



AMERICAN ACADEMY of ACTUARIES

Objective. Independent. Effective.™

July 10, 2014

Via email to kdefrain@naic.org

Rich Piazza
Chair, Casualty Actuarial and Statistical (C) Task Force
c/o Kris DeFrain, Director, Research and Actuarial
National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Comments on the Proposal to Change the Basis of Insurance Regulatory Information System Ratios 11, 12, and 13

Dear Rich:

The Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries¹ appreciates this opportunity to provide feedback to the National Association of Insurance Commissioners' (NAIC) Casualty Actuarial and Statistical (C) Task Force (CASTF) on proposed changes to Insurance Regulatory Information System (IRIS) Ratios 11, 12, and 13.

Background

As you know, last September, the Financial Analysis and Research Development (FARD) (E) Working Group requested that the CASTF examine proposed changes to the basis for calculating IRIS Ratios 11 (One-Year Reserve Development to Surplus), 12 (Two-Year Reserve Development to Surplus), and 13 (Current Reserve Deficiency to Surplus) to include all loss adjustment expenses (LAE). Currently, the "reserve ratios" are based on loss and defense and cost containment (DCC) expenses. The proposal would revise the IRIS ratio formulas to also include adjusting and other expenses (A&O). The CASTF has reviewed the proposed calculations and requested feedback on its findings.

COPLFR is responding to CASTF's request for comments on the proposed changes. Our remarks address the benefits and drawbacks of the proposal, the impact of the proposal on insurers, the results of research conducted using publically available data, and some commentary on A&O expense allocation.

¹ The American Academy of Actuaries is an 18,000-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.

Observations

1. About two-thirds of COPLFR's members recommended no change. One reason for that position was the small effect on insurers as a whole. The remaining third was split between (a) making the proposed change and (b) designing a way to use both the current formula for the IRIS ratios along with the new formula. The members of the group who favored making the change did so because, among other reasons, they believe it will reveal an area in which companies under-serve. Members cited anecdotal evidence of such under-reserving, and they believe the benefit of revealing under-reserving outweighs the drawbacks of making the change.
2. To assess the effect such a change would have on insurers, we calculated IRIS Ratios 11 and 12 including and excluding A&O using data from the 2012 and 2013 Annual Statement filings. The results of this analysis are provided later in this letter. The results indicate that a small number of the approximately 1,370 insurers in each year would have changed their status, from having or not having an unusual value for the ratio to the opposite.
3. Using the same set of data, we analyzed the extent to which, if the proposal was approved, companies could manipulate the IRIS ratios by altering the allocation of A&O reserves by loss year on Schedule P. We found that approximately 15 percent of the companies with an exceptional value for IRIS Ratio 11 could have a change in that status.
4. In considering the potential for manipulation of the allocation of A&O to accident year, we found ambiguity in the Annual Statement Instructions related to allocation of A&O to loss year. We have included a further description of this inconsistency, along with a proposed solution to it, in Appendix A.
5. We did not assess whether a change in companies' allocation of A&O to loss year is by itself a driver of whether companies have an exceptional value.

Impact of the Proposal

The proposal would not universally result in a change from "usual" to "unusual" values. Some companies would benefit from the proposed change; others would not.

Benefits

- Theoretically, and assuming that a reasonable and reliable allocation of A&O reserves and payments by loss year were achievable, practicable, and in use, the proposed change would provide a more appropriate measure of adverse development and potential reserve deficiency.

Drawbacks

- The result of the proposed formula is subject to manipulation, as each company has an element of discretion in its assignment of A&O payments and reserves by loss year.
- This assignment of A&O payments and reserves by year may vary by company enough to reduce the comparability of the metrics across companies.

- The proposed formula is more complicated to calculate because Schedule P is not currently constructed to allow for easy calculation. Prior-year Schedule P information is needed to perform the calculation. This can cause problems where the prior-year Schedule Ps are calculated on a different basis than current-year Schedule Ps. Such differences can be caused by restatements as a result of, among other things: changes in pooling, divestitures, acquisitions, and commutations.
- In its current form, the proposed formula is complicated to calculate. The calculation could be made easier by making numerous other changes to the Annual Statement Blank and the Instructions, as outlined in the CASTF draft response to the FARD Working Group referral. However, such changes would require financial and other resources, and the need for such resources could potentially be ongoing.
- Insurance regulators may not realize the impact on a particular insurer of the inclusion of A&O and may need additional information about the effect of adding A&O during the transition to its inclusion to fully understand its impact.

Other Comments

- State regulators currently have the option of including A&O in their calculation of the IRIS ratios if they believe the result would be materially different or if they suspect a company of manipulating its financial statements.

Approach

Our review included Annual Statement data on a group basis from SNL Financial. We reviewed 1,377 companies for year-end 2012 and 1,352 companies for year-end 2013. For each year, we excluded companies with negative surplus in any of the three most recent years (current plus two prior) from our review. For this reason, there are fewer companies included for IRIS Ratio 12 than for IRIS Ratio 11.

Analysis of Insurance Company Data

For each company and each Annual Statement year, we calculated the results of IRIS Ratios 11 and 12 using both the current and proposed formulas. The figures below outline the results of our analysis. Using IRIS Ratio 11 at year-end 2012 as the example:

- Under the current formula, 78 companies exceeded the 20 percent threshold result.
- Under the proposed formula, 88 companies would have exceeded the 20 percent threshold result.
- The change (i.e., 10 additional companies) is comprised of three companies changing from an exceptional to a usual result and 13 companies changing from a usual to an exceptional result. Exhibit 1 (attached in Appendix B) graphs the results for all 1,377 companies.

Figure 1: IRIS Ratio 11

Result	as Reported with DCC Only	Exceptional To Usual	Usual to Exceptional	as Proposed with DCC and A&O	Percent Change
<i>Year-end 2012:</i>					
Usual	1,299			1,289	-1%
Exceptional	78	(3)	13	88	13%
Total	1,377			1,377	
<i>Year-end 2013:</i>					
Usual	1,281			1,266	-1%
Exceptional	71	(3)	18	86	21%
Total	1,352			1,352	

Figure 2: IRIS Ratio 12

Result	as Reported with DCC Only	Exceptional To Usual	Usual to Exceptional	as Proposed with DCC and A&O	Percent Change
<i>Year-end 2012:</i>					
Usual	1,270			1,255	-1%
Exceptional	90	(4)	19	105	17%
Total	1,360			1,360	
<i>Year-end 2013:</i>					
Usual	1,208			1,194	-1%
Exceptional	111	(4)	18	125	13%
Total	1,319			1,319	

As companies have discretion in the allocation of A&O reserves and payments by loss year, and as this discretionary allocation does not currently affect the IRIS ratio results, it is unknown whether the additional unusual values or the absence of unusual values are the result of a faulty A&O allocation, or truly an indication of adverse development.

If the proposal is approved, it would be theoretically possible for a company to influence the results of the IRIS ratios by selecting a different allocation of A&O expenses. To test an extreme, we calculated the results of IRIS Ratios 11 and 12 assuming that each company altered its allocation of A&O reserves to place all reserves as of Dec. 31, 2012 (for the 2012 Annual Statement) in loss-year 2012 and all reserves as of Dec. 31, 2013 (for the 2013 Annual Statement) in loss-year 2013.

As shown in Figure 3 below, 16 of the 88 companies with an unusual IRIS Ratio 11 result in 2012 (or 18 percent) would have been able to produce a usual result by allocating all A&O reserves to the most recent loss year. The IRIS Ratio 11 results for year-end 2013 were comparable. IRIS Ratio 12 (Figure 4 below) had fewer companies with the potential to change the result.

Figure 3: IRIS Ratio 11

Result	as Reported	with Modified A&O Allocation	Change	Percent Change
<i>Year-end 2012:</i>				
Usual	1,289	1,305	16	1%
Exceptional	88	72	(16)	-18%
Total	1,377	1,377		
<i>Year-end 2013:</i>				
Usual	1,266	1,280	14	1%
Exceptional	86	72	(14)	-16%
Total	1,352	1,352		

Figure 4: IRIS Ratio 12

Result	as Reported	with Modified A&O Allocation	Change	Percent Change
<i>Year-end 2012:</i>				
Usual	1,255	1,260	5	0%
Exceptional	105	100	(5)	-5%
Total	1,360	1,360		
<i>Year-end 2013:</i>				
Usual	1,194	1,203	9	1%
Exceptional	125	116	(9)	-7%
Total	1,319	1,319		

COPLFR appreciates this opportunity to provide input to the CASTF. We hope these observations are helpful, and we welcome any further discussion or review that may be helpful to this process. If you have any questions about our comments, please contact Lauren Pachman, the Academy's casualty policy analyst, at pachman@actuary.org or (202) 223-8196.

Sincerely,

Lisa Slotznick, FCAS, MAAA
Vice Chairperson, COPLFR
American Academy of Actuaries

Appendix A

Recommended Changes to Annual Statement Instructions on Allocation of Loss Adjustment Expenses by Year

The current Schedule P Interrogatories state in Item 3, “The Adjusting and Other expense payments and reserves should be allocated to the years in which the losses were incurred based on the number of claims reported, closed and outstanding in those years.” (The Schedule P instructions also mention that reinsurers should report A&O “according to the reinsurance contract.”)

The NAIC Instructions for Schedule P include the following: “Reporting entities should assign the ‘Defense & Cost Containment’ expenses to the accident year in which the associated losses were assigned. Reporting entities may assign the ‘Adjusting & Other’ expenses in any justifiable way among the accident years. The preferred way is to apportion these expenses in proportion to the number of claims reported, closed or outstanding each year.” The NAIC Instructions are somewhat more flexible than the Schedule P Interrogatory Instructions.

We have the following universe of situations (A) through (D):

	Accident Date is available	Accident Date is not available
Defense & Cost Containment LAE	(A)	(B)
Adjusting & Other LAE	(C)	(D)

Filling in the table with some examples, we have:

	Accident Date is available	Accident Date is not available
Defense & Cost Containment LAE	Bill from outside law firm for work on an individual claim or in-house attorney with detailed tracking of hours	Salary of in-house attorney who works on a number of claims each day but without detailed tracking of hours to individual claims
Adjusting & Other LAE	Bill from outside adjusting firm for work on an individual claim or in-house claim department with detailed tracking of hours spent	Salary of in-house claim department employee without detailed tracking of hours to individual claims

The Annual Statement Instructions only explicitly cover the two cells in the above table that are shaded in **YELLOW**. The Instructions never explicitly recognize that insurers may have accurate accident date information for A&O LAE and may use it to recognize the accident year of the expense.

Here is a suggestion for some improved wording related to the A&O. We also recommend revisiting the wording on the DCC instructions for consistency.

1. NAIC Annual Statement Instructions – 2013 Annual Statement Instructions, page 268

Current wording:

... Reporting entities may assign the “Adjusting & Other” expenses in any justifiable way among the accident years. The preferred way is to apportion these expenses in proportion to the number of claims reported, closed, or outstanding each year.

Suggested change:

... Reporting entities may assign the “Adjusting & Other” expenses in any justifiable way among the accident years. One acceptable way is to assign these expenses to the same year as the associated loss or claims. Another acceptable ~~The preferred~~ way is to apportion these expenses in proportion to the number of claims reported, closed, or outstanding each year (unless the insurer is aware that this approach does not reproduce a reasonable allocation to accident year, and can produce a more reasonable allocation).

Rationale for the change:

The word “preferred” implies that other ways are discouraged. That is inconsistent with the first sentence. It also may be that an allocation strictly based on claim counts may not reflect the relative costs involved to service the claims—e.g., certain types of claims may require greater levels of claim servicing, and an insurer capable of tracking such details should not be discouraged from reflecting this information in allocating A&O reserves and payments.

2. Schedule P Interrogatories – Question 3

Current wording:

The Adjusting and Other expense payments and reserves should be allocated to the years in which the losses were incurred based on the number of claims reported, closed and outstanding in those years. When allocating Adjusting and Other expense between companies in a group or a pool, the Adjusting and Other expense should be allocated in the same percentage used for the loss amounts and the claim counts. For reinsurers, Adjusting and Other expense assumed should be reported according to the reinsurance contract. For Adjusting and Other expense incurred by reinsurers, or in those situations where suitable claim count information is not available, Adjusting and Other expense should be allocated by a reasonable method determined by the company and described in Interrogatory 7, below. Are they so reported in this statement? Yes [] No []

Suggested change:

The Adjusting and Other expense payments and reserves ~~may~~^{should} be allocated to the years in which the losses were incurred in any justifiable way that reflects the costs to adjust claims by accident year, with one generally acceptable method being to apportion such expenses to accident year based on the number of claims reported, closed and outstanding in those years. When allocating Adjusting and Other expense between companies in a group or a pool, the Adjusting and Other expense should be allocated in the same percentage used for the loss amounts and the claim counts. For reinsurers, Adjusting and Other expense assumed should be reported according to the reinsurance contract. ~~For Adjusting and Other expense incurred by reinsurers, or in those situations where suitable claim count information is not available, Adjusting and Other expense~~

~~*should be allocated by a reasonable method determined by the company and described in Interrogatory 7, below. Are they so reported in this statement?—Yes []—No []—Briefly describe how such expenses are allocated in this statement.*~~

Rationale for the change:

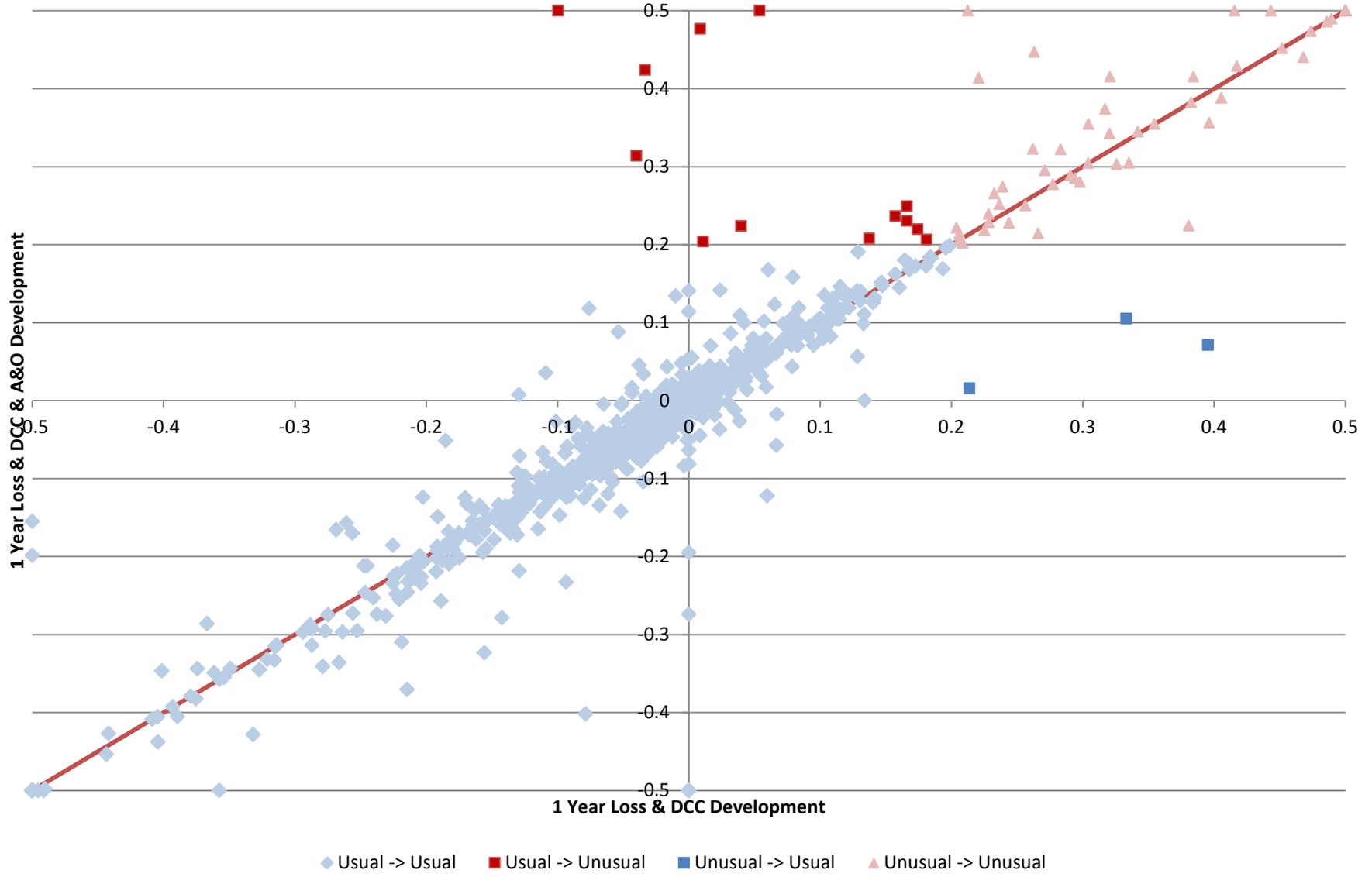
The word “should” in the current Interrogatory wording implies that any way other than that suggested is not acceptable. That conflicts with the 2013 Annual Statement Instructions on page 268, where it says, “*Reporting entities may assign the ‘Adjusting & Other’ expenses in any justifiable way among the accident years.*” The suggested wording makes the Interrogatory wording consistent with the wording of the Annual Statement Instructions.

Appendix B

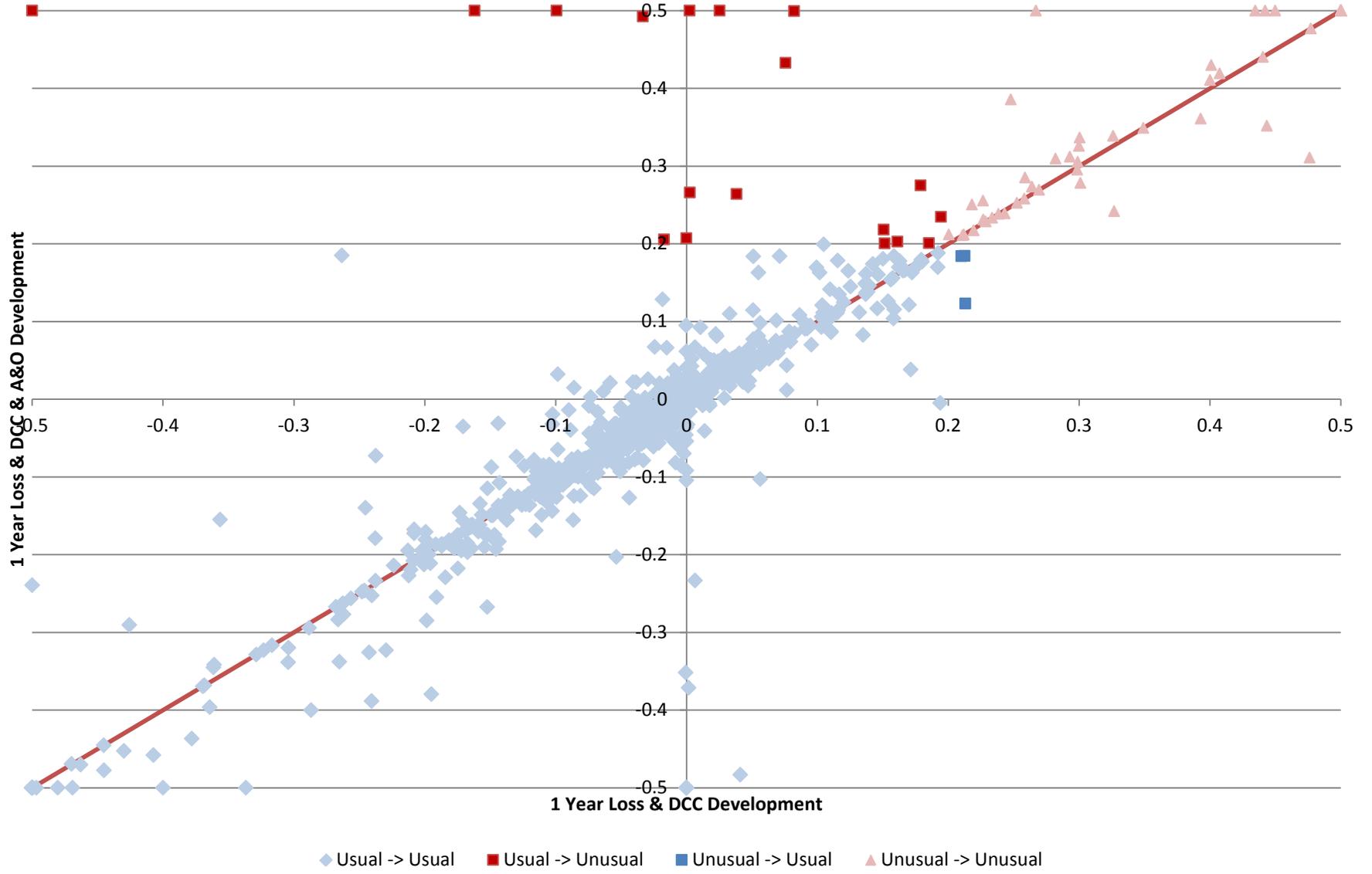
Impact of Inclusion of A&O on IRIS Ratio Results for 2012 and 2013²

² Annual Statement data from SNL Financial.

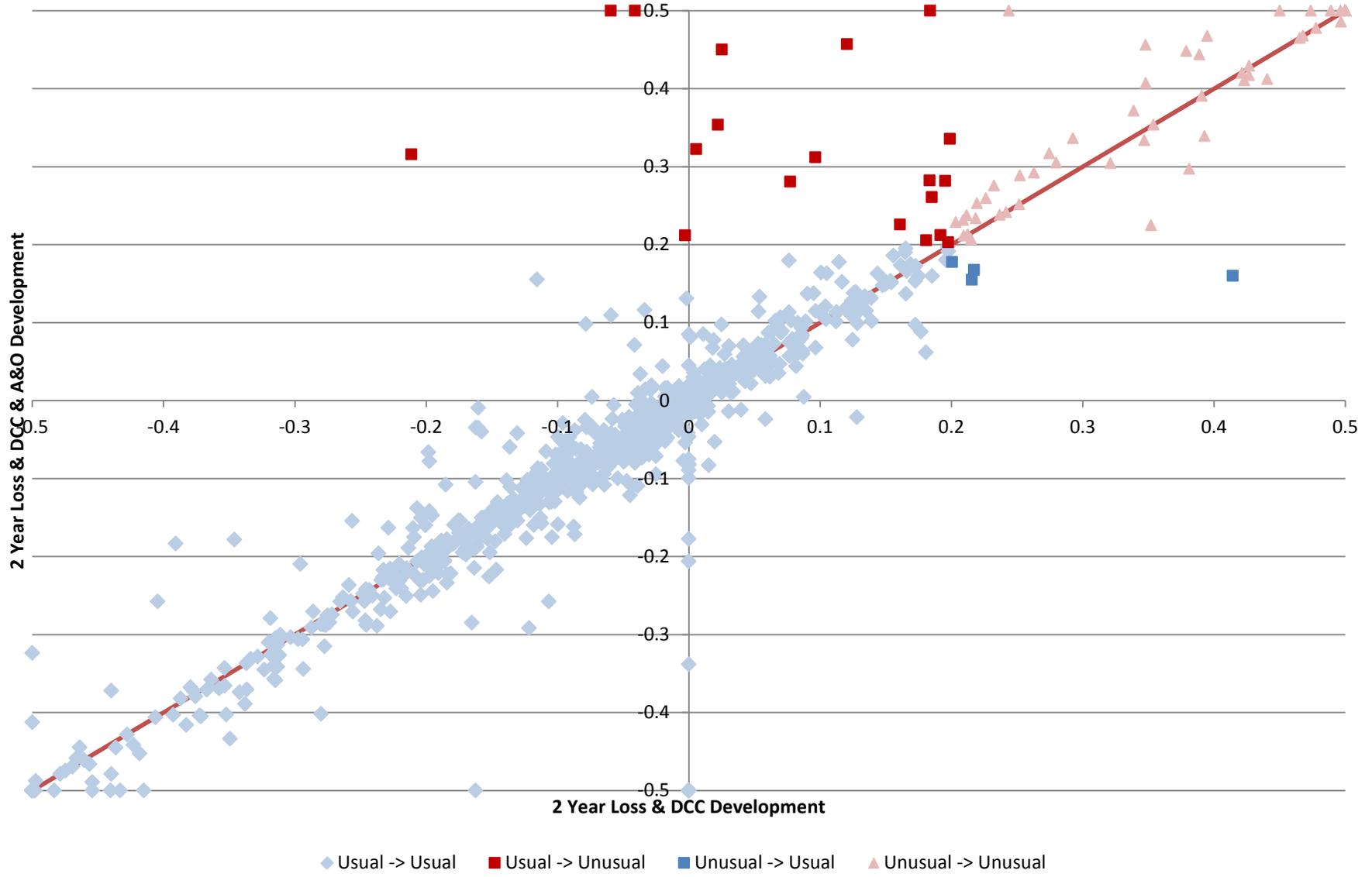
IRIS Ratio 11 Year End 2012



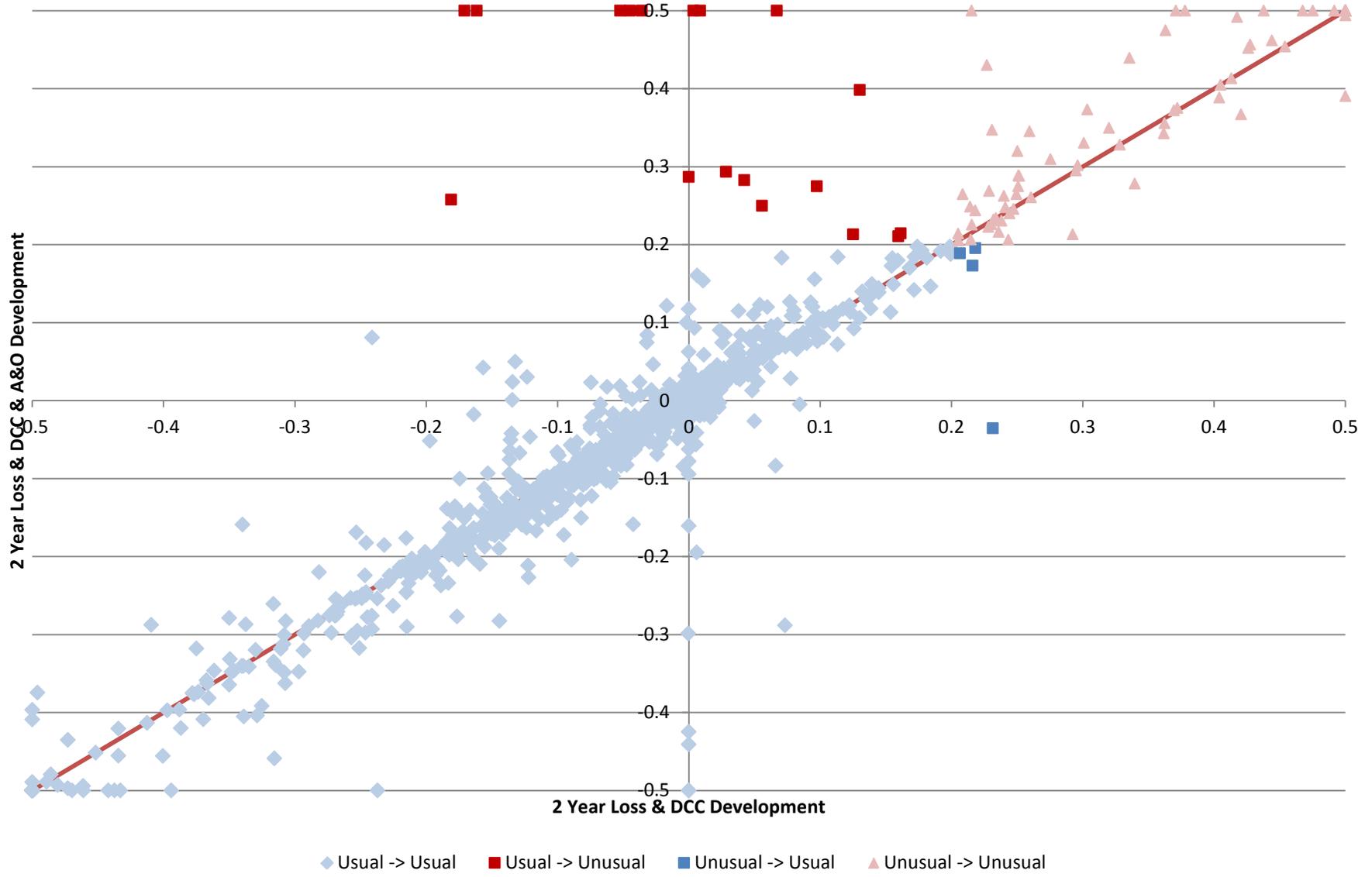
IRIS Ratio 11 Year End 2013



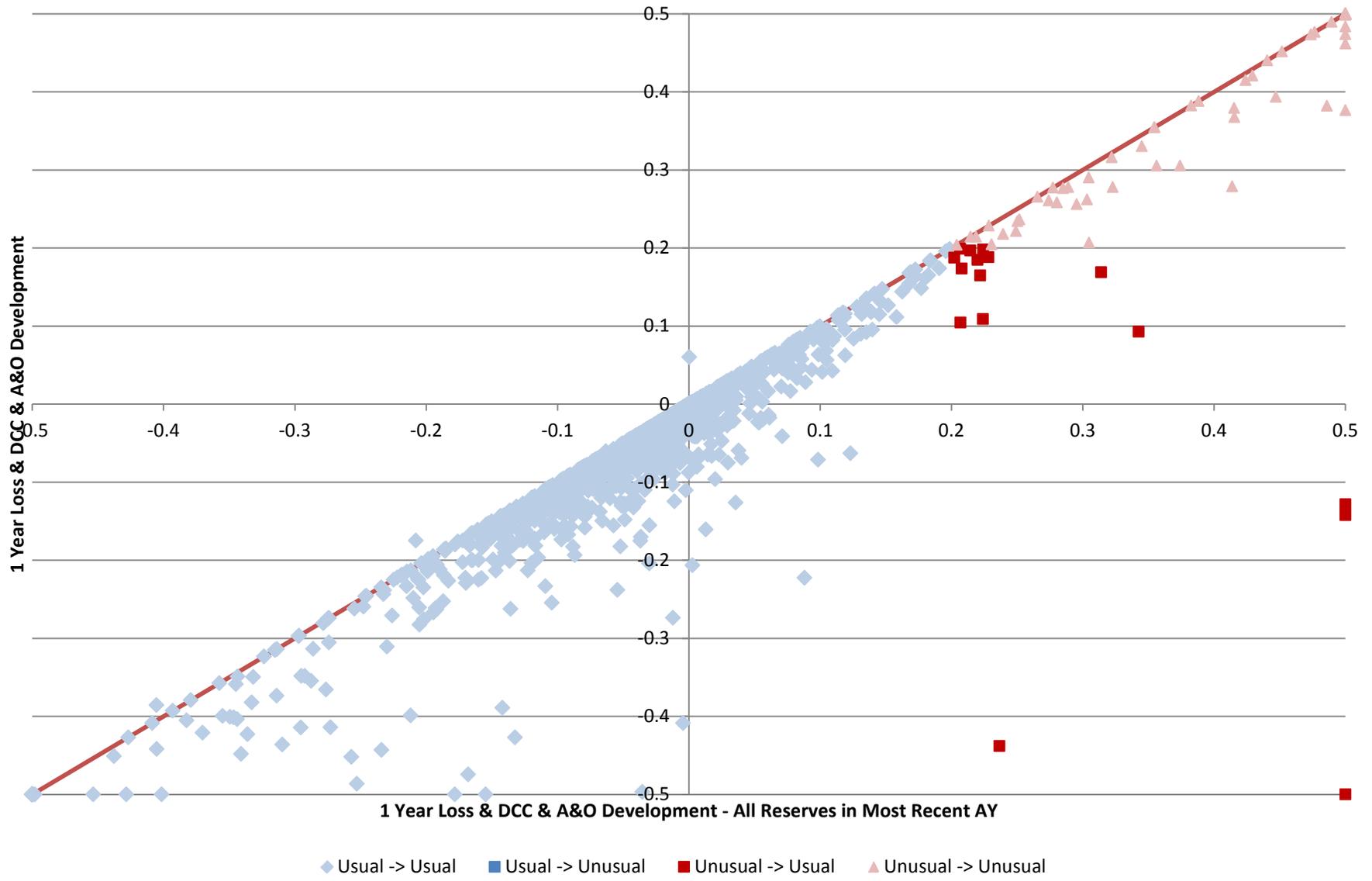
IRIS Ratio 12 Year End 2012



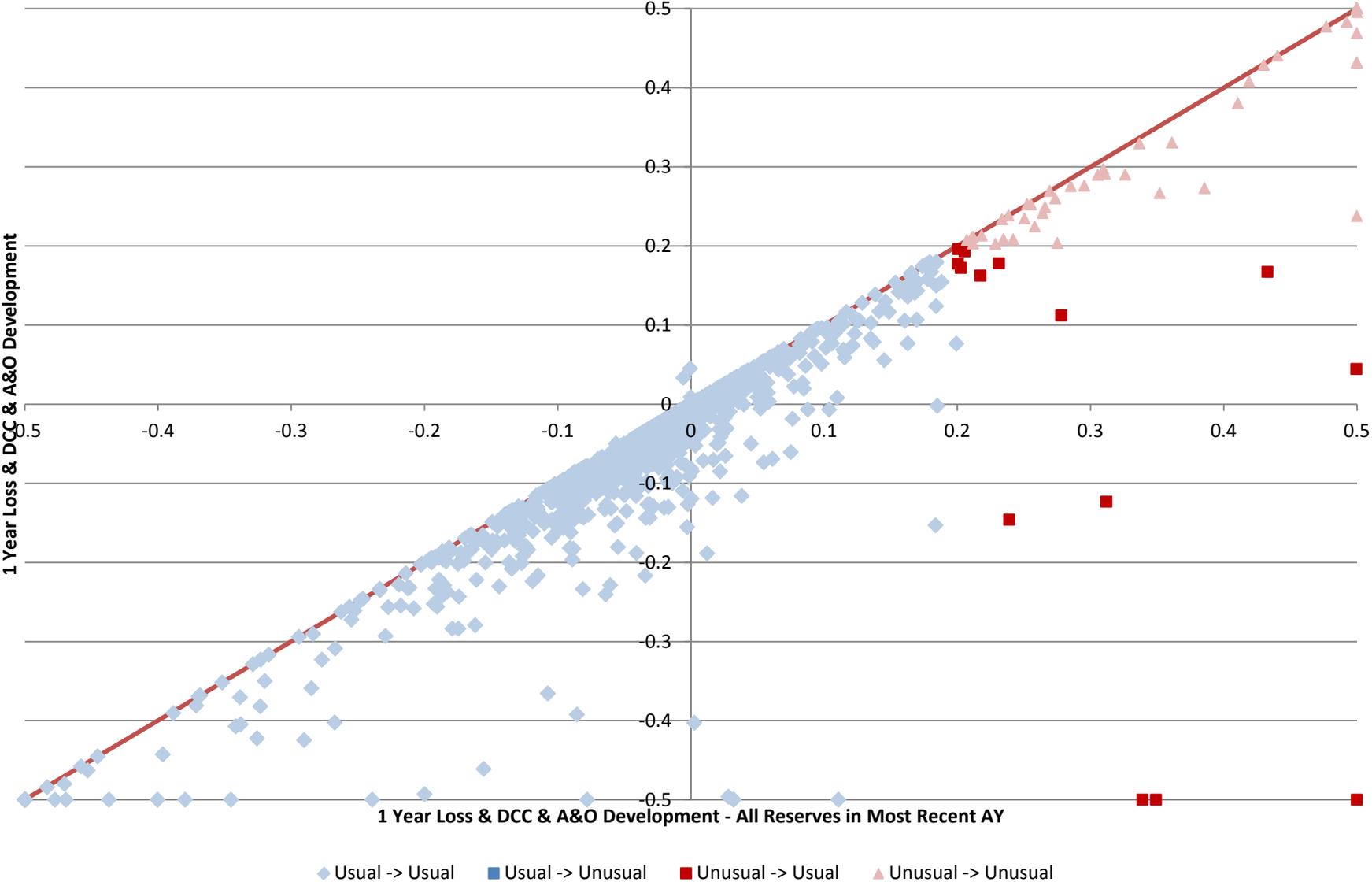
IRIS Ratio 12 Year End 2013



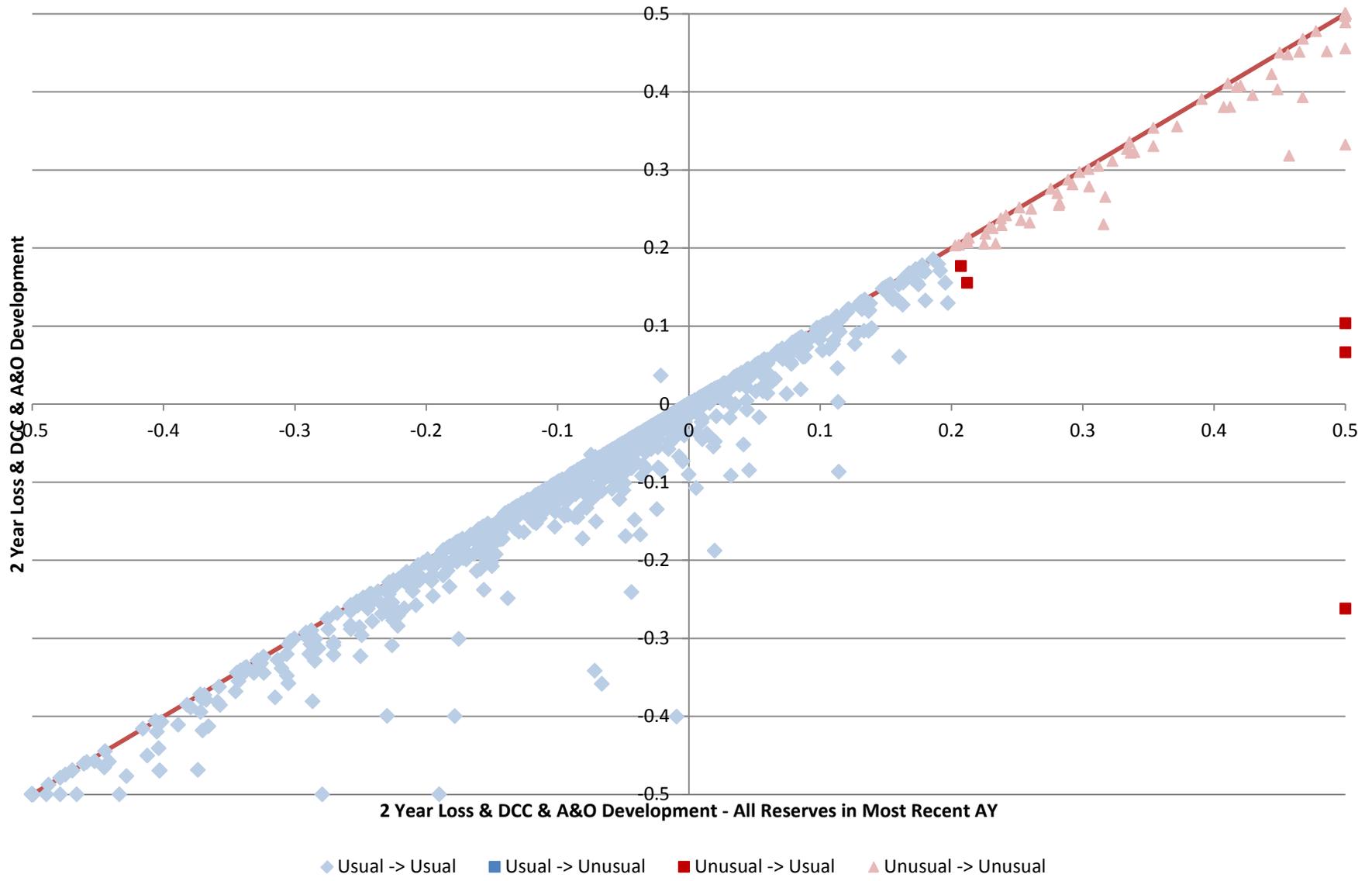
IRIS Ratio 11 Year End 2012



IRIS Ratio 11 Year End 2013



IRIS Ratio 12 Year End 2012



IRIS Ratio 12 Year End 2013

