

24. (2.75 points)

An insurance company expanded its offering of errors and omissions (E&O) coverage in 2009, but later experienced significant and unanticipated development on this exposure relative to total loss and LAE reserves. The actuarial review of E&O reserves conducted in 2013 took into consideration the change in development patterns.

An excerpt from the Five Year Historical Data exhibit is provided below:

ANNUAL STATEMENT FOR THE YEAR 2015
FIVE YEAR HISTORICAL DATA

	1 2015	2 2014	3 2013	4 2012	5 2011
One Year Loss Development (000 omitted)					
73. Development in estimated losses and loss expenses incurred prior to current year (Schedule P, Part 2-Summary, Line 12, Col.11)	76	776	3,218	1,935	1,675
74. Percent development of losses and loss expenses incurred to policyholders' surplus of prior year end (Line 73 above divided by Page 4, line 21, Col. 1 x 100)	0.2	2.8	9.3	5.6	5.2

a. (0.5 point)

Identify an intended audience and briefly describe the primary purpose for Item E of the Actuarial Opinion Summary Supplement (AOS).

b. (0.75 point)

Propose language for Item E of the AOS at year-end 2015.

c. (0.5 point)

Provide two questions that a regulator may have subsequent to reading the Item E disclosure in part b. above.

d. (1 point)

To answer each of the questions posed in part c. above, identify one additional resource that the regulator could consult, and briefly describe what useful information may be found from each resource.

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QUESTION 24	
TOTAL POINT VALUE: 2.75	LEARNING OBJECTIVE: D
SAMPLE ANSWERS	
Part a: 0.5 point	
<p>Sample answers include:</p> <ul style="list-style-type: none"> • An intended audience may be domiciliary regulators. The purpose of item E is to disclose whether 3 or more of the last 5 years have had 1 year development greater than 5% of the prior year's surplus and disclose what factors may have caused that deviation • Regulator – helps identify companies that have been under reserving over the past five years • Regulators – identify whether adverse development has occurred in excess of 5% of policyholders' surplus in 3 or more of the last 5 years. 	
Part b: 0.75 point	
<p>Sample answers include:</p> <ul style="list-style-type: none"> • This company has experienced adverse development of greater than 5% in 3 of the last 5 years. The years are 2011, 2012, and 2013. This was due to significant and unanticipated development on the E&O line of business. • Loss + loss expenses have developed adversely by more than 5% of prior year end surplus in 3 out of the past 5 years. This is due to an expansion into a longer tailed line of business (E+O) without immediately reflecting changes in the book in the development patterns. Management has noted the issue and corrected for it as seen in the latest 2 years. • In reviewing IRIS 11 ratios, 3 out of 5 recent calendar years resulted in outcomes greater than 5%, which considered to be unusual. The reason behind this comes from the errors & omission coverage offered back in 2009, which resulted adverse development in years between 2011 & 2013. However, the company has been increasing less adverse development in recent last two years, which I'm not concerned with. 	
Part c: 0.5 point	
<p>Any two of the following:</p> <ul style="list-style-type: none"> • May want to know if other IRIS ratios are alright • May want to check if there is sufficient reinsurance or reinsurance coverage • What are the underlying drivers that is causing the adverse development? • Which lines of business are responsible for this adverse development? • What development procedures did they change? Only for this line? • How are they accounting for the bad development in the prior years? • How the development compared to change in reserve estimate? • Is the development related to issue unique to the insurer? • Is this line of business expected to continue? • Are there reinsurance collectability issues and is reinsurance adequate? • Are the reserves adequate now? • What issues with E+O caused this. Which accident years? • Have the writings in this coverage stabilize or is it growing, since cannot see from what is 	

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provided?

- How much of this coverage as a percentage of total reserves?
- Is there a solvency concern?

Part d: 1 point

Any two of the following (Including identifying the resource and briefly describing the information):

- Schedule P –
 - Historical loss development by line of business can be used to evaluate reserve adequacy by year
 - to compute frequency and severity to compare to the industry
- Schedule F – to see if there are any reinsurance treaties impacting loss and surplus
- Notes to the Financial Statement - The note on the change in incurred loss should note changes and what line of business caused the change
- IRIS Ratio 13 – IRIS ratio 11, 12, 13 to see if reserve is inadequate during latest years
- Company management - provide insight to the changes in claim handling or insight to the drivers of adverse development
- Underwriting & Investment Expense Exhibit – will have written premium by line of business, can see how much E&O is part of the total business
- Competitor Annual Statements – could compare other insurers financial statements to see if they experienced adverse development in E&O coverage as well and benchmark against the company
- IEE – will show profitability by line of business and may be able to identify problems specific to E&O exposures
- SAO (with any of the following listed as useful information that may be found):
 - Relevant comments on unusual IRIS ratios for IRIS ratio 11, 12, or 13
 - Relevant comments on the collectability of reinsurance
 - Changes in methods and assumptions that may have caused the unanticipated development
 - Regulator can check the appointed actuary's opinion on whether reserves are now adequate
- Five year historical data: RBC analysis

EXAMINER'S REPORT

Candidates were expected to understand the user and purpose of Item E of the Actuarial Opinion Summary, the language the actuary would use in commenting on unusual values in Item E, the additional information a regulator may wish to obtain as a result of adverse deviation indicated in Item E, and available resources that could be used in order to provide the information.

Part a

Candidates were expected to demonstrate an understanding of the audience of the AOS a general understanding as to the primary reason Item E is included in the AOS.

Common errors include:

- Stating the intended user as management or the board of directors. This was not

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<p>accepted since company management and the board of directors should already know the actuary's range and 5-year historical experience.</p> <ul style="list-style-type: none">• Discussing the purpose of the Item A through D of the AOS, not specifically Item E• Stating the purpose as an indicator of whether reserves are sufficient; there is insufficient information to make that determination.
Part b
<p>Candidates were expected to demonstrate an understanding of the key information provided in Item E of the AOS.</p> <p>Common errors include:</p> <ul style="list-style-type: none">• Failing to discuss the cause of the adverse development.• Failing to state the results (3 out of 5 years, >5% deviation)• Stating the cause of adverse development was related to Asbestos & Environmental claims, or other factors not presented in the question. Information provided in the question made it clear the development was caused as a result of the E&O line of business.• Stating very broadly that the development was caused by unanticipated development. The text states that "the AOS also requires explicit discussion of reserve elements and/or management decisions to which such adverse development can be attributed."• Stating solely that development was caused by expansion of E&O. Expansion into a new line should not necessarily lead to adverse development in the reserves.
Part c
<p>Candidates were expected to demonstrate an understanding of additional information a regulator may request in order to assess the reserve adequacy and solvency of a company that has experienced adverse development in 3 of the past 5 years.</p> <p>Common errors include:</p> <ul style="list-style-type: none">• Requesting additional information that was already clearly provided in the exam text provided for Item E in part b.• Requesting two pieces of information that were essentially one in the same• Asking if pricing for E&O is adequate (something a solvency regulator reviewing Item E would be less likely to be interested in)• Broad questions regarding the mix of business, for example "is the mix of business changing?"
Part d
<p>Candidates were expected to demonstrate an understanding of resources available that would provide sufficient information to answer the questions posed in part c., as well as the useful information that could be found in the resources listed.</p> <p>Common errors include:</p> <ul style="list-style-type: none">• Stating a resource without providing insight to the information provided• Requesting information that a (solvency) regulator would likely not be interested in.

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- Stating a resource that would not provide sufficient information provided the question posed in part c. (in particular, the Five-Year Exhibit which does not contain enough detail to answer many of the questions posed)
- Stating the same resource twice without clearly stating the different locations and different information that could be found in each part of the same source.
- Stating a resource that addressed a question that was extremely unrelated to the question at hand
- Using IRIS Ratio 11 or 12 as a resource, which are both immediately available and evident in Item E. IRIS 13 (or listing all three) was accepted, however.
- Schedule T as it was seen as providing information at too high of a level to be useful in this situation