Article from:

Small Talk

September 2013 – Issue 40

My Expectations of Appointed Actuaries for Smaller Life Insurance Companies

By Randall A. Stevenson

For the past 15 years I have been involved in the financial solvency examinations and financial analyses of numerous smaller life insurance companies. During those reviews, I have developed certain expectations of actuaries performing work for smaller life insurance companies which differ from the expectations of actuaries performing work for large insurers. This article is primarily a reflection of my experiences and expectations related to actuarial work performed and reported for small life insurance companies by the appointed actuary, although the information should be useful for other actuaries. All actuaries are expected to follow the Actuarial Standards of Practice and Code of Professional Conduct. Here we will focus on issues, while not necessarily unique to smaller companies, which are more likely to be a concern or focus during a review of actuarial work that has been performed for smaller companies. Expectations vary between states and may vary between individuals within an insurance commissioner's office.

Regulation

In order to understand what regulators are likely to expect, one must understand the purpose of regulation. The goal of regulation is to protect the consumer, which includes providing a level playing field for insurers and a competitive market from which consumers can choose products. This is done through regulation of financial solvency and market conduct. Market conduct is primarily involved with ensuring the insurers treat the policyholders fairly and the companies compete under a uniform set of rules. Financial solvency is focused on assuring insurers will have adequate funds available to meet future obligations as they become due. While GAAP accounting focuses on the value of a business as a going concern, statutory accounting focuses on the liquidation value of a business. Statutory reserves are intentionally conservative, with the goal of releasing reserves as favorable experience unfolds. The appointed actuary should understand this and design products and establish reserves that do not attempt to circumvent the purpose of regulation.

Expertise and Knowledge

The appointed actuary should be involved in corporate governance. The actuary should have ready access to the company's senior management and communicate with them as needed, and at least annually. Normally actuaries for small companies operate from smaller actuarial firms and represent numerous regional clients. This presents a challenge, as the actuary must have sufficient breadth of expertise to service several clients and yet a certain depth of knowledge about each client. Part of the depth of knowledge includes an understanding of the products held, offered and planned; another part is knowledge of the clients' investments. Ideally the actuary would be involved in reviewing reinsurance treaties before they are enacted, since smaller companies do not always have the expertise which regulators assume exists with both parties of reinsurance treaties. With the risk-focused examination approach, controls of material risks have become the focus of solvency examinations. The appointed actuary should be a key advisor to the company in developing controls over liabilities, growth, asset management, data quality, sales illustrations, underwriting, and other areas where actuaries are involved. The actuary should also be familiar with the controls the company uses related to information provided for the computations of reserves and asset adequacy. And finally, actuaries should be sure adequate, effective controls are documented and operating with respect to the work they produce for a company.

Communication

The appointed actuary should present results that are consistent with expectations based on the prior years' results or provide an explanation as to why current results appear inconsistent with prior results. Actuaries should also make sure results are reasonable. It would be advisable for an appointed actuary to include an informal memorandum to the Department of Insurance along with the actuarial opinion that explains any anomalies when comparing subse-

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quent years. For example, if the premium, number of insurance policies and amount of insurance for a plan increases and the reserves for the plan decrease, this is likely to prompt the financial or actuarial analyst to inquire about the anomaly. It would save time and effort if the anomaly had an explanation submitted with the actuarial opinion.

Common Errors

The appointed actuary should check the data used to compute reserves to ensure it is reasonable. In general, small company databases are prone to errors due to lack of controls in data entry and data modification, lack of understanding of how reserves are computed by company personnel, and limited technical skills related to the software used. Some examples would include a large percentage of the policies having dates of birth the same as or after the dates of issue, policies with $0 reserves absent from the database, and a relatively high number of policies with individuals well beyond the limiting age of the mortality table. A policy's issue date should not be earlier than the existence of the mortality tables used to establish its reserves. Premiums, total face amount of insurance, and the number of insured individuals in the database should reasonably match the company's reported information and from other available sources.

Annual Statement

The appointed actuary should be familiar with the company's annual statement. Even a cursory review of the company's annual statement can often provide the actuary with a tremendous amount of information and help establish the reasonableness of actuarial items. How does the company's reported return on investments compare with actuarial assumptions and the market based on the assets it holds? Are gross premiums greater than net premiums? What are commissions and expenses compared to premiums? If gross premiums are less than the sum of expenses, commissions and net premiums, is a gross premium valuation needed? How do deferred, advanced and due and uncollected premiums compare to annual premiums? What is the ratio of death benefits to the sum of reserves released due to death and tabular cost? Are there any unusual changes in the Five-Year History or the Exhibit of Life Insurance? Has the company reported reserves and other information as submitted by the appointed actuary? Many of these and similar questions can be answered by a quick review of the annual statement. Addressing unusual matters before the annual statement is sent to the regulators can save the company considerable expense and time. The main actuarial exhibits are the reserve exhibits, currently known as Exhibits 5 through 8. Exhibit 5 should include valuation standards, which is a minimum of the interest rate and mortality table. Ideally a notation of the method (i.e., FPT, NLP or CRVM) and range of years of issue for the policies would also be included.

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State Law

The appointed actuary should be familiar with laws of the state of domicile. Often small companies, especially single-state companies, have state-specific exemptions or requirements. Some states permit single-state companies to forgo the asset adequacy requirements if certain other criteria are met; some permit specific types of business to discount certain reserves; and some permit the use of mortality tables that are not recognized by all members of the National Association of Insurance Commissioners (NAIC). If there is a particular concern, it is better to discuss it with the regulators as soon as possible. An annual call to the appropriate regulatory actuary of the state of domicile to inquire about any pending or recent legislation, including feedback on the impact, can help the regulator and the client. Insurance departments are very protective of their domiciliary companies and want to avoid closing them because closure deprives the state of jobs and revenue; it also reduces competition within the market and hurts the reputation of the insurance industry. If meeting an actuarial regulatory requirement does not make good business sense, make sure the regulatory actuary is aware of this and request a permitted practice, if appropriate. It is easier for a state to issue a permitted practice for a single-state company than for a multi-state company.

Reserve Analysis

Although the Analysis of Increase in Reserves (page 7 of the annual statement) is considered by some to be a dinosaur, if properly completed, it is a particularly useful tool for small companies and reviewing regulators. Underwriting for small companies can be an issue. Because a reviewing actuary noticed the death benefits paid were significantly more than the reserves released due to death plus the tabular cost, more than one company has been alerted to agents writing policies to people on their death beds. Tabular interest significantly greater than the investment earnings indicates a possible asset inadequacy or an investment program that needs improvement. Surrender benefits exceeding the reserves released for terminations should be a red flag concerning the amount being paid as cash surrender values.

Conclusion

Overall, small company actuaries can offer significant value to their clients by helping them identify and correct problems before the regulators must take action. The appointed actuary is often the best person to represent and advocate for the company when discussing financial solvency concerns with regulators, especially regulatory actuaries. Finally, small company actuaries must meet the challenge of balancing the cost of the services they provide with the value provided to their clients.

Randall Stevenson, ASA, FCA, MAAA, is a consulting actuary with Risk & Regulatory Consulting, LLC. He was an actuary with the Louisiana Department of Insurance for seven years, worked at the NAIC for three years and has been a contract examining actuary for the past five years. He can be reached at *randall.stevenson@riskreg.com.*

On the Research Front

SOA RELEASES 2008-09 INDIVIDUAL LIFE EXPERIENCE REPORT

The Individual Life Experience Committee has completed their latest report on intercompany mortality experience by amount of insurance and number of policies under standard individually underwritten issues. This includes the two study years 2008-09. The Excel files contains more detail of the data summarized in the report as well as data from the two prior studies for comparative purposes. Some of the Excel files are pivot tables that allow examination of combinations of the factors presented in the report. If you have any questions, please do not hesitate to email Jack Luff at JLuff@soa.org or call him at 847.706.3571.

NOW AVAILABLE: OLDER AGE MORTALITY AND OTHER ASSUMPTIONS SURVEY RESULTS

Mortality at older ages has been an increasingly important issue for new products and profitability of current products. The Product Development Section sponsored a company survey of mortality and other actuarial assumptions for life and long term care insurance products sold at older ages. Results are now available in a new report authored by Tim Rozar, Catie Muccigrosso and Susan Willeat of RGA Reinsurance Company. Topics addressed include product designs and sales trends by age; underwriting requirements at older ages; mortality assumptions at older ages including selection factors, mortality level, preferred discounts and mortality improvement; and lapse assumptions. Comparisons between fully underwritten life insurance and long-term care insurance are also provided.