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Read. Think. Write.

The Statement of Actuarial Opinion for the Health Annual Statement

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There's more to signing the actuarial opinion on a health insurer's annual statement than simply running a few claim triangles and selecting an incurred-but-not-reported (IBNR) estimate. The actuary signing the opinion for a statutory statement must offer six—count 'em, six—opinions regarding each item in their actuarial opinion statement.

The purpose of this article is to review those six items, talk about what they mean in the real world, and offer some case studies. We focus on weaknesses—while most people do a good job, problem areas are more interesting and usually more informative to look at.

Read, Think, Write

If you are the actuary signing a formal Statement of Actuarial Opinion, you need to do three things (in addition to actually calculating the reserves):

> **Read—**Read what the statement you are signing actually says. Read the applicable Actuarial Standards of Practice. Read other available guidance from the NAIC, the ASB, the AAA and the actuarial literature.
>
> **Think—**Think about what you are signing. Can you really make those statements? Have you done the work to support the statements?
>
> **Write—**Don't just sign the standard wording if that's not what you really believe to be true. Write what you actually think. Also, write down (not necessarily in the opinion statement itself) the work you did to support your opinion.

But before you can even sign the statement, you have to be qualified to do so. Many people seem to think they are qualified to do something just because they have been doing it for a long time. However, the Academy qualification standards are quite explicit, and have three components: basic education, experience and continuing education. You need all three. Some recent FSAs may not meet the basic education requirement; the Academy offers an excellent course to meet those requirements. Attending SOA meetings and reading articles, like this one, help meet the continuing education requirements. But remember to write down what you do to meet continuing education requirements—that's part of the requirement, too.

What Do We Opine On?

Typical items that the actuary opines on in his statement include: unpaid claim liability, unpaid claims adjustment expenses, accrued medical incentives, aggregate policy reserves, claim reserves and experience-rated refunds.

There is some difference of opinion among actuaries about what to do if you believe that no liability is necessary for one or several of these items. Do you state that the liability is zero, or do you leave it out of your opinion altogether? The authors believe that it is usually more appropriate to include a zero item in the opinion statement—it says that you've thought about the issue and that your professional opinion is that no liability need be booked. Other actuaries, also knowledgeable, disagree with us. (Of course, opining that a liability is zero requires that the actuary actually do sufficient investigation to determine that zero is, in fact, the right number).

Occasionally, especially in consulting situations, clients will ask us not to opine on a certain item. They want us just to look at certain items and leave the rest to someone else. We believe that requires a modification of the opinion statement: the omission cannot be ignored. In the statement, one of the things we're asked to say is that all liabilities that ought to be established have been; if you've been asked not to look at something, you can't make that statement. Modification of the wording is necessary.

Now, let's look at the six statements we are asked to make for each of the items we opine on.

The liabilities are in accordance with accepted actuarial standards...

The first item states, "The liabilities are in accordance with accepted actuarial standards consistently applied and are fairly stated in accordance with accepted actuarial principles." This really says three things: compliance with standards, consistent application of those standards, and following sound actuarial principles. Not only

do the liabilities have to meet standards, they have to be sound in principle as well. For areas where sound standards exist, this is easy. Where standards are absent, principle is the guide.

What is meant by 'consistently applied'? We're not talking about year-to-year consistency here, as that is addressed in a separate opinion item. We believe that this means consistent application (of standards and principles) amongst the various calculations you do to support the liabilities and reserves for the current year.

However, if there are sound reasons for using a different methodology, then you're not being inconsistent. For example, consider a claim liability calculation where you may be using a six-month average factor for one cell and a 12-month average factor in another. As long as there are sound actuarial reasons for that difference in approach, it passes the consistency test, and you do not need to change the wording in the opinion.

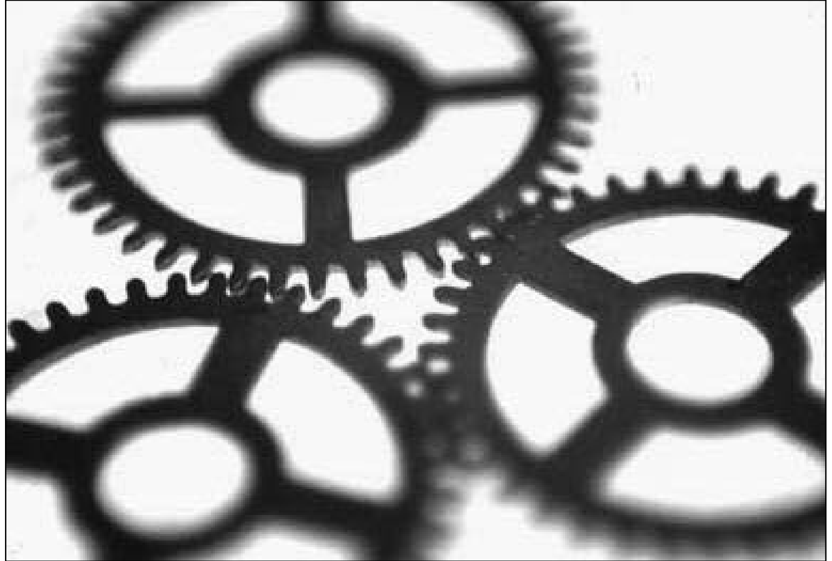
...are based on appropriate actuarial assumptions...

The second opinion we render is that the liabilities "are based on actuarial assumptions relevant to contract provisions and appropriate to the purpose for which the statement was prepared." Here, again, we're really saying three things: that the assumptions are appropriate, that they're consistent with the contract, and that they're appropriate for the purposes of the statement.

"Appropriate for the purposes of the statement" has traditionally been interpreted by actuaries to mean that (for a statutory statement) the liabilities are conservative. Think of a 'best estimate' as a 50/50 number—there is a 50 percent chance it is too high, and 50 percent chance that it is too low. An old, influential Jack Bragg paper in the *Transactions* suggests that for a statutory statement, a 75/25 number is appropriate, i.e., that there is a 75 percent chance that the booked number is ultimately sufficient. This is the rule of thumb actuaries have used for years.

... meet the requirements of the state...

The next opinion we make is that the liabilities "meet the requirements of the laws of the state (state of domicile), and are at least as great as the minimum aggregate amounts required by the state in which this statement is filed." For group health liabilities, there's typically not much said in state law or regulations, and this may be a moot point.



It seems to be geared more to life or individual A&H policies.

Note that the newer valuation law, which has been adopted in a handful of states, also requires that we attest to meeting the laws of the state in which the statement is being filed, not just the state of domicile. If you have a plan that operates in a lot of states, you have some research to do about the laws in those states.

...make good and sufficient provision...

Of the six items upon which we opine, the good and sufficient provision is the one that gets the most attention. We state that the liabilities "make a good and sufficient provision for all unpaid claims and other actuarial liabilities of the organization under the terms of its contracts and agreements." The 'sufficient' part seems to be well-understood by most actuaries; it means that the reserve being booked is adequate to cover the liabilities. Traditionally, this has meant that some margin is there, so that the amount booked will be adequate to cover reasonably adverse deviation in experience.

What if a company is insisting on booking a number that's a best estimate—a "50/50" number? We can change the wording if we're not confident in the sufficiency statement. We might say that instead of the reserves being sufficient, they are reasonable.

(continued on page 16)

But what does it mean for reserves to be "good"? Historically for many actuaries this has meant that the reserves are not too high, that there's not too much margin in the reserves. So, if a liability has a 25 percent margin, and we think that's too much, we may not feel that it is a good provision, in which case we would drop that word out of the opinion statement and leave it with sufficient.

There is certainly disagreement amongst actuaries on the issue of overly sufficient reserves, including disagreement between the authors of this article! Bob believes large margins in reserves are fine and should be left to management's discretion—there's nothing wrong with having set too much money aside to cover future obligations. Tom thinks holding too much in liabilities can lead to implications in things like earnings reporting, rate increase filings and possibly the ongoing debate among regulators in some states regarding appropriate surplus levels for Blue Cross organizations. Bob would, of course, point out these issues to management, but leave the ultimate decision on margin level to them, modifying opinion wording as appropriate.

...consistent with the preceding year-end...

Here we opine that the liabilities "are computed on the basis of assumptions consistent with those used in computing the corresponding items in the annual statement of the preceding year-end." This doesn't mean that changes in completion factors from one year to the next aren't okay, but if you're going to (for example) move from a loss ratio approach one year to a completion factor approach the next, you might mention it in your opinion.

This statement is frequently qualified for two reasons: if the actuary was not involved in the prior year's calculation and has no knowledge of how it was done, or, if it's a new item on the statement and did not exist in the prior year.

...provision for all items which ought to be established...

The final opinion we render is that the liabilities "include appropriate provision for all actuarial items that ought to be established." This requires that the actuary do some research. It requires that the opining actuary have knowledge or the ability to get knowledge about what's going on in the company. Interviewing management is appropriate: ask about new lines of business, ask about new reinsurance agreements or new types of contracts, etc.

Sometimes consultants, outside the day-to-day operations of the company, may not feel confident that they know everything that is going on. They will change the wording to say something like "according to management," and have in the data reliance letter a statement from management that the actuary has been told everything that's relevant.

A Hypothetical Case Study

Consider now two fictional, hypothetical companies: Deep Pockets Mutual and Shoestring Health Plan. Neither of these are actual companies, but we have seen the scenarios we present in actual practice (though not all at the same company).

Deep Pockets Mutual is booking a conservative unpaid claim liability—above the high end of our range, to which it has added a 20 percent margin. Its claim adjustment expense (CAE) reserve is very adequately funded at 10 percent. Further, they hold a conservative premium deficiency reserve on its individual business, calculated assuming no rate increases. DPM is also booking an unearned premium reserve of 50 percent of a month's premium on all its business, including on its group business, even though 90 percent or more of groups pay on the first of the month. (This may seem silly, but we've actually seen companies want to hold this type of unearned premium reserve on group business where everybody is paying on the first of the month.) Finally, they are also booking a liability for deferred compensation for officers.

Shoestring has established a claim liability within our range, but below our mid-point. To that it has added a margin of 2 percent. Moreover, it does not separately establish any unpaid CAEs; they assume it's covered in the margin. So, in reality there's no margin at all, and the 2 percent is inadequate to even fund the CAE. To top things off, Shoestring calculates its experience-rated refund liability assuming that it will recover 100 percent of experience rating deficits. (It's an optimistic management team.)

Now, these are two very extreme cases, at the two ends of the spectrum. But elements of these extremes come up from time to time. What can the actuary do?

One approach is to issue a qualified opinion. The actuary says what he thinks is true in his opinion statement, and the regulator can decide what to do about it. To qualify an opinion, be straightforward. Write a paragraph, right before the opinion state-

ment, which lays out the facts. Then in the lead to the opinion, the actuary can say, "Except for the matters mentioned in the previous paragraph, in my opinion, etc."

That would probably work in a less extreme case, but probably would not be appropriate for Shoestring: it would be like saying reserves are not adequate, but except for that, the reserves are good and sufficient. If a qualified opinion isn't going to work, what are your options? One is to convince management to book reserves that you can agree to. Maybe they just don't understand how aggressive they are being and can be educated. If this doesn't work, your next option is to tell management that you intend to sign an opinion that states that the reserves are inadequate. This may seem an obvious remedy, but is not one to be taken lightly. If you're a consultant and you don't sign a clean opinion, it means you are likely to lose a client; and if you're an employee it means you will probably lose your job. Such is the burden of the professional.

Let's now look at Deep Pockets, which is certainly a better problem to have. There may be concerns, as I mentioned earlier, about earnings implications and regulatory concern about "hiding money." We may modify our opinion so that we don't say "good and sufficient," and, instead, just say "sufficient." We're professionals; it's our name going on the bottom of the opinion statement. It's in our judgment to decide whether we want to say it's good and sufficient or not.

Other Concerns

There are four other issues the actuary may wish to consider:

ASOP 16. Actuarial Standard of Practice 16 says that the actuary should at a minimum disclose how much she knows about the financial status of provider entities that are capitated. The concern is that an insolvent provider group may leave the health plan at risk for claims for which an IBNR liability should be held. However, it's often difficult for the actuary to know the financial status of the capitated entity. Unless the provider group is publicly traded, financial statements aren't readily available. (You may know how that provider group is doing under your contract, but they may have multiple contracts with various health plans.) Often, the actuary may add a caveat or disclaimer to the opinion that she does not know the financial status of any capitated provider entities.

Data Reliance. Many actuaries will expand on the standard NAIC data reliance wording, stating explicitly that if the data relied upon is incorrect, the actuary's opinions may also be incorrect.

Asset Adequacy. Life & Health Insurance Company ("blue blank") opinions may require that an asset adequacy analysis be performed, but the health opinion does not. However, the actuary may include caveat language explicitly stating that he has not performed asset adequacy analysis, and that he has assumed that the assets backing the liabilities will be available.

Variability of Results. Many actuaries will include in their opinion a statement indicating that the actuarial amounts opined upon are based on projections and estimates, and that actual results will vary from these projections.

Summary

Read what you are signing; read all the appropriate standards; read relevant actuarial literature. **Think** when you sign that statement, you're making a professional commitment. Think about what you are committing to and whether or not it's actually true. **Write** appropriate qualifications or caveats, write what you think and document the thinking that supports your conclusions in your file.

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