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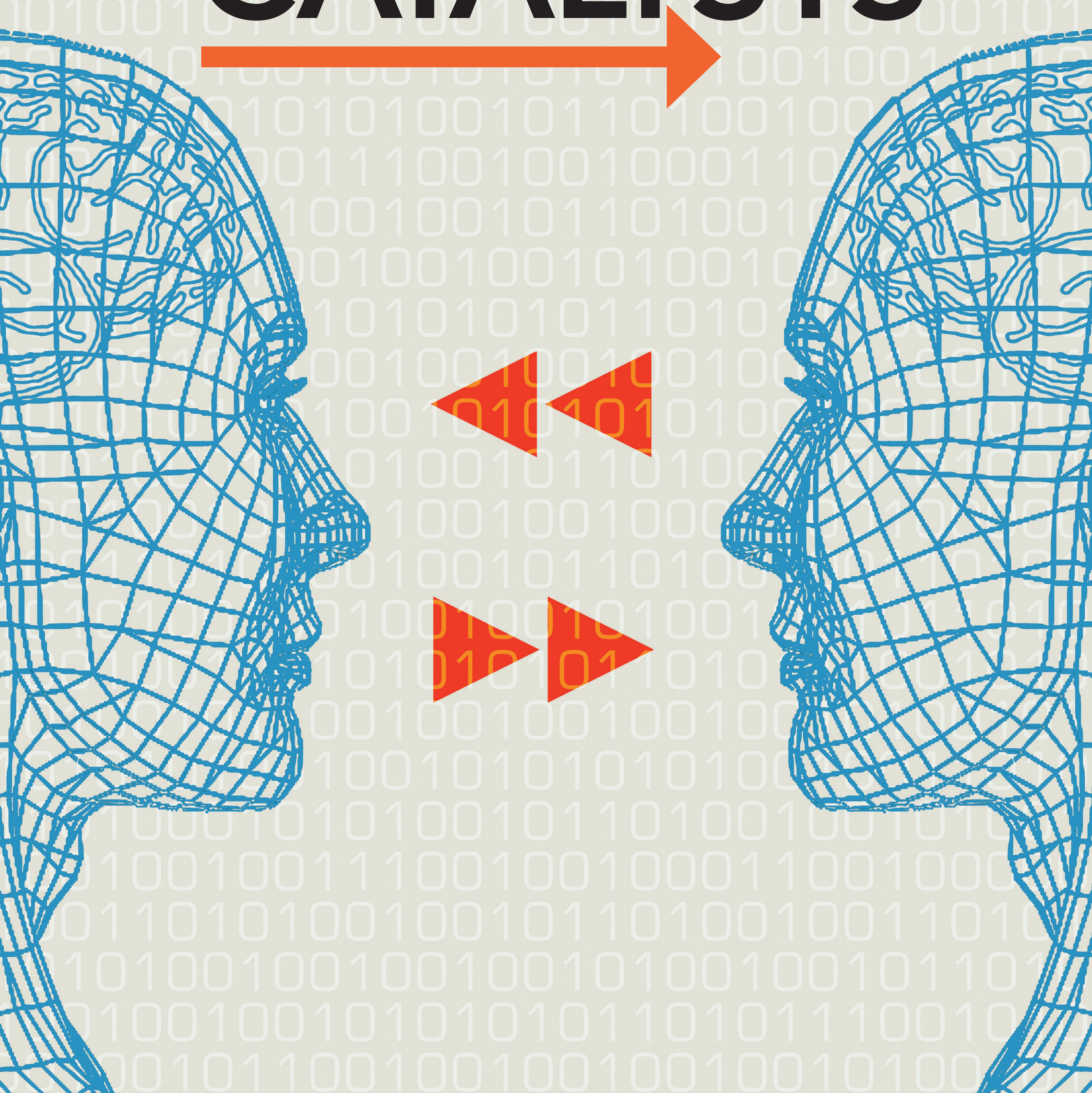
ACTUARIES AS CATALYSTS



INSURANCE ACCOUNTING is in the midst of significant changes, many of which were proposed during a time of severe economic uncertainty. Given the concern about these regulations by many insurance finance executives, it is time for a re-examination of the capabilities of the financial reporting function. BY NOEL HAREWOOD

THE RECENT FINANCIAL CRISIS led to significant questions about insurers' financials, including capital adequacy, dividend-paying ability and return on capital. Future and expected regulatory changes will pose challenges as insurers move toward fair-value-type accounting, new principle-based regulations for reserves and capital, and Solvency II for European insurers and their subsidiaries. Implementation of these proposed changes will prove difficult for some, especially insurers whose actuarial projection systems and models are not well established or not as robust as they need to be.

Companies need to rethink how they assess and communicate the performance of their insurance businesses, and develop systems and processes that can generate timely, secure and auditable information. In addition, the actuarial processes necessary to measure liabilities are likely to differ significantly from those now in place. Finally, companies will need the right assumption-setting processes and robust experience investigations. Implementing these processes is not a simple matter and will require strong actuarial competencies and models, as well as ample time for testing and interpreting the results.

But before companies can tackle these upcoming challenges in financial and regulatory reporting, they need to have a clear understanding of the capabilities of their financial and regulatory reporting (FRR) function. They must assess the current state of the organization in terms of the following:

- **Technical:** Can the organization prepare and produce financial results correctly?
- **Controls/governance:** Can the organization be confident of the accuracy of its results?
- **Analysis:** Can the organization explain the causes of performance in the period in question?
- **Forecasting/budgeting:** Can the organization reasonably and accurately forecast its financial position?
- **Driving decisions:** Finally, can the organization use the financial information to drive strategic decisions?

This assessment can be made on multiple levels, and most companies will find themselves in different stages for various reporting metrics and processes (Figure 1). Any time a new regulation or reporting standard is established, companies will find themselves in the technical stage by necessity. But the assess-

Figure 1: Five Stages of Financial and Regulatory Reporting Evolution

	Stage 1: Technical	Stage 2: Controls/ Governance	Stage 3: Analysis	Stage 4: Forecasting/ Budgeting	Stage 5: Driving Decisions
Clear line of sight from financials to company actions?					●
Able to produce realistic forecasts under multiple scenarios?				●	●
Able to explain results and why they differ from expectations?			●	●	●
Is the process controlled and auditable?		●	●	●	●
Able to produce results correctly?	●	●	●	●	●

ment can also be viewed as an overall read on the FRR function. Organizations that rate strongly overall are likely to "evolve" faster for new requirements as well, giving them a strategic advantage.

For insurers, actuarial components are a critical part of the financial reports, and so actuaries can be expected to play a critical role in moving the overall FRR function forward. In fact, the FRR function in an insurance company cannot advance significantly without actuarial expertise. Actuaries are therefore in the position of being able to help drive the evolution of a company's finance function.

FINANCIAL AND REGULATORY REPORTING: FIVE STAGES OF EVOLUTION

Stage 1: Technical

The initial stage of financial reporting evolution is the technical stage. At this stage, the organization is focused on *doing*—producing the required information and financial statements correctly, according to the standards specified in the regulations. Analysis of the results may not be as robust as management might like, and may focus more on establishing reasonableness and compliance than on understanding how to use the information to make decisions.

The technical stage requires:

- Knowledge of the required information (e.g., reserves, deferred acquisition cost (DAC) balances)
- Knowledge of the appropriate guidance/standards
- Ability to calculate the required amounts.

The familiarity with the standards is critical to this stage. Specifically, the organization must be able to appropriately apply the specific methodologies and bases to the affected business. As an example, consider what was then called SFAS 157 (pre-codification). Implementation of this regulation required an initial understanding of both what was affected (fair values) and what was required in the calculation (e.g., risk margins).

In addition to knowing what to do, which depends heavily on the expertise of key personnel, the organization must be able to do it. This requires processes, systems and models to perform the calculations. In early-stage financial reporting organizations, these processes are often implemented manually, as topside adjustments.

The organization in this stage is able to produce the required reporting, albeit usually with some difficulty. Further, these organizations typically use undeveloped or partially developed systems and processes (workarounds) to produce the required financials.

This is the first area where actuaries can make substantial contributions to advancing the organization. Actuaries are often knee-deep in the production process over the fourth and first quarters, and for many involved in financial reporting, these are the "grind" months. However, what happens in the other months (the off-season)? This is where actuaries can work to refine and enhance both their own knowledge and the actuarial and data processes in place.

Stage 2: Controls/Governance

Gaining confidence in the organization's reporting results is the next step in the evolution of the financial reporting process. Strong audit controls and good governance practices are essential to this step.

Both shareholder and regulatory reporting are now expected to have material controls processes, as a result of Sarbanes-Oxley and the Model Audit Rule (MAR). While many actuaries may have been isolated from Sarbanes-Oxley, the MAR incorporates many of the same concepts, and will have a much broader applicability. Even without the regulatory drive to improve, many organizations are now beginning to demand more reliability in their financials.

Organizations in the governance stage will implement robust controls for the process of developing the reported results. This often includes moving many of the elements of the calculation to a production environment, minimizing manual intervention. In addition, companies at this stage will typically streamline the process for more efficient reporting.

Actuarial controls, particularly around models, are an area that needs specific focus. One option is to work to enhance controls via software, but even without this, process controls around the modeling can be effective in improving the control environment.

Stage 3: Analysis

Once companies are able to quickly and efficiently produce the required financials, analysis becomes a central issue. Analyzing and assessing performance is a key stage in the reporting process because it allows management to move beyond developing the numbers to understanding the profitability of the insurance product or line of business.

The ratios and projections are crucial to assessing past performance, creating comparables, presenting projections and setting performance benchmarks. Why are the results emerging as they are? What happened over the last reporting period? This level of analysis is the next stage in adding value as a reporting function.

Certain elements of reporting often generate questions (e.g., DAC amortization and fair-value reserves). Anticipating these questions and enhancing the process to include appropriate analytics means that these questions can be answered more quickly and thoroughly and as part of the routine process rather than ad hoc. These analytics are central to building a more savvy reporting function, and should be a central role for financial reporting actuaries. Actuaries need to provide the support for allowing management to understand the changes in actuarial items (e.g., reserves, DAC) and also for allowing management to understand the emergence of the risk-capital-value trade-offs in the business.

NEW FINANCIAL AND REGULATORY REPORTING REQUIREMENTS HAVE PLACED GREAT STRAINS ON THE RESOURCES OF FINANCE ORGANIZATIONS AT INSURERS …

Stage 4: Forecasting/Budgeting

Budgeting and forecasting are crucial to planning and to the overall success of any organization. However, budgeting for insurers is more complicated than for other companies, given the complex nature of some of the critical components of an insurer's balance sheet. When a company can project these elements effectively, it significantly improves the quality of its financial planning and budgeting functions.

This is an area where many companies struggle or rely on approximations. This may be due, in part, to competing priorities for computing power and staff resources. There are hardware and software solutions available to accommodate the technological demands, but a strong partnership between the actuarial and technology aspects of the financial reporting process is essential in order to optimize performance.

Companies operating at this level are able to use actuarial systems to produce multiple forecasts for value-based activities such as scenario planning. The ability to produce realistic projections also allows for more extensive use of the actuarial control cycle. This is a significant step in developing financial information of strategic value.

Stage 5: Driving Decisions

The ultimate goal of the finance function at all companies is to provide timely information to reach the final stage in the FRR process driving business decisions. Highly evolved financial reporting functions are better able to work at the strategic level working both to improve broader financial information in other areas of the organization (e.g., pricing) and to determine improved metrics for management purposes. Actuarial expertise has a critical role to play as part of this function.

SUMMARY

New financial and regulatory reporting requirements have placed great strains on the resources of finance organizations at insurers; in some cases, the requirements have revealed shortcomings and weaknesses in accounting, governance and controls, analysis, and budgeting and forecasting.

Greater regulatory changes lie ahead as insurers move toward fair-value accounting, new principle-based regulations for reserves, and capital and Solvency II for European insurers and their subsidiaries. The challenge is ensuring that the finance function can deliver under the new requirements.

Actuaries wishing to contribute to the new finance function need to be able to effectively answer the following:

- Is the actuarial team up to speed on current regulatory requirements?
- Are appropriate controls in place for actuarial components of financial reports?
- Are actuarial models under appropriate controls?
- Are changes in reserves and DAC clearly explainable?
- Are the risk, capital and value positions of the company reasonably estimated under multiple scenarios?
- Is the actuarial function seen as an effective partner?

Answering these questions can help actuaries identify how far the function has evolved in its financial and regulatory reporting. Insurance financial reporting cannot advance far without the appropriate actuarial support. A

A version of the article "Actuaries as Catalysts for Advancing Financial Reporting" was previously published by Towers Watson. Copyright Towers Watson.

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