20. (3 points)

Given the following information, identify four ways in which the AA likely did not follow the appropriate standards of practice or educational guidance and describe what the appropriate action should have been in each instance.

An AA for a federally-regulated property and casualty insurance company prepared the calculation of premium liabilities associated with the unexpired portion of in-force insurance contracts. The company had no swing-rated policies or inter-company pooling arrangements, but had implemented rate decreases on all lines within the last three months.

First, she collected the following elements and included them in her analysis:

- Unearned premium reserve
- Deferred policy acquisition expenses
- Unearned (ceded) commission
- Deferred tax assets
- Expected adjustments to premiums as a result of audits, late reporting and endorsements
- Expected commission adjustments on policies with variable commissions

Next, the AA determined the future claims and adjustment expenses associated with the unearned premium. For most lines of business, the AA selected future expected loss ratios using the valuation of claims liabilities. However, for two specific lines of business, she used a separate ad hoc analysis. Some expected loss ratios were adjusted to the future period during which the unearned premium will be earned, while the rest were kept at the historically observed levels.

When the AA discounted the expected losses and adjustment expenses associated with the unearned premium, the AA used the same discount rate, payment patterns and discounting periods that were used for the claim liabilities. Most MfADs were also the same as those used for the claim liabilities. For two lines of business, however, the MfADs differed materially from those used for the claim liabilities. No discounting was applied to the maintenance expenses or future reinsurance costs as it was not deemed material.

The AA calculated a positive equity in the unearned premium, as follows:

Net unearned premium
+ Unearned reinsurance commissions
- Premium deficiency
- Net policy liabilities in connection with unearned premium

<< QUESTION 20 CONTINUED ON NEXT PAGE >>

As the equity in the unearned premium was lower than the DPAE, the AA set up a premium deficiency equal to the difference. This amount was booked as a liability in the company's P&C Annual Return, page 20.20.

As the AA prepared the final report, she became aware of two potential subsequent events: a calculation error and a court decision that would affect claim costs.

The AA determined that the calculation error was not material since its size would not affect the decisions of senior management or the directors of the company. If it had been material, the AA determined that it would have required adjustment in her work.

The court decision occurred before the calculation date and was determined to be material. The court decision made the entity different, and the purpose of the work was to report on the company as it was at the calculation date. The AA described the event in the report, but did not reflect its impact in the work.

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QUESTION 20	
TOTAL POINT VALUE: 3	**LEARNING OBJECTIVE(S): C1**

SAMPLE ANSWERS

<u>Sample 1</u>

- The calculation formula for equity in unearned premium is wrong. It should be Net Unearned Premium – Net Policy Liability + Unearned Commissions + Premium Deficiency
- When the equity in unearned premium is lower than the DPAE, the AA should reduce the DPAE to the equity in unearned premium, not book it as a premium deficiency. Premium deficiency is only booked when the equity in unearned premium is negative.
- The AA should reflect the court decision in her work instead of only describing it because the court decision occurred before the calculation date and was material.
- Discounting periods for premium liabilities should not be the same as claim liabilities. The AA should adjust the discounting period to account for the average accident date of the UPR.

<u>Sample 2</u>

- As there was a rate decrease recently for all lines of business, the AA should adjust all expected loss ratios to the future period, not leaving some at the historical observed levels.
- The AA included deferred tax assets in her analysis of premium liabilities. These should not be included in a premium liability analysis so she should exclude them.
- The AA considered only senior management and directors when determining materiality of the calculation error. All users of the report should be considered when determining materiality.
- The formula of equity in unearned premium is incorrect. It should be MAX(0, Net Unearned Premium – Net Policy Liability + Unearned Commissions)

EXAMINER'S REPORT

Candidates were expected to know the CIA standards of practice and educational guidance regarding premium liabilities valuation.

Common errors included:

- Stating that the actuary's work must be adjusted for the calculation error even though it was not material.
- Stating that MfADs must be the same for premium liabilities and claim liabilities.