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Why independence matters in actuarial services

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Selecting the right actuary is not always easy.

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Risk managers and the "C-suite" commonly engage an actuary to project future losses and liabilities of their insurance programs. When the actuary can accurately project losses and provide additional insight into the insurance program, there is an added return on the investment.

Selecting the right actuary is not always easy. Actuarial estimates are a complex process that require expertise and familiarity with insurance programs, especially self-insurance programs and alternative risk financing vehicles. It is critical for the actuary to have business sense and the ability to step back from textbook calculations, and to work with the understanding that any material change in actuarial assumptions and resulting estimates may impact the bottom line of a company.

There are various avenues in which actuaries are hired. Often a broker will have a client with a need and will recommend actuaries within its network. Sometimes this network will consist of an actuarial practice that the broker is a parent of or an actuarial department within the same firm as the broker. If the broker doesn't have actuaries on staff or believes in full independence, then the broker may reach out to an outside actuary for assistance for its client. Other times, actuaries may directly meet risk managers through conferences and other industry events or even through recommendations by other risk managers.

Actuarial expertise is important when working with an actuary but is not the only criteria that should be considered in the process. If you want to maximize your chance of having an actuary work entirely for you without any other agendas, independence definitely matters. When it comes to actuarial services, true independence isn't as common as you might think.

Sarbanes-Oxley: The catalyst of today's business environment.

Companies have extended the principles of SOX outside of auditors to encompass any and/or all consultants or vendors hired, including actuaries, to ensure full separation among all parties.

The Sarbanes-Oxley Act of 2002 (SOX) created new and expanded requirements for all U.S. public company boards, management, and public accounting firms. There are also some provisions that apply to privately held companies. Within SOX, top management must individually certify the accuracy of financial information. SOX increased the oversight role of boards of directors and the independence of outside auditors who review the financial statements of a company.

One key provision within SOX is to avoid any conflict of interest, whether actual or perceived. Many companies during the initial days of SOX ensured that all utilized vendors were truly independent and unbundled any services that may have been contracted through one firm into separate, unaffiliated firms. At the same time, some firms offering services that may have been perceived as conflicting (e.g., auditing, brokerage, and/or actuarial) sometimes split them off and focused on core competencies.

In Section 201, SOX states that it is unlawful for a public accounting firm to provide audit services contemporaneously with non-audit services including but not limited to actuarial services. Companies have extended the principles of SOX outside of auditors to encompass any and/or all consultants or vendors hired, including actuaries, to ensure full separation among all parties. The application of SOX principles can provide significant opportunities to management. Many companies value the different perspectives that several professional service firms and consultants can bring. Sometimes these viewpoints can be opposing but can provide knowledge and resources that allow management to make decisions in the best interest of the company.

Is your actuary truly independent?

When determining if an actuarial consulting firm is truly independent, a company may ask two simple questions. Is the actuarial firm a provider of another service to your company? Does the firm present any possible conflicts?

Actuaries in many different roles may interact with risk management and the C-suite. Let's take a look at where actuaries commonly exist in the insurance industry:

- Insurance company actuaries
- Insurance brokers with actuarial services offerings
- Accounting firms with actuarial services offerings
- Independent actuarial consulting firms

Most insurance companies have actuaries on staff to determine the proper premiums to charge policyholders. Larger insureds or policyholders typically will have large deductibles or self-insured retentions with their policies. The insurance company actuary's role is to determine the adequate premium to charge based on expected losses above the deductible or retained loss level. Sometimes when estimating these excess losses, the insurance company actuary may also calculate the deductible or retained losses and this may be shown to the policyholder. The insurance company's actuarial estimates are not necessarily unbiased. The insurance company is in business to make a profit, so the rates it derives will likely include loads for contingencies to protect itself.

The insurance company's actuary may also produce actuarial estimates to support the collateral the insurance company requires from its insureds. The insurance company has a vested interest in ensuring that the collateral is adequate, and therefore its actuary's estimate is usually not a true expected value. Again, the estimate would often include a loading or margin for adverse contingencies. If the insured was to book the collateral estimate prepared by the insurance company actuary as its balance sheet reserve, there is a high likelihood that it may be overstated.

Insurance brokers with actuarial service offerings are a critical component in the relationship between large corporate insureds and sophisticated insurance companies. The insurance broker's actuaries can be trusted advocates, helping the corporate insureds quantify the cost-benefit relationship of taking on additional risk through higher retentions. Additionally, the insurance broker's actuaries can be very beneficial in collateral negotiations with the insurance companies. It can ease the negotiation process to have the insurance company actuary explain and defend the company's excess premiums or collateral position to the insurance broker actuary and then have the insurance broker actuary advocate for clients to lower excess insurance cost and collateral requirements, should the client's historical loss experience justify such a position.

The role of the insurance broker's actuary is to offer support to the broker. The broker may have a vested interest in helping its client lower the cost of risk by obtaining slightly aggressive but reasonable actuarial estimates (i.e., toward the lower end of the expected range of reasonable outcomes) that help procure lower excess premiums and less collateral for the client. However, while aggressive estimates may be beneficial for certain purposes, they may not be appropriate for budgeting or setting up balance sheet reserves. Such estimates could potentially understate the true underlying risk, resulting in possible future increases.

In addition, some brokers that own actuarial firms may only recommend their internal actuarial service resources as a way to initially get a foot in the door. However, the end goal may be to eventually obtain the more lucrative brokerage services. This too causes a conflict that can be avoided.

The larger accounting firms have their own actuarial departments. The main job the actuary at an accounting firm has is to confirm the reasonableness of the actuarially determined reserves as part of the audit process. They usually will conduct some reasonability tests and review the actuarial calculations supporting the carried reserves on a company's financial statements. The actuary will then create a range of "reasonable results" within which a company can book. The issue potentially with this range is that it can tend to be rather large and can create false confidence for a company, because the company won't know if it is on the low side or high side of the audit-presented range. In addition, some accounting firms have actuaries that offer consulting services. These services may not be truly independent because the targets are often the same clients of the accounting or audit services. Thus an inherent conflict may exist.

When an insurance company, broker, or accounting firm acknowledges a conflict of interest, it will likely recommend that a client retain an independent actuarial firm for assistance. A company should also want to preserve full transparency and have unbiased financial statements and thus should engage an independent actuarial firm.

When determining if an actuarial consulting firm is truly independent, a company may ask two simple questions. Is the actuarial firm a provider of another service to your company? Does the firm present any possible conflicts? It is critical that a company takes its time and does its homework on an actuarial consulting firm, because this firm should be engaged on the

premise of becoming a long-term partner. Actuarial services are a specialized craft often taking several years of experience to attain the requisite expertise. Management should ensure that the actuarial consultant has business sense and is able to clearly communicate. Seeking an independent actuarial firm is not only smart business but may be considered an appropriate fiduciary responsibility.

What benefits can your independent actuary bring?

The right independent actuary can become a value-added service provider for the company.

Management should seek an independent actuary that understands and has experience in its business sector and specific coverage exposures. Not all actuarial models work on certain lines of coverage, which is due to the intricacies of some coverages, and therefore actuarial models must be tailored to the exposures of each company. Once management has obtained the right actuarial expert, it is time to reap the benefits that independent actuarial services can offer:

Financial reporting: Often an actuary will estimate the loss reserves for accrual purposes, which consists of known case reserves and incurred but not reported (IBNR) losses. The IBNR will be estimated by the actuary without any bias, which will help ease the mind of the auditor and company management. In fact, some auditing firms request that the actuary send a statement declaring any conflicts of interest when preparing the actuarial report. In addition, the actuary can project next year's losses (again without any bias) to help for preparing budgets. If a company has a captive, it is best to have the actuarial services separate from other service providers in the captive. This will help ensure adequate funding with no influence from outside parties. An overfunded or underfunded captive can cause significant problems for the insureds, parent, and regulators. An independent actuary can also conduct a proper, unbiased captive feasibility study and provide feedback to an organization wondering whether a captive even make sense for a company, again with no influence from outside parties that may have other agendas.

Insurance decisions: Management will receive the right advice regarding its optimal insurance structure, and help in important negotiations on premiums and/or collateral. An independent actuary will be able to model losses at different retentions to show management the variability of the losses and potential savings of costs by switching to a different retention. The actuary can also model how much insurance should be purchased so that a company has appropriate protection. Having the independent actuary and the broker's actuary run parallel insurance scenario studies provides management with multiple perspectives on the costs and benefits of retaining additional layers of risk. The independent actuary's results can be shared with the broker's actuary and can also be used for premium negotiations with the insurance company's actuary. Sometimes, because the actuary is independent, the insurance company may be more likely to give credit to the results. The independent actuary can discuss the results with the insurance company because there is no connection. The actuary can also provide an independent estimate of any collateral requirement. Negotiations between the insurance company's actuary and the company's independent actuary are usually well received when there are no conflicts of interest.

Business decisions: There are critical times when a company needs full independence. Going through a merger or acquisition is one of those times. Management requires an unbiased estimate of the liabilities and exposure of the company being acquired or divested. Prior to a potential acquisition of a new company an actuary can be hired to provide helpful input to management regarding the underlying risk. The risk can be stress-tested under different scenarios such as if previous habits continue or if new risk management (i.e., safety initiatives) results in loss improvements. These scenarios can be very useful when risk management is talking with the C-suite. There may also be times when a company wants to consider a new operation or may be offering a new product to customers. The actuary can provide a cost-benefit analysis to see if the proposed offering matches the company's long-term goals and risk profile. In fact, an actuary is often invited to strategic planning conversations and can be valuable during any litigation and arbitration support.

Risk management: An independent actuary can be a risk manager's valued partner. The actuary can provide an allocation of premium or liabilities to divisions or entities. Because the allocation is determined by an outside party, it is usually more easily accepted by all parties. This also helps to create more time for risk management to focus on higher priorities. The actuary can also provide in-depth safety studies that help determine loss drivers. When presenting such results to the C-suite, independence can be important because these studies often show the effectiveness of risk management. An outside look may reveal new insights into areas where there could be opportunities for improvement. The actuary can also provide industry benchmarks to a program. When benchmarking, it is important to convert the benchmark statistics into terms of the company's exposures. Adjustments should take into account changes for retentions, jurisdictions, frequency trends, and severity trends. An appropriate benchmark helps management compare the insurance program with peers.

Trusted advisement: As a trusted adviser, the independent actuary can provide actuarial services and help create and implement strategic initiatives. The actuary can provide verification to the company about risk management practices. Management can rely on the expertise regarding actuarial needs and even non-actuarial needs. The independent actuary will often be fully integrated into the company's risk management and finance team and may be relied upon at all times of the year. When working with an actuary it is a best practice to have frequent conversations, before, during, and after any actuarial work. Make sure the actuary understands the scope of the analysis. Management should meet with the actuary in-person and request a list of the drivers and changes in results. Management should also try to best understand the analysis and assumptions and challenge the actuary and ask questions. Through this process, both sides will understand each other's view better, which will lead to more fruitful analysis and action plans by risk management. An independent actuary will be able to share additional viewpoints to risk management and the C-suite outside of the other consultants utilized by the company. The right independent actuary can become a value-added service provider for the company.

The following are key attributes of a trusted adviser:

- Understands the client
- Is consistent (can be depended on)
- Provides fresh perspectives and historical experiences
- Helps the client think things through by separating logic from emotion
- Challenges status quo and current practices by uncovering areas for opportunity
- Is honest and tells the truth at all times
- Is intelligent and friendly
- Is motivated to bring success to the client and looks out for the client's best interests

What are other risk managers in the industry saying?

The following are thoughts and considerations from industry peers about actuarial independence:

"To retain control over the insurance placements, independent actuaries are needed as a counter force to the brokers and underwriters who might not have the same goals as a risk manager." Peter Rosiere, VP Risk Management, Sodexo, Inc.

"We value the actuary as a partner with our risk management program. Clear communication, without any hidden agenda, has always been important to us." Joshua Hardwood, Director Risk Management, Telephone and Data Systems, Inc.

"Different insights from independent and objective perspectives have allowed me to holistically better evaluate our risks and focus my time on risk management. Separate viewpoints create additional validation and even a new way of thinking." John Kline, Director Risk and Insurance Management, Discover Financial Services

"We use actuarial estimates on a regular basis to guide our strategic decisions. Using an independent actuary with no possible conflicts adds to the credibility of the numbers. This is a key value when working with executive leadership." Daniel Conner, VP Risk and Insurance, Franciscan Health, Inc.

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Richard and Tony specialize in property and casualty insurance. Their clients include Fortune 500 corporations, public entities, healthcare institutions, privately held companies, commercial insurers, and risk-retention groups.

Milliman's Chicago office completes actuarial studies each year for over 100 self-insured/large-deductible clients. Our history of quality and thoroughness is recognized throughout the industry. The Chicago office of Milliman understands the common issues among self-insureds such as incomplete data and changes in exposures or management style, as well as other actuarial issues such as the impact of large losses, change in reserving philosophy, and getting credit for risk management. We work with our clients as partners and approach each assignment with objectivity and full transparency. We differentiate ourselves through our combination of *independence, communication, experience, technical ability, client service and peer review.*

Milliman is among the world's largest independent actuarial and consulting firms. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe. Milliman is the partner of choice for property and casualty (P&C) risk analysis. Built from our traditional strength as a premier actuarial adviser, Milliman consultants retain an unbiased view, global and local perspectives, and a focus on providing clients with high-quality services.

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Milliman has a strong ethic of peer review that is employed in any project that is undertaken. This process requires a secondary review of the work performed, reports prepared, and overall project management. The reviewer is selected as someone familiar with the project, but who has not performed significant work on the specific project. This allows for impartial review and the opportunity for additional insights. The review is structured to identify any outstanding issues that were not addressed, to ensure that the information is presented in a logical and complete manner, and to ensure that the overall quality of the work meets Milliman's high standards. This process adds an additional level of security for our clients.

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