



# AMERICAN ACADEMY *of* ACTUARIES

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December 22, 2005

Glen McKay, CA, ARe  
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Bermuda Monetary Authority  
31 Reid Street  
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Bermuda

## **Re: Draft Guidance Note #4 – Role of the Loss Reserve Specialist – Draft for Comment**

Dear Mr. McKay:

In October 2005, the Bermuda Monetary Authority (BMA) issued a draft for comment of its Guidance Note #4, *Role of the Loss Reserve Specialist* (Draft Note). The Draft Note sets out the BMA's interpretation of the requirements of Bermuda's Insurance Act 1978, as amended, and its regulatory approach and expectations regarding the Loss Reserve Specialist (LRS), and the preparation of the Statement of Actuarial Opinion (SAO) for Bermuda insurers.

The purpose of this letter is for the Committee on Property and Liability Financial Reporting ("COPLFR") of the American Academy of Actuaries<sup>1</sup> to provide comments to the BMA on the Draft Note.

### **General Observations**

The October 2005 Draft Note is different in several important respects from the Guidance Note #4 that was provided by the BMA in March 2005. We believe that the Draft Note significantly clarifies the "adequacy" standard and the obligations of the actuary where reserves are discounted. We appreciate the BMA's attention to these important issues.

Based on our review of the Draft Note, COPLFR believes that there are a few remaining areas where we would request confirmation that our interpretation is consistent with the intent of the BMA. They are:

- The standard of "adequate" to be included in Bermuda SAOs;
- LRS evaluation and comment on amounts set aside where loss reserves include discounting; and
- Circumstances when discounting is allowed.

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The remainder of this letter contains our interpretations in each of these areas. If our interpretations are not correct, the BMA may wish to provide some additional clarification.

### **Adequate Standard**

The Draft Note states that the SAO must indicate whether the carried loss reserves “...*make an adequate provision for all unpaid loss and loss expense obligations of the Company under the terms of its contracts and agreements.*” [Paragraph 34, Part 5]

The Draft Note defines the term “adequate” as follows:

***Adequate. In the context of a LRS opining on Line 17 of Bermuda Statutory Financial Statements, means that the held reserve equals or exceeds a reasonable estimate of liabilities.*** [Paragraph 9]

We interpret this provision to mean the following:

1. We assume that the reference to “a reasonable estimate of the liabilities” in the definition of the word adequate is intended to include any estimate that the Loss Reserve Specialist considers to be reasonable. In the context of Actuarial Standard of Practice Number 36 (ASOP 36) which guides actuaries providing Statements of Actuarial Opinion in the United States, this reference would be interpreted to include amounts below the actuary’s “point estimate” or “best estimate” that are in the actuary’s “range of reasonable estimates.”
2. The description of adequate reserves as equaling or exceeding “a reasonable estimate of the liabilities” means that if the held reserves are above the actuary’s reasonable estimate of liabilities – even significantly above – they would be considered adequate. This would be a different standard than that of ASOP 36, in which the LRS may render an opinion of redundant or excessive reserves.

### **Discounting**

The Draft Note references the need for a risk margin when reserves are discounted. Specifically, the Draft Note states the following:

***In addition, where loss and loss expense reserves are discounted, the Insurance Act requires that loss and loss expense reserves include “A proper amount set aside by the insurer for possible variations in ultimate amount of losses, the payment dates of the losses, and the applicable interest rates” (IAR, Schedule III, Part I, Item 17(d)). Therefore as part of opining on Line 17 where loss and loss expense reserves are discounted, the Loss Reserve Specialist is expected to evaluate the amount set aside, and include a comment on such an amount in the opinion.*** [Paragraph 34, Part 5]

We interpret this provision to mean the following:

1. The margin should be based on the actuary’s judgment and analysis of foreseeable variation in indicated nominal reserves, payout patterns and discount rates. It will be up to the LRS to determine the margin indicated by the analysis.

2. One possible way of addressing this provision might be for the LRS to calculate alternative discounted reserves using somewhat higher than best estimate reserves, applying a slightly faster payment pattern, and using a somewhat lower discount rate. The result of the analysis would provide insight into the indicated discounted reserve, with margin. There may be other valid approaches as well.

### **When Discounting is Allowed**

The Draft Note states the following:

*The provision for loss and loss expenses may be discounted:*

- a) Where both the amount of the loss provisions and the payment dates of the losses are fixed;*
- b) Where neither the amount of the loss provisions nor the payment dates of the losses are fixed but the insurer's Approved Auditor and the Loss Reserve Specialist is of the opinion that the amounts and dates are reasonably ascertainable; or,*
- c) Where the loss provisions in question in the insurer's statutory financial statements were discounted on or before 31st December 1988, and have been discounted in each subsequent year.*  
[Paragraph 25]

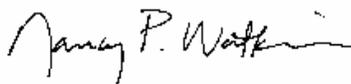
We interpret this provision to mean the following:

1. The provisions of scenarios a) and c) are clear. No additional guidance is likely to be needed.
2. With respect to Scenario b), we understand this to mean that a reasonable reserve payout pattern can be estimated based solely on an analysis of company-specific data, without supplementary information from other industry sources. This would imply that the company's data must be of sufficient volume, consistency and duration to be used as a basis for the estimated payout pattern.

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If any of our interpretations do not properly reflect your intent, additional clarification would be helpful. We hope that the comments in this letter are useful to the BMA and we appreciate the attention you have shown to our past comments. We would be pleased to meet with you and discuss this letter in greater depth.

Sincerely,



Nancy Watkins, Chair  
Committee on Property and Liability Financial Reporting  
American Academy of Actuaries

cc: John Purple, Chair, Casualty Actuarial Task Force