AMERICAN ACADEMY of ACTUARIES

MEMORANDUM

To: P/C MAAAs

From: Committee on Property and Liability Financial Reporting

Subject: California Workers' Compensation Insurance Guidance

Date: 3/21/2005

The purpose of this guidance is to inform you of a recent change in reporting requirements for companies licensed to write workers' compensation in California and provide information regarding the actuarial opinion component of the report.

BACKGROUND

For many years, the California Department of Insurance (CA DOI) has required companies licensed in the state to file a "Special CA Schedule P" (SCASP) for California workers' compensation insurance. The current SCASP can be downloaded from the CA DOI web site at:
http://www.insurance.ca.gov/FAD/Statementforms_2004/Statementforms_2004.htm

The SCASP contains direct, assumed and ceded premiums, losses, and loss adjustment expense reserves (including Incurred But Not Reported or IBNR), and other information specific to the reporting company's California workers' compensation business. The SCASP must be filed by March 1, 2005.

Recently, the CA DOI issued new requirements for an "Actuarial Certification" of the loss reserves contained in the SCASP (Page seven of the SCASP), evaluated as of December 31, 2004. Page seven contains the following opinion wording:

> "In my opinion, the California workers' compensation reserves reported on the Company's Special California Schedule P make a reasonable provision for all unpaid loss and loss adjustment expense obligations of the Company for its California workers' compensation exposure under the terms of its contracts and agreements."

The Actuarial Certification is to be completed if the company's California workers' compensation deposit requirement is $1 million or higher, and it must be submitted by April 1, 2005. The Actuarial Certification must be signed by a qualified actuary, and notarized. According to the CA DOI, the Actuarial Certification may be provided by a qualified actuary other than the reporting entity's Appointed Actuary.

FREQUENTLY ASKED QUESTIONS

This new opinion requirement poses potential issues for actuaries. To address these issues, the American Academy of Actuaries (Academy) Committee on Property Liability Financial Reporting (COPLFR) has had dialogue with the CA DOI regarding the opinion requirement. Based on these discussions, clarification has been provided by the CA DOI on numerous areas related to the SCASP. See the attached *Exhibit 1 – California Special Workers' Compensation Schedule P – Questions and Answers* for questions posed by COPLFR and the answers from the CA DOI.

ASOP 36 CONSIDERATIONS

COPLFR has reviewed the Actuarial Certification required by the SCASP in light of the scope of Actuarial Standard of Practice (ASOP) *No.* 36 – *Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves*. Consequently, COPLFR suggests that actuaries consider the relevant provisions of ASOP 36 when responding to the SCASP. Further, the actuary providing the Actuarial Certification may wish to provide an attachment addressing certain provisions of ASOP 36. According to the CA DOI, it is up to the individual actuary as to whether to provide additional text beyond the statement contained in the SCASP.

COPLFR notes that there are several ASOP No. 36 requirements which may be applicable in the case of the SCASP Actuarial Certification, including but not limited to the following:

Paragraph 3.3 – <u>Contents of a Statement of Actuarial Opinion</u>, including

- 3.3.1 – Items Covered in the Opinion: This section states that the Statement of Actuarial Opinion should list the items on which the actuary expresses an opinion.
- 3.3.2 – Types of Statements of Actuarial Opinion: This section outlines the five different types of opinions, how each type should be issued, and the circumstances under which each should be used.
- 3.3.3 – Significant Risks and Uncertainties: This section requires an explanatory paragraph when the actuary reasonably believes that there are significant risks and uncertainties that could result in material adverse deviation. If the risk of material adverse deviation disclosure is made, the explanatory paragraph should contain a description of the major underlying risk factors and the materiality standard used.

Paragraph 3.4 – <u>Materiality</u>: This section states that the materiality standard should be determined in the context of the purpose and intended use of the Statement of Actuarial Opinion.

Paragraph 4.2 – <u>Documentation</u>: This section states that the actuary should be guided by the provisions of ASOP No. 9, *Documentation and Disclosure in Property and Casualty Insurance Ratemaking, Loss Reserving, and Valuations.*

Paragraph 4.6 – <u>Disclosure in the Opinion</u>: This section lists other disclosures to be included in the Statement of Actuarial Opinion as applicable (e.g. discounting, qualified opinions, reliance on the work of others, etc.)

Further, COPLFR would like to inform actuaries that much of the discussions and materials contained in the Academy 's P/C Practice Note (Statements of Actuarial Opinion on P&C Loss Reserves as of December 31, 2004) does not apply to the SCASP. This practice note was written to apply only to the National Association of Insurance Commissioners' (NAIC) statutory Statement of Actuarial Opinion, which is a different document and has different regulatory requirements than the SCASP Actuarial Certification.

This communication is intended to assist actuaries providing the SCASP Actuarial Certification of California workers' compensation reserves. The information, discussion and considerations contained herein are not binding on any actuary and should not be regarded as an authoritative statement of what constitutes generally accepted practice in this area. Actuaries who have questions regarding the SCASP are encouraged to contact the CA DOI directly.

Exhibit 1

Special California Schedule P ("SCASP") - Workers' Compensation Questions and Answers

[Questions were posed by American Academy of Actuaries Committee on Property Liability Financial Reporting, and answers were provided by the California Department of Insurance.]

1. There is an exemption for companies whose reserves fall below a certain threshold. What is the threshold?

   Answer: The SCASP is to be filed by all companies licensed to write or authorized to reinsure Workers' Compensation in California in 2004. The Actuarial Certification in Part VII is to be completed if the company's SCASP deposit requirement is $1 million or higher.

2. What is the new deadline going to be for the 2005 opinions? Will this apply to the opinion part only, or the whole Special Schedule P?

   Answer: The deadlines for the 2004 SCASP is April 1, 2005 for the Actuarial Certification in Part VII and March 1, 2005 for the rest of the SCASP.

3. Can a qualified actuary other than the appointed actuary fulfill this requirement?

   Answer: Yes, because the SCASP instructions are silent on this point.

4. Will there need to be a formal Statement of Actuarial Opinion, with multiple sections like the NAIC SAO, or just an Opinion paragraph, or something in between?

   Answer: The only SCASP requirement is that the actuary must make the statement on Page 7, namely:

   "In my opinion, the California workers compensation reserves reported on the Company's Special California Schedule P make a reasonable provision for all unpaid loss and loss adjustment expense obligations of the Company for its California workers compensation exposure under the terms of its contracts and agreements."

   If the actuary wishes to provide additional text, this is up to the individual.

5. If there is to be a formal SAO, can you give us some guidance on key issues like materiality thresholds for risk of material adverse deviation?

   Answer: See #4.

6. Will there need to be a formal report, or can the underlying documentation be workpapers, etc. adequate to fulfill professional documentation standards?

   Answer: See #4. A report is not required; however it is possible that the California Insurance Department may request supporting information on a case-by-case basis.

The actuary is required to comply with professional standards, including those regarding documentation of work and statements of actuarial opinion.

7. Does this apply to reserves on direct, assumed, gross, net, or some combination of those?

   Answer: The opinion is intended to apply to reserves net of authorized reinsurance to the extent that credit for deposit is taken as shown in Page 1, Column 20, Grand Total.

8. If the opinion covers net reserves, a couple of significant potential complications could be aggregate covers and reinsurers excluded from the Special Schedule P because they aren't licensed in CA. In many companies, the reinsurance allocation process is so accounting-driven and complex that there is no way an actuary could assess it. With respect to the underlying date, in some companies it may prove to be logistically infeasible for the actuary to be sure that the Special Schedule P data is the same as the corresponding CA values in the Annual Statement Page 14. How should these situations be handled?

   Answer: The CDI understands that in some situations it may be infeasible to the ceded loss and LAE reserves as shown in Page 1, Column 19. For these situations, it would be sufficient for the actuary to opine on the reasonableness of the direct and assumed loss and LAE reserves as shown in Page 1, Column 18, Grand Total, and that the ceded loss and LAE reserves as shown in Page 1, Column 19 are derived through a reasonable allocation process.

9. How (to whom) will the revised Special Schedule P instructions be communicated?

   Answer: The CDI sent out the revised SCASP to all affected companies on February 8. It can be downloaded from Department's website at:

   http://www.insurance.ca.gov/FAD/Statementforms_2004/Statementforms_2004.htm

10. The spot where the actuary is to identify himself or herself includes a blank to identify the consulting firm he or she is associated with. Is the implication that an actuary outside the company is to be engaged to render this opinion? Or can the company's appointed actuary, who is an officer of the company, render this opinion?

    Answer: There is no requirement that the actuary rendering this opinion must be from outside the company. If the actuary is a company employee, he or she could fill the company's name in the blank.

11. Have you considered whether signing the one-sentence opinion as written may leave an actuary technically non-compliant with the requirements of ASOP 36? For example, ASOP 36 Section 4.6 provides a list of items a) thru j) that should be disclosed in the statement of actuarial opinion if they pertain.

    Answer: See #4.

12. Who is qualified to sign the actuarial certification -- anyone who meets the requirements of a qualified actuary for P&C loss reserve opinions in California?

Answer: Yes. The requirements spelled out in the Actuarial Opinion Instructions, which are contained in the Annual Statement Instructions, will apply.

13. In the case where a life insurance company is required to file the SCASP because of WC carve-out business, can a life actuary sign the actuarial certification?

    Answer: No, a life actuary is not qualified to sign the actuarial certification on the SCASP. A property-casualty actuary should sign the certification.

14. In the case of #12, can the signer be either the appointed actuary or a company employee?

    Answer: The Appointed Actuary must sign, unless the opinion is signed by a qualified actuary as specified in the Property-Casualty Actuarial Opinion Instructions.

15. What is the actuary supposed to do with the form if the opinion is something other than "reasonable"?

    Answer: If the actuary believes that it is inappropriate to render a "reasonable" opinion, he or she should provide the type of opinion that is appropriate. He or she should also be prepared to answer questions asked by representatives of the California Department of Insurance. The Department will require that each company transacting workers compensation insurance in California maintain deposits sufficient to cover reserves that meet the "reasonable" standard.

16. With respect to ceded reinsurance, actuaries typically would not know if the reinsurer has established a deposit sufficient to cover the ceded reserves. Is it okay for the actuary to assume that the reinsurers have established sufficient deposits for purposes of opining on the reasonableness of net loss reserves?

    Answer: Yes, the Department will review the filed SCASP and verify that the deposits held by the assuming reinsurers are sufficient. If the deposit is deficient, a notice will be sent to the ceding and assuming companies.

17. Are reserves for USL&H exposures intended to be within the scope of the actuarial certification?

    Answer: Yes, companies that write USL&H fund its deposit and report this business on the SCASP.

18. Part VI, item 4 deals with discounting WC reserves. Is this an additional discount or is it referring to the usual 3.5% indemnity discount?

    Answer: It is important to note that it is not permissible to record reserves for unpaid losses on California workers compensation exposures on a discounted basis in the Annual Statements filed with the California Insurance Department. It is permissible, however, for a company to discount its entire California workers compensation reserve for the purpose of determining the amount of the required deposit. The rate used for this discounting is specified in the California Insurance Code Section 11693. Companies that wish to discount its WC reserves should contact the Workers' Compensation Deposit Review Team at 213-346-6433 for additional instructions and form.

19. Part VI, 4.b., requires the discount information to be supported actuarially. Would the actuary signing the actuarial certification be responsible for the discount documentation? Should this discount be covered in additional actuarial text even though Part VI is certified by an officer of the insurer? What is the officer actually certifying?

    Answer: The Department would require actuarial support for the payment pattern used for discounting. The same actuary who provides the opinion on the reasonableness of the reserves must be the one who provides the discount documentation. Part VI – certification by an officer is required. The officer must certify that the information provided on the SCASP is true and correct.

20. Considering the response to Question 7, should the phrase "as shown in Page 1, column 20, Grand Total" added to Actuarial Certification paragraph? The answer to Question 8 allows certification for Page 1, column 18. Depending on the insurer situation the actuary will be opining on column 16a + 17a, 18, or 20. Additional language by the opining actuary is needed or space on the form for the actuary to specify what the opinion is covering.

    Answer: The actuary should specify which reserves he or she is opining on. This would normally be the reserves found in column 20. In the special circumstance covered by questions 8 and 22, it may be permissible to opine on either column 18 or the sum of columns 16a and 17a. In these cases, the actuary is still required to comment on the reasonableness of the allocation of ceded and/or assumed reinsurance, as the case may be. Consistent with this form's instructions for data entry, these and other additional comments may be placed on a separate sheet or sheets and attached to the back of the completed forms.

21. Page 1, column 18 and 20, includes the calculation of unallocated from Part II on page 2. The unallocated is by formula and not determined by the actuary. What review is need by the actuary? Should the actuary exclude ULAE from the opinion?

    Answer: Consistent with the answers to question 19, the actuary will be opining on the reserves found in either column 20, or column 18, or the sum of columns 16a and 17a. The ULAE calculation in part II does not affect any of these columns. It only comes into play in determining the values shown in column 22, and possibly column 25. Therefore, this is a non-issue. The actuary is required to offer an opinion on the full loss and loss expense reserves, including the ULAE reserves carried by the company.

    Although the unallocated from Part II on page 2 is by formula, it is the actuary's responsibility to check if the distribution is correct for the company.

22. Our FAQ 8 deals with complicated ceded reinsurance. What happens when there are similar complications with respect to assumed reinsurance? Can the actuary base an opinion on direct reserves and a reasonable allocation of assumed reserves?

    Answer: By all means, the opining actuary of the assuming company should communicate with the opining actuary of the ceding company to ascertain that the reserves are reasonable on the assumed business especially the big blocks of assumed business. We would certainly expect that a serious effort would be made to do so in both the cases of ceded and assumed reinsurance, and we would expect a

written explanation as to why this cannot be done. "Boilerplate" statements will not be acceptable.