

# Statutory Issue Paper No. 55

## Unpaid Claims, Losses and Loss Adjustment Expenses

### STATUS

Finalized June 23, 1998

**Original SSAP and Current Authoritative Guidance: SSAP No. 55**

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. Current statutory guidance for recording unpaid life and accident and health insurance claims is contained in Chapters 11 and 14 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). Current statutory guidance for recording unpaid property and casualty losses and loss adjustment expenses is contained in Chapters 10 and 11 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual). Current statutory guidance for recording unpaid managed care claims, losses and loss adjustment expenses is contained in Chapter 8 of the Accounting Practices and Procedures Manual for Health Maintenance Organizations (HMO Accounting Practices and Procedures Manual). This guidance requires the recognition of a liability for unpaid claims, losses and loss/claim adjustment expenses.

2. GAAP guidance for recording unpaid claims and unpaid losses and loss/claim adjustment expenses is substantially consistent with current statutory guidance. This guidance is found in *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60).

3. The purpose of this issue paper is to establish statutory accounting principles for recording liabilities for unpaid claims and claim adjustment expenses for life insurance contracts and accident and health contracts and unpaid losses and loss adjustment expenses for property and casualty insurance contracts, that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). The guidance set forth in this issue paper applies to all contracts as defined in *Issue Paper No. 50—Definitions and Classifications of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50).

4. This issue paper does not address policy reserves for life and accident and health policies. These reserves are addressed in *Issue Paper No. 51—Life Contracts*, *Issue Paper No. 52—Deposit-Type Contracts*, *Issue Paper No. 54—Individual and Group Accident and Health Contracts* (Issue Paper No. 54), and *Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts*.

5. This issue paper does not address liabilities for punitive damages. These liabilities shall be recorded in accordance with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5).

### SUMMARY CONCLUSION

6. Claims, losses and loss/claim adjustment expenses shall be recognized as expense when a covered or insured event occurs. In most instances the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims-made type policies the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. 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. The future payments associated with settling unpaid claims, unpaid losses and loss/claim adjustment expenses meet the definition of a liability as established in Issue Paper No. 5. 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, with a corresponding charge to income.

7. The following are types of future costs relating to property and casualty contracts as defined in Issue Paper No. 50, which shall be considered in determining the liabilities for unpaid losses and loss adjustment expenses:

- a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the insurer as of the statement date;
- b. Incurred But Not Reported Losses, (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the insurer as of the statement date. As a practical matter this also may include losses that have been reported to the company but have not yet been entered to the claims system or bulk provisions. Bulk provisions are reserves included with other IBNR reserves to reflect deficiencies in known case reserves;
- c. Loss Adjustment Expenses: Costs expected to be incurred in connection with the adjustment and recording of losses defined in subparagraphs 7.a. and 7.b. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage. Loss adjustment expenses can be classified into two broad categories: Defense and Cost Containment (DCC) and Adjusting and Other (AO):
  1. DCC include defense, litigation, and medical cost containment expenses, whether internal or external. DCC include, but are not limited to, the following items:
    - i. Surveillance expenses;
    - ii. Fixed amounts for medical cost containment expenses;
    - iii. Litigation management expenses;
    - iv. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by accident year;
    - v. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in defense of a claim, and fees or salaries for rehabilitation nurses, if such cost is not included in losses;
    - vi. Attorney fees incurred owing to a duty to defend, even when other coverage does not exist;
    - vii. The cost of engaging experts;
  2. AO are those expenses other than DCC as defined in (1) above assigned to the expense group "Loss Adjustment Expense." AO include, but are not limited to, the following items:

- i. Fees and expenses of adjusters and settling agents;
- ii. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year;
- iii. Attorney fees incurred in the determination of coverage, including litigation between the insurer and the policyholder; and
- iv. Fees and salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster.

8. The following future costs relating to life and accident and health indemnity contracts, as defined in Issue Paper No. 50, shall be considered in determining the liability for unpaid claims and claim adjustment expenses:

- a. **Accident and Health Claim Reserves:** Reserves for claims that involve a continuing loss. This reserve is a measure of the future benefits or amounts not yet due as of the statement date which are expected to arise under claims which have been incurred as of the statement date. This shall include the amount of claim payments that are not yet due such as those amounts commonly referred to as disabled life reserves for accident and health claims. The methodology used to establish claim reserves is discussed in Issue Paper No. 54;
- b. **Claim Liabilities for Life/Accident and Health Contracts:**
  - i. **Due and Unpaid Claims:** Claims for which payments are due as of the statement date;
  - ii. **Resisted Claims in Course of Settlement:** Liability for claims that are in dispute and are unresolved on the statement date. The liability either may be the full amount of the submitted claim or a percentage of the claim based on the reporting entity's past experience with similar resisted claims;
  - iii. **Other Claims in the Course of Settlement:** Liability for claims that have been reported but the reporting entity has not received all of the required information or processing has not otherwise been completed as of the statement date;
  - iv. **Incurred But Not Reported Claims:** Payments for which a covered event has occurred (such as death, accident or illness) but has not been reported to the reporting entity as of the statement date;
- c. **Claim Adjustment Expenses for Accident and Health Reporting Entities:** Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 8.a. and 8.b. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;
- d. **Claim Adjustment Expenses for life entities:** Costs expected to be incurred (including legal, investigation, etc.) in connection with the adjustment and recording of life claims in the course of settlement defined in subparagraph 8.b.

9. The following costs relating to managed care contracts as defined in Issue Paper No. 50 shall be considered in determining the claims unpaid and claims adjustment expenses:

- a. Claims unpaid for Managed Care Reporting Entities:
  - i. Unpaid amounts for costs incurred in providing care to a subscriber, member or policyholder including inpatient claims, physician claims, referral claims, other medical claims, resisted claims in the course of settlement and other claims in the course of settlement;
  - ii. Incurred But Not Reported Claims: Liability for which a covered event has occurred (such as an accident, illness or other service) but has not been reported to the reporting entity as of the statement date;
  - iii. Additional medical costs resulting from failed contractors under capitation contracts and provision for losses incurred by contractors deemed to be related parties for which it is probable that the reporting entity will be required to provide funding;
- b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 9.a. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;
- c. Liabilities for percentage withholds (“withholds”) from payments made to contracted providers;
- d. Liabilities for accrued medical incentives under contractual arrangements with providers and other risk-sharing arrangements whereby the health entity agrees to share savings with contracted providers.

10. The liability for claim reserves and claim liabilities, unpaid losses, and loss/claim adjustment expenses shall be based upon the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. These liabilities will not be discounted unless authorized by specific issue papers, including Issue Paper No. 54 and *Issue Paper No. 65—Property and Casualty Contracts*.

11. Various analytical techniques can be used to estimate the liability for IBNR claims or losses, future development on reported losses/claims, and loss/claim adjustment expenses. These techniques generally consist of statistical analysis of historical experience and are commonly referred to as loss

reserve projections. The estimation process is generally performed by line of business, grouping contracts with like characteristics and policy provisions. The decision to use a particular projection method and the results obtained from that method should be evaluated by considering the inherent assumptions underlying the method and the appropriateness of those assumptions to the circumstances. No single projection method is inherently better than any other in all circumstances. The results of more than one method should be considered.

12. For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims (including IBNR for death claims and accident and health claims) is subject to future events, no single claim or loss and loss/claim adjustment expense reserve can be considered accurate with certainty. Management's analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and a low estimate, the best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's range shall be realistic and therefore shall not include the set of all possible outcomes but instead only those outcomes that are considered reasonable.

13. In the rare instances when, for a particular line of business, after considering the relative probability of the points within the estimated range, it is determined that no point within management's estimate of the range is a better estimate than any other point, the midpoint within management's estimate of the range shall be accrued. It is anticipated that using the midpoint in a range will be applicable only when there is a continuous range of possible values, and no amount within that range is any more probable than any other. For purposes of this issue paper, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be accrued. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability.

14. If a reporting entity chooses to anticipate salvage and subrogation recoverables (including amounts recoverable from second injury funds where applicable), these recoverables shall be estimated in a manner consistent with paragraphs 10-12 of this issue paper and shall be deducted from the liability for unpaid claims or losses.

15. Changes in estimates of the liabilities for unpaid claims or losses and loss/claim adjustment expenses resulting from the continuous review process, including the consideration of differences between estimated and actual payments, shall be considered a change in estimate and shall be recorded in accordance with *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3). Issue Paper No. 3 requires changes in estimates to be included in the statement of operations in the period the change becomes known.

### **Disclosure**

16. The financial statements shall include the following disclosures for each year full financial statements are presented. Life and annuity contracts are not subject to this disclosure requirement.

- a. The balance in the liabilities for unpaid claims and unpaid losses and loss/claim adjustment expense reserves at the beginning and end of each year presented;

- b. Incurred claims, losses and loss/claim adjustment expenses with separate disclosure of the provision for insured or covered events of the current year and of increases or decreases in the provision for insured or covered events of prior years;
- c. Payments of claims, losses and loss/claim adjustment expenses with separate disclosure of payments of losses and loss/claim adjustment expenses attributable to insured or covered events of the current year and to insured or covered events of prior years;
- d. The reasons for the change in the provision for incurred claims, losses and loss/claim adjustment expenses attributable to insured or covered events of prior years. The disclosure should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects;
- e. A summary of management's policies and methodologies for estimating the liabilities for losses and loss/claim adjustment expenses including discussion of claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures;
- f. Disclosure of the amount paid and reserved for losses and loss/claim adjustment expenses for asbestos and/or environmental claims, on a gross and net of reinsurance basis (the reserves required to be disclosed in this section shall exclude amounts relating to policies specifically written to cover asbestos and environmental exposures);
- g. Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, when applicable) deducted from the liability for unpaid claims or losses.

## DISCUSSION

17. The statutory principles outlined in the conclusion above are consistent with the current statutory guidance for recording a liability for unpaid claims and unpaid losses and loss/claim adjustment expenses. Property and casualty insurers report the liability for loss adjustment expenses separate from the liability for losses while life and accident and health insurers and managed care providers accrue such expenses as part of the claim liability, claim reserve or claims payable. The description of the types of costs considered DCC and AO are consistent with the P&C Accounting Practices and Procedures Manual adopted by Accounting Practices and Procedures (EX4) Task Force in June 1995 to be effective for calendar years beginning January 1, 1997 (later revised to January 1, 1998). Recording estimated salvage and subrogation recoveries continues to be optional.

18. In addition to requiring management to record its best estimate of its unpaid liability for unpaid claims, unpaid losses and loss/claim adjustment expenses for each line of business, the conclusion expands current statutory guidance to require the accrual of the midpoint of a range of loss or loss adjustment expense reserve estimates when for a particular line of business, no point within management's range of reasonably possible estimates is determined to be a better estimate than any other point. This conclusion is consistent with Issue Paper No. 5 which states:

When an amount within management's estimate of the range of a loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When, in management's opinion, no amount within management's estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management's estimate in the range shall be accrued. For purposes of this paragraph, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management's best estimate shall be used.

Additionally, the conclusion expands the disclosure requirements of current statutory guidance to include the information set forth in paragraph 16. The disclosure required by paragraph 16 provides disclosure in those circumstances where the accompanying exhibits are not part of the company's financial statements (e.g., annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

19. The conclusions above are consistent with the guidance provided for the recognition of claim costs in FAS 60 with the exception of paragraph 13 of this issue paper which requires the accrual of the midpoint of management's estimate of the range of loss or loss adjustment expense reserve estimates when no point within management's continuous range of reasonably possible estimates is determined to be any more probable than any other. Although FAS 60 is rejected in Issue Paper No. 50, it is considered appropriate that the recognition of claims costs be consistent with those provisions of FAS 60 as they are consistent with the Statement of Concepts. The disclosures required in paragraph 16 are consistent with the guidance in *AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*. This pronouncement will be addressed in its entirety in a separate issue paper. This issue paper rejects AICPA Statement of Position 92-4, *Auditing Insurance Entities' Loss Reserves*.

20. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

#### Conservatism

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

#### Recognition

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies.

#### **Drafting Notes/Comments**

- Accounting for reinsurance is addressed in *Issue Paper No. 74—Life, Deposit-Type and Accident and Health Reinsurance* and *Issue Paper No. 75—Property and Casualty Reinsurance*.
- Accounting for title insurance is addressed in *Issue Paper No. 57—Title Insurance*.
- Excess statutory reserves are addressed in *Issue Paper No. 65—Property and Casualty Contracts*.
- Claims-made insurance contracts are addressed in *Issue Paper No. 65—Property and Casualty Contracts*.
- Mortgage Guaranty contracts are addressed in *Issue Paper No. 88—Mortgage Guaranty Insurance*.
- Financial Guaranty contracts are addressed in *Issue Paper No. 69—Financial Guaranty Insurance*.
- Property and Casualty liabilities subject to discounting are discussed in *Issue Paper No. 65—Property and Casualty Contracts*.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE****Statutory Accounting**

21. The P&C Accounting Practices and Procedures Manual, Chapter 10, Losses, includes the following guidance:

Recognition

Even though there are many methods of estimating unpaid losses, the underlying goal is to have unpaid losses reflect the liability outstanding for losses that have occurred as of the financial statement date. Losses, except for “claims-made” policies, are recognized as they occur and not as they are reported to the company. Because of this basis of recognition, unpaid losses are grouped in (1) reported and (2) incurred but not reported (IBNR). Reported losses are those of which the company has been notified. The incurred but not reported losses are those losses that have occurred but have not been reported to the company. As a practical matter, losses which have been reported to the company but not yet entered into the system may be included as IBNR.

Valuation

Generally, a company is required to determine what the value of its claims will be when ultimately settled. Excluding certain types of losses, discussed under Loss Reserve Discounting below, statutory accounting practices require that for every dollar of unpaid losses the company reserve a whole dollar for the future payment of those losses.

Estimation of Reported Losses Unpaid

Unpaid losses for claims that have been reported may be determined in many ways. One way is for the claim to be assigned to an individual who estimates the value of the claim as needed facts are gathered.

Shown below are three examples of methods of calculating unpaid losses, which use information that may be maintained on an accident or report year basis. If historical information is maintained and used by accident year, then the unpaid losses include IBNR unpaid losses and the IBNR unpaid losses must be split from the total. If report year data is used, then the result is an unpaid loss figure for reported claims and IBNR unpaid losses must be estimated separately.

Reported losses may be estimated based on paid loss patterns for particular lines or coverages. This method determines the pattern of prior years paid losses as they relate to ultimate losses. A percentage of paid losses to ultimate losses is calculated at each stage of development. This percentage is then divided into the paid losses for other years in the same stage of development to determine the estimated ultimate loss dollars. The paid losses are then subtracted from the ultimate loss dollars to determine the required unpaid loss amounts. The sum of these amounts for all open years is the total unpaid losses. This method, as is the case with respect to any method based in whole or in part on past experience, is only reliable to the extent there is sufficient volume of similar loss claims in prior years. In addition, changing trends and factors affecting a company’s loss liability, such as inflation and trends in jury awards, must always be carefully considered and reflected. Special problems, such as changeovers from a tort to a no-fault system, require special consideration and treatment in estimating unpaid losses.

Another means of establishing unpaid losses is to estimate ultimate loss counts and estimate the average ultimate cost of a claim. These two estimates are then multiplied by each other to establish an ultimate cost. Paid losses to date are subtracted from this ultimate cost figure to arrive at unpaid losses.

The ultimate loss count may be determined by developing a percentage of losses reported at the particular stages of development of prior years. These percentages may then be divided into current reported losses to determine ultimate numbers. This, of course, is assuming that a representative

pattern is present for prior years. The average cost of incurred losses may be determined by developing the average cost of closed claims at various stages of development. After review of prior years average closed claim cost, a factor is developed and used to project trends in total loss costs. This trend factor is then applied to the average closed claim cost of prior years to determine an estimated average ultimate cost for the year being reviewed.

Another method that may be used is unpaid loss counts and average values of unpaid losses. The average value of unpaid losses is multiplied by the unpaid loss count to arrive at an ultimate figure. From this figure, partial payments are subtracted to arrive at a current unpaid loss amount. Average values of unpaid losses are determined by reviewing prior years information as it develops.

Some of the other methods that may be used include frequency and severity analysis and projection of loss ratios.

The foregoing are examples of the many general methods in use. Also, in practice, there are many variations to these methods. Some companies use a combination of methods to establish their unpaid losses. For example, for liability losses that require a great deal of time to settle, average unpaid loss amounts may be assigned until adequate information is compiled. Then the individual case estimate methods may be used.

#### Incurring But Not Reported Losses

With reported losses representing the liabilities for reported claims, the company must also record a liability for losses that are incurred but not reported. Various methods are used for estimating IBNR losses. Following are examples of two methods.

In a formula method, IBNR losses are related to some base, such as incurred losses, reported losses, premiums and exposures. Sometimes a formula approach is used in estimating total unpaid losses and the IBNR losses are separated from the reported losses by factoring.

In the averaging method, separate projections are made of IBNR claim counts and the average cost for which those claims will settle. The product of these two estimates is the IBNR unpaid losses.

Whatever methods are selected for establishing unpaid losses, the goal should always be reserve adequacy.

#### Recoveries from Salvage and Subrogation

Anticipated salvage and subrogation may be taken into account when determining ultimate incurred losses and unpaid losses, to the same extent that other factors affecting ultimate claim costs are taken into account. The company is expected to maintain appropriate data and perform appropriate actuarial tests to support the reasonableness of the anticipated salvage and subrogation recoveries.

Companies which have previously reported reserves gross of salvage and subrogation should report the change to the net method as a change in accounting principle. The cumulative effect on prior years of the change should be reported as a write-in item in the surplus section of the annual statement. The change in reserve calculated using the net method should be included in net income for the year of the change and all future years.

22. The P&C Accounting Practices and Procedures Manual, Chapter 11, Loss Adjustment Expenses, includes the following guidance:

The liability for unpaid loss adjustment expenses includes expenses that will be incurred in connection with the settlement of losses unpaid at the statement date. The liability should be the company's best estimate of the loss adjustment expenses that will be necessary to settle both reported and incurred but not reported unpaid losses. In addition to these expenses, the company must establish a liability for incurred but unpaid loss adjustment expenses, the same as for incurred

and unpaid general expenses. The liability for unpaid loss adjustment expenses should provide for the estimated expenses necessary to adjust all unpaid losses irrespective of payments made to third party administrators, management companies or other entities, not specifically covered by a contract of insurance.

#### Allocated Loss Adjustment Expenses

Allocated unpaid loss adjustment expenses are calculated by various methods. Examples of methods used are as follows:

Calendar year paid allocated loss adjustment expense is related to the calendar year paid losses. The ratio developed on the basis is then multiplied by the amount of the loss reserve for each of these coverages to determine the unpaid amount.

Another method tracks accident year development and computes a ratio on an incurred-to-incurred basis. Prior accident years data is accumulated at various stages of development. The ratio of accumulated allocated loss adjustment expense paid to accumulated losses paid is calculated at each stage of development. This process should start with the oldest accident year and move forward. The ratio of paid-to-paid for each accident year under review is then compared to the paid-to-paid ratios for prior accident years at the same stage of development. After this comparison, the estimated ultimate incurred-to-incurred ratio is projected for the accident year under review, based on the subsequent development of prior years' paid-to-paid ratios. The estimated incurred losses for the accident year under review are then multiplied by the incurred-to-incurred ratio to determine ultimate allocated loss adjustment expense amounts. Paid allocated loss adjustment expense is then subtracted to arrive at the unpaid amount. This method recognizes that older claims may require larger amounts of loss expenses.

The liability-to-liability ratio method establishes the liability directly by multiplying the estimated loss liability for each accident year by an estimated liability-to-liability ratio (allocated loss adjustment expense liability to loss liability). It starts by calculating the liability-to-liability (outstanding-to-outstanding) ratios that should have been used in prior accident years at the same stage of development. These prior ratios are then reviewed, and an outstanding-to-outstanding ratio is selected for the accident year involved.

Again, if allocated loss adjustment expense levels increase with age, then the outstanding-to-outstanding ratios will increase with age up to some cut-off age. The selected outstanding-to-outstanding ratios by accident year have no permanence and must be reselected at the end of each new accounting date. This method also requires the maintenance of accident-year data on an all-time cumulative basis through each stage of development.

#### Unallocated Loss Adjustment Expenses

A commonly used method of calculating unpaid, unallocated loss adjustment expenses computes a paid, unallocated expense ratio to paid losses. Based on this paid-to-paid ratio, each coverage is reviewed as to the percentage of unallocated handling that is complete at the time the claim is opened. This percentage is subtracted from 100% to determine the work that remains to be done. This percentage is then multiplied by the developed paid-to-paid factor. The factor that results from this calculation is then multiplied by the outstanding unpaid losses to determine the unpaid, unallocated loss expenses.

For IBNR paid losses, the full paid-to-paid factor is normally used to determine unpaid, unallocated loss adjustment expenses. This is done because these claims have not been opened and therefore little, if any, work has been completed.

Unpaid loss adjustment expenses are shown as a liability on the annual statement.

23. The Life/A&H Accounting Practices and Procedures Manual, Chapter 11, Unpaid Life Insurance Claims, provides the following guidance:

#### Life Insurance Claims

A life insurance contract provides a death benefit, an annuity benefit, or an endowment benefit. The company knows (with few exceptions) the amount of its obligation to each policyholder when it is presented with a claim or when the policy matures. At any statement date the company will owe unpaid policy proceeds which must be provided for in its financial statements.

In addition to the proceeds of the basic contracts, amounts may be payable for supplementary benefits attached to the basic contracts. These include accidental death benefits, payor death or disability benefits, premium waiver as a result of the disability of the insured, and in some instances, disability income benefits. As with the basic contract, the amount of accidental death benefits payable is a fixed amount, known to the company, once the criteria for payment has been established. Payor death requires reserving a specific number of premium payments contingent upon the insured living to a certain age. Payor disability, premium waiver, and disability income require the establishment of reserves based on appropriate morbidity factors and mortality factors. All or part of these reserves may be included in unpaid claims at statement date.

For all practical purposes, payment of life insurance claims and the accrual of the liability for unpaid claims is the same for ordinary, industrial, and group coverages. The liability for unpaid claims consists of both reported and unreported claims. The instances where a company may not be able to make an exact determination of its liability for a life insurance claim might include claims that are being resisted by the company and those involving an accidental death of the insured.

The liabilities that are reported in the statutory financial statement include the following:

1. Due and unpaid. This item consists of claims on which all processing has been completed and which have been approved for payment, but which have not been paid prior to the statement date. The reported amount may be compiled from a claims register, an inventory of such claims, checks requested, or possibly drafts outstanding and, with an expeditious claims-paying system, may be small or zero.
2. Claims in course of settlement: resisted. This item contains the liability for claims that are in dispute and are unresolved on the statement date. The liability either may be the full amount of the submitted claim or a percentage of the claim that is based on the past experience of the company with similar resisted claims. The company should also accrue at year end for the estimated additional expenses (legal, investigation, etc.) involved in settling resisted claims. This latter item is included with other general expenses in the statutory financial statement.
3. Claims in course of settlement: other. These are claims that have been reported to the company but on which all required information has not been received, or the processing not otherwise completed, on the statement date. The company may include all claims that are being held up for reasons beyond its control. These may include awaiting the election of an option by a beneficiary, the completion of reasonable investigation, or determining who is entitled to receive the amount due. The amount of the liability may be based on the past experience of the company but it generally is a compilation of the claims that are pending at the statement date.
4. Incurred but not reported (IBNR) claims. This represents the company's liability for claims that have not been reported to it but the insured had died or become disabled prior to the statement date. At the end of the year the liability for IBNR claims may be estimated using any of the following techniques or any other technique which has proved reasonable for the particular company:
  - a. Establish a cut-off period of a few weeks subsequent to year end and complete a list of all claims received during the cut-off period that relate to the prior year and then determine the liability for those claims using the same methods as for claims in the course of settlement.

- b. Inventory the prior years IBNR claims that were received after the prior years cut-off period and on the basis of past experience, estimate those claims that will be reported thereafter.
- c. Analyze the past years experience and project it into the future after considering various modifying factors, such as insurance in force, paid claims, and claim frequency and severity. This should be done by the company's actuary to ensure that all current actuarial assumptions and methods are used.

The policies on which claims have been incurred but not reported until after the statement date will be included in the valuation of insurance in force. By reserving the face amount of the policy as an IBNR claim, the reserve for IBNR claims would be redundant. The policy reserves on those claims, therefore, are deducted either from the aggregate reserves for life policies or from the IBNR claim reserve.

24. The Life/A&H Accounting Practices and Procedures Manual, Chapter 14, Accident And Health Claims provides the following guidance:

Accident and health insurance policies generally provide for the coverage of such benefits as hospital and medical payments, disability and loss of time (income), and accidental death and dismemberment. Claims on accident and health policies are payable in the manner dictated by the risk that is insured. Usually, hospital and medical and accidental death and dismemberment claims are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims, for partial or total disability due to accident and sickness, are paid to the insured weekly or monthly during the period of disability, or a settlement may be reached between the company and the insured for a discounted lump sum payment.

The insurer's claims reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate reserves established. This is the same treatment described with regard to aggregate reserves in Chapter 13.

#### Claim Liabilities and Reserves

Unpaid benefits on accident and health policies are discussed in this chapter and Chapter 13. Amounts that would not be payable on the statement date (the unaccrued portion) are detailed in Chapter 13 as claim reserves. The amounts that are payable on the statement date (the accrued portion) are covered below as claim liabilities.

The various methods described in the following paragraphs are not an exhaustive listing, nor are the descriptions of such methods necessarily complete.

#### Due and Unpaid Claims

The instructions for completing the statutory financial statement for life and accident and health companies state that only claims which are complete except for the payment of the amount due should be included. Claims that have not been paid, because all of the required information has not been received, should be included with claims in course of settlement. The amount of due and unpaid claims generally will be small. The amount of the liability usually is determined on an exact inventory basis of claims on hand ready to be paid. In practice, a seriatim calculation of this liability is very difficult. Many companies take the approach that if all information is available to pay a claim then it has been paid. All claims on which the Company has only partial information are reported as "Claims in course of settlement."

#### Claims in Course of Settlement: Other

This item includes the liability for resisted claims in the amount the insurer expects the claim to be settled and paid. The accrued claim liability for all unresisted claims also is included.

For loss-of-time (disability income) policies, the accrued portion of the next periodic payment must be included. For example, when payments on a claim are made to the insured on the fifteenth day of each month and when the valuation date is the end of the month, one-half of the monthly payment is accrued, but not yet due, on the valuation date if the insured is still disabled on the valuation date.

One method is to set up a reserve equal to one-half of all monthly payments being made for loss-of-time policies. A more accurate method to determine the accrued and unpaid liability on reported disability claims is to compute the total amount accrued to the valuation date for each claim, then subtract the amount that already has been paid.

For other than loss-of-time policies, various methods are used in determining liabilities for these claims. Because these methods may produce total claim liabilities, a breakdown between unaccrued and accrued amounts should be made for allocation between claim reserve and claim liability. Although not intended to be a complete list, the following are examples of these methods:

1. An estimate may be made for each outstanding claim. Generally, this is not feasible unless the number of claims is relatively small.
2. Average claim factors may be developed from actual claim experience on similar claims outstanding at previous statement dates. To determine the total liability, these average factors are applied to the current outstanding claims. The calculation of factors, and their application to outstanding claims, should be done separately for each major type of benefit. Furthermore, the average claim factors should recognize the effects of inflation.
3. A formula method determines the adequacy of the claim liability at previous statement dates and of the total claims incurred on a line of business through retrospective studies. The amount of claims paid is related to a pre-established base, such as premium in force, unearned premium reserve, and so on. The percentages developed are applied to the same base on the statement date to develop the current liability. The formula method may be desirable, also, because it can include a provision for the liability for claims incurred but unreported.

#### Incurred But Not Reported (IBNR) Claims

The formula method, previously described for computing claims in course of settlement, probably is the most commonly used method to calculate this liability. Another method, sometimes called the lag system, is based on the assumption that a significant portion of the incurred but unreported claims will be reported within a specified period after the statement date. Under this method, the insurer establishes a liability for the claims reported, plus an estimated amount for claims reported after the "lag" period. The instructions for preparing the statutory financial statement contain an illustration of a method for computing the reserve for future contingent benefits, i.e., deferred maternity benefits.

For any method that is used, the insurer should verify the appropriateness of the IBNR liability by retrospectively calculating the exact amount of the liability for past valuation period.

#### Statistical Computation

The statistics developed from prior experience are essential in computing the claim reserves on accident and health policies. The important dates required for individual claims include the incurred date of the claim, the reported date, and the date of the claim payment.

The reported date is the date the claimant notified the company and a claim file is opened. The payment date may be either the date the partial payment is made or the date the final payment is made.

The incurred date must be defined by the contract and any applicable statute for various coverages. For example, for deferred maternity benefits, the incurred date is the date of conception. For major medical coverages, the incurred date should take into account the date of disability, the date the

initial expense was incurred, and the date the deductible was satisfied, if and as these features affect the company's contractual obligation under the claim. Hospital and surgical policies present less of a problem because either the date of admission to the hospital or the surgery date is utilized as the incurred date.

If subsequent treatment for the same condition falls within the definition of one illness, as set forth in a hospital, medical, or major medical contract, the original incurred date must be used and any payments considered part of the original claim. In summary, the assignment of incurred dates must bear a logical relationship to the situation creating the claim and must be consistently applied from year to year and is generally the date of the first compensable treatment.

In regard to loss-of-time disability policies with an elimination period, the duration of disablement shall be considered as dating from the time that benefits would have begun to accrue had there been no elimination period.

### Reinsurance

On policies that have been reinsured, the liability for claims should be reduced by the amount recoverable from the reinsurer. The amount of reinsurance that is recoverable on claims relating to specific policies should be reported at actual amounts. For incurred but unreported claims, the liability should be estimated net of reinsurance recoverable, unless the company has reliable experience supporting an estimated separation into direct and reinsurance ceded portions. The latter situation usually arises under quota share group reinsurance.

25. The HMO Accounting Practices and Procedures Manual, Chapter 8, Liabilities, provides the following guidance:

### LIABILITIES

#### COVERED AND UNCOVERED LIABILITIES

Any liability for health care expenses for which an enrollee is not responsible in the event of the insolvency of an HMO is deemed to be a covered liability. One method of assuring that an enrollee will not be liable for unpaid medical bills if an HMO becomes insolvent is through a "hold harmless" provision contained in provider contracts. This provision prohibits the provider from seeking payment for medical expenses directly from the enrollee. At present there is a standardized hold harmless agreement adopted as a "guideline" by the National Association of Insurance Commissioners and the National Association of Health Maintenance Organization Regulators and is an attachment to the Model HMO Act.

If this provision is present in provider contracts, then the medical expense for that provider is considered to be a covered liability.

#### Uncovered Liabilities

Uncovered liabilities are defined as those expenditures that are covered by the HMO for which an enrollee would also be liable in the event of the organization's insolvency. These are expenditures for health care services for which the HMO is at risk. They do not include expenditures for services when a provider has agreed not to bill the enrollee even though the provider is not paid by the HMO, or for services that are guaranteed, insured or assumed by a person or organization other than the HMO.

When preparing its annual statement, an HMO must determine the amount of both the covered and uncovered liabilities and report such amounts in the columns provided in the annual statement blank. The instructions to the annual statement also provide that the HMO describe in the notes to the financial statements the manner in which each liability reported as covered has been covered, i.e., hold harmless agreement, parental guarantee, etc.

Accrued and Unpaid Claims

The establishment and maintenance of adequate reserves is essential to the successful management of an HMO. Claim reserving techniques must be sufficient to project the amount of claims outstanding at the end of each financial reporting period. The amount reported should include provisions for claims that are known and pending as well as for claims incurred but not reported (IBNR).

The statutory annual statement blank contains a schedule for reporting the various parts of the unpaid claim liability. This is titled Schedule F, "Unpaid Claim Analysis." The Unpaid Claim Analysis consists of two parts. Section 1 is used to report unpaid claims for the current year by line of business. For purposes of completing this report, claims are classified into four distinct types:

- Inpatient Claims
- Physician Claims
- Referral Claims
- Other Medical Claims

The information contained in Section 2 of Schedule F provides for an analysis of the claims unpaid for the prior year as reported on the previous year's annual statement. The purpose for including this section is to measure the adequacy of the claim reserves established in the prior year's annual statement by comparing the actual amount paid in the current year against the reserves that were previously established.

In Section 1 of Schedule F, column 2 is used to report the aggregate amount of claims in process of adjustment by classification; column 3 is used to report the estimated liability by classification for claims incurred but unreported (IBNR). The aggregate total of claims in the process of adjustment and the provision of IBNR claims is shown in column 4.

Before delving further into a discussion on developing incurred but not reported reserving techniques, it is important to review lines of business and determine what should be reported in each line. The following schedule reflects the various lines of business and indicates the nature of claim cost that should be reported under each line:

<u>LINE OF BUSINESS</u>	<u>NATURE OF CLAIM COST</u>
Inpatient Claims	<p>Inpatient hospital costs of routine and ancillary services for HMO members while confined to an acute care hospital. Does not include out-of-area hospitalization.</p> <p>Routine hospital service includes regular room and board (including intensive care units, coronary care units, and other special inpatient hospital units), dietary and nursing services, medical surgical supplies, medical social services, and the use of certain equipment and facilities for which the provider does not customarily make a separate charge.</p> <p>Ancillary services may also include laboratory, radiology, drugs, delivery room and physical therapy services. Ancillary services may also include other special items and services for which charges are customarily made in addition to a routine service charge. Charges for non-HMO physician services provided in a hospital are included in this line item only if included as an undefined portion of charges by a hospital to the HMO. (If separately itemized or billed, physician charges should be included in referrals, above.) Include the cost of utilizing skilled nursing and intermediate care facilities.</p>

Skilled nursing facilities are primarily engaged in providing skilled nursing care and related services for patients who require medical or nursing care of rehabilitation service. Intermediate care facilities are for individuals who do not require the degree of care and treatment which a hospital or skilled nursing care facility provides, but do require care and services above the level of room and board.

Physician Services

Expenses for physician services provided under contractual arrangement to the HMO including the following:

LINE OF BUSINESS

NATURE OF CLAIM COST

- Salaries, including fringe benefits, paid to physician for delivery of medical services;
- Capitated payments paid by the HMO to physicians for delivery of medical services to HMO subscribers;
- Fees paid by the HMO to physicians for delivery of medical services to HMO subscribers. This includes capitated referrals; (Do not include expenses for medical personnel time devoted to administrative tasks.)

Compensation, including fringe benefits, paid by the HMO to non-physician providers engaged in the delivery of medical services and to personnel engaged in activities in direct support of medical services. This includes dentists, psychologists, optometrists, podiatrists, externs, nurses, clinical personnel such as ambulance drivers, technicians, paraprofessionals, janitors, quality assurance analysts, administrative supervisors, secretaries to medical personnel, and medical clerks.

Referrals

Expenses for providers not under HMO arrangements such as consultations.

Other Medical

Costs directly associated with the delivery of medical services under HMO arrangements which are not appropriately assignable to the medical expense categories defined above; e.g., costs of medical supplies, medical administration expense (except compensation), malpractice insurance, etc.

Expenses for other non-contracted health delivery services including emergency room costs incurred by HMO members for which the HMO is responsible on a fee-for-service basis; and out-of-area service costs for emergency physician and hospital.

Another important aspect in reporting claim liabilities is to include only liabilities relating to actual amounts due providers or enrollees for health care services. Items consisting of withholds or the provision for withholds should be reported as a separate liability in the annual statement. Further, claims payable or claims incurred but not reported (IBNR) are not to be adjusted for amounts receivable from other HMOs or indemnity carriers such as coordination of benefits or subrogation. Such receivables are to be reported as an income item in the period received.

Determining IBNR Claims

There are a number of methods used to develop IBNR reserves. Two of the most common are the lag system which is based on the assumption that a majority of claims to be incurred will be reported within a given number of months after the statement date. Under this method, an HMO bases its

reserve on an estimate of the reported claims within a specific time following the statement and it includes an amount for claims reported after the “lag” period. A second method bases claims on the development of prior years IBNR results and adjusts this amount for any increase or decrease in business and for the impact of inflation.

Regardless of the method used to develop IBNR claims, the method used should be tested through a retrospective analysis of claims for past periods.

#### Accrued Medical Incentive Pool

This amount represents the accrual for withholds from IPAs or are a “risk bonus” in capitate medical groups or other such arrangement in which the HMO may return incentive funds to providers. This liability shall not include percentage withholding from providers which should be reported separately. The amount due should be supported by signed agreements and the basis for establishing the liability should be documented when determining the amount of this liability.

#### AMOUNTS WITHHELD FOR RISK-SHARING

These amounts are also included in amounts withheld from providers, generally in a capitated fee arrangement, requiring the provider to share the risk in the event of adverse claim costs. These amounts are held pursuant to a written arrangement which outlines the circumstances under which the so-called gain or loss on the capitated arrangement has been determined. The amounts reported may carry over from one period to another and it may be difficult to determine. HMOs should maintain data to support the amounts withheld on an annual basis, as well as information to support all disbursements.

26. The minutes of the June 6, 1995 meeting of the Accounting Practices and Procedures (EX4) Task Force indicate the Task Force has adopted changes to Chapter 11, Loss Adjustment Expenses and Chapter 17, Loss Adjustment Expenses Incurred of the P&C Accounting Practices and Procedures Manual to be effective for calendar years beginning January 1, 1997 (later revised to January 1, 1998). The revised chapters are presented below:

#### CHAPTER 11

#### LOSS ADJUSTMENT EXPENSES

Every property/casualty insurer is required to maintain reserves in an amount estimated to provide for the expenses of adjustment or settlement of all losses or claims incurred on or prior to the date of statement, whether reported or unreported, which are unpaid as of such date and for which the insurer may be liable. The loss adjustment expense reserve maintained should be established at an amount which is irrespective of any payments made to third-party administrators, management companies, managing general agents, or other entities not specifically covered by a contract of insurance.

Loss adjustment expenses are categorized as “allocated” or “unallocated.” Separate data is shown relative to payments of these expenses and separate reserves are required to be stated for each component within Schedule P of the Annual Statement blank. Relative to allocated loss adjustment expenses, separate reserve provisions are required to be shown for known case reserves and incurred but not reported reserves, and for each of the segments, there is a further requirement to show reserves for direct plus assumed business as well as the ceded portion of those reserves. The actuarial techniques existent for determining the reserves required for each of these components are more precise relative to the allocated expenses because the payments and reserves history are more precisely apportioned to loss years and are thus more homogeneous. Unallocated loss adjustment expenses paid, apportioned to loss year based on formula, are less likely to present data with the same measure of homogeneity.

Allocated loss adjustment expenses can be identified with a particular claim and thus can be linked to the particular loss year underlying such claim. (Note: relative to claims-made type policies, claims are distributed on the basis of report year, i.e., the year a loss is reported to the insurer rather than the year in which the claim was incurred).

See Chapter 17 - Loss and Loss Adjustment Expenses Incurred for a description of the component parts of "Allocated Loss Adjustment Expenses."

The reserve for unallocated loss adjustment expenses should be apportioned to loss year. This apportionment may be based on a formula or formulas containing such items as claim counts or paid to paid patterns that reflect experience for the company and the line of business.

In circumstances involving reinsurance where the definition of allocated loss adjustment expense contained in the contract is consistent with the definition in Chapter 17, it is expected that there would be symmetry of annual statement presentation. In certain instances, where reinsurance contracts define expenses to be covered thereunder differently than the definition of allocated loss adjustment expenses in Chapter 17, there may be a difference in the classification of these expenses between the ceding and assuming parties.

In reviewing the adequacy of an insurer's loss adjustment expense reserves, it is important to group same homogeneously for proper analysis. This may require additional groupings other than the allocated and unallocated categories presented in the financial statements. Also of critical importance, is an evaluation of the company's claims handling procedures over time to discern changes in methods of claims handling, e.g., switching from outside counsel to in-house attorneys.

Frequently, the categories of loss adjustment expense are analyzed by reference to arrays of data by line of insurance that related such expenses to other parameters, such as paid losses, incurred losses or earned premiums. Accordingly, the examination of loss adjustment expense reserve requires some or all of the following procedures:

1. Evaluation of prior developments of reserves;
2. Evaluation of known case reserve adequacy patterns;
3. Evaluation of timing patterns of expense payments in terms of how billings are made as well as the philosophy of claims handling;
4. Notation of any material end-of period transactions which might distort analysis, e.g., major claim settlements;
5. Evaluation of premiums earning procedures or changes which might reflect new forms of policy issuance such as the issuance of cash-flow type policies.

Evaluation of the reasonableness of loss adjustment expense reserves involves many of the same skills that are needed to evaluate the reasonableness of loss reserves. The most typical utilized data arrays for allocated loss adjustment expenses usually present cumulative payments therefore, either separately or in relationship to cumulative loss payments. Ultimate payments or ratios are then calculated and current reserves are computed either by subtracting payments to date from projected ultimate payments or by applying the ultimate ratio to projected ultimate losses and then subtracting allocated loss adjustment expense paid to date.

Relative to unallocated loss adjustment expenses, a common method is to relate such cumulative payments by loss year to a common base, usually earned premium. Ultimate ratios of unallocated loss adjustment expenses to earned premiums are calculated. These ultimate ratios are then multiplied by the related calendar years' earned premiums with cumulative payments to date subtracted to arrive at the required reserves. The use of earned premiums as a base allows for reasonableness tests for a particular insurer as between years as well as amongst insurers, and is rooted in earned premiums being representative of exposures. This has its limitations in that the

amount of such earned premiums is not adjusted for premium adequacy level changes and premium adequacy levels may be inconsistent. (Note: if premium adequacy/inadequacy levels are consistent, the use of earned premiums as base or benchmark will not necessarily result in distorted conclusions). In other words, doubled earned premium volume could mean doubled policy exposure and therefore doubled claims adjusting overhead, doubled premium adequacy with not concomitant claims adjusting overhead increase or somewhere in-between.

## CHAPTER 17

### LOSS AND LOSS ADJUSTMENT EXPENSES INCURRED

#### Losses Incurred

Losses incurred are reported in the Underwriting and Investment exhibits of the annual statement. Losses incurred are shown in a separate exhibit in the annual statement by adding the current year change in unpaid losses to the paid loss amount for the current year. The paid figure is direct paid losses, plus assumed paid losses, less ceded paid losses. Unpaid loss changes are also calculated on a basis net of reinsurance.

#### Loss Adjustment Expenses Incurred

Loss adjustment expenses incurred as presented in the annual statement comprise all expenses incurred in connection with the adjustment and recording of policy claims.

They include the total of the expense classification "Claim Adjustment Services" and the types of expenses incurred by company employees in connection with the adjustment and recording of claims. Examples of expenses incurred in these activities are estimating the amounts of claims, disbursing claims, maintaining records, general clerical, secretarial, office maintenance, supervisory and executive duties, supplies, and postage.

Loss adjustment expenses are either "allocated" or "unallocated." Allocated expenses are those that can usually be related to specific claims. Typically they are "Claim Adjustment Services" as modified to include defense, litigation and medical cost containment expenses, whether internal or external, including overhead, and to exclude fees and expenses of all adjusters and settling agents.

Allocated loss adjustment expenses are adjusted for reinsurance assumed and ceded in accordance with the terms of applicable reinsurance contracts. In addition, an assuming reinsurer may incur expenses in its adjustment of reinsured losses. Such expenses for "Claim Adjustment Services" modified as described above are also to be treated by the reinsurer as allocated expenses.

Unallocated expenses are those expenses other than allocated expenses as defined above assigned to the expense group "Loss Adjustment Expense."

For further information on allocation of expenses, see Chapter 19 - Expenses.

#### Uninsured Accident and Health Plans

See Chapter 14 - Premiums for the discussion of uninsured accident and health plans and partially insured accident and health plans.

Loss paid by the insurer under uninsured accident and health plans should not be reported in the underwriting and investment exhibits. Loss payments under the insured portion of partially insured plans are reported as accident and health losses.

27. The Minutes of the September 23, 1997 meeting of the Casualty Actuarial (Technical) Task Force contain the following:

Casualty Actuarial (Technical) Task Force  
Clarification of Revised ALAE Definition

INTRODUCTION

The Casualty Actuarial (Technical) Task Force (CATF) has extensively studied the issue of financial reporting inconsistencies that occur because of the different business procedures applied by insurers to settle claims. To increase the consistency of reporting between insurers, the task force recommended to the NAIC's Accounting Practices and Procedures (EX4) Task Force that a revised ALAE definition be adopted. The change was adopted by the Accounting Practices and Procedures (EX4) Task Force to be effective Jan. 1, 1998. The rule will be moved to the Annual Statement Instructions as it is deemed to be more of a financial reporting issue than an accounting guidance issue. The task force intends that the revised definition change the emphasis from assignment of claim expenses based on whether they could be specifically assigned to a single claim to a process where "Claim Adjustment Services" including defense, litigation and medical cost containment are assigned to the bucket or hopper currently known as "allocated loss adjustment expenses—ALAE" and remaining expenses associated with adjusting and recording policy claims are assigned to a bucket or hopper currently known as "unallocated loss adjustment expenses—ULAE." The titles containing the terms "allocated" and "unallocated" seem to be causing difficulties for those attempting to understand the revised definition because they associate the term "allocated" with assignment or tying the expenses to a specific claim. As a result, the CATF intends to pursue a future Blanks Proposal to change the titles. The ability of an insurer to assign a particular type of expense to a single claim is no longer the determining factor as to whether the claim expenses will be deemed to be ALAE or ULAE. The goal of the task force in suggesting the change is to have consistent reporting of expenses related to defense, litigation and medical cost containment among the various companies. Thus whether a company uses its own employees or hires outside firms no longer matters.

THE REVISED RULE

The Annual Statement Instructions are amended (effective 1/1/98) to include a specific delineation between allocated and unallocated loss adjustment expenses, which states:

Allocated loss adjustment expenses include defense, litigation and medical cost containment expenses, whether internal or external. Allocated loss adjustment expenses include the following items:

- i. Surveillance expenses;
- ii. Fixed amounts for medical cost containment expenses;
- iii. Litigation management expenses;
- iv. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by accident year;
- v. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in defense of a claim, and fees or salaries for rehabilitation nurses, if such cost is not included in losses;
- vi. Attorney fees incurred owing to a duty to defend, even when other coverage does not exist; and
- vii. The cost of engaging experts.

The foregoing list is not intended to be all inclusive.

Unallocated loss adjustment expenses are those expenses other than allocated expenses as defined above assigned to the expense group "Loss Adjustment Expense." Unallocated loss adjustment expenses include the following items:

- i. Fees of adjusters and settling agents;
- ii. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year;
- iii. Attorney fees incurred in the determination of coverage, including litigation between the insurer and the policyholder; and
- iv. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster.

The foregoing list is not intended to be all inclusive.

#### GUIDANCE IN ASSIGNING CLAIM ADJUSTMENT EXPENSES

The Casualty Actuarial (Technical) Task Force has been asked to provide additional guidance to clarify how various expenses should be classified once this change is implemented. As a result, several questions have been raised about the classification of Loss Adjustment Expenses. The questions and suggested answers follow:

1. Should surveillance expense be classified as ALAE, consistent with the NCCI's classification?

**Answer:** Yes, even though an apportionment among the claims may be required.

2. Please confirm that litigation management expenses, i.e., costs incurred to conduct audits of outside legal bills for cost containment expenses, should be classified as ALAE.

**Answer:** Yes, even though an apportionment among the claims may be required.

3. Should fixed amounts for medical cost containment expenses, such as medical bill review, that are not identified to specific claims be classified as ALAE or ULAE?

**Answer:** ALAE, even though an apportionment among the claims may be required. Note: medical cost containment expenses could be included in losses.

4. Certain voluntary and involuntary market pools (USAIG, MAELU, and JUAs) do not provide a split of LAE. How should they be treated?

**Answer:** ALAE if reported by accident year; ULAE if reported by calendar year.

5. What is the definition of an adjuster? Does it include appraisers, rehabilitation nurses, private investigators, hearing representatives, reinspectors or fraud investigators?

**Answer:** Any of the above are ALAE if they are working in defense of a claim. Any of the above are ULAE if they are working in the capacity as an adjuster, except for rehabilitation nurse expenses, which are ALAE. **Note:** rehabilitation nurse expenses could be included in losses.

6. If an attorney engages in adjustment activities, should the attorney's expense be classified as ULAE?

**Answer:** Yes

7. Do attorney expenses include expenses incurred in securing an opinion regarding matters of coverage, to defend denials of coverage or to evaluate issues of coverage?

**Answer:** Expenses incurred in the determination of coverage, including litigation between the insurer and the policyholder, are ULAE. Defense expenses incurred owing to a duty to defend, even when other coverage does not exist, are ALAE.

8. Are experts' expenses (doctors, engineers, architects, etc.) ALAE or ULAE? How about outside appraisers? These expenses do not fall neatly into the defense, litigation, medical cost containment or adjuster categories.

**Answer:** (a) the costs of experts are either ALAE or included in losses. (b) the costs of outside appraisers are ULAE unless the appraiser is working in defense of a claim in which case the costs are ALAE.

9. Does legal overhead for a subsidiary with its own law department (for example, charges passed down to a subsidiary from a corporate law department) become ALAE? If so, at what level must this data be captured (company, claim, product, coverage, etc.)? What is the meaning of overhead? Would it pertain to salaries/benefits etc. of staff associated with the above activities?

**Answer:** (a) ALAE. The fees charged should include overhead, just like an outside firm charges. Overhead should include the proportionate cost of floor space and associated staff salaries in the same manner as an outside law firm. (b) the level of detail should be enough to prepare Schedule P.

10. NAIC defines ALAE as expenses that can be related to specific claims. Why would Claims Adjuster expenses (e.g., Travel to a specific claim site, etc.) which can be related to a specific claim be excluded?

**Answer:** The first sentence in this question is inaccurate. The apportionment of claims expenses is not dependent on whether the expenses can be related to specific claims. Claims adjuster expenses are ULAE.

11. What is the NAIC's definition of "defense expense"?

**Answer:** Defense expense includes all expenses to defend claims, excluding adjuster expenses.

#### ADDITIONAL COMMENTS

a) There is no special concern about any potential tax problems, but there could be slight tax effects.

b) This new definition of ALAE/ULAE is not retroactive. However, prospectively the change could be implemented on a calendar year or an accident year basis. On a calendar year basis, the expenses in the new and older accident years have the new definition as they develop in the loss and expense triangles. On an accident year basis, the expenses in the new accident years have the new definition and the expenses in the older accident years have the old definition. It is optional to the company which way to do it. There is a split among companies as to which is easier. The actuary should be able to handle either way as long as it is known which choice was made. This information should be disclosed in Interrogatory 8 of Schedule P.

c) The old 45/5 rule for reporting ULAE payments was repealed by a CATF Blanks proposal which was adopted and effective with the 1997 Blank. Insurers should now apportion ULAE payments and reserves by year based on claim counts. For instance, the old rule was based mostly on the theory that 50% of the calendar year ULAE should be assigned to the year in which the claim file was opened (the current year) and 50% to the year in which it was closed. An insurer could now base the apportionment of payments and reserves by the number of claims outstanding, the number of claims reported, etc., or any relationship which seems appropriate. The ALAE payments and reserves are assigned to the accident year of the claim. When ALAE payments and reserves are apportioned, they should be apportioned based on dollars, not claim counts.

d) The task force will also consider a proposal to rename ALAE and ULAE.

28. The Minutes of the June 21, 1993, Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force provide the following with respect to non-renewable accident and health contracts:

The consensus of the working group was that the presence of non-renewal provisions or expense incurred provisions in accident and health policies does not eliminate the requirement to establish sufficient reserves at a financial statement date to cover the estimated duration of an incurred illness under this type of policy.

29. The Minutes of the June 23, 1998, meeting of the Casualty Actuarial (Technical) Task Force contain the following:

1. Discuss Issues Related to the Implementation of the Definition of ALAE/ULAE

Richard J. Roth, Jr. (Calif.) reported that inquiries related to the Jan. 1, 1998 implementation of a definition of allocated loss adjustment expenses (ALAE) and unallocated loss adjustment expenses (ULAE) had dropped off dramatically. He believed that the definition was achieving its intended goal to provide more uniform reporting of information in Schedule P. He believed that regulatory actuaries would benefit from obtaining data that more closely matches expenses between insurers.

Elise Liebers (N.Y.) reported that she and Judy Pool (Ill.) had volunteered to address the various names selected to replace the terms "ALAE" and "ULAE" to coincide with the new definition. She advised that they had considered several proposals. A proposal by James F. Golz (Wausau) suggested ALAE be renamed *Special Claim Adjustment Expense (SCAE)* and that ULAE be renamed *General Claim Adjustment Expense (GCAE)*. A proposal by Mr. Roth suggested that ALAE be renamed *Defense and Cost Containment (DCC)* and that ULAE be renamed *Adjusting and Other (AO)*. Ms. Liebers added that an informal contest was also held to select a name. Ms. Liebers advised that she and Ms. Pool preferred the Golz proposal with a minor amendment. They proposed that ALAE be renamed *Special Claim Expense (SCE)* and that ULAE be renamed *General Claim Adjustment Expense (GCAE)*. They believed that "adjustment" in SACE would be confusing.

Mr. Roth advised that a name would need to be selected at the meeting, as related Blanks proposals would need to be prepared. He asked each task force members to declare their preference. Upon motion by Clark Simcock (D.C.) and second by R. Michael Lamb (Ore.), the task force, by voice vote decided to rename ALAE and ULAE as *Defense and Cost Containment (DCC)* and *Adjusting and Other (AO)* respectively.

Joe Pomilia (National Association of Independent Insurers—NAII) noted that there remained several places in the Blank where the term *loss adjustment expense* was used. He added that this could be confusing to insurers as they report information to the states and the NAIC. Mr. Roth advised that the new terms were a division of *loss adjustment expense* and as such should not be confusing.

Mr. Roth noted that the information packet prepared for the task force contained two draft letters responding to the questions about the appropriate assignment of certain items to ULAE and ALAE. He asked if the task force agreed with the proposed responses. There were no changes suggested so Mr. Roth directed NAIC staff to distribute the letters (Attachments One through Four).

## Generally Accepted Accounting Principles

30. FAS 60 provides the following guidance:

### Claim Cost Recognition

17. A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue (paragraphs 15 and 16).

18. The liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience.<sup>4</sup> Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as salvage, subrogation, or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims.

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<sup>4</sup> Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60.d.).  
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20. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (claim adjustment expenses) shall be accrued when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function.<sup>5</sup>

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<sup>5</sup> Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.  
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31. The *AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies* (AICPA P&C Audit and Accounting Guide) provides the following guidance:

### Loss Reserves

8.17 Both SAP and GAAP require that insurance companies report a provision for all incurred losses that are unpaid as of the balance sheet date, including losses incurred but not reported. The liability is based on management's estimate of the ultimate cost of settling each loss. The statutes of many states, however, require minimum reserves for certain lines, called excess Schedule P reserves, primarily bodily injury liability and workers' compensation. The minimum reserves are based on the company's actual loss ratio in the five years immediately preceding the most recent three years. The lowest ratios for these years, with a stipulated minimum ratio of 60 percent (65 percent for workers' compensation) and a maximum ratio of 75 percent, are used. The determined ratio is applied to earned premium for each of the three most recent calendar years. The minimum reserves are then compared with the estimated liabilities for each of the three years, and any excess of the minimum over the estimates is reported as a separate liability in the statements prepared under SAP. Any changes in the excess reserves are reported as charges or credits directly to surplus. When financial statements are prepared in accordance with GAAP, the entries are reversed, and the excess reserves are restored to retained earnings.

32. *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves* provides the following guidance:

#### **Estimating Methods**

2.8 Various analytical techniques exist to assist management, consulting actuaries, and independent auditors in estimating and evaluating the reasonableness of loss reserves. These techniques generally consist of statistical analyses of historical experience and are commonly referred to as loss reserve projections.

2.13 Loss reserve projections can be performed using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

2.14 Within each of these methods, there are a variety of techniques and loss data that may be used; there are also methods that combine features of these basic methods. No single projection method is inherently better than any other in all circumstances.

#### **Loss Reserve Ranges**

4.15 Because the ultimate settlement of claims is subject to future events, no single loss reserve estimate can be considered accurate with certainty. An audit approach should address the inherent variability of loss reserve estimates and the effect of that variability on audit risk. The development of a single loss reserve projection, by itself, does not address the concept of variability and may not provide sufficient evidence to evaluate the reasonableness of the loss reserve provision in the financial statements. An analysis of the reasonableness of loss reserves should include an analysis of the amount of variability in the estimate. One way to perform this analysis is to consider a range of loss reserve estimates bounded by a high and a low estimate. The high and low ends of the range should not correspond to an absolute best-and-worst case scenario of ultimate loss settlements, because such estimates may be the result of unlikely assumptions. The range should be realistic and therefore should not include the set of all possible outcomes but instead only those outcomes that are considered reasonable. Extreme projections should be critically analyzed and, if appropriate, be adjusted, given less credence, or discarded (this would apply to projections outside a cluster of other logical projections that fall within a narrower range).

33. *AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* (SOP 94-5) provides the following guidance:

10. Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

- a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable
- b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years
- c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

Also, insurance enterprises should discuss the reasons for the change in the provision for incurred claims and claim adjustment expenses attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

34. The *AICPA Audit and Accounting Guide: Health Care Organizations* provides the following guidance:

#### Accounting for Health Care Costs

13.02 Health care costs should be accrued as services are rendered, including estimates of the costs of services rendered but not yet reported. Furthermore, if a provider of prepaid health care services is obligated to render services to specific members beyond the premium period due to provisions in the contract or regulatory requirements, the costs of such services to be incurred, net of any related anticipated revenues, also should be accrued currently. Costs that will be incurred after a contract is terminated, such as guaranteed salaries, rent, and depreciation, net of any anticipated revenues, should be accrued when it is determined that a contract with a sponsoring employer or other group will be terminated.

13.03 Amounts payable to hospitals, physicians, or other health care providers under risk-retention, bonus, or similar programs should be accrued during the contract period based on relevant factors, such as experience to date.

13.04 The basis for accruing health care costs and significant business and contractual arrangements with hospitals, physicians, or other associated entities should be disclosed in the notes to the financial statements.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life, Accident, and Health Insurance Companies, Chapter 11, Unpaid Life Insurance Claims, and Chapter 14, Accident and Health Claims
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 10, Losses, and Chapter 11, Loss Adjustment Expenses
- Accounting Practices and Procedures Manual for Health Maintenance Organizations, Chapter 8, Liabilities
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- *Issue Paper No. 54—Individual and Group Accident and Health Contracts*
- Minutes of the June 6, 1995, Accounting Practices and Procedures (EX4) Task Force
- Minutes of the June 21, 1993, Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Minutes of the September 23, 1997, meeting of the Casualty Actuarial (Technical) Task Force
- Minutes of the June 23, 1998, meeting of the Casualty Actuarial (Technical) Task Force

### Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *AICPA Statement of Position 92-4, Auditing Insurance Entities' Loss Reserves*
- *AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies*
- *AICPA Audit and Accounting Guide: Health Care Organizations*
- *AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*

**State Regulations**

- No further guidance obtained from state statutes or regulations

**Other Sources of Information**

- Casualty Actuarial Society, *Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves* (Also published as Appendix 2 to *Actuarial Standard of Practice No. 9, Actuarial Standards Board*)