

**MATERIALITY STANDARD**

There are numerous ways an actuary can establish his or her materiality standards, and examples are provided in the COPLFR Practice Note. Common methods are based on a percentage of reserves, surplus and movements in Risk-Based Capital (RBC) levels, among others. Materiality standards such as 10% of loss and LAE reserves or anywhere from 10% to 20% of surplus are commonly used. However, some actuaries establish materiality standards using a set dollar amount based on the actuary's particular knowledge of the company's operations. As an extreme example, for a company operating with limited surplus and/or under regulatory intervention, a deviation in loss and LAE reserves greater than \$0 might be considered material.

Regardless, there is no "one size fits all" in terms of formulaic materiality standards. The standard is based on the actuary's personal opinion as to what he or she considers material in relation to the company's reserves and surplus. As noted in Appendix 7 of the COPLFR Practice Note, "Although certain quantitative measures can be suggested for consideration in certain circumstances, no formulaic approach to a quantitative materiality standard can be developed."<sup>110</sup>

**Smith considered a deviation in net loss and LAE reserves of more than:**

1. 10% of net loss and LAE reserves, which he calculated as:

$$10\% \text{ of } \$51.557 \text{ million} = \$5.156 \text{ million}$$

2. 20% of policyholders' surplus, which he calculated as:

$$20\% \text{ of } \$31.024 \text{ million} = \$6.205 \text{ million}$$

Or

3. The reduction in surplus that would result in additional action per the NAIC RBC formula, which he calculated as the difference between the following:
  - ▶ The company's total adjusted capital of \$31.024 million,<sup>111</sup> which produces an RBC ratio of 559% based on authorized control level (ACL) RBC of \$5.552 million per the Five-Year Historical Data exhibit
  - ▶ Adjusted capital at the next RBC level of \$11.104 million, which is equal to two times ACL

<sup>110</sup> American Academy of Actuaries Committee on Property and Liability Financial Reporting, "Statements of Actuarial Opinion on Property and casualty Loss Reserves 2011," Appendix 7, "CAS VFIC Note on Materiality and ASOP No. 36: Considerations for the Practicing Actuary," page 77.

<sup>111</sup> Differences from above due to immaterial rounding errors that may occur in the Annual Statement.

Part IV. Statutory Filings to Accompany the Annual Statement

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The difference between \$31.024 million and \$11.104 million is \$19.920 million.

For purposes of establishing his materiality standard, Smith selects the smallest of the three balances, which in this case happens to be 10% of net loss and LAE reserves (\$5.156 million).

#### MAJOR RISK FACTORS

Once materiality is defined, the actuary determines whether there are significant risks or uncertainties that could result in material adverse deviation in the company's loss and LAE reserve. According to the NAIC instructions to the SAO, "If such risk exists, the actuary should include an explanatory paragraph to describe the major factors, combination of factors, or particular conditions underlying the risks and uncertainties that the actuary reasonably believes could result in material adverse deviation."<sup>112</sup> Examples of risk factors are provided in the COPLFR Practice Note.

Note that the actuary is not expected to list all risks that the company is exposed. Rather, only those major risk factors that could result in the reserves developing adversely by an amount that is material relative to the actuary's materiality standard. To illustrate, Smith identifies and provides details about major risk factors that materially affect the variability of the reserves held by Fictitious Insurance Company. The major risk factors identified are mass tort claims; so-called "Chinese drywall" claims; cumulative injury losses; claims from large deductible workers' compensation policies; and claims related to catastrophic weather events, including wildfires, tornadoes and hurricanes. The uncertainty associated with these types of claims adds to the variability in the company's recorded reserves.

#### RISK OF MATERIAL ADVERSE DEVIATION

The actuary is required to make a clear statement within the SAO as to whether or not there are significant risks or uncertainties that could result in material adverse deviation. That determination is based on the major risk factors identified by the actuary, the actuary's professional opinion of the variability inherent in the unpaid claim estimates and the actuary's materiality standard.

In the case of Fictitious, Smith concludes that there are significant risks that could result in the net reserve amount deviating adversely from that recorded by the company by a material amount. This conclusion was determined in part quantitatively, by comparing the distance between the company's net recorded loss and LAE reserve and the high end of Smith's range to his materiality standard.

As shown in the Smith's Actuarial Opinion Summary for the company, he has developed a range of reasonable unpaid loss and LAE claim estimates on a net of reinsurance basis of \$43

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<sup>112</sup> 2011 NAIC Annual Statement Instructions Property/Casualty, page 13.