

REPORT OF COMMITTEE ON COMPENSATION AND LIABILITY  
LOSS AND LOSS EXPENSE RESERVES

## WRITTEN DISCUSSION

RUSSELL P. GODDARD

The committee has attacked a problem which has been in need of study for many years. In view of the importance of the problem, it would be advisable to have the report well buttressed with answers to the questions which will be raised and criticisms which will be leveled at any change from our present Schedule P. The following objections are some of those which are bound to arise in the course of the consideration of the report by insurance commissioners and others interested in the solvency of insurance companies. It is not assumed that these points have not been thoroughly considered by the committee, but it is felt that discussion at this point of time may be made in anticipation of similar discussions later on.

- (1) The report gives scant attention to the reserve problem for new insurance companies for which ratios of paid-to-incurred losses can not be determined. Presumably the present reserve methods are unsatisfactory when applied to new, and comparatively new companies, but it might be well to have a frank discussion of the inadequacies of any arbitrary tests of reserves for this class of carrier.
- (2) For well established companies the ratios of paid-to-incurred are relatively stable and there may be a danger that too much reliance may be placed on the control values of these ratios. This is particularly true, of course, for immature policy years for which the amount of outstanding loss reserve is largest.
- (3) The use of paid-to-incurred ratios as a test assumes a fairly constant proportion of long-term cases. These ratios may prove misleading in the event that something has happened to change this proportion, such as the passage of law amendments increasing the term of death or permanent total cases, or if the particular company has entered a new state with a higher proportion of such cases than other states in which the company previously operated, or if on the other hand the company has been able to adopt a program of settling such cases by lump sums.

It is felt that a discussion of these items will smooth the course of the committee report after it leaves the pages of the *Proceedings*.

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### WRITTEN DISCUSSION

J. C. MONTGOMERY

The Committee's report focuses attention at a particularly opportune moment on what is perhaps the most troublesome problem facing casualty companies today in the preparation of their annual statements, that is, the question of establishing for Compensation and Liability lines loss and loss expense reserves that will be adequate but not excessive, with the added objective of segregating these two types of liabilities so that their corresponding items of losses and loss expenses incurred will be properly reflected in the Underwriting Exhibit. The subject is equally important to the companies from the standpoint of their internal exhibits, including data on branch and agency loss ratios, profit sharing statements, classification and other rating filings, and other procedures involving the use of case estimates on open claims.

Irrespective of the merits or defects of Schedule "P" versus other possible loss reserve substitutes, every effort should be made, as the report suggests, to eliminate the existing confusion caused by the fact that the present formula loss reserve includes the element of unpaid loss expense. A separation into the two elements could readily be accomplished in one of several ways, that is, by distinct calculations, or by changing the framework of present Schedule "P", or by a supplemental schedule in which to indicate the portion of the reserve required for loss expense. To go a step further, should the sum of the expense reserve plus the total of case estimates, including therein provision for incurred but not reported, be exceeded by the Schedule "P" formula reserve, the differences might also be stated separately as a "contingent loss reserve" under liabilities on page 5 and treated as a charge against surplus in the miscellaneous section of the Underwriting and Investment Exhibit on page 9. (A similar principle is already recognized in the Casualty Expense Exhibit, which provides for an adjustment item at line 48 representing the difference between the company's estimates and the statutory reserve.) A three-part reserve of this nature, which would not lessen the basic control through minimum reserves now exercised by Insurance Departments, is sound from an accounting standpoint and should not be too difficult to incorporate in existing reserve laws by amendments, if such be necessary.

The establishment of case estimates of guaranteed adequacy for actual losses only, whether for Schedule "P" purposes or, in lieu thereof, an independent case estimate reserve increased by factors for incurred but not reported cases, is, for the reasons cited by the Committee, the far more difficult problem. This is particularly true today as respects the proper valuation of third party bodily injury claims under inflationary conditions that make data on closed cases of dubious current value, either in the mind of the examiner reviewing each claim or for determining averages per case, per-

centages of ultimate costs, or similar bases discussed as possible substitutes for the "minimum reserve" principle. The situation 18 years ago, when the previous Committee reported, was relatively stable as respects damage values. A competent claims man could estimate his reserves on the basis of his past experience and, in the aggregate, come reasonably close; today, not only are basic values distorted but jury verdicts for bodily injuries are frequently for fantastic amounts that are unpredictable. This naturally makes the reserve problem that much more important but correspondingly more difficult of solution.

It appears undeniable that in an inflationary period, when adequate reserves are so vital, there seems to be no single yardstick that can be used by the majority of companies to measure with any consistency the adequacy of their case estimate totals for third party bodily injury claims. This difficult situation is aggravated by the disproportionate growth in recent years of "incurred but not reported" losses caused to some extent by personnel difficulties in the field and home offices. Periodical reserve tests, though advisable, are of limited value since they suffer, in only lessening degree, from the weaknesses inherent in their original reserves, until the number of tested cases still outstanding has become a relatively small proportion of the total, by which time economic and personnel conditions may have further changed and conclusions based thereon consequently subject to question. Thus, in the last analysis, we find ourselves dependent upon the claims examiner's judgment as a base against which some precaution must be established and maintained until the actual ultimate costs or a close approximation thereof can be determined. Schedule "P" provides only the imperfect protection of a minimum reserve, it is true, and can be criticized in several respects, but it does have the definite advantage that its control is predicated upon the total of each policy year's expected losses rather than outstanding cases only, and thus it operates to restrain a company from taking what might prove mistaken advantage of apparently subnormal losses. Tying up potential profit this way is, naturally, more inconvenient to the small or weaker company, while from the viewpoint of the large, well capitalized company an objection might be raised concerning the size of the sums unnecessarily restricted; the fact is, however, that in the one case such protection for the benefit of the public is obviously essential, while in the other, the situation is hardly likely to represent a serious hardship.

Granting that the various criticisms concerning the effects of Schedule "P" on current loss ratios and earnings are justified, it can however be argued that since these distortions can be removed by appropriate revision of the Schedule, they do not constitute sufficient reason for entirely discarding the minimum reserve principle. To say that the chief purpose of minimum reserves is to guarantee adequate reserves is a rather broad assumption. A minimum reserve can be only a measure of protection, hardly a guarantee. Moreover, it is a measure that can readily be increased where necessary, a remedy that it considerably easier to apply and to diagnose more promptly the need thereof under Schedule "P" than might otherwise be possible, because of the variations to which the individual carrier's loss development trends are subject. These variations, of course, would naturally

be more pronounced in medium or small companies due to the fluctuating incidence of very large claims. The effect of a company's net retention on such claims suggests further possibilities of distortion in projecting an estimated reserve based on the rate of payment.

While the present and previous Committee have made it clear that their objectives are adequate reserves without regard to existing State law requirements, the fact remains that the eventual solution must be one that either meets those requirements or can be woven into amendments thereof that will maintain the controls desired by Insurance Departments. It must, moreover, be based upon data that can be readily audited by Insurance Department examiners in checking the annual statement. The principal, possibly the only, virtue of Schedule "P" may be that it permits this check while maintaining a degree of safety through the minimum reserve principle, and though admittedly the value thereof is lessened by the influence of varying rate levels or rating plans used by some carriers, its importance cannot lightly be dismissed without offering a substitute that embodies equal protection and ease of verification. The annual statement is after all the only practical means by which Insurance Departments can maintain financial supervision of carriers between examinations. It is prepared primarily for that purpose, and while Schedule "P" cannot alone guarantee solvency, it is hardly probable that reserves predicated upon a company's own limited data would be any more successful in that respect.

Concerning recommendation 2, it seems questionable whether a breakdown as between reserves for reported and unreported cases would actually prove useful, either for purposes of comparison with prior years or with other companies. Conditions within many companies, such as current status of clerical work, territorial distribution of business, closing dates, etc., vary from year to year and, accordingly, variations in very carefully calculated reserves could very well be misunderstood by others not familiar with the facts. Certainly, the company itself will want to analyze its reserve developments by reported and unreported, but if the over-all reserve proves consistently adequate, that fact should be sufficient for annual statement purposes.

In any event, if the Committee's recommendation to segregate losses from loss expense in the reserve calculation could be adopted, with possibly a further provision for treating, as a separate liability, the excess of formula reserve over reserves based on case estimates and the reserve for loss expense, one worthy objective would be accomplished as respects clarifying the presentation of financial statement data and operating results while the search is continued for a solution to the problem of establishing loss reserves on a basis that will be satisfactory to the companies and the supervising authorities as well.

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## WRITTEN DISCUSSION

F. S. PERRYMAN

This report is of very great importance, not only as respects the existing unsatisfactory state of affairs in regard to Schedule P but also in respect of the very sound suggestions advanced by the Committee to cure the present situation. The present state of affairs as to the treatments of reserves for Liability and Compensation insurance in the annual statement is so confused and so out of date that those of us whose job it is to deal with these matters are apt to take it for granted that everyone else is also fully convinced of the need for reform and, if I may make one comment on the report (a criticism, if you will, of omission rather than of commission) it is that the report may well have been amplified as to the reasons for the unsatisfactory nature of the present Schedule P methods. The report should contain the whole story since, before its recommendations can be carried out, it will be necessary to convince not only carriers and company officials, Insurance Department Commissioners and personnel but also, in many instances, legislators.

As to the remedies proposed by the Committee, I am fully in sympathy with them. It is, to my mind, of the utmost importance that steps along the lines advocated by the Committee be taken to cure the present confusing and anachronistic situation. I would have been among the first to take strong issue with the Committee had they not faced the issue squarely and had they not advocated a straight-forward principle that reserves should be established for: (a) known cases; (b) cases which have been incurred but which are not yet known to the companies; (c) expenses of settling outstanding liabilities; and (d) reserves for any other contingencies arising out of these lines of business. Since, as I said, I would have been quick to have taken issue with any less direct and proper approach, I should, in all fairness, add my testimony to the soundness of the conclusions and suggestions of the Committee.

Strictly speaking, the annual statement should be an exhibit of the financial condition of the company and any test as to the soundness of the reserves carried, or, for that matter, any other figures, should play only a secondary role in the statement. However, such information, though secondary, is not unimportant. The test of reserves proposed by the Committee can only be regarded as tentative and will probably be so regarded by the Committee. From time to time, doubtless, improvements in this test of reserves may be effected but it must be remembered that all such tests, coming as they do after the event, are rarely conclusive but only indicative as to the current financial situation of the company. There is no substitute for good management and good faith.

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## WRITTEN DISCUSSION

T. F. TARBELL

The expected loss ratio method of determining loss (and loss expense) reserves as illustrated by "Schedule P" unquestionably served a useful purpose in the earlier years of the present century, particularly as respects the determination of adequate, or reasonably adequate, reserves for the various liability coverages. Its value in establishing proper or even adequate, reserves for the Compensation line, except for a short period following the general enactment of Compensation Acts, has in the mind of the writer been open to question.

The Committee is to be congratulated on its thorough study of the subject and its sound conclusions and recommendations. The writer subscribes to the same without reservations. He concurs that the schedule has outlived its practical usefulness and under present conditions results in distortions of underwriting and surplus results and confusion as respects basis of taxation of profits under the Federal Income Tax Law.

Let us review the record.

At the time Schedule P was first introduced into the statement it applied, of course, to Liability only as the date was several years prior to the enactment of Compensation Laws. In the early days of Compensation the Schedule was extended to embrace both lines but after a few years, around 1915, separate schedules were provided for each line.

There was justification, if not need, for such a method of determining reserves in the period prior to the general enactment of Compensation laws. The major part of Liability business written by the Casualty Companies was Employers Liability and the old common law defenses were available to the Employer (and his insurer). Under such conditions the problem of estimating a company's liability for unsettled claims was naturally a difficult one and the requirement of a minimum reserve based upon a theoretical loss ratio was logical.

Since the early days, so to speak, conditions have changed materially, particularly as respects Liability insurance. The public has become more aware of its legal rights in event of injury for which another is responsible, or alleged to be responsible, or, to use a more general term, has become increasingly claim conscious. The universal use of the Automobile has no doubt been the major contributing factor to this condition. The point of this is that the determination of claim reserves does not, on the average at least, involve the elements of uncertainty existing under conditions of thirty to forty years ago.

Turning to Compensation we must also admit that in the early days, roughly from 1913 to about 1918, there was justification for a loss ratio reserve basis. However, as benefits became more or less standardized through legal interpretations and awards, the problem of determining adequate reserves for individual claims became greatly simplified.

At this point it might be appropriate to emphasize that for many years the formula reserve for Compensation has been inoperative as it applies to the latest year of issue, due, of course, to the fact that a very considerable portion of premium actually earned under the exposure for that year is not determined and charged until the following calendar year. The amount of the "back-log" may be affected and vary with economic, or general business, conditions as respects policies subject to annual audit, but it is an ever present substantial factor under policies subject to periodical audit. This "back-log" is not restricted to the latest year of issue but also affects the previous year of issue. No practical method of overcoming this condition has ever been suggested. In the opinion of the writer the problem is not susceptible of satisfactory solution.

One test of the value of the present Schedule is its effectiveness in preventing insolvency. Possibly it has had some value in this respect but the writer is not aware of any instances. If a company in questionable financial condition is desirous of concealing the same there are other, and probably easier, avenues of approach. The oft repeated commonplace "You can't legislate honesty" might be paraphrased in the present instance to "You can't design a statement which cannot be circumvented."

The greatest advance in the statement as respects loss reserve for the lines under consideration was the introduction of Schedule P, Parts 5 and 5A. While it may be argued that these schedules are of value from a retrospective viewpoint, nevertheless they have a distinct current value in that they give fair warning that the transgressor eventually, and within a reasonably short period, will be brought to bar. The proposals of the Committee incorporate these "run-off" tests in an improved form. For the Compensation line in particular, where in general the rate of liquidation of claims by an individual company with a reasonable volume of business follows a definite pattern, a reasonable indication is afforded for testing the adequacy of the loss reserve for the latest policy year. The incorporation of the lines in Schedule "O" is additional substantiating data for the adequacy of the aggregate reserve for all policy years.

It is the writer's firm belief that the adoption of the Committee's recommendations would in no way detract from the value of the annual statement from the standpoint of solvency standards.

## REPORT OF COMMITTEE ON COMPENSATION AND LIABILITY LOSS AND LOSS EXPENSE RESERVES

### COMMITTEE'S REVIEW OF DISCUSSIONS

The Committee is indebted to the members of the Society who submitted discussions of the report. In addition to the foregoing discussions, members of the Committee have received a considerable number of informal comments. As a result of its consideration of the points raised, the Committee finds no impelling reason for making any change in the original recommendations.

As to the question of companies which have recently commenced writing the lines under consideration, the Committee recognizes the existence of the problem of possible overextension. As regards compensation, the problem simply is not being met by the present Schedule P method because of the lag in the recording of audited premiums. As regards liability, the present Schedule P method may, in some cases, provide a safeguard, which safeguard, however, may be absent when most needed. In any event, the Committee feels that this problem of overextension should not be met through arbitrary loss reserve standards.

Assuming that there is substantial agreement in principle with the Committee's recommendations, the question naturally arises as to whether anything constructive can be accomplished prior to necessary statutory changes. The following specific changes in the annual statement blank could be made as of the end of this year without any changes in the Statutes:

1. The inclusion of separate lines for compensation, automobile liability, and liability other than automobile in the bloc at the top of the present page 5 of the annual statement.
2. The inclusion of separate items for compensation, automobile liability, and liability other than automobile in the section for loss expense on page 5.
3. The inclusion of the statutory excess, divided as between compensation and liability, as a separate liability item on page 5.
4. The inclusion of a provision for the increase or decrease in the above statutory excess in the miscellaneous portion of the Underwriting and Investment Exhibit. Thus, changes in the statutory excess would not affect underwriting results.
5. The inclusion of compensation, automobile liability, and liability other than automobile in Schedule O.
6. The subdivision of Column 12 in Schedule P, Part 1, to provide separate loss and loss expense reserves; a similar subdivision of Column 11 in Schedule P, Part 2.
7. The subdivision of Schedule P, Part 5, to provide separate exhibits for automobile liability and liability other than automobile.

8. The provision in Parts 5 and 5a of two additional columns to show the paid and outstanding losses for the latest valuation date.

Inasmuch as the annual statement blank will probably undergo considerable change before the end of 1949, this is a particularly appropriate time to consider the above revisions. As has already been noted, these revisions would not require action by other than the Blanks Committee of the National Association of Insurance Commissioners.