



AMERICAN ACADEMY *of* ACTUARIES

November 12, 2002

Mr. Jon Michelson, FCAS, MAAA
Chairperson
Committee on Reserves
Casualty Actuarial Society
1100 North Glebe Road, Suite 600
Arlington, VA 22201

Dear Jon:

Thank you for the opportunity to provide initial input to your project to update the Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves. After reviewing the existing document, we would suggest the following areas may merit your attention:

The American Academy of Actuaries'¹ Committee on Property and Liability Financial Reporting (COPLFR) has noted, as we expect you have, that whatever new statement of principles might be developed needs to be consistent with other actuarial standards and pronouncements. For example, Actuarial Standard of Practice (ASOP) No. 36, recently introduced, discusses/defines such items as credibility and homogeneity of data, materiality, etc. The P&C statement of loss reserve opinion practice note discusses what constitutes a reasonable range.

It may help the document's readability to highlight terms later defined in the definitions section or endeavor to define terms before they are used. The term "incurred" for example is used in several contexts in the document and incurred losses are never defined.

The treatment of incurred but not reported (IBNR) appears to need refocusing:

- The emphasis on explicitly allocating reserves between "pure" IBNR and case development should be reduced. While this is an important theoretical concept and is useful in understanding the IBNR phenomenon, it is rarely a significant operating issue for insurers and virtually never one for self-insurers.
- The discussions of the various possible classifications of reserves, *e.g.* case reserves, IBNR, and reopened reserves, and how they might relate to one another on pages two and three are confusing and need to be clarified.

The statutory definitions of what constitutes allocated loss adjustment expense and unallocated loss adjustment expense (ULAE) have changed and as an offshoot, the names of these areas have been

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changed to Defense and Cost Containment and Adjusting and Other. In addition to incorporating the new definitions, you may have to note that the statutory concepts may differ from those used in other areas of the operation, *e.g.*, in retrospectively rated or reinsurance contracts, and that the older titles may persist.

Statutory treatment of salvage and subrogation has changed.

There is very little discussion of the issues in Adjusting and Other reserving in the document.

The discussion on Pools and Associations may need to be revised to reflect opinion requirements.

Recognition of the existence of claims made coverage may need to occur earlier. For a large part of the document, the entire discussion of reserves assumes an occurrence policy. Some general comments are needed near the beginning of the document to put the reserve discussion in the appropriate context. Also, perhaps some mention should be made that an entity that purchases claims-made coverage may need to establish a reserve for IBNR claims.

The fourth principle on page four says reserves should be evaluated within the financial reporting contexts in which the reserve is presented. In the sentence directly following, it states that "the same principles apply in each context in which the reserves are stated."

The sentence in the first page beginning "The accounting date is the date. . .," should be changed to remove the word "insured."

The section on Provision for Uncertainty appears to need refining. For example, it appears to indicate that adding a margin for uncertainty to a reserve amount to be discounted is optional. ASOP No. 20 says "The actuary should be aware that a discounted reserve is an inadequate estimate of economic value unless appropriate risk margins are included." Also, this paragraph implies that margins are less appropriate for shorter tailed lines. Health insurance reserves often have explicit safety margins built in. Statutory accounting may require these margins in many instances.

The following topics would appear to be candidates for addition to the document:

- Reserving for mass torts
- Emergence of latent liabilities/retroactive redefinition of coverage
- Treatment of hyper-inflation (as more actuaries operate in the international arena)
- Treatment of coverages not denominated in US currency (we will forward a white paper completed by COPLFR in the late 1990's)
- Reserving for securitized/indexed coverage
- Exposure modeling
- Risk transfer considerations and how they affect reserves
- Using proprietary models
- Reserving for catastrophic/extreme events
- Ceded reserves
- Net reserves

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There is no discussion of "best estimate" or and very limit discussion of ranges of reasonable estimates in the current document. This may be appropriate, as these items appear to fall more into the "reserving practices" rather than the "reserving principle" area. If these topics are added, some discussion about aggregating such estimates is also probably in order. For example, is a "best estimate" for a book of business the sum of "best estimates" for each line of business within that group? As noted above, any such discussions need to be consistent with discussions in standards that already exist.

COPLFR appreciates the size and importance of the task the Committee has undertaken. We would be happy to assist the Committee as it progresses. Our group and its members may particularly be of help in reviewing proposed drafts or in assisting in crafting wording in specific areas.

We look forward to following the Committee's progress in the coming months. Thank you for your consideration. If you have any questions or would like more information, please contact Greg Vass, the Academy's senior casualty policy analyst, at (202) 223-8196.

Sincerely,

Andrea Sweeny, FCAS, MAAA
Chairperson
Committee on Property and Liability Financial Reporting
American Academy of Actuaries