



AMERICAN ACADEMY *of* ACTUARIES

June 9, 2002

Ms. Anne Kelly FCAS, MAAA
Casualty Actuarial Task Force
National Association of Insurance Commissioners (NAIC)
Chief Casualty Actuary
New York State Insurance Department
25 Beaver Street
New York, NY 10004

Dear Ms. Kelly:

Over the past few months, the Committee on Property and Liability Financial Reporting (COPLFR) has worked closely with the Casualty Actuarial Task Force (CATF) as it considered various revisions to the Annual Statement Instructions regarding the Property/Casualty Statement of Actuarial Opinion (SAO). We have appreciated the opportunity to have our opinions heard, along with those of insurance companies, industry groups and other constituents of the NAIC. We believe this interactive process has greatly improved the proposed language and increased its chance for successful implementation.

It is our understanding that one of the agenda items at the NAIC's June meeting is a proposal to amend the Annual Statement Instructions to prohibit the Appointed Actuary from entering into an agreement of indemnification, or limitation or release from liability, with respect to the SAO.

While we understand the regulator's interest in not shielding shoddy or unprofessional actuarial work, COPLFR strongly believes that this proposal requires further study and discussion, as the issues surrounding the use of such agreements are complex and may have ramifications that are not readily apparent. The purposes of this letter are to:

- Provide some background on the use of such agreements,
- Mention some of the issues we have identified relative to the proposed prohibition of the agreements, and
- Request that no action be taken, but that this proposal be deferred pending a thorough discussion involving the NAIC constituency.

Background

To the extent that actuaries and their firms are using indemnification agreements and limitations of liability, they are doing so in response to a dramatic change in the legal landscape for actuarial liability. Lawsuits are now being brought against actuaries

based on the premises that outcomes that differ from the projected result necessarily do so as a result of negligence or wrongdoing, and that individual assumptions can be fairly judged with the benefit of hindsight. Even if the actuary ultimately prevails, the expense of defending an actuarial malpractice lawsuit is very high.

COPLFR understands that indemnification agreements and limitations of liability are generally not applicable to acts of fraud and willful misconduct.

While the NAIC has decided to impose limitations on auditors' ability to seek indemnification for work performed on the required statutory audit, we note that there are fundamental differences between the actuarial and audit functions. Audits are signed by the firm, whereas Actuarial Opinions are signed by the individual Appointed Actuary, who may face serious risk of individual liability if a suit is brought. Individual actuaries are directly subject to professional discipline through the ABCD. Actuarial work, by its nature, is more prospective and judgmental in nature, while audit work is more retrospective and determinate with a focus on historical information. No matter how carefully actuarial work is performed, the actuary's projections almost always differ to some extent from actual circumstances that ultimately develop, but it can be difficult for courts to appreciate to inevitability of that difference. Finally, the auditor's letter expresses a fairly limited opinion on whether the financial statements are fairly presented. The actuarial opinion goes well beyond this to discuss risks underlying the reserves and various business issues affecting the company. The actuarial opinion may, in fact, affirmatively state that reserves are inadequate or excessive and by how much.

Issues

COPLFR has identified the following issues and potential ramifications of prohibiting indemnification agreements and limitations of liability for Appointed Actuaries:

- These types of agreements also protect the actuary from suits brought by others for statements that may be alleged to damage the company or its stock value. An adverse Statement of Actuarial Opinion or a disclosure of significant risk of adverse deviation are two examples. As regulatory actuaries express a need for more information, the fear of such suits may make Appointed Actuaries less inclined to draw regulators' attention to problems within the companies on which they opine. We note that the Standard Valuation Law provides life actuaries with some protection in this regard.
- The effect of limiting such agreements appears to fall more heavily on consulting actuaries than on company employees. The internal actuary is generally protected by the company's D&O policy. The consulting actuary must either assume the risk internally or bear the cost of E&O insurance.
- The effect of limiting such agreements may affect consulting actuaries in larger firms more than those in smaller firms. Since smaller firms are less likely to have

E&O insurance and/or significant assets, they may be less likely to be subject to lawsuits.

- E&O insurance premiums for actuarial consulting firms are increasing, and availability is now an issue. The indemnification agreements and limitations of liability are methods used to contain costs and increase availability. The prohibition of such agreements is likely to exacerbate the existing issues of insurance affordability and availability for consulting actuaries. A consulting actuary without E&O insurance is essentially risking the entire assets of the consulting firm on his or her work, and the inability of the market to price E&O insurance affordably may prevent actuaries from making certifications that are critical to the successful regulatory oversight of property/casualty insurers.
- Actuaries may be drawn into suits where the alleged “errors” arise solely from erroneous data or management misrepresentations, both of which may be beyond the actuary’s control. The cost of defending such a suit can be considerable, even if the actuary ultimately prevails.
- To offset the increased risk associated with the work, the cost of SAOs provided by consulting actuaries may increase significantly. This increase may be more acutely felt by smaller insurance companies, who are less likely to have internal actuaries providing the SAOs.

COPLFR appreciates the opportunity to provide these comments. We would be pleased to discuss the information we have developed to date with the CATF in more detail or to answer any questions you may have.

Very truly yours,

Andrea M. Sweeny, FCAS, MAAA, FCA, Chairperson
Committee on Property and Liability Financial Reporting

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