ASSOCIATION OF INSURANCE AND REINSURANCE RUN-OFF COMPANIES

AIRROC® MATTERS

A NEWSLETTER ABOUT RUN-OFF COMPANIES AND THEIR ISSUES

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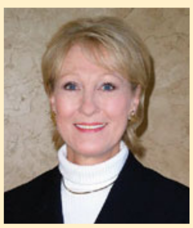
Message from CEO and Executive Director

Ready, Set, Go!


Trish Getty

By Trish Getty

As I take pen to paper in the dog days of summer in Atlanta, July, 2009, I think about what is **hot** on the minds of most AIRROC committee members these days… the AIRROC/Cavell Commutation & Networking Event set for October 19-21, 2009. Picture little mice running around, working feverishly behind the scenes to arrange and track event registration, hotel matters, AIRROC/Cavell coordination, marketing plans, ramping up our "AIRROC Matters" special Rendezvous edition, finalizing the education agenda for October 19, etc. AIRROC appreciates all of the time, effort, support and dedication of so many who make this event a resounding success year after year. At the end of the day, all will appear seamless… our goal.

Our early thank you to the event sponsors who make our delegates' attendance economically feasible so that we can get business done, close old books and get on with the rest while enjoying one another's company. Thank you.

Please register very soon for the October Event through either www.airroc.org or www.commutations-rendezvous.com.

Meanwhile the AIRROC Legislative/Amicus Sub-Committee "Small Claims Task Force"

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Are You Getting the Most Value from Your Actuary?


Tom Ryan


Jason Russ

By Tom Ryan and Jason Russ

Actuaries play various integral roles in the efficient functioning of the runoff industry. These roles include projecting liabilities, estimating payout patterns, assisting in realizing reinsurance assets, modeling financial results, and pricing commutations. Actuaries may use complex methods to provide these services, and the product of their work may not always be well understood. Misinterpretations or misunderstandings of the results can be costly. This article describes the key disclosures actuaries should be providing with their work product along with frequent items of confusion; references are made throughout to the Actuarial Standards of Practice (ASOPs) that govern actuarial work done in the United States, specifically ASOP #43, which became effective in 2007. We provide pertinent questions to ask your actuary to ensure your understanding of their work. Better understanding will lead to better decision making and will add greater value. To illustrate these concepts, we provide a series of fictional case studies.

> *Actuaries play various integral roles in the efficient functioning of the runoff industry.*

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AIRROC/CAVELL
Commutation & Networking Event

Meet with an expected 500 worldwide delegates to resolve issues, further commutation discussions, pursue reinsurance recoveries and network with industry principals mixed with entertainment.

October 19 - 21, Hilton East Brunswick

See Registration Form (On Page 17)

Are You Getting the Most Value from Your Actuary? *continued from page 1*

Case #1: You are looking to commute a specific contract, and you receive an actuarial report that includes an estimate of the unpaid losses for that contract. Can you rely on the estimate?

ASOP #43 requires actuaries to disclose the intended purpose of use of any unpaid claim estimate. What was the purpose in this case? If the purpose was to provide an overall estimate for financial reporting purposes, it is possible the estimation of results for specific contracts was secondary, done as a rough allocation. This should be viewed differently from the case where an actuary has specifically identified the purpose of the estimate as to provide assistance for the commutation of that specific contract. In either case, the actuarial report should also provide a description of the methodology and assumptions, which would also assist in judging the reasonableness of relying upon the actuary's estimate.

Any user relying on the actuary's work needs to understand that the estimates may have been done in a short time period or with limited access to those with the most knowledge of the book.

ASOP #43 refers to several other disclosures that may also assist. For example, constraints may exist in the performance of an actuarial analysis, such as those due to limited data, staff, or time. If, in the actuary's judgment, the constraints create a significant risk that a more in-depth analysis would produce a materially different result, the actuary should communicate this risk. Often during the review of liabilities for a transaction, due to timing or confidentiality issues, an actuary may not have the desired access. Any user relying on the actuary's work needs to understand that the estimates may have been done in a short time period or with limited access to those with the most knowledge of the book.

"Any user relying on the actuary's work needs to understand that the estimates may have been done in a short time period or with limited access to those with the most knowledge of the book."

Case #2: You are looking to limit the risk of future adverse development on a runoff block's reserves through the purchase of retroactive reinsurance. An actuarial report provides a range of unpaid loss estimates. Can the high end of the range be used to judge the limit needed for this protection?

A range of reasonable estimates is typically narrower than a range of possible outcomes and is usually produced by appropriate actuarial methods or alternative sets of assumptions than an actuary considers to be reasonable.

"Range" is a term that can result in confusion when used by actuaries. There are two common types of ranges – a range of reasonable estimates and a range of possible outcomes – both are referred to commonly only as ranges.

A range of possible outcomes includes all the possible results of the claims process. This type of range is usually generated by statistics or simulations but can also be based on scenario testing or historical observation. A distribution generally describes all possible outcomes.

A range of reasonable estimates is typically narrower than a range of possible outcomes and is usually produced by appropriate actuarial methods or alternative sets of assumptions than an actuary considers to be reasonable. Be warned – no objective boundaries exit for a "reasonable" range – it is very subjective and based on judgment of the actuary.

When provided with a range, ask what type of range are we discussing – reasonable estimates or possible outcomes? How was the range determined? What is the likelihood of outcomes outside the range? Is the range based solely on the variability of historical data, or does it include a provision that the future might be unlike anything that has ever occurred before? Once these questions are answered, one is in a better position to understand how to use the results.

"A range of reasonable estimates is typically narrower than a range of possible outcomes and is usually produced by appropriate actuarial methods or alternative sets of assumptions than an actuary considers to be reasonable."

Case #3: You are deciding upon the total reserve to book for a block of business. An actuarial report provides an estimate of the unpaid loss, which the actuary calls a "best estimate." Is it appropriate to book this amount?

The term "best estimate" is insufficient guidance, as it begs the question "best estimate of what?" According to

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ASOP #43, the actuary must provide further description of any unpaid claim estimate. This description should include:

- Intended measure – for example, mean, median mode, low estimate, high estimate, mean plus a specific risk margin, etc. A term now used by some is "actuarial central estimate," which represents the expected value over the range of reasonably possible outcomes
- Whether the estimates are gross or net of recoverable
- Whether the estimates are discounted for the time value of money

If this information is not explicitly detailed in the actuarial communication, ask the actuary for it. Armed with this information one could make a better decision as to the appropriate reserve to book.

…it is rare that different actuaries provided with the same data and information will provide point estimates of liabilities that match exactly.

Case #4: You are negotiating a commutation with a cedant, and both your actuary and the actuary for the cedant have provided estimates, but they differ significantly. How can this be reconciled?

It can be difficult to understand and explain, but it is rare that different actuaries provided with the same data and information will provide point estimates of liabilities that match exactly. It is, thankfully, slightly more often that ranges of results provided by different actuaries can be similar or overlap, but these too can be very different. When faced with these differences, it is important to understand what is driving differences – are there different methods being used and why? What are the strengths and weaknesses of each method related to the particular task at hand? Are the methods the same but different key assumptions used? Are the two actuaries even measuring the same thing? Remember the confusion regarding "ranges" and "best estimate".

Often the different results are from actuaries on different sides of the negotiating table in a transaction or negotiation. When this occurs, there is a need to determine what details each side is willing to provide and acknowledge that each may have to give information to get information. To be most efficient, each side must focus on areas where judgment differences are most likely to occur; the actuary should be able to provide insight to assist in this.

Conclusion

To get the most value from an actuary's work, users need to understand what the actuarial work-product represents. One may not need to understand precisely the underlying actuarial methods but knowing the key assumptions and what the results represent are critical and will lead to better, more informed decision making. ■

Jason Russ and Tom Ryan are consulting actuaries and Principals in the New York office of Milliman, Inc. Both Jason and Tom specialize in providing actuarial services to the run-off community – in the U.S. and abroad. They can be reached at Jason.Russ@milliman.com and Tom.Ryan@milliman.com.

Notes from Editor and Vice Chair

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typically a blend of unpaid, recoverable claims, outstanding loss reserves and IBNR — are recoverable under reinsurance agreements. Ben's analysis culminates with recent decisions that sustain a panel's decision to permit such recoveries.

Add Nigel Curtis' usual dose of *"Present Value"* (run-off "pop culture" and KPMG's *"Policyholder Update"* and "the deed is done."

We are your voice in the run-off world. Let us hear from you. ■

Mr. Scarpato is an arbitrator, mediator, run-off specialist, attorney-at-law and President of Conflict Resolved, LLC, based in Yardley, PA. He can be reached at peter@conflictresolved.com.