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## **Hold On to Your Actuary!**

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The involvement of the actuary in the initial establishment of an alternative risk transfer program is fairly well known and documented. But now that your program is up and running, does the actuary bring anything to the table with regard to the ongoing management and operations of the program? The short answer is yes. But, of course, you knew that, otherwise this article would be quite short and not very useful. The long answer involves looking at the various roles the actuary serves in managing and maintaining a successful and financially strong ART program. And let's face it, I'm an actuary. I don't do short answers.

There are really two main functions actuaries perform for their ongoing captive clients. The reserving function establishes recommended levels for the funds, or reserves, to cover the expected expenditures on claims arising from the insurance coverage currently or previously provided. The pricing function establishes projected premium levels for coverages anticipated to be provided by the captive in future policy periods. Both functions provide direction to the management of the captive in their efforts to maintain the financial strength and integrity of the entity and help ensure that the captive continues to meet its obligations well into the future.

South Carolina, along with all other NAIC-accredited domiciles, requires that ongoing captives retain the services of an approved, qualified actuary. The actuary must be appointed by the captive's Board of Directors at their annual meeting. The NAIC Annual Statement instructions state that any "insurer or reinsurer authorized to write property and/or casualty insurance under the laws of any state and who files on the Property and Casualty Blank" must include a Statement of Actuarial Opinion (SAO) with their Annual Statement each year. The SAO sets forth the actuary's professional opinion on the methodologies and assumptions used to determine the reserves reported in the Annual Statement and generally makes a determination regarding the reasonableness and adequacy (or deficiency) of the stated reserves to cover the expected insurance liabilities. Among numerous other items, the actuary takes into account losses, loss adjustment expenses, salvage and subrogation, reinsurance arrangements, unearned premium reserves, and any exposure the captive faces that carries the potential for material adverse deviation from expected results. Accompanying the SAO is a full report detailing the work the actuary has done to be able to offer his/her opinion. The SAO and accompanying report must be maintained at the captive offices and available for regulatory examination for seven years.

Although not specifically required in the SAO or accompanying report, there are several ways the actuary can help the captive manage its ongoing concerns. Emergence tests are often used to examine and compare the actual emergence and development of losses with that anticipated by previous actuarial studies, including the initial feasibility study. These

tests can provide the captive with important insights into how its business may vary (or not) from that of the industry as a whole, and what assumptions and predictions previously made about the captive's operations may need to be revisited or revised. Claims tests can provide further insight. These tests can examine and clarify important information about the claims process such as the number and average severity of claims, the speed with which claims close, and the length of time from the occurrence to reporting of claims.

In both emergence and claims tests, the actuary needs to work closely with claims administration and the captive's management to gain a clear understanding of changes that may have occurred or are anticipated to occur in the claims handling process and the reserving philosophy of the captive and its claims administrator. Changes in claims handling or reserving can have surprisingly significant impact on the future financial integrity of the captive if not quantified or properly addressed in loss reserving models. For example, without proper adjustment, a reduction in the rate of settlement of open claims may result in underestimation of loss reserves, and potential subsequent financial impairment when those reserves turn out to be inadequate. The actuary can help quantify this impact and, if necessary, recommend changes going forward to maintain the captive's financial solidity.

At initial startup, premiums are established based upon projections of how loss experience, expenses, and investments will perform in the future policy periods. Oftentimes, the actuary is compelled to use data external to the actual operations going into the captive, either from a lack of data, low credibility of that data, or both. Industry experience, from rates to loss development patterns, is typically used to supplement the data unique to the operations going into the captive. But as the captive itself matures, it will capture the data of the actual programs placed into it, accumulating its own loss experience, and allowing the actuary to develop premiums based less on generic industry information and more on the unique characteristics of the actual risks being assumed by the captive.

Even where industry rates or experience aren't relied upon at initial setup, often the volume of data is insufficient to do little more than charge average rates within the captive. As the captive matures, it may become feasible to refine the premiums charged by the captive by incorporating rating classifications. For example, a large corporate insured placing workers compensation exposures into its captive may wish to allocate the premiums charged by the captive to numerous plants and locations. Initially, that allocation may be based on size of the plant or number of employees. But what about those plants or operations that have significantly different exposures than others? What about locations that have a significant population of office workers or plants that are relatively more modernized and thus safer? Accumulation of data within the captive can allow the actuary to develop rating structures that take these factors into account, establishing more refined classification systems, and subsequently premiums that match more closely with the captive's actual exposure to risk.

In addition, rarely, if ever, does the risk assumed by the captive stay static from policy period to policy period. Trends in claim costs, court judgments, inflation, and even the actual risks insured can, and do, affect the future cost of providing coverage. Obviously, changing costs demand changing the price charged for coverage. And it's not always the things that make costs go up. Implementation of additional loss control or safety procedures can have a profound impact on the actual cost of assuming risk. Changes in claims or operating expense and improvements in the investment income outlook can also have a significant impact on the premium level required by the captive to cover its obligations. The actuary can, and should, adjust and revise projected future premiums to match the future expected costs.

Finally, many captives get up and running by taking on only the core risks of the parent. Many programs start out with the basic general liability and workers' compensation exposures, for example, with the eventual goal of placing other exposures into the captive down the road. New or unique coverages, new classes of insureds, and even underwriting changes in current programs all demand accurate pricing to ensure a solid financial future. The actuary is critical to developing the rate structures and establishing premium levels that will allow the captive to achieve these goals.

In many ways, the actuary plays a vital role in the ongoing management and leadership of the alternative risk transfer program. Throughout the life of the program, the actuary can assist management in steering the right course. Adequate reserves maintain the financial integrity of the program, allowing it to meet its current obligations. Accurate and dynamic pricing ensures that the captive will continue to meet its obligations and goals into the future.