 19 – MPL example



Claims Handling/Settlement/Reserving

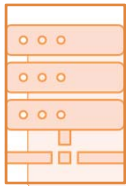


Issue of incorrect coding of double amputee claims in prior years

- Multimillion dollar claims coded incorrectly to GL

Auditors tested claims data independently – verified data is consistent

- Miscoded claims identified



Tested impact of miscoding

- Claims closed – no material impact on projection of outstanding loss

If policy term aggregates in place

- This may have had a different answer

State Specific, Geographic or Line of Business Concentration

“... the Company began to experience adverse development ... Sources of this development were identified as New York construction business, in particular claims made under general liability policies using the New York Labor Law 240 and 241 which allow injured workers to sue the jobsite owner or general contractor for their injuries rather than accept workers’ compensation benefits (labor law claims).”

- Legislature allows claims to fall under WC and GL
- Ensures actuary and auditor understand claims, limits, and proper recording

Thank You

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