

By Vince Amoroso and Dale Schuh

IN MAY 2004, SHELL OIL'S RESTATEMENT OF ITS OIL RESERVES played out in the popular press—including a series of articles in the *Wall Street Journal*. The company announced that it would revise its estimates of its oil and gas reserves downward by 20 percent to undo past overstatements.

In the first two months of 2004, the National Association of Insurance Commissioners (NAIC) registered 20 property/casualty and 13 life and health insurance company insolvencies. A.M. Best reports that in the property/casualty industry, for years 1969 to 2002, “deficient loss reserves, usually associated with rapid growth and inadequate pricing” were the primary cause of insolvency 54 percent of the time. Only 16 percent of insolvencies were attributable to fraud.

Like peas and carrots, an overstatement of oil company reserves goes together with an understatement of insurance company reserves. Both tend to present a better current financial position at the expense of future earnings when either the oil isn't there or benefits paid to policyholders are higher than expected.

Both insurance company and oil company professionals know that the process of setting aside reserves for future use is a complicated business. Historic data are analyzed, long-range assumptions prognosticating future events that can tax the most clairvoyant crystal ball are used, and a blizzard of calculations is performed to arrive at a company's year-end reserves and obligations.

Often, the companies bring in outside professionals to review the reasonableness of the data, assumptions, and methods used. In other cases, outside professionals perform their own calculations to estimate appropriate levels of reserves. Outside auditors, for their part, review an insurer's financials, including reserve levels. Nevertheless, even without “mistaken” calculations, the future usually refuses to play out as expected.

In instances where bad things happen, one would need to scrutinize the facts to gain an insight into whether affected companies' boards of directors were derelict in their duties. But in a milieu saturated with stories alleging accounting and other misdoings at Enron, WorldCom, and the like, a company's board of directors could be forgiven if it frets out loud, “Could this happen here, and will I be blamed?”

A board of directors has the right to rely on others when fulfilling its duties. When reviewing the reserves established by an insurance company, boards in general and audit committees in particular typically rely on the opinion of their appointed actuary. Nothing precludes the appointed actuary from being an employee of the company or of a consulting firm that derives a significant percentage of fees from the company. In both instances, however, a reserve review by an independent external auditor is in order.





Actuary On Board

**A disinterested
actuary on the board
of an insurance company
can go a long way toward
improving the quality
of its governance.**

Following these procedures, most board members may conclude that they've met their responsibility. But what are board members to think when they read reports from Standard & Poor's in which the ratings agency says that U.S. companies were understating reserves by billions of dollars? Similarly, FitchRatings, in a special 2003 report on property/casualty reserves, concluded that industry-wide property/casualty reserves are understated by \$46 billion to \$77 billion.

An Actuarial Assist

Often, in meeting its duty of care, a board can run into difficulties understanding the reserving process when reviewing a reserve opinion, even when the reserving techniques are fully articulated. Directors who were never deeply involved in the reserving process, for example, may not appreciate the magnitude of differences of estimated obligations calculated on a termination, projection, or ongoing bases of valuation. They may not appreciate the choice of a discount rate (if any). They may not appreciate the mortality table selected. They may be frustrated by the fact that reserve reviews are necessarily a continuing process as the future unfolds and assumptions are or are not realized.

An insurer's board that has no directors who have a working familiarity with the reserving process may well have difficulty gaining confidence that reserve levels selected by management and "approved" by the outside auditor are reasonable and sufficient. Given the facts at hand, one way to help achieve such confidence, if permitted under company bylaws, is to have an individual with an actuarial background as a member of the board.

Today, many insurers have actuaries sit on their boards. But we believe that with few exceptions these actuaries come from the company's senior executive staff or a closely aligned consulting arrangement. The insurer's CEO or CFO may be an actuary or the insurer's chief actuary, may sit on the company's board.

But what benefit could be gained from a skilled, disinterested individual with actuarial credentials, whether an EA, FSA, or FCAS? Could the boards of today's solvent insurance companies benefit from an independent director who is an actuary?

An Independent Perspective

By training and experience, most actuaries either are familiar with or can learn the process by which reserves at a given company are set. An actuary with an affinity for long-term thought, one who is accustomed to dealing with assumptions and recognizes that "certainty" is ephemeral, can help a board in its monitoring role. Accepted by the other board members as a member of their "independent" team, an actuary can assist the board in

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discharging its fiduciary obligations by asking relevant questions of both management and outside auditors concerning the reserves.

We don't believe that the actuary's product credentials (life and health versus property/casualty) have to align themselves with the products sold by the company. In fact, more value is added if a different perspective is used. We also don't believe it's the board's role to review, in an "actuarial checking" sort of way, the reserve calculations performed by in-house actuarial staff or outside consultants. That level of micromanagement would overstep a board's role of oversight in a way that would squander its limited resources of time and effort and expose the board to potential liability.

For any board of directors, asking the right questions is key. In his Feb. 21, 2003, letter to Berkshire Hathaway, Inc. shareholders, Warren Buffett makes a similar point: "The key job of the audit committee is simply to get the auditors to divulge what they know." His letter goes on to suggest questions an audit committee could ask the outside auditors to maximize the chances that the auditors have detailed what they learned. An actuary should be able to assist an audit committee in pursuing similar questions of the outside auditor and appointed actuary. Even where an insurer has no audit committee, an actuary could still assist its full board in discharging its duties.

Probing the outside auditor on its review of the insurer's reserves, including its specific findings, would tend to suggest the level of care used by the auditor for its review. Questions could be asked, for example, about what changes in actuarial assumptions were made in the past year and what effect those changes had on reserves and reported income. In those cases where the auditor doesn't undertake independent calculations to arrive at its estimate of required reserves, an audit committee might consider probing deeper.

Mandated Governance

In these changing times, the Securities and Exchange Commission (SEC), and the NAIC are promulgating rules to assure good governance. Good intent, however, often leads to onerous and costly regulations. Even the ancient Greeks recognized the folly of this approach. As Plato stated, "Good people do not need laws to tell them to act responsibly, while bad people will find a way around the laws." Regardless of how these related reforms shake out, the presence of an independent actuary on a board provides many benefits.

Most insurers aren't subject to SEC reporting requirements. But such requirements provide useful guidance even for those companies that aren't SEC registrants. Beyond assisting the

board with its oversight of the insurer's reserves, pricing processes, and benefit obligations, an independent actuary might be able to serve as a "required" financial expert on its audit committee pursuant to Sarbanes-Oxley. SEC rules describe independence criteria for audit committee members of listed companies. The two principal elements of these criteria are:

- The individual, other than in his or her capacity as a member of the board or any associated committee, cannot accept any consulting, advisory, or other compensatory fee from the company or any subsidiary.
- The individual cannot be affiliated with the insurer or any of its subsidiaries. The term "affiliated" is generally defined as having a financial control relationship, in either direction, with an organization.

As an aside, it should be noted that the SEC independence rules that apply to accounting firms are stricter than the corresponding ones that apply to actuaries. As food for thought, we believe that the Actuarial Standards Board should consider narrowing this difference.

An actuary's training and experience generally provide the individual with technical skills that would be helpful in serving on an insurer's board. Periodically, management describes reserve or pricing methods or strategies. We would expect that an independent actuary should be more facile in critically considering the contents of such presentations than non-actuarial board members. The same is true for considering the outside auditor's presentations of findings. An actuary would likely have a keener understanding of an auditor's presentation than board members who have a manufacturing or retail background.

Skills

To bring value to a board, an independent actuary should possess other attributes beyond technical expertise. Strong communication skills and a facility for long-range planning and thinking are critical.

The ability to communicate effectively to intelligent but non-actuarial board members is a must. The ability to ask questions that elicit responses from management and outside auditors that are comprehensible to such other board members is perhaps just as important. Earning the respect and trust of other board members is an integral part of becoming an effective member of that team.

A Valuable Experience

The value that an individual with an actuarial background brings to a board can be enormous. Conversely, an individual with an actuarial bent who likes talking, getting to know successful people from different backgrounds, and interacting with

senior company officials would likely enjoy the experience of serving as an insurer's outside director.

Unless an actuary has had experience in the specific segment of the insurance company's business, serving on its board will entail a learning curve. Learning the big picture of setting reserves for property/casualty products, which is qualitatively different from setting reserves for pensions or other life and health products, may take some getting used to. An individual who likes to learn will take pleasure from this aspect of the experience.

As for talking and interacting with other board members and senior company management, this is something many actuaries have had experience with. Consultants spend their careers doing this. Making presentations to clients, their chain of command, and, on occasion, their boards, is all part of the job. Actuaries who have worked in the insurance industry also have their workdays filled with these activities—reporting on results of their units and participating in work groups that report to senior management or the board are part of the routine. The important thing here is that the individual has enjoyed this aspect of his or her working life.

The choice of verb tense in the previous sentence is not accidental. Opportunities to serve as an independent director of an insurance company may be limited by current employment. Conflicts of interest are to be avoided if the full value to the policyholders and shareholders is to be provided. Actuaries who are independent could improve their chances for being considered to serve on an insurer's board by participating in industry and professional activities to enhance their visibility.

Conclusion

Companies' boards of directors are under increased pressure and scrutiny to discharge their responsibilities effectively. Actuarial skills are critical to the success of an insurance company. Similarly, such skills would add value to an insurer's board. Helping a company's board with its oversight of an insurer's reserving and pricing practices is an area where an actuary can assist.

More broadly, an actuary may be able to contribute to a board's oversight of long-term planning and related activities. Finally, an actuary who enjoys working on board matters with talented people, many of whom do not come from insurance industry backgrounds, will likely find the experience rewarding. And, the actuary might enjoy doing it. ●

VINCE AMOROSO is a consulting actuary in Washington, D.C. He has been on the board of Sentry Insurance, headquartered in Stevens Point, Wis., since April 2003. DALE SCHUH has been chairman of the board since 1999. There has been an actuary on Sentry's board since 1987.

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