AMERICAN ACADEMY *of* ACTUARIES

November 16, 2012

Via email to: kdefrain@naic.org

James J. Donelon
Chair, Casualty Actuarial and Statistical (C) Task Force
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

RE: Issue 2012-16: Actuarial Calculation of Death, Disability or Retirement Reserve

Dear Commissioner Donelon:

The Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries[1] respectfully submits the following comments on the proposed changes to SSAP No. 65 for your consideration. Our comments are, in part, based on a review of the August 23, 2012 memorandum from Joe Fritsch, chair of the Statutory Accounting Principles (E) Working Group (SAPWG), relating to the proposed changes.

We understand that the goals of the proposed revisions are:

(1) Improve consistency in accounting and reporting of the Death, Disability and Retirement (DDR) reserve; and

(2) Allow the use of additional actuarial methods that may provide alternative but equally acceptable representations of the DDR reserve obligation.

We believe that the proposed revisions would result in fundamental changes to the definition of the DDR reserve and, if implemented, will have the following unintended consequences:

- The traditional reserving approach would not be allowed; and
- Imposition of a requirement to carry significantly higher liabilities for DDR reserves, due to the elimination of consideration of future premiums.

In addition, the different approaches to the accounting and reporting of the DDR reserve, all of which estimate different quantities, are based on different representations/definitions of the DDR reserve. Without further study, it is not clear whether the different quantities estimated by each of the approaches represent equally acceptable representations of the DDR reserve. The stated goal of allowing these specific actuarial methods may conflict with the stated goal of improving

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

consistency in accounting and reporting. We believe further review is needed to understand the potential financial impact of the use of the different approaches.

The various approaches under consideration are as follows:

- Traditional Approach—in most cases, measures the difference in the net present value of the loss and loss adjustment expense (LAE) under future-issued DDR coverage and the net present value of expected future DDR-related premium to be collected on in-force policyholders.
- Unreported Claims Approach—measures the nominal amount of loss (and LAE) dollars associated with unreported claims on occurrences through the evaluation date and reflects credit for on-going claims to be reported under claims-made coverage. This approach therefore includes only those claims that are expected to be reported under a future-issued DDR endorsement to in-force policyholders.
- Market Withdrawal Approach—the loss and LAE dollars for claims covered under the DDR endorsements issued to current in-force policyholders as of the evaluation date through the expiration of their current policies (for a maximum of 12 months), including covered claims occurring after the evaluation date. According to the August 23 memorandum, the result is booked on a net present value basis without consideration of future premium.

Based on recent discussions with staff and our reading of the August 23 memorandum, it is our understanding that the SAPWG does not intend to change the definition of the DDR reserve obligation. The current definition was designed to be consistent with the obligations of the DDR provisions typically associated with medical professional liability claims-made policies.

COPLFR believes that the proposed revisions and goals have the following implications:

- The various approaches are not different methods representing the same liability but, rather, different approaches measuring materially different definitions of a DDR reserve requirement.
- With different exposures potentially measured through different approaches, there would be less consistency from company-to-company, not more, in the estimation and reporting of the DDR reserve.
- The current SSAP No. 65 and Issue Paper 65 related to DDR do not, in our opinion, prescribe a single method, but, rather, a set of factors and relevant considerations to be made in the development of the DDR. There are several methodologies available for determining the DDR reserve within the Traditional Approach.
- An important goal of the current statutory guidance is to match revenues and expenses associated with this coverage using techniques drawn from life insurance practices. The Unreported Claims Approach moves away from this goal.
- The current SSAP No. 65 does not specifically allow discounting for this reserve, although Issue Paper 65 does include consideration of the time value of money. We agree that discounting is an appropriate consideration of the DDR reserve and that language explicitly allowing discounting of the full loss and LAE or unearned premium liability of the DDR reserve, rather than implying its use, would clarify what is permissible.
- The Unreported Claims Approach or alternative methods are not clearly authorized in the proposed revisions, although the background and goals imply an intent to allow them. As stated above, however, the Unreported Claims Approach will measure different liabilities

than the Traditional Approach and thus may lead to greater inconsistencies and a very different definition of what the DDR reserve represents.

- The Market Withdrawal Approach is inconsistent with a going concern accounting philosophy.

Conclusions

If the SAPWG does not intend to revise the scope, definition, or representation of the DDR reserve obligation, we recommend no change to Issue Paper 65 and SSAP No. 65 paragraphs 4—9, 11, and 12. We recommend explicitly authorizing that the full DDR reserve may be calculated using provisions for the time value of money (discounting). This would still require modification to the proposed SSAP No. 65 Paragraph 10, as that revised paragraph only addresses discounting of the loss reserve portion. Because the DDR is a portion of the unearned premium reserve, including discounted loss and discounted LAE, it is our opinion that discounting is appropriate for the full DDR liability.

If the SAPWG desires changes in the definition or representation of the DDR reserve obligation, we request additional information regarding that change to provide further perspective on the applicability of different methods and the financial impact of such a change.

<u>Additional Details Supporting the Comments above</u>

<u>The Current Definition and Traditional Approach</u>
The current NAIC accounting guidance is included in SSAP No. 65, paragraphs 4-12 and Issue Paper 65, Paragraph 41. Within SSAP No. 65, the DDR reserve is defined as follows:

> Some claims-made policies provide extended reporting coverage at no additional charge in the event of the death, disability, or retirement of a natural person insured. In such instance, a policy reserve is required to **assure that premiums are not earned prematurely**. **The amount of the reserve should be adequate to pay for all future claims arising from these coverage features, after recognition of future premiums to be paid by current insureds for these benefits**. The reserve, entitled "extended reporting endorsement policy reserve" shall be classified as a component part of the unearned premium reserve considered to run more than one year from the date of the policy. (emphasis added)

While an extended reporting endorsement may be issued at no additional charge, this does not mean that the coverage afforded under the extended reporting endorsement is free. Rather, the claims-made premiums paid annually by each insured include a provision to fund the claims expected to be insured in the future under yet-to-be-issued extended reporting endorsements. Under this "level funding" approach, a portion of the annual premiums for all insureds is used to fund the cost of extended reporting endorsements that will be issued in the circumstances of death, disability, or retirement.

The ***current*** reserving principle for DDR may be summarized as follows:
Current Liability = Present Value of (Cost of Future DDR Claims – Future Premiums)
The liability for DDR policies is for all claims that will ultimately be insured under DDR policies when issued, regardless of whether they have yet occurred, and an offset to the liability is allowed for future premiums that will be collected to fund this expense.

Issue Paper 65, Paragraph 41, details the factors that should be considered in estimating the reserve. These factors provide more detail regarding elements that should go into the evaluation of the reserve, but they do not prescribe a single methodology. Actuaries are able to utilize various methods that meet the intent, spirit, and details necessary to project this reserve.

The SAPWG's **proposed revisions** result in a reserving principle that may be described as follows:
Current Liability = Present Value of Cost of Future DDR Claims
The effect of the proposed changes would be to require insurance carriers to establish a claim liability for all claims that will ultimately be insured under DDR policies issued to current policyholders, regardless of whether the claim has occurred and **with no recognition that a portion of the claim liability will be funded with premiums that are yet to be collected.**

Because of this change, the proposed language would require significantly higher DDR reserves than under the Traditional Approach because it disallows the reduction for the present value of future premiums to be collected.

The Unreported Claims Approach

The Unreported Claims Approach estimates the liability only for claims that have occurred as of the evaluation date and that will ultimately be insured under a DDR policy issued to a current policyholder. This approach gives credit for reported claims on future claims-made policies issued prior to the DDR but does not add new occurrences that will be included in the coverage at the time of future DDR issuance, nor does it include the time value of money or premiums to be paid over time.

The Unreported Claims Approach represents a small subset of the claims and associated loss and LAE within the Traditional Approach. The Unreported Claims Approach does not apply credit for the time value of money or the collection of premiums over time. Due to these differences, the Unreported Claims Approach is measuring a different representation of the DDR liability than the Traditional Approach. More direction from the NAIC as to a new definition of the DDR liability would be needed before we could evaluate the merits of the Unreported Claims Approach within that context. Additionally, more review is needed to determine or value potential financial impacts associated with the Unreported Claims Approach or any change in definition of the DDR reserve.

The Market Withdrawal Approach

The Market Withdrawal Approach estimates the liability only for claims that will be insured under DDR endorsements issued in the next 12 months, related to in-force policies at the evaluation date, regardless of whether or not the claim has yet occurred. This approach can also be thought of as estimating the liability for all future claims to be insured under DDR policies, with an offset allowed for claims that will be insured under DDR policies issued more than 12 months after the evaluation date.

The Market Withdrawal Approach seems inconsistent with statutory accounting principles that appear to favor insurance company valuations on a going concern basis, as well as the concept of matching revenues and expenses.

Other Approaches

Additional or alternative methods may be reasonable and appropriate in certain circumstances. The current accounting standard, for example, states that a policy reserve is required “to assure that premiums are not earned prematurely.” This in itself suggests that, assuming level-funding of the exposure over time, it would be reasonable to estimate the policy reserve as a percentage of the earned premium, particularly for start-up entities. It should be noted that this approach is not within the current SSAP No. 65 and Issue Paper 65 guidelines.

We appreciate the opportunity to comment on the proposed revisions, and we hope you find these comments helpful. If you have any questions about our comments, please contact Lauren Pachman, the Academy’s casualty policy analyst, at pachman@actuary.org.

Sincerely,

Dale Ogden, ACAS, MAAA
Chairperson, Committee on Property and Liability Financial Reporting
American Academy of Actuaries