



AMERICAN ACADEMY *of* ACTUARIES

M E M O R A N D U M

To: Mr. Bert Horowitz, Chairperson, Task Force on Reserving Principles,
Casualty Actuarial Society

From: Committee on Property and Liability Financial Reporting (COPLFR),
American Academy of Actuaries

Subject: Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment
Expense Reserves

Date: 5/30/05

COPLFR is pleased to submit the following comments in regard to the draft “Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expenses Reserves.” COPLFR wishes to express its appreciation to the Task Force members for their hard work and dedication in preparing the draft Statement.

We concur with the Task Force’s comments that much of the existing Statement contains language better suited for a Standards of Practice document. We also appreciate the additional discussion in the draft concerning reserve uncertainty and reserve ranges. With these understandings we offer the following for your consideration:

Introduction

The sentence “*Loss reserves are utilized for a variety of purposes, including financial reporting, valuation, commutation and ratemaking*” appears to define reserving contexts, rather than serve as an introduction. We suggest that it be removed, or moved to the context section.

Section I – Definitions

Loss and Loss Reserves

The Task Force should consider the inclusion of the five loss reserving elements from the current Statement. These elements appear to fit better within a Principles document than within a Standards document, and add an important educational component for the reader.

Dates

The Task Force may wish to revisit the inclusion of valuation and review date in this section. Discussion of these dates may be more appropriately addressed in a Standards document.

COPLFR suggests that additional discussion be included concerning the loss or “trigger” date and its relation to the accounting or “reserve” date. The Task Force may wish to consider language contained in SSAP 5 or SSAP 55 for guidance. For example, SSAP 55, Section 4 states:

“Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs...”

Final Settlement

The definition of final settlement should be revised to recognize that it applies to the contracted liability. An insurer can reach its final settlement with an insured, long before the insured reaches its final settlement with a claimant.

Section II – Context

It is our understanding that “context” refers to the environment or “purpose” surrounding the presentation of a reserve, while “considerations” reflect those items the actuary should consider in developing their estimate. The Committee may wish to include a statement such as, “Reserves should be evaluated based on the context of their use.”

As previously noted, the introduction to the draft states that *“Loss reserves are utilized for a variety of purposes, including financial reporting, valuation, commutation and ratemaking.”* COPLFR believes that this statement generally addresses the contexts in which loss reserves are presented. Items #1 and #4 within the draft appear to be more like considerations than context, and would be better suited for discussion in a Standards document.

The document should also make mention of the applicable laws and accounting principles under which the reserves are being presented. For example, several foreign accounting standards require reserves to be presented at higher than expected confidence level, while still others have prescribed methodologies for the calculation and presentation of reserves under local statutory guidelines.

Finally, the wording of this section would suggest that the contexts listed make up the universe of possible contexts. Was this the intent? If not, COPLFR would suggest additional wording to suggest that though these are the most relevant contexts, there may be additional contexts in which loss reserves should be considered.

Section III – Principles

Inherent Uncertainty

The draft language seems to imply that the uncertainty inherent in an estimate is dependent solely upon events occurring subsequent to the valuation date. This appears to exclude the uncertainty resulting from such factors as operational and legal changes that may have affected the loss information on which the actuary is relying. The Task Force may wish to consider the inclusion of language such as:

“In addition, the uncertainty in the actuary’s estimate may be increased due to factors underlying the insuring or insured entity’s loss history. Such factors may include (but are not limited to) operational changes, staffing level changes, underwriting changes, legal changes, etc.”

The Task Force may wish to note, *“The events of the past are not always reflective of the future.”*

Range of Reserves

While it is true that the uncertainty inherent in the reserving process implies that different amounts within a range of reserve estimates can be reasonable, it is also true that ultimate results outside of the range are possible. More importantly, such results do not necessarily call into question the quality of the underlying actuarial analysis. COPFLR believes that this possibility should be explicitly identified in the reserve range section.

Selection of Loss Reserve

The draft states that the *“selection of a loss reserve from within a range of actuarially reasonable loss reserves depends upon the relative likelihood of the estimates...”* This statement seems to imply that the actuary must consider the frequency of possible outcomes within their range, or the “mode,” even though the draft previously states that a range of outcomes can be reasonable. Should the Task Force wish to maintain this statement, we suggest it be revised to read:

“The selection of a loss reserve from within a range of actuarially reasonable loss reserve estimates depends upon the context in which the loss reserve is to be presented, and other considerations in the development of the estimate. It is therefore possible for the recorded reserve to differ from the actuary’s selection and still be reasonable.”

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COPFLR has appreciated the opportunity to review the draft Standard. Our comments are meant to be interpreted as suggestions and/or observations, not as criticisms. Please do not hesitate to contact us should you have any questions concerning our response.

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