1992 CASUALTY LOSS RESERVE SEMINAR

6F: ALLOCATED LOSS ADJUSTMENT EXPENSE RESERVES

Moderator

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Panel

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BRUCE BASSMAN: You are in session 6F which is Allocated Loss Adjustment Expense Reserves. My name is Bruce Bassman. I'm a consulting actuary with Tillinghast in Philadelphia and I will be the moderator for this morning's session. I would like to remind you that this session is being recorded and we would encourage you to use the microphone during the question and answer period. I would also like to make the point that any of the opinions expressed by the panelists this morning do not represent the position of their companies or organizations. Mike had suggested that I add the phrase that "anything here can't be used in legal proceedings."

During this session, we will be looking at allocated loss expense reserves not only from the actuarial perspective. We will also be looking at the management and claims perspective - litigation management issues and a number of things involving, for example, case reserving for allocated loss adjustment expense. Before we get to our panelists, I'd just like to talk briefly about allocated expense reserves. If you look at the industry balance sheet at the end of 1991, there was about a $40 billion ALAE reserve compared to a surplus for the industry of about $160 billion. That is a pretty significant leverage. It's certainly not the leverage that the loss reserves would have. I think that the loss reserves were about $260 billion compared to about $160 billion of surplus. Nevertheless, allocated expenses do represent a significant liability for the industry.

Tillinghast, back in 1989, conducted a survey of 38 of the top 75 property casualty companies. He looked at reserving practices among these organizations. One of the things that came out of this survey is that very few companies were reserving separately for allocated loss adjustment expense. Only 12 out of the 38 companies were doing so. We're seeing a trend toward more companies doing this over the last few years, but, still, in my view there is a lot of information that's not being collected by the industry to help better estimate the ultimate cost of legal defense. In fact, I was at a session this morning on reinsurance reporting and looking at the RAA loss development. RAA data uses incurred losses and paid ALAE for reporting patterns. And it just made me wonder how much of the uncertainty in the loss development tail would be eliminated if the industry were setting up case reserves for ALAE. Another thing that came out of the study on reserve practices is that only about 4 companies were really looking closely at the components of allocated expenses - attorney fees or legal defenses versus adjusters versus independent appraisers versus expert witnesses. We'll hear more about the different components of ALAE from our panelists. It seems as though the industry, generally, has not been paying enough attention to establishing an accurate reserve for ALAE.

This is a brief overview of the relationship, of total loss adjustment expense reserves to total loss reserves. Individual information was not available prior to 1989 to look at the allocated separately, but the allocated reserve represents about 80% of the total loss adjustment expense reserve. You can see the trend, over the past six years, has been upward. In other words, of the total reserves, the loss adjustment expense reserves are a bigger component. There are fairly significant upward changes in some of the lines such as multi-peril. Even the workers' compensation looks like a rather insignificant increase, but, when you look at the total level of loss reserves for that line, certainly, this is somewhat reflective of the crisis. What we're seeing in the workers' compensation line is the increased use of litigation. Medical malpractice is really the only line there that showed any kind of a dip downward during the late 80's but it is coming back up. If you looked at this information going back to the mid-70's through the mid-80's, you would see a similar trend. O.K. With that as a background, I'd like to introduce our first speaker, Mike Conroy. Mike is an executive vice president at Home Insurance Company. He is the chief administrative officer with responsibilities for several functions including claims, loss control, actuarial, and systems. Mike will be giving us an overview from the claims and management perspectives - the process of reserving for allocated loss adjustment expense, what is involved with setting up case reserves both procedurally and from a systems point of view. He will also be touching on a number of other areas in the litigation management field. Mike.

MICHAEL CONROY: Thank you, Bruce. As I told Bruce, being responsible for administration in those various functions - a little bit of knowledge is a dangerous thing. I was mentioning to somebody outside that we have a tendency sometimes to get wrapped up in ourselves and our industry in terms of the importance of what we do and, every so often, reality sets in. Yesterday, sitting on the runway at O'Hare, I had a stewardess sitting across from me and we were 15th in line to take off - we got off the gate on time. We were 15th in line to take off and she said, "Are you going to Denver?", and I said yes. She said, "And what for?" and I said business. She said, "Well, what are you going to do there?" and I said well, I'm going to talk to a group. She said, "Oh, what kind of a group?", and I said well, a lot of them are actuaries. Then the glaze came over her eyes (laughter) and she said, "Oh, do they have something to do with the investment community?". So, I explained to her my definition of an actuary and she said, "What are you talking about?" and I said allocated loss adjustment expense. She said, "Excuse me, I have to go to the galley." and the gentleman sitting next to me was a lawyer. As soon as I said allocated loss adjustment expense he had an idea about that. (Laughter) For ten minutes, we talked about my perception of legal services and his perception of insurance - he picked his book up, I picked my work up and we didn't talk for the rest of the trip. (Laughter)

What I want to talk to you about is really the subject of loss adjustment expenses and, when I mention loss adjustment expenses, I call it ALAE. It's synonymous as far as I'm concerned. What I'd like to do is sort of give you - these are the slides the organization put together for me. One of the things I try to do is I try to take up allocated loss adjustment expense when I was asked to talk about it and fit it into some of the major issues that we're dealing with as an industry in the property and casualty area. Really, it falls into the civil justice system in terms of allocated loss adjustment expenses. It's really part of that process. Tillinghast did a study in 87 which said that direct tort costs are costing the industry about $117 billion. It was being compounded at a rate of about 12% per year and, if you carry that out to 1991, you're in the area of about $184 billion. If any of you have read Peter Huber's book on the liability crisis - or some of his articles - he would suggest that tort costs today are about $300 billion when you take direct tort cost and indirect tort cost. If you just take the medical profession, the AMA did a study in 89 that said for every dollar that's paid in premium doctors will generally do about $2.70 in unnecessary work in terms of diagnostic studies or to really over-document their files with respect to the litigation process. They estimated that that effort on the part of the medical profession is costing about $15 billion in indirect tort costs. If you then step back and take a look at the U.S. and the fact that we're market economy and you take a look at what tort costs are doing to us as a market economy with respect to competition and innovation, studies have indicated that about 2.5% of our gross national product represents direct tort costs. If you look at the U.K., that's about 5 times higher than the U.K. and about 7 times higher than what we see in Japan. So, you really have to look at the tort issue from an economic perspective and try to decide what impact that's having on our ability to compete as a country. When you get down to the level of allocated loss adjustment expense, I can tell you, from an operation perspective, that that's the singular largest expense for most property and casualty insurance companies today. I've been in the business about 28 years and, 15-20 years ago, it was almost a non-issue. It was something that not a lot of people understood, not a lot of people wanted to know about. You never went and did a separate presentation on allocated loss adjustment expenses to your board, or to your CEO. Today, that's a fact of life. That number, for companies, can be anywhere from 50 to 100 to 200 to 300 to $400 million a year. So, you're in the boardroom talking to your CEO and your outside board members because they have a concern about it and they want to know what are you doing in terms of trying to manage that process. So, I think, from my perspective, you've got to have a bias to manage your allocated loss adjustment expense effectively as an organization. The ISO legal defense cost study. They only put that out because, I think, it was an important study in 1988 which said that, over the past 40 years, the ratio of legal defense costs to indemnity costs has tripled indicating significantly more growth in the defense side than in the indemnity side. For all claims, the ratio of legal defense cost to indemnity increases the longer the claim remains open. Therefore, the level of ALAE is a function of claim activity. The longer you have that case open on the books, the more the ratio is going to increase. I think Terry will show you some slides and I think, as Bruce pointed out, in some of the classes of business it's more significant than others. If you take, say, personal auto and medical malpractice. In that ISO study, they looked at GL and they show that, in 1940, about 10 cents of every dollar in indemnity was the cost for ALAE. In 1950, it went up to 14 cents to every dollar. In 1970, 26 cents - 1980, 33 cents and I would suspect that, in 1990, we're close to 40 cents. There is no question that reserving for ALAE is difficult because it takes longer for the expenses to emerge over time with respect to payments. Now, when you get into the types of ALAE, being in the business this long, I've come across a number of different definitions of ALAE. I've heard one organization describe it as encompassing the cost that a carrier incurs that can be directly allocated to a particular claim. The NCCI, in one of their publication, said that it's legal expenses which represents payments to outside attorneys to include miscellaneous related litigation expenses such as expert witnesses, court reporters, private investigators. Tillinghast, in a presentation they did up in Boston years ago, said that ALAE is investigation expenses, cost containment expenses and litigation expenses directly related to a particular claim. ISO, in their study in 88, said that they are the direct costs attributed to settling a specific claim. For liability claims, the primary components of ALAE are the cost of attorneys, expert witnesses and legal defense costs. There's also some discussions as to how staff counsel is treated in organizations as to whether that is part of ALAE or not part of ALAE. Is that just considered non-allocated direct overhead? The NCCI had done a staff proposal at one time and it said they looked at attorneys fees for legal services, whether it was inside or outside, as ALAE. They also looked at both court and alternative dispute resolution expenses as ALAE. They talked about medical exams, expert witnesses, records or documents costs and, then, any cost containment expenses such as bill reviews or PPL expenses. They consider that ALAE. Certainly, the salaries, the traveling expenses of claim personnel or other personnel in a company is not ALAE or expenses that can be defined as part of the loss shouldn't be classified as ALAE.

Getting into, from an operational perspective, the cost effective management of ALAE, just to give you an idea how companies are dealing with this issue, and this is fairly generic, you could probably spend a couple of hours talking on any one of these subjects, but, as I said, it is the singular largest expense item in most property and casualty companies. There's a lot of attention being paid to the issue of ALAE and, particularly, legal services which makes up a major component or legally-related costs which is the major component of ALAE. Outside counsel. I think most companies today have really moved away from looking at firms in terms of controlling legal expenses to really dealing with lawyers. I think companies today are more interested in matching up their cases with the right lawyer so that they're getting quality representation for their policyholder at the most cost effective price and with an agreement between the parties as to what the appropriate resolution of that case is. Insurers today are fairly sophisticated - they're fairly sophisticated in their approach to the issue of both outside law firms and staff counsel. I'll talk about staff counsel in a minute. They're really looking at lawyers rather than firms. Most companies have approved lawyers. They have different tiers for law firms as to whether they're a national law firm, regional law firm or local law firm. Most companies today have a very sophisticated litigation program and people that are charged solely with litigation management within that company. The litigation budgets are really a function of the policies and guidelines that companies have put in writing to spell out what the responsibilities or roles of the parties are in terms of the roles of the defense attorney, the role of the company. It clearly spells out what the company wants that defense attorney to do, what they don't want them to do and, as part of that process, there is a litigation budget that is, generally, agreed upon by the parties to talk about what the cost will be between the defense attorney and the client, in this case both the policyholder and the company. You'll find that more law firms today, that are going to be around over the next decade, have really changed their practices. They are much more sensitive to the issue of cost effective management of the law firm, controlling their overhead and really understanding who the clients are - both the policyholder and the insurer. Ultimately, it is the policyholder, but, if you have a philosophy that talks about quality representation, I think the conflict issue is negated to some extent. The billing practices and audits - a number of defense firms have told me over the years that the greatest thing that came along for them is the hourly billing system. Their viewpoint is that the industry did a disservice to themselves by imposing the hourly billing system. I think the industry did that to try to get more specificity into the billing practice of firms, but firms approached it rather intelligently and developed minimum billing - a minimum billing practice - where, if they spent 5 minutes on the file, they would bill a minimum of 15 minutes. The types of services that were being charged, there was a question as to whether it was appropriate or not. So, I think you'll find that companies are attempting to have a combination of billing practices with firms today to try to get a control over the legal services. They are dealing with contract rates, they're dealing with incentive programs to try to shorten the time frame between when the litigation is filed and when the resolution of the case is done. I mean, the reality of the world is most cases get settled. The Rand studies have suggested that 96-97% of cases get resolved before you go into a courtroom and that 3% that ends up in court - half of that, generally, will get resolved either before trial or on appeal. So, the shorter - the more you can shorten the time frame, between the time a case goes into litigation to when it gets resolved, the more cost effective it's going to be for all parties. The other issue that's really becoming fairly common is the audit process. There are a number of firms that have - their primary job today is to audit the billing practices of outside firms and there's also a lot of computerization that's been added to the review of legal services. Staff counsel. Staff counsel has been an approach by many companies to get a better control over legal services. It's common practice for large companies to use staff counsel as a very cost effective way to control a lot of their - what I would call - plain vanilla litigation - the personal auto, the simple GL, some of the simple professional liability. Studies have shown that you can, with staff counsel, reduce your cost about 40-60% depending upon the case and the particular jurisdiction or geographical area that you're in. They can do it for 40-60% less than what you have been paying to outside counsel in the past. There will always be a need for outside counsel, but it's in the more specialized types of litigation. I think staff counsel is coming under attack in a number of states because it is reducing the amount of work that, heretofore, went to those firms that had an insurance defense practice and, when you consider the fact that there's not a lot of real estate practice out there today or merger and acquisition. You're also finding a great number of firms that, heretofore, wouldn't touch insurance defense work that have now set up insurance defense practices. I think staff counsel is going to continue to grow over time. But, you have to justify it based upon the types of expense incurred and I think that you, will find that staff counsel will have a significant benefit. Alternative dispute resolution. I think you're really just seeing the tip of the iceberg relative to the issue of controlling the ALAE. Today, many companies have people dedicated solely to ADR within their organizations. There are mandatory percentage of cases that some companies have set that must move into some type of ADR. ADR can be anything from mediation, arbitration, rent a judge. You can - what it does is it significantly reduces transaction costs. When you can resolve a case within 60 to 90 days or within six months that, normally, would take 2 to 3 years or possibly 4 to 6 years depending upon the jurisdiction you're in. In Philadelphia, you're probably, in Common Pleas, you're probably going to take maybe 4 or 5 years before you get to trial. Then, I was just reading an article recently - divorces, in some areas, are taking 16 to 24 months. The other thing that ADR is suitable for is the more complex types of cases. I think you get a better understanding of the issues in an ADR process than you might in a courtroom before a jury. We had an experience recently with a very, very complex case involving millions of dollars. We got it into a binding arbitration. It took us 7 months. Normally, that type of case, in my experience, would have taken probably about 4 to 5 years after you went through trial and the appropriate appeals. It's not a favorite of many law firms. They view it as an encroachment on their ability to bill. Lawyers make their money in the discovery process - not trying cases. But, on the other hand, there are several law firms that have moved into this arena full-time. They've given up their law practice and, in an essence, have become mediators.

O.K. Now into some of the specifics with respect to case reserving for ALAE's. I've had some experience on this subject because I've had a real interest in trying to move our company into a specific case reserve methodology with respect to ALAE. As Bruce mentioned, in the study by Tillinghast, about one-third of the companies surveyed indicated that they were doing some type of specific case reserves for ALAE. Most companies, the only time you reflect the ALAE on a case basis is after payment. Reserves for the future or for future payments are accounted for in bulk through an actuarial case expense reserve process. From my point of view, I believe that specific case expense reserves represents a step ahead for companies and has significant benefits - particularly companies that are in the more complex or long-tail business. These are some of what I see as the benefits. I think it does - I guess - raises the issue up within an organization in terms of getting a better focus and attention on the part of both the actuarial function as well as the claim function, depending upon what method or approach you have with respect to specific case reserving. For claims, I would say that, if you are giving your claim professionals the right to set specific case expense reserves, they are going to view it almost like a budget process in the sense that, once they set that future projection, what they believe the expenses will be, they're going to follow that very closely and you're going to get more timely recognition of when you're going to be exceeding that expense reserve or, if you build in a system where when it reaches 50-75% it's automatically reviewed, but, certainly, I think adjustments would be made in a more timely fashion. Those adjustments would require justification. Measurement of underwriting profit. It certainly would provide a more accurate determination of underwriting at the policy account producer and profit center level since the case expense reserve process would be more precise than current bulk or approximation of loss expense reserve allocation procedures that are currently in place in many companies. This is one of the criticisms that we've run into with respect to bulk allocation. On a line of business argument, people will raise geographical differences or - you know, we're getting - there's a built-in bias if we're in a certain part of the country where expenses are higher than other parts. Improved information. Certainly, it would provide the underwriters more precise information at renewal and also show them situations where there's been an erosion of policy limits and this expense is part of policy limit. It would help them on the pricing side as well. On the retro-plans, where you're writing retro-programs, if you don't cede your expense until the case is closed or up to the conclusion of case, it would certainly accelerate retro-premium billing and that becomes really a time value of money issue. It would also provide better information policy, dividends and workers' comp. Aggregates. I think it would certainly help in terms of getting better control of aggregates that include loss expense in the overall limit. The reinsurance benefit. One of the things reinsurers have complained about is the - what they would consider to be not timely notification of reinsurers when expense is part of limit - if you have a system that doesn't generate that until the case is concluded. Contingent commissions - that would certainly provide more accurate calculations of profit sharing commissions rather than approximate expense dollars for a particular producer. Competitive and complete cost data. It gives you an ability to provide more complete cost data to, certainly, larger accounts. Bureau reportings. It certainly would improve the ability to meet bureau reporting requirements where they want to know specific expense information. Actuarial reserve tests - more complete information for the actuarial reserve tests. The control of litigation expenses - it would provide more accurate data for use in controlling litigation expenses. In cash flow, on certain lines of business, expense is a big, significant part of the incurred loss and, from a financial perspective, it's more helpful in cash flow analysis or the anticipation of cash flow. Systems and staff implications. I guess in my experience, people become comfortable with systems so you get a lot of nay sayers with regard to re-tooling your systems to get to a reserving process where you are going to specifically case reserve ALAE. Whatever the approach you take, whether it's a formula, by line of business and the ability for the claim professional override the system or where you're asking the claim professional to do it on each matter, but, the cost of implementing such a change from a systems perspective is fairly involved and fairly expensive. In our organization, we're dealing with - just some of the systems we would have to deal with would be the unit step, the retro-adjustments, our financial accounting, contingent commissions, the actuarial statistics and ratemaking, IBNR reinsurance, claims systems, risk management tools. For the staff, it requires, if you're going to ask your claim professionals to take on an additional responsibility in terms of the financial management of claim other than asking them to set the reserve in terms of what they expect that ultimate loss to be, and now you're going to ask them to also set what they believe to be a projection for the expense payments made over time, it's going to require a re-focus on their part. It's going to add complexity to their job and there's going to be, certainly, some training involved in that. If you do this, the data elements that are changed are going to need time for the data to develop. How you'll approach it - I think Terry will go into some of the ideas about how you approach specific case reserve for ALAE. But, I do think, as I mentioned before, I think it's a step ahead for the industry and a step ahead for the companies and for, I think, the ability to get a better handle on what those costs are in those lines of business that take a long time to develop because I think there's a tendency to focus more of our time on the loss indemnity side and less on the more precise and accurate projection of what our ALAE is. So I do think that companies are moving in this direction and I think I would hope to see that the next study that any organization did that that one-third would be somewhere in 50-60%. Thank you.

MR. BASSMAN: Thank you, Mike. Before we hear from Terry, I'd like to just get a quick show of hands. How many in the audience are involved in some way, either having direct responsibility or as support, for establishing the allocated loss expense reserves of their company? More than I thought. How about from the claims side? How many people from the claims area? Well, we just heard the management and claims perspective and now we'd like to turn to the actuarial side and hear from Terry. Terry O'Brien is a partner with Coopers & Lybrand in their Chicago office where he has spent his past 11 years. Terry is a Fellow of the Casualty Actuarial Society, a Member of the American Academy of Actuaries and he was a past committee member for the CLRS program committee. Terry's going to talk about some of the methodologies used in establishing ALAE reserves - advantages and disadvantages - and some broad industry overviews of the relationship of expense reserves and loss reserves. Terry.

TERRENCE O'BRIEN: Thank you, Bruce. This is a definition that is in regulation 30 of the New York Insurance Department and, you notice, attorney fees are included as part of allocated expenses. On the other hand, many companies believe that, because internal attorney fees are salaries, they should be in unallocated expenses. One of the things I want to point out is that, if you shift from a program of using external attorneys and start to use in-house attorneys, your reserve level is going to drop just because of the different reserving techniques that are typically used for those two different pieces. So, you should be aware of that. It's probably to your benefit, as far as keeping an accurate adequate reserve, to categorize internal attorneys fees as allocated loss adjustment expenses instead of unallocated loss adjustment expense. I've had arguments with people who say you can't do that, but, from a point of view of keeping an adequate reserve, it would be better. If you don't do that, you probably want to use a more elaborate technique for unallocated expenses.

There are a few things that are specific to allocated expenses, the loss reserve opinion requirements and some changes that are going through. You do have to opine on the allocated loss adjustment expenses both on a net basis and on a direct plus assumed basis. This year, it's explicitly been included that the unallocated expenses - the total of column 21 and Schedule P - should be included in the opinion on total loss adjustment expenses for direct plus assumed and we have a new requirement that you have to reconcile the Schedule P data. I'm sure you've all heard about that from other panels.

First, let me point out that the scale is wrong. It's billions of dollars not millions of dollars and I hope you can see that. Does that help? The scale for loss reserves is on the left hand side and the scale for loss adjustment expenses is on the right hand side. I fixed them so they would be coming up somewhat equal to begin with back in 87. You can see, by the different slopes, how loss adjustment expenses have crept up at a greater rate than loss reserves.

This chart shows the same phenomenon that allocated expenses have been going up or, in this case, it's total loss adjustment expense, have been going up as a percentage of total reserves moving up from less than 17% to about 19% between 87 and 1990. And, they've also been going up as a percentage of total liabilities on the balance sheet - going up from less than 10% to about 11% there.

Here we see what's been going on for private passenger auto. Back in 1981 and moving out from there, we were slightly less than 6% and that the ratio of paid allocated expense to paid loss is less as reported now than on an ultimate basis. Meaning that the outstanding ratio of allocated expense to loss is greater for the portion that's outstanding than for the portion that has already been paid and that's what you normally expect because you have the larger cases out there and you're going to have more allocated loss adjustment expense going towards those cases than for the simpler ones that were paid earlier on. So, you see, that consistent relationship and then, as you go further out, you can see how the ultimate is actually growing over time, moving up somewhat steadily, almost showing a spike up for 1990. I don't have 1991's aggregate statistics, but I wouldn't be surprised if it continued to move up at a rapid rate like that. You see the drop off for the paid portion and so that just shows how the ratio of losses - or allocated paid to losses paid - grows over time. That's what you'd normally expect. Private passenger auto, even though it's showing an increase here, it's been somewhat tame compared to some of the other lines. Commercial auto shows a similar pattern. The absolute ratio is quite a bit higher so, if you're mixing your lines, you're going to get some average of those two. It would probably benefit you to keep them separate because they do have significantly different components for the allocated expenses at least as a ratio. The reason for this is probably the higher severity losses that you would expect for commercial auto or the greater proportion of the losses are higher severity type losses so you expect more litigation costs there. Again, we see the relationship with the paid to paid ratio is less for each of the years compared to the ultimate to ultimate ratio.

Homeowners shows a more erratic sort of pattern. Part of this is just because you're dealing with a combination lines that is predominantly property and some liability, but the liability piece of it has the vast majority of the allocated expenses. So, it fluctuates quite a bit. If you look at 1989, you see that the ultimate ratio has dipped down there. That's probably attributable to the catastrophes - Hugo, San Francisco earthquake during that time. Big component there of property loss - no where near the average level of litigation costs expected to be associated with that so you'd see a dip down there. I think that's why you would get this type of somewhat erratic pattern because of the property piece of it. We found, though, that when you break out the liability piece from the property piece, you see ratios tremendously higher than this and, especially when you're talking about the outstanding piece - unpaid - allocated to unpaid loss. The ratios can be astronomical for some jurisdictions.

Workers' compensation. There's an interesting pattern here that was quite level up until 1984. Then we saw a movement up for the next 3 years. Then a dip down for the next 2 years. Then a spike up for 1990. I'm suspicious of that movement down in 1988 and 89 as being accurately reserved. Everything that I hear - litigation costs are going up for workers' compensation. So, there may be a hint of under-reserving in there. Maybe some of you would like to comment on that after I'm through. Now, other liability shows a different pattern than what we've seen in the previous lines. In the earlier lines, we were seeing, for the most part, that the paid to paid ratio was less than the ultimate to ultimate ratio. Here we see for the earliest years that the paid to paid ratio is quite a bit higher - or somewhat higher - than the ultimate to ultimate ratio. Now, that could be for a variety of reasons. You could expect that you don't have much in allocated to paid, but you do have significant losses to wrap up or that you have a lot in both categories, it just happens to be that the losses are going to be quite a bit more. When I look at the data for individual companies, I don't see a pattern that supports this type of relationship though. The overall ratios, you can see, are quite a bit higher for 85 and prior versus 86 and subsequent. Now, there may be some justification for that because you do have environmental losses in the earlier years. Those are subject to a lot of litigation. That might be why we're seeing that type of pattern showing up here, but overall I think there's good reason to be concerned about the adequacy of allocated loss adjustment expense reserves in other liability. Now, malpractice has that same pattern of having the paid to paid greater than the ultimate to ultimate ratios, but this is something that we've seen for years and years and is borne out in individual company data. Early on, you do have quite a bit in defense costs going out. You don't have a high rate of settlement on the losses so your indemnity payments are not coming through yet. Those are quite a bit delayed, but the allocated loss adjustment expense payments are coming through early so you see these higher ratios early on and then the pattern of dropping off, as a ratio, is fairly consistent just because you have the large payments coming through further out. Not that you have a drop off in the absolute dollars of allocated expenses going out, but just very small payments on both sides allocated and lost in the very early goings.

There are a variety of ways that allocated loss adjustment expenses can be reserved. Mike had referred to case basis. My experience is that case basis, on a claim by claim by individual adjusters, is not a very popular way of addressing the problem. I've yet to come across a company that really thinks they've done a good job and is pushing that as the primary technique that you would be looking at essentially incurred allocated loss expense development as your primary technique for reserving. I just haven't run across any companies that are that confident about their case reserving for allocated expenses. So, while I applaud Mike's pushing for that and I'd like to see better numbers coming through and more reliable numbers, it just isn't out there right now and it isn't something that I would rely upon heavily without first testing and developing some confidence with the individual company's data. For the most part, the case basis allocated expense reserves are not particularly reliable. Some companies have formula reserves where they've looked at it either in a simple fashion or a more elaborate fashion. Sometimes it's just a straight allocation of l% across all the reserves that are outstanding on a case basis. You know that there are going to be problems with that, but, if you have a development of that ratio over time, there's going to be an understatement for the most recent years - excuse me, for the older years and an overstatement for the most recent years - that type of thing - if you're using an average ratio. Other companies use a far more elaborate process that recognizes the different ratios by year of development and may recognize other things like whether a claim is in suit or not and can get a more accurate formula-type reserve. Again, formula reserves are not that much better than what my experience is with case basis reserves. They don't tend to be all that consistent. The formulas change over time so reliability of those is questionable. Then you have just straight old IBNR type of reserves, including bulk for known claims, and that's what we're going to talk about for most of the rest of this presentation. The magnitude of the ALAE reserves is dependent on the line of business, as you saw with those earlier slides, policy limits and other things that are under the control of the company so you have to be well aware of what it is you're looking at. Some companies use outside adjuster and those would show up as allocated expenses. Other companies use internal adjusters and those would show up as unallocated expenses. If you're shifting, by jurisdiction or for the company in total, one use or another, it's going to have some effect on your reserves and you should recognize that and compensate for it. Also, the use of internal and external attorneys will have a big effect on what your allocated expense reserve should be.

Now, I have a personal bias that, any time I can, I like to look at the allocated loss adjustment reserves separately and look at the data that underlies it separately from the loss data. Now, you can't always do that, but that's my personal bias. Some of the times that you can't do that is if you're just using Schedule P data off of one annual statement and you have it combined. You can't do much about that. That's the data that's presented so, either if it's off of Schedule P or it's from some other source, you've got to deal with it. That's - those are your cards and you've got to play them. In some instances, it makes a lot of sense to put the two together. If you're looking at something like medical malpractice where you have the vast majority of the payments early on coming from allocated expenses, it may make a lot of sense to put the two together and make a projection off of that. Alright, it's especially meaningful if you have a policy limit that applies to the total of loss and loss adjustment expense, then you're going to see different patterns emerging on both a and net and gross basis. So, you want to pay attention to that type of thing and see what the impact is by combining the data,but for the most part, you should be looking at them separately.

Now, in my experience, companies don't use a lot of different techniques for projecting allocated loss adjustment expenses. Some companies can have a half a dozen to a dozen techniques for losses and they look at all sorts of different things for different lines and make all sorts of adjustments on the loss side and then you ask about allocated expenses and, whereas you've got a pile of material for losses like this, they give you one sheet of paper and it says - O.K., here's allocated expenses and we did it in a half an hour and that should be good enough for you. Allocated expenses are very volatile. They are subject to changes that are internal to the company and they're subject to some changes that are external as far as the litigation environment that you're in. So, if you're in different jurisdictions, you might see very different ratios of allocated expense to loss. And, you want to catch up to these things, not only for reserving purposes, so you have an adequate reserve, but for pricing purposes and also for operational purposes. If something is going on out there, probably the first place you're going to spot it is in your loss reserving data. One technique I don't have up there is just the straight calendar year paid to paid. Now, we all know that that's no good so don't use it, but we still see companies using it. The first three techniques are used somewhat frequently. Those are pretty common I see quite a few companies looking at a standard development triangle type of technique - that's what I'm talking about for the paid allocated development method - where you just take the ratios of consecutive columns, get a cumulative factor off of those and make a projection. The second one is used less frequently than that. Where, before you start, you take the ratio of allocated loss adjustment expense payments to loss payments, on a cumulative basis, and then take the development triangle of that. The third one, which is a particular favorite of mine, is to look at the incremental payments, so you take the two triangles, on an incremental basis, look at the ratios, project down - meaning by development year what the ratio is going to be - and then you project out what the loss payments are and apply those ratios. I find that to be a particularly good technique because it adds a lot of stability to the projections. Everyone is always looking at the ultimate allocated to loss ratio and, using that as a guide, either formally or informally, in making their selections because there is such volatility in any allocated projection. Now, the last three are techniques that I've seen very infrequently. I'm sure I could count the number of companies on one hand that use more elaborate types of techniques to project their allocated expenses. There are some companies that feel that they can relate their allocated expenses for the number of claims - sometimes they break it out between claims that are in suit and those that are not in suit - getting average amounts, seeing what the trends are for severity and so on. Some companies relate their allocated expenses to exposures, pure premiums, that type of thing. I don't know that it works particularly well. It does produce a good deal of stability. Some companies get pretty elaborate and apply some inflation to incremental averages and make projections off of those. But, like I said, it's quite infrequent that you see a company doing that. I would like to push for more companies using more techniques because you see a very wide range of estimate coming out of allocated loss adjustment reserving techniques and you need to narrow it down.

The straight projection method has some advantages. It's easy to understand. Everyone knows how to do a development triangle. It's good when you have a consistent amount of allocated payment coming through each year, especially in the first couple of years. It will reflect changes in settlement patterns. It will reflect them after they've taken place though, so you won't catch them right off the bat. It's surprising, some companies will go through and do a projection based on losses - or do their loss projection and reflect changes in settlement patterns - then they go to their allocated projection and ignore what they found out in the earlier projection. You can go through and do adjustments to this type of technique just like you do for losses. But, the big disadvantages are that you come up, frequently, with very large factors for the most recent year and you could have answers that are all over the place if you don't relate your allocated projection to something else. So, it's not a particularly stable technique.

Tail factor might be quite difficult to estimate, but you're always going to have that problem with virtually any technique that you have.

Now, the advantages to the paid to paid technique are similar to those for straight development although you can also see what's going on with the ratios and sometimes those ratios will be more stable than the pure development. The biggest disadvantage to using both of these techniques together is that some people think that these are truly independent techniques and they might use it with another technique and select something that is close to what comes out from these two techniques and, my experience is that, they tend to move together for the most part. So, they're not truly independent. If you use both of those techniques and you don't see very different answers, don't feel more confident because those two are close together. Look at a third technique and average the third technique with the result of those two and not give equal weight to the ratio technique and the pure development technique. Here's a simple example. In this example, I've incorporated a slowing down of loss payments. So, you see the development factors are getting somewhat larger. I've made selections. I haven't given those a great deal of thought. I haven't gone back and related the settlement pattern and made adjustments for that so these selected factors could be low because I'm only averaging to get to the selected. These are the allocated expense payments. Same triangle. Ratios of consecutive columns down in the bottom panel there. And, again, I've averaged to get a selection. Now, here you see the magnitude of some of the allocated development factors. So, if you're using a factor of 8.5 and you have a range from 4 to 11, that's quite a bit of swing in any individual factor. Again, I'm using averages so I'm going to understate it because I know I had a slow down in both the loss and allocated expense development. In this particular technique, both loss and allocated are, in this example, moving together. So, the ratios are staying consistent. That's the way I've contrived this example. It doesn't necessarily have to happen that way, but sometimes it does and it benefits you to look at this when things are changing. You can see where the selections are a good deal easier to make because of the stability of those ratios. We have two different projections then. In the top panel, we have the straight allocated development projection and you can see, in that last column, that the ultimate allocated to loss development the ratios have fallen off, come back a little bit, but they've dropped off quite a bit. That's because there's been this slow down in the allocated payments and we haven't caught it in our selection of factors. In the bottom panel, you see the ratios and the projection of those ratios to ultimate and the application of those ratios to the ultimate loss and you can see how the ratios have remained quite a bit more stable and give you a better answer because - in my example here, I've assumed that the ratios are going to remain the same. So, you may want to try a technique like this when you see some change in your settlement pattern.

Now, the incremental paid to paid tends to be more stable just because it's more of an additive type of technique than a multiplicative technique. When you're dealing with development factors, you're multiplying everything out and you get the leveraging effect. When you're dealing with incremental ratios, you're adding things together and what has taken place in earlier periods is not going to have a huge effect on the reserve and it actually won't have much of an impact if it's taken place in the first 12 months because you've filled that out entirely. You don't need to project what's going to go on in the first 12 months at the end of 12 months. There are some disadvantages. If you're looking at these ratios and they're not really representative of what's going on - that there is no correlation between allocated payments and loss payment, then you're trying to model something that isn't meaningful. You do find that your data gets sparse when you get out into the tail and you have only a few observations and you have trouble selecting what the ratios might be because they're all over the place. That's another disadvantage to this type of technique. You find that those tail factors have a good deal of leverage on the overall reserves.

Now, I've put together an example, here, where a company is switching from using outside adjusters to in-house adjusters and you have the two separate patterns of allocated expenses, or just expenses, where the adjuster costs come in quite a bit quicker and they reach ultimate, virtually, at the end of 24 months. But, the defense costs, everything excluding the adjusters, doesn't even reach 20% by the end of 24 months and takes quite a bit longer to play out. So, you have these two distinct pattern and, if your company is switching from one to the other - using external adjusters to using internal adjusters, it can throw off your development triangles quite a bit. Here I've segregated the cost excluding the adjusters, all the defense costs, and you can see how small the payments are in the early going - how large the factors are. I've used the normal development technique to make a projection of what the ultimate allocated expense would be for all the defense costs.

On this next slide, I show what the adjuster costs are and how they develop out and you can see that they're quite a bit higher, during the first 12 months, than the defense costs were. And I make a projection of these separately.

Now, in this summary, I take the two sets of ultimates, add them together. Really, what you should be comparing is the total for 88 and 89 and on the (inaudible) development under all other for 90 and 91 because, in my example, the company has switched from using outside adjusters to internal adjusters for 90 and 91. In the combined development, I've used the data in that fashion where I've excluded adjuster costs for 90 and 91. And you can see how low the projections are because the ratios, on a combined basis, are going to be quite a bit less. Then, I've used the incremental paid to paid method for the same data across all years and you can see, if you make that comparison, that the results are quite a bit closer for 90 and 91 between the incremental method and the all other on it's own. That type of stability that you get is one of the advantages of the incremental method and you do have such control over your expenses for allocated that you can have these type of distortions occurring with some regularity.

The last thing I'd like to talk about, just quickly, is that California workers' comp is a big problem. We're seeing that it has a related problem for loss adjustment expenses. The abuses that are going on out there are showing up in the losses. Companies are trying to combat that to get it under control, to take aggressive action. This is increasing the ratio of allocated to loss. It's hoped that that will reduce the overall loss and it's hoped that that will have a permanent benefit that will allow the companies to go back to lower ratios of allocated expense after they've demonstrated their willingness to fight those people who are abusing the system. But, it's questionable how effective that's going to be at this point. Here are the incremental ratios that I've concocted for one example and, in this one, you see a company that, in 91 and 92, is willing to spend 50% more in allocated expenses and, at the same time, they're paying more in losses. So, the ratios are not reflecting a full 50% increase. After that time, you're going to see a drop off and a return to the traditional pattern. Now, if you take the same type of data and look at it in a development triangle, you're going to see things being quite a bit more difficult to understand what's going on. This type of array of the data allows you to look at how things are moving. Now, you can have the opposite effect where companies don't really benefit from the allocated payments that - all it does is lead to more payments - and there isn't any drop off in the loss side. That's what I'm showing here - that you have an even greater increase in allocated payments, losses still go up and then the company concedes that those efforts, and all the expense, hasn't really benefited the company in reducing losses overall. It falls back down, but it falls back to a level that is still higher than where they were at before.

MR. BASSMAN: Thank you, Terry. I'd just like to make a few comments before we open it up for questions. One of the things that was talked about was the changes in claims procedures that are going to impact the allocated loss expense projections. One of the other considerations is to look at changes in business that the company is writing. If you're looking, for example, at your general liability ALAE reserve and you are shifting from traditional business, OL&T and M&C type coverages, to more professional liability coverages, E & O, D & O, your reserve requirements are going to change dramatically. We were looking at averages for GL before that were in the 30% range - ultimate allocated expense to loss. In some of the professional liability lines - lawyers, accountants, even police professional - the allocated ratio is in excess of 100%. That is, there's more spent for defense than there is for indemnity. You need to be tuned into that when you're looking at your overall reserve level needs. If you've got a change in mix of business, then an assumption that your ultimate paid to paid ratios are going to be stable could be a very inadequate one. In helping my clients reserve for allocated expense. I look at the ultimate ratio of loss expense to loss and question if that ratio is stable or declining. Given what we've seen in the industry the results suggest are that things are getting worse. The ratios are getting higher and, if you combine that with the fact that some perceive the industry's loss expense reserve to be about 50% deficient it's clear that this ratio, under normal circumstances, should be going up. I would encourage you to look closely at your own company results if, in fact, they are showing some stable relationships in the more current accident years.

Another point I wanted to make was in terms of pricing. We're here to talk about reserves, but, for those of you who are involved in pricing, often the loss adjustment expense or the allocated loss adjustment expense is loaded in as a factor. You take your losses and you hit them by 1.15 or whatever, depending upon the line of business. Given the fact that the ratio is increasing, you could significantly understate your pricing needs if you're going back and taking a 2 or 3 year average. An incurred to incurred ratio is going to understate your rate level indications and it could be pretty dramatic.

The other point I wanted to make was, in evaluating the allocated expense reserves, if you're recognizing changes in claim department procedures whereby more of these investigative activities are going to be done inside the company and that perhaps allocated expenses are going to be reduced, be sure that your assumptions, when you're setting your unallocated reserve, are consistent with that. In other words, the anticipation would be that your paid to paid ULAE ratios are going to be increasing so there should be coordination in establishing these two reserve components.

Mike, did you have any further comments?

MR. CONROY: Just two comments. I wouldn't want you to leave here unless I made a clarification. Terry mentioned that I was advocating case basis approach to reserving ALAE and I'm really not. What I'm advocating, really, is a combination of case and formula by the actuarial department, but, really, what I'm suggesting is that, for future payments, we reflect that on a case-specific basis. My bias, really, is that a lot of lines of business can be done on a formula basis by the actuarial function and, as the aging process occurs, adjust it. I think the claim professional should have an override because there are certain cases where the formula is just not going to be adequate. Sometimes it's too high and, in some cases, it's very, very low, particularly when you get into coverage litigation where you know you're going to spend $100,000 in legal defense cost and the formula generates a formula, on a line of business basis, say, of $13,000 or $15,000. The other thing is that there are some very, very small lines of business where you have dedicated claims professionals where you're dealing with almost a fixed cost approach where they're much more capable of projecting future costs than the actuarial function simply because of the lack of data. The other thing that Terry talked about up here was the changes in patterns going from outside adjusters to inside adjusters. I can tell you, although that can be dramatic, the more dramatic is where a company moves from outside counsel to staff counsel and they don't have a charge back system. You can imagine what can occur just from a business point of view in terms of underwriting and pricing when you look at the incurred losses. So, with that . .

MR. BASSMAN: I'd like to, at this point, open it up for questions please use the microphone and identify yourself.

BARRY LIPTON: I'm Barry Lipton from Fireman's Fund. Mike, I was wondering do your adjusters put the case expense reserves up at time of receipt of claim or when it goes into suit?

MR. CONROY: We're still in the developmental process. We're doing it on an incremental basis, but they will be able to do a - again, depending upon the lines of business. Now, as I said before, a lot of lines of business can be handled by the actuarial function where they can approach future payments on a formula basis and then adjust the formulas depending upon how long the case stays open. But, the - on certain lines of business, the claim professional would have the right, particularly on small lines of business, to set a specific case expense reserve. Then they could adjust what the actuarial department said if the case was developing abnormally. But, it would be an override function.

MR. BASSMAN: Anyone else?

OLLIE WILSON: I'm Ollie Wilson. I'm a consulting actuary. I'd be interested to know if you've done any studies that would show the ratios of ALAE to paids by policy limits. That is to say, if you have a low limit - and I'm speaking here particularly of the automobile lines - if you have a low limit BI policy, how much would you need for ALAE on the loss versus how much would you need in ALAE on the loss for higher limit policies?

MR. CONROY: I can't say that I've really done a study looking at that particular aspect. I mean, you could tell that it's going to be quite a bit different just by reflecting the differences between commercial auto and private passenger auto where you typically have different limits - commercial auto probably having $500,000 or $1 million limits. You may want to look at some of the substandard auto carriers who are likely to have lower limits out there. That's what I would like to to see what the differences are versus just standard or preferred carriers. I haven't studied that. The ratio is not that high for auto private passenger. You're talking 7%. I don't know what the savings are, but you know that companies are far more willing to pay $25,000, when that's the policy limit, than $100,000 or $250,00 or whatever it might be where you have higher limits. That's where I would research. I just don't have a lot of feel for it off the top of my head.

UNIDENTIFIED SPEAKER: I think five or ten years ago, companies approached staff counsel differently. They even had an expectation that there would be high turnover because they paid low salaries and they got lawyers right out of law school that just passed the bar exam and they felt that they would get a great deal of productivity out of those lawyers and then loose them in 3 or 4 years. But, I think it's changed.

MR. BASSMAN: We still have a few more minutes for questions. Anyone else? Yes.

LEE BARKLEY: I'm Lee Barkley with the Washington State Insurance Commissioner's Office. Terry, you were commenting on the need for separating allocated from loss - different times the preferability of doing that - and, as I see some statements of opinion, there are times when it appears that that may not have been separated and the opinion will say that the amounts carried on these two lines are in the aggregate - reasonable or whatever. I was wondering if you feel an obligation, on a statement of opinion, to separate the adjustment expense from the loss - how you handle that?

MR. O'BRIEN: I don't know if I feel an obligation. I guess I'd be looking to the regulators to specify what's really intended there. What you're seeing may not be a function of how they attack the problem, but the result where you could have a deficiency on one piece of the reserve and a redundancy on another piece of the reserve. The combined reserve is acceptable and that's what they're trying to communicate to you. I'm not certain if that's what you're seeing though. I think, at this point, loss reserve opinions are still in such an early stage that we need a lot of guidance from regulators on what it is they really want to know and how we can communicate it to them so we don't mislead them, but we do what's proper for our companies or our clients.

MR. BASSMAN: Any other questions? Well, thank you for participating and please join me in thanking our panel.

1992 CASUALTY LOSS RESERVE SEMINAR
Session 6F: Loss Adjustment Expenses

Presented by:

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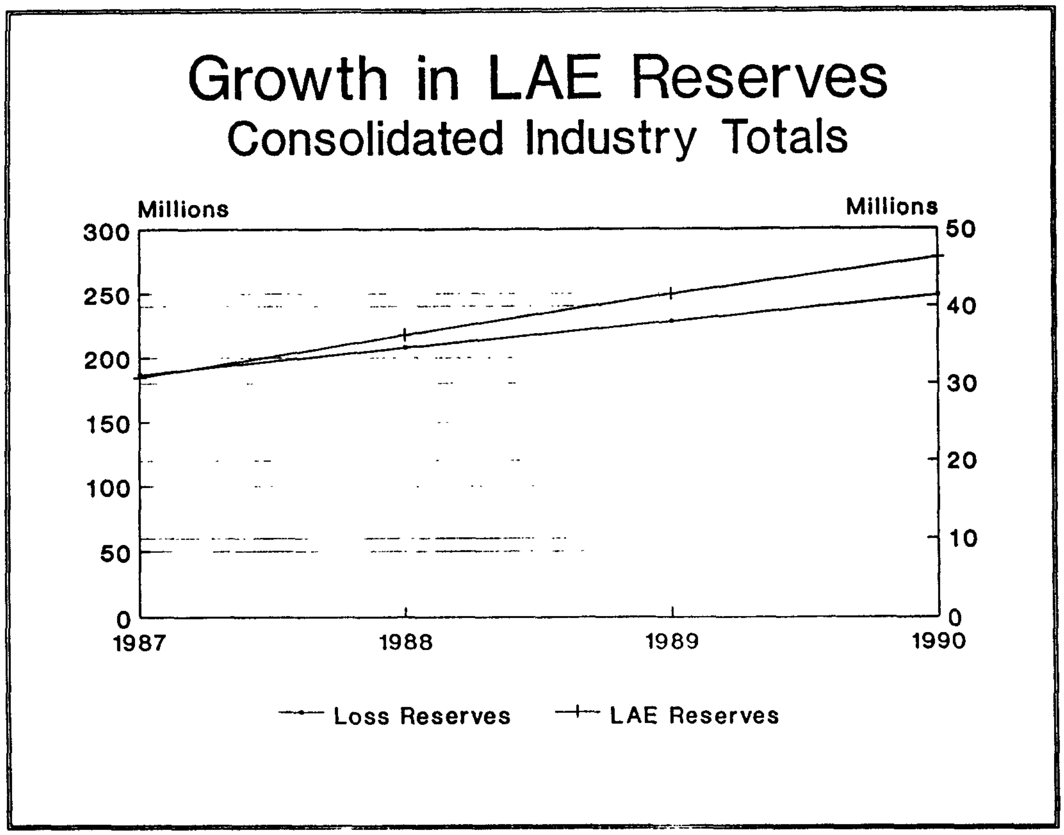
DEFINITION OF ALAE

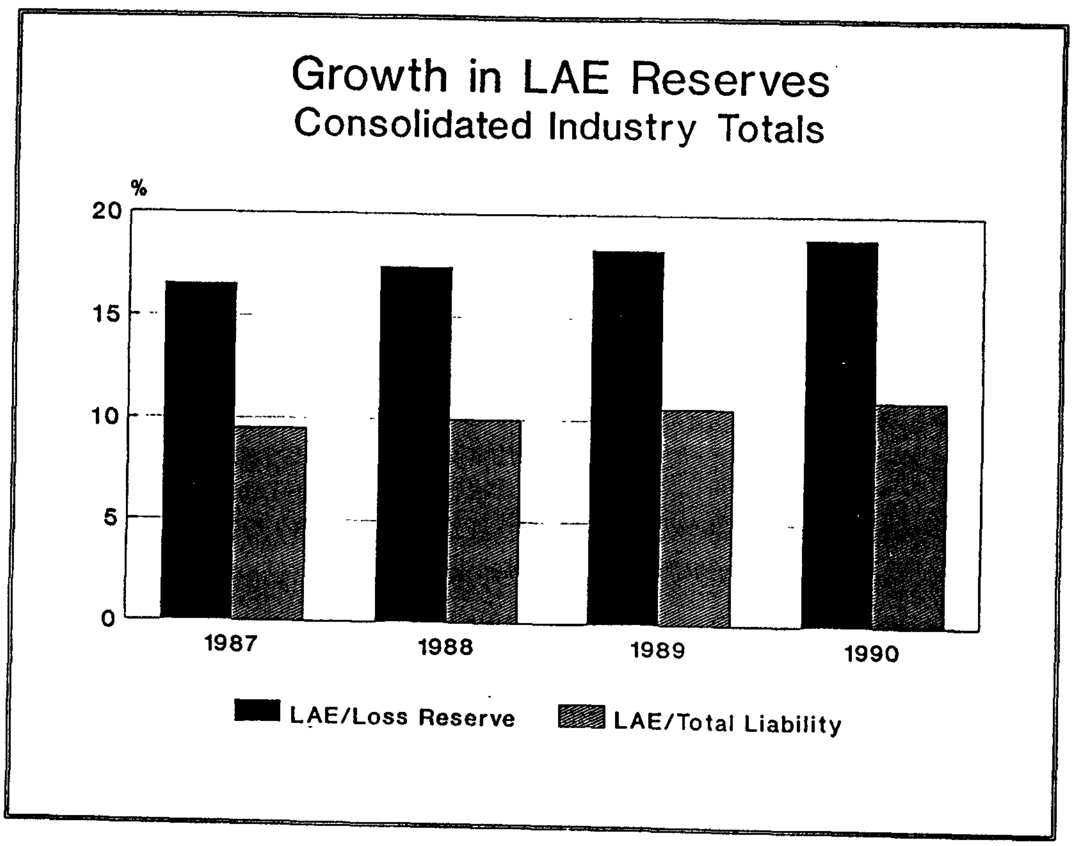
Those expenses which can be attributed to specific claims, including attorneys' fees, investigative fees, court costs, expert witness fees, and outside claims adjusters' fees (if they are apportioned to specific claims)

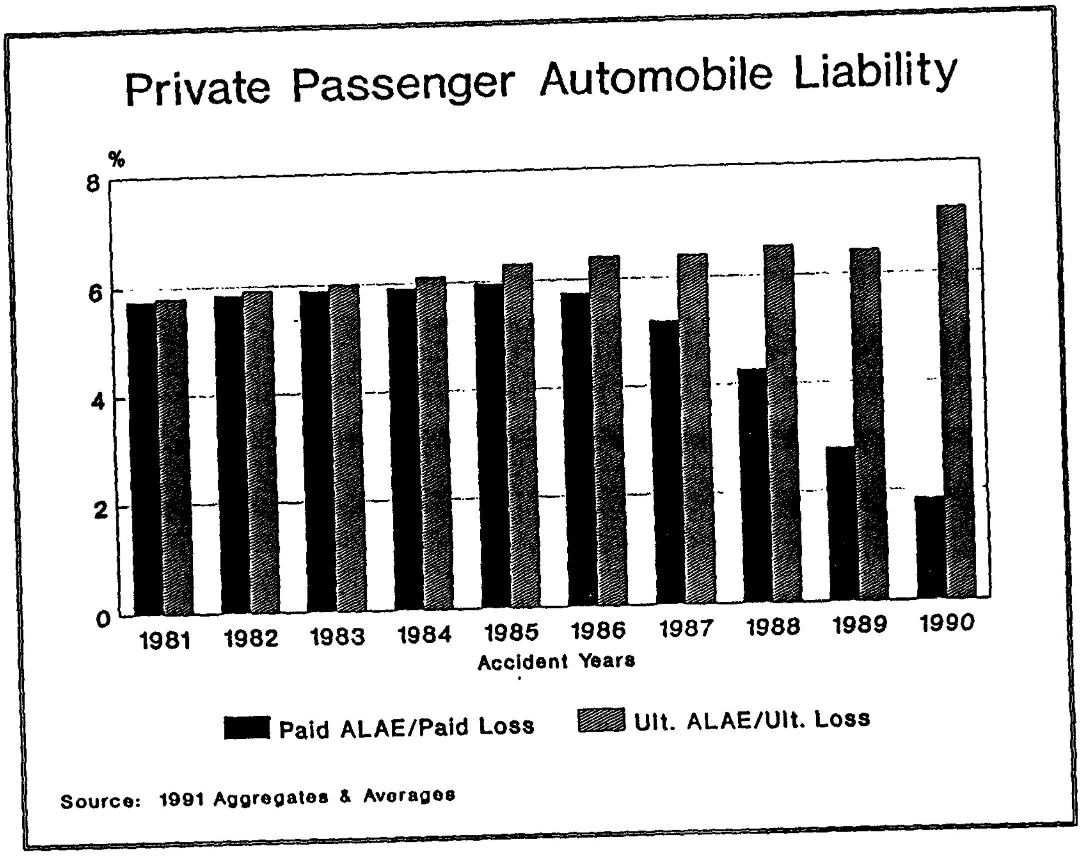
Regulation 30 of the NY Insurance Dept., *Uniform Classification of Expenses of Fire & Marine & Casualty & Surety Insurers*

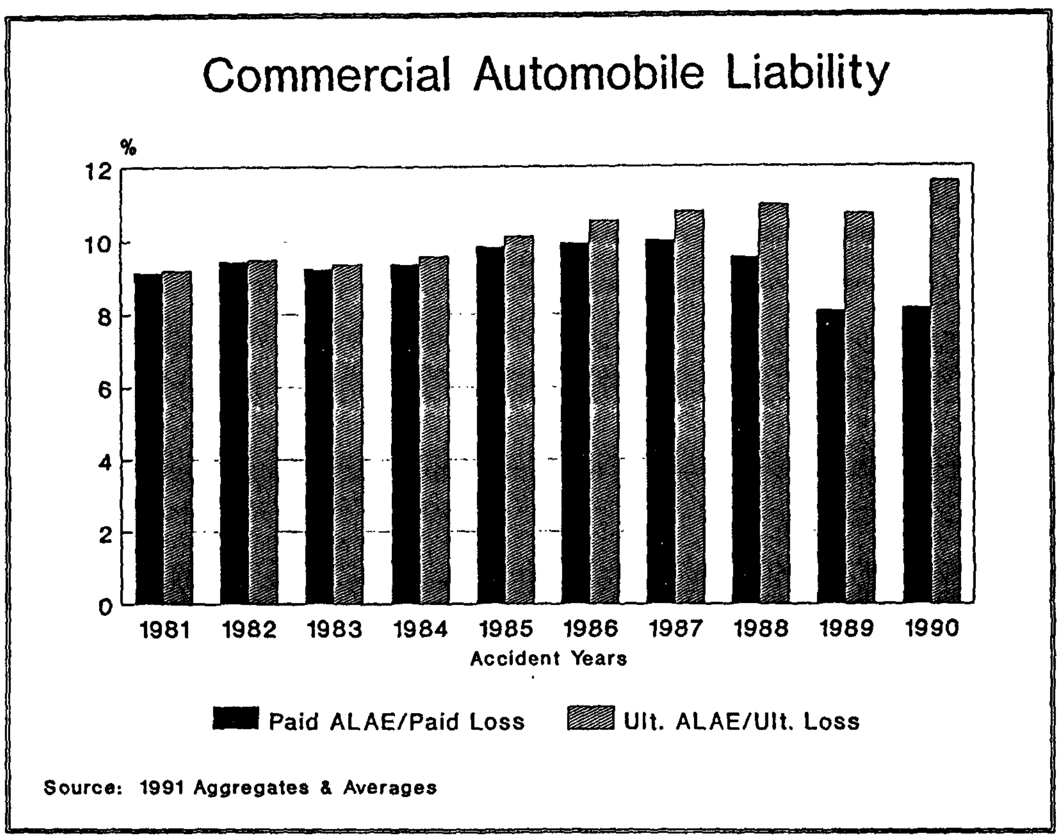
Loss Reserve Opinion Requirements

- ALAE reserve must be reviewed for reasonableness on a direct and net basis
- ULAE reserve must be included on Direct + Assumed basis in addition to Net basis
- Reconciliation to Schedule P


Growth in LAE Reserves
Consolidated Industry Totals
Millions
Millions
300
250
200
150
100
50
0
50
40
30
20
10
0
1987
1988
1989
1990
Loss Reserves
LAE Reserves


Growth in LAE Reserves
Consolidated Industry Totals
%
20
15
10
5
0
1987
1988
1989
1990
LAE/Loss Reserve
LAE/Total Liability


Private Passenger Automobile Liability
%
8
6
4
2
0
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
Accident Years
Paid ALAE/Paid Loss
Ult. ALAE/Ult. Loss
Source: 1991 Aggregates & Averages


Commercial Automobile Liability
%
12
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8
6
4
2
0
1981
1982
1983
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1986
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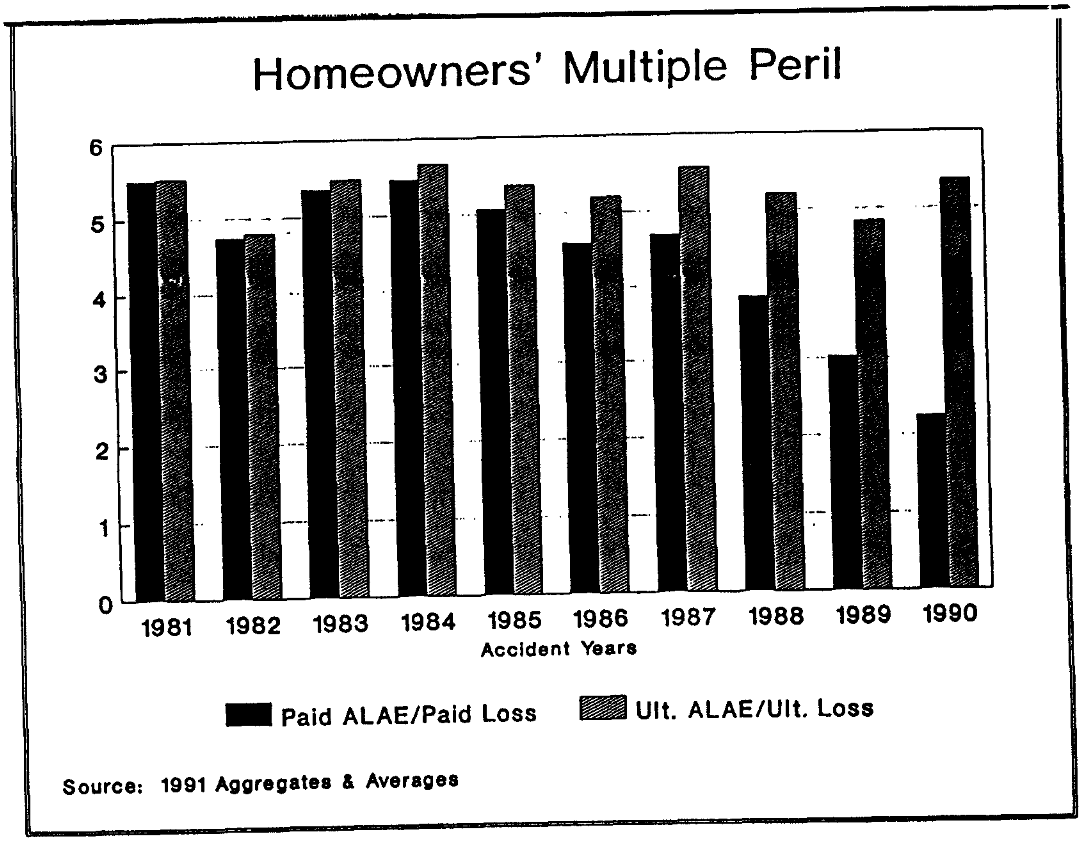
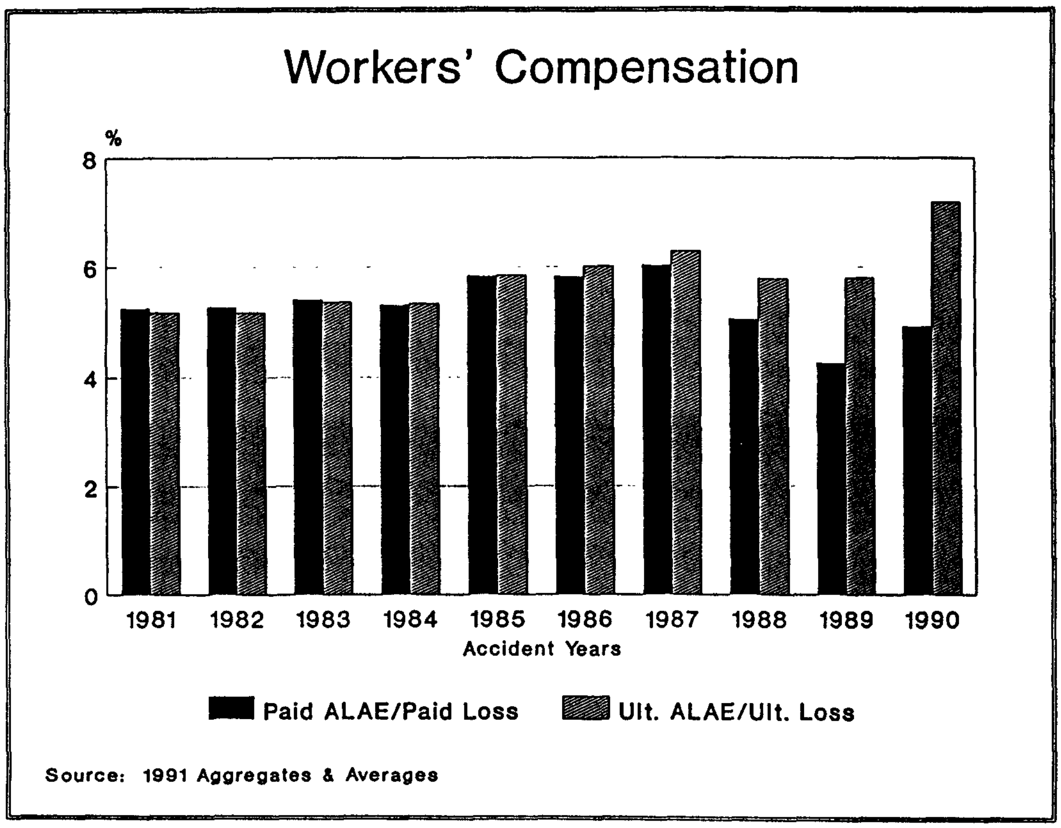
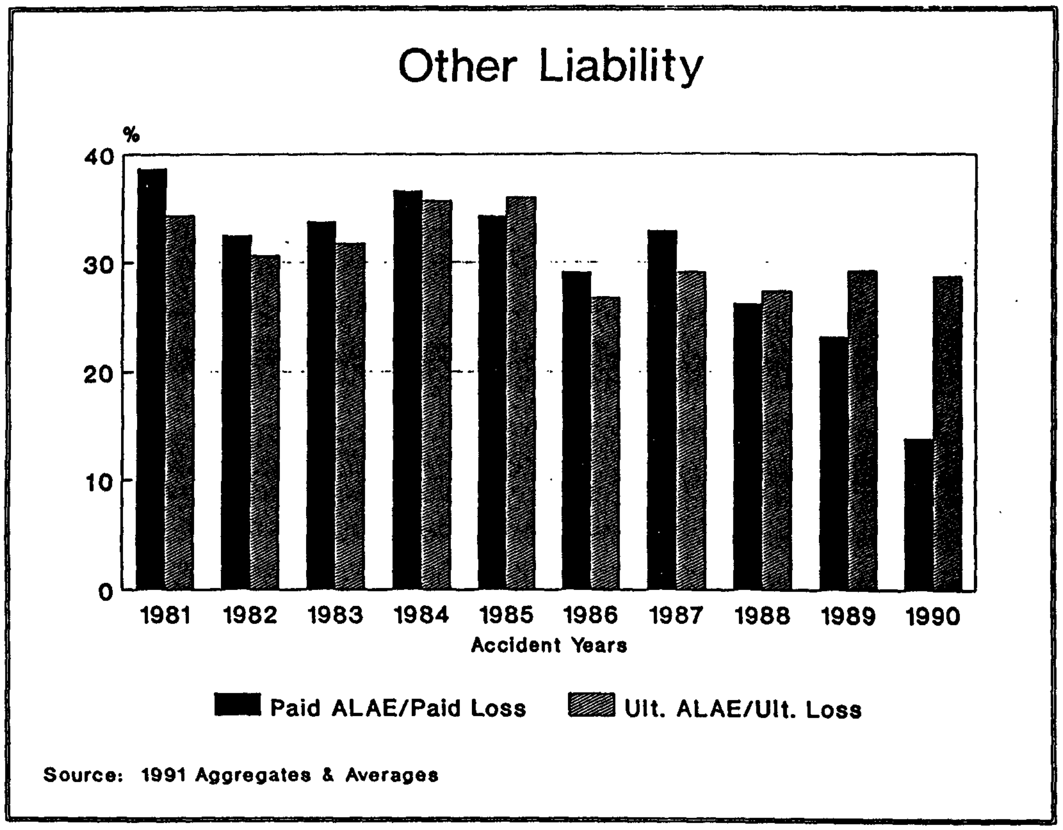
1988
1989
1990
Accident Years
Paid ALAE/Paid Loss
Ult. ALAE/Ult. Loss
Source: 1991 Aggregates & Averages

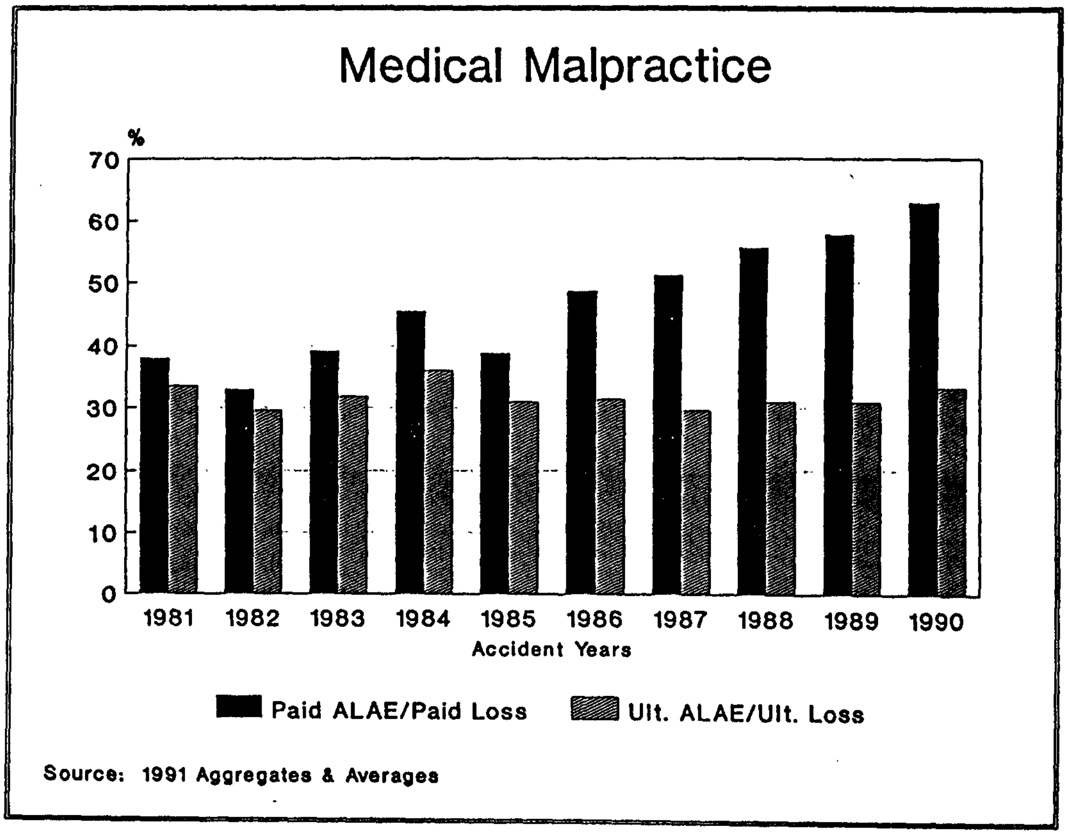


Homeowners' Multiple Peril
6
5
4
3
2
1
0
1981 1982 1983 1984 1985 1986 1987 1988 1989 1990
Accident Years
Paid ALAE/Paid Loss
Ult. ALAE/Ult. Loss
Source: 1991 Aggregates & Averages



Workers' Compensation
%
8
6
4
2
0
1981 1982 1983 1984 1985 1986 1987 1988 1989 1990
Accident Years
Paid ALAE/Paid Loss
Ult. ALAE/Ult. Loss
Source: 1991 Aggregates & Averages


Other Liability
%
40
30
20
10
0
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
Accident Years
Paid ALAE/Paid Loss
Ult. ALAE/Ult. Loss
Source: 1991 Aggregates & Averages


Medical Malpractice
%
70
60
50
40
30
20
10
0
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
Accident Years
Paid ALAE/Paid Loss
Ult. ALAE/Ult. Loss
Source: 1991 Aggregates & Averages

RESERVES FOR ALAE

- Case basis reserves
  claim by claim basis
- Formula reserves
  % of indemnity, etc.
- IBNR reserves
  including bulk adjustments
- Magnitude of reserve for ALAE depends on line of business, definition of policy limits, extent of use of outside adjusters and outside legal counsel

WHEN SHOULD ALAE & LOSSES BE PROJECTED ON A COMBINED BASIS?

Combine	Separate
Schedule P data	ALAE develops differently than loss
policy limits defined on a loss plus ALAE basis	changes in reliance on outside claims adjusters or outside legal counsel that affect the ALAE data may be dampened if data is combined
when ALAE is a large proportion of the total loss plus ALAE	
when the data is not available on a segregated basis	

ALLOCATED LOSS ADJUSTMENT EXPENSES
Projection Methods

- Paid ALAE Development Method
- Ratio of Paid ALAE to Paid Loss Development Method
- Incremental Ratio of Paid ALAE to Paid Loss Method
- Ultimate ALAE to Loss Ratio Method
- Counts & Severities Method
- Exposures & Pure Premiums Method
- Inflation Adjusted Incremental Averages Method

PAID ALAE PROJECTION METHOD

<u>Advantages</u>

Simple to use and understand

Good for coverages where losses develop early and quickly

Shows changes in settlement patterns

<u>Disadvantages</u>

Factors may be erratic and very large for immature periods

Tail factor selection may be difficult for long tail lines

ALAE payments made during les mature years may be very small

RATIO OF PAID ALAE TO PAID LOSS DEVELOPMENT METHOD

Advantages

Development factor approach advantages

Trends in the ratios can be observed

Ratios may remain stable even when claims settlement rate changes

Disadvantages

Development factor approach disadvantages

Loss and/or ALAE amounts used to calculate the ratios may be small or erratic

Results tend to parallel paid ALAE development method

Paid Loss
Other Liability

Acc. Year	12	24	36	48
1988	170	390	820	1,040
1989	180	650	2,330	
1990	290	1,230		
1991	370			

Acc. Year	12: 24	24: 36	36: 48	48: ULT
1988	2.28	2.10	1.79	
1989	3.58	3.59		
1990	4.56			
Sel	4.25	3.00	1.79	1.50

Paid ALAE
Other Liability

Acc. Year	12	24	36	48
1988	25	101	225	291
1989	27	169	629	
1990	29	332		
1991	59			

Acc. Year	12: 24	24: 36	36: 48	48: ULT
1988	4.04	2.23	1.29	
1989	6.26	3.72		
1990	11.45			
Sel	8.50	3.05	1.29	1.50

Cumulative Paid ALAE/Paid Loss
Other Liability

Acc. Year	12	24	36	48
1988	.147	.259	.274	.280
1989	.150	.260	.270	
1990	.100	.270		
1991	.160			

Acc. Year	12: 24	24: 36	36: 48	48: ULT
1988	1.76	1.06	1.02	
1989	1.73	1.04		
1990	2.70			
Sel	1.80	1.05	1.02	1.01

Ultimate Loss & ALAE
Other Liability

Acc. Year	Ultimate Loss	Paid ALAE	LDFs	Ultimate ALAE	ALAE/ Loss
1988	1,560	291	1.50	436	.280
1989	6,256	629	1.93	1,213	.194
1990	9,908	332	5.91	1,962	.198
1991	12,666	59	50.21	2,962	.234

Acc. Year	Cum. Ratios	LDFs	Ult. Ratios	Ultimate ALAE
1988	.280	1.01	.280	436
1989	.270	1.03	.280	1,752
1990	.270	1.08	.290	2,873
1991	.160	1.95	.312	3,952

INCREMENTAL RATIO OF PAID ALAE TO PAID LOSS METHOD

Advantages

- Ability to adjust for changes by development period
- Trends in ratios can be observed
- Does not depend on current evaluation of paid ALAE to project reserves

Disadvantages

- Assumes close relationship between ALAE and loss
- Incremental ratios may be erratic, especially in the tail
- Not a direct match of losses and ALAE due to partial payments

INFLATION ADJUSTED INCREMENTAL AVERAGES

Advantages

Ability to adjust for changes by development period

Observe residual trend after removing the effects of claims cost inflation

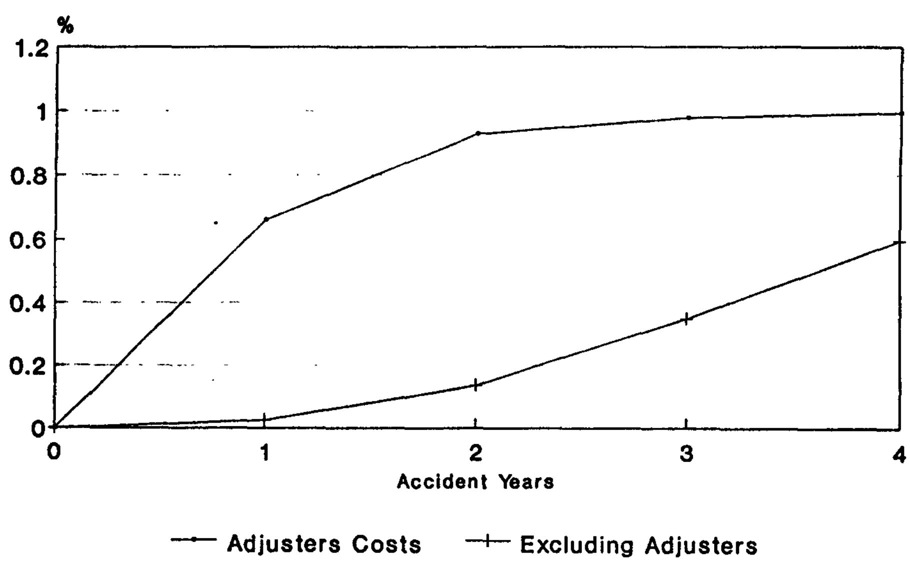
Disadvantages

Industry inflationary trends may not apply to a particular company's book of business

Incremental ratios may be unreliable if loss or ALAE amounts are small or erratic

Not a direct match of losses and ALAE due to partial payments

Paid ALAE Percentage of Ultimate Auto Liability



Paid ALAE - Excluding Adusters Costs
Auto Liability

Acc. Year	12	24	36	48
1988	694	3,340	9,513	15,596
1989	952	5,307	12,210	
1990	915	5,115		
1991	822			

Acc. Year	12: 24	24: 36	36: 48	48: ULT
1988	4.813	2.848	1.639	
1989	5.575	2.301		
1990	5.590			
Sel	5.447	2.518	1.639	1.450

Paid ALAE - Excluding Adjusters Costs
Auto Liability

Acc. Year	Paid ALAE	LDFs	Ultimate ALAE	Indicated Reserve
1988	15,596	1.450	22,614	7,018
1989	12,210	2.377	29,023	16,813
1990	5,115	5.984	30,608	25,493
1991	822	32.596	26,794	25,972
TOTAL	33,743		109,039	75,296

Paid ALAE - Adjusters Costs
Auto Liability

Acc. Year	12	24	36	48
1988	2,205	3,082	3,201	3,229
1989	2,546	3,849	3,981	
1990	2,939	3,219		
1991	1,728			

Acc. Year	12: 24	24: 36	36: 48	48: ULT
1988	1.400	1.039	1.009	
1989	1.512	1.034		
1990	1.100			
Sel	1.406	1.053	1.016	1.006

Paid ALAE - Adjusters Costs
Auto Liability

Acc. Year	Paid ALAE	LDFs	Ultimate ALAE	Indicated Reserve
1988	3,229	1.006	3,248	19
1989	3,981	1.022	4,069	88
1990	3,219	1.076	3,465	246
1991	1,728	1.513	2,615	887
TOTAL	12,157		13,397	1,240

Comparison of Ultimate ALAE

Auto Liability

Acc. Year	ALAE Development: Indep. Adjusters	All Other	Total	Combined Results: Dvlpmt Method	Incre Method
1988	3,248	22,614	25,862	27,296	24,137
1989	4,069	29,023	33,092	34,761	28,544
1990	3,465	30,608	34,073	21,414	28,654
1991	2,615	26,794	29,409	13,765	26,890
TOTAL	13,397	109,039	122,436	97,237	108,225

AVERAGE ALAE METHODS/ULTIMATE RATIOS METHOD

<u>Advantages</u>

Avoids applying large LDFs to small paid ALAE amounts

Good for new lines of business

Good for volatile lines of business

<u>Disadvantages</u>

Depends on expected ultimate averages/ratios which are difficult to determine

Need count or exposure information in addition to paid ALAE (except for ratio of ultimate ALAE to loss method) to calculate the reserve

Changes in ALAE
California Workers' Compensation

- Loss payments increased due to abuses of the system by attorneys & physicians
- Companies increased ALAE payments in fighting such abuses
- Legislation was passed to eliminate the abuses
- Doubts about the effectiveness of company and legislative actions
-

Paid ALAE - Effective Use of ALAE
California Workers' Compensation

Incremental Paid ALAE to Paid Loss

Acc. Year	12	24	36	48	60	72
1989	.025	.095	.204	.230	.188	.162
1990	.025	.119	.222	.169	.188	
1991	.031	.130	.163	.169		
1992	.034	.095	.163			
1993	.025	.095				
1994	.025					
Historical	.025	.095	.163	.169	.188	.162

Paid ALAE - Ineffective Use of ALAE
California Workers' Compensation

Incremental Paid ALAE to Paid Loss

Acc. Year	12	24	36	48	60	72
1989	.025	.095	.306	.317	.235	.203
1990	.025	.178	.306	.211	.235	
1991	.047	.178	.204	.211		
1992	.047	.119	.204			
1993	.031	.119				
1994	.031					
Historical	.025	.095	.163	.169	.188	.162