Using Reserve Disclosures: From the Outside Looking In

Casualty Loss Reserve Seminar
September 7, 2012 | Denver, Colorado, USA

Introductions

Panelists

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Moderator

Mark Littmann, PwC

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Ground-Rules for our Discussion
Including disclaimers

- This presentation is prepared and intended for general educational and discussion purposes only.
- It should not be used as a substitute for consultation with professional advisors.
- <u>The views and opinions expressed by the panelists and moderator may or may not be reflective of their own personal views and opinions; the views and opinions are not expressions of position by their employers.</u>
- Enjoy the exchange of information and ideas.
- Contribute.

Outline for our Discussion

- Who are these external users?
- The range of required disclosures
- An analyst's perspective
- SEC hot topics
- Dialogue

Who are these external users?

Who are these external users?

- NAIC and state insurance regulators
- Investors
- Securities & Exchange Commission (SEC)
- Ratings agencies
- Investment analysts

The range of required disclosures

Smitesh Davé

The Travelers

The range of required disclosures

“Much ado” about a critical accounting estimate

Quantitative

- Roll-forward of prior reserves
- Estimated reserve cash flows
- Development triangles
- Variability
  - sensitivities
  - extent of historical movements
  - ranges

Qualitative

- Management discussion & analysis (MD&A)
- Methods & assumptions underlying the recorded reserve
- Key drivers of change in estimates from prior periods
- Key risks

The range of required disclosures
Roll-forward of prior year-end reserves

- Typically current and prior 2 reporting periods

(in millions)	12/31/2011	12/31/2010	12/31/2009
Gross Reserves, Beginning of Year	$51,000	$53,000	$55,000
Reinsurance Recoverable	11,000	12,000	14,000
Net Reserves, Beginning of Year	40,000	41,000	41,000
Incurred Losses, Current Year	17,000	14,000	14,000
Incurred Losses, Prior Year	(1,000)	(1,000)	(1,000)
Paid Losses, Current Year	8,000	6,000	5,000
Paid Losses, Prior Year	8,000	8,000	8,000
Net Reserves, End of Year	40,000	40,000	41,000
Reinsurance Recoverable	10,000	11,000	12,000
Gross Reserves, End of Year	$50,000	$51,000	$53,000

The range of required disclosures

Estimated Reserve Cash Flows (Contractual Obligations)

- Disclosed within Liquidity and Capital Resources in 10-K

(in millions)	**Total**	Less Than 1 Year	1-3 Years	3-5 Years	After 5 Years
Reinsurance Recoverables	**$10,000**	$2,000	$2,000	$3,000	$3,000
Net Reserves	**$40,000**	$9,000	$11,000	$6,000	$14,000
Gross Reserves	**$50,000**	$11,000	$13,000	$9,000	$17,000

The range of required disclosures
Development Triangles

- Statutory Schedule P
  - Net loss and defense & cost containment (DCC)
  - US business
  - By accident year, line of business
- US GAAP Development Triangle
  - Gross and net loss and (all) loss adjustment expense (LAE)
  - Total business (US & non-US)
  - By reporting date for all lines combined

The range of required disclosures

Development Triangles

- The US GAAP development triangle in a public company's annual financial statement filed with the SEC is NOT the same as in the statutory annual statement (e.g., Schedule P)

	Reserves as of year-end			
Development	2008	2009	2010	2011
Net Liability Unpaid	2,000	2,100	2,150	2,200
Net Liability Re-estimated as of:				
One Year Later	1,990	2,080	2,130	
Two Years Later	1,960	2,075		
Three Years Later	1,955			
Cumulative Net Deficiency / (Redundancy)	(45)	(25)	(20)	

The range of required disclosures

Qualitative information

- Management discussion & analysis (MD&A)
- Methods & assumptions underlying the recorded reserve
- Key drivers of change in estimates from prior periods
- Key risks

The range of required disclosures

Behind the scenes

The process by which the disclosures are prepared must be efficient, effective, timely, and accurate.

- Timeline
- Resources
- Controls

An analyst's perspective

Julia Ferguson, CFA

Dowling & Partners

An analyst's perspective
Additional disclosures we would like to see (1/2)

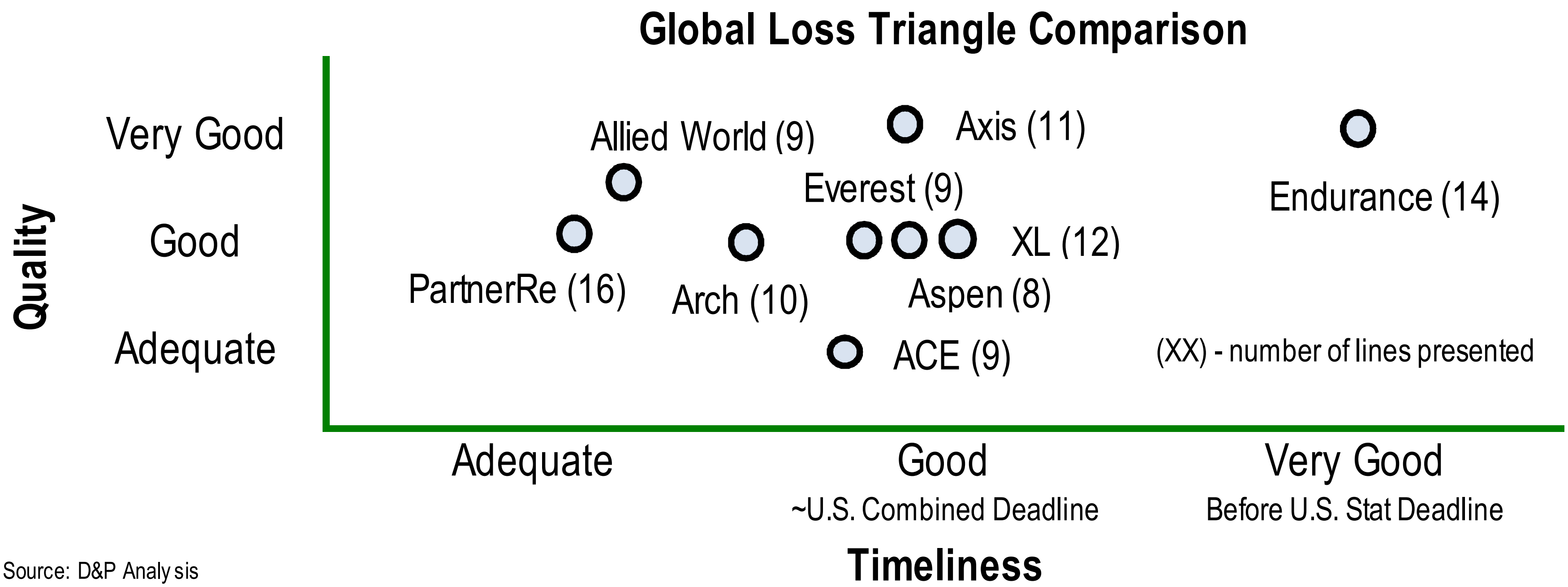
- Adjustments for catastrophes & large losses
- Changes in business mix and underlying exposures within reserving lines that affect development patterns
- Reinsurance - changes in reinsurance programs and adjustments for commutations
- Changes in pricing, market conditions & loss cost trends by line
- More than 10 years of development for long tail lines
- Development patterns and tail vs. industry benchmarks

An analyst's perspective
Additional disclosures we would like to see (2/2)

- More granular "customized" by line split (i.e., showing excess workers' comp separately from other workers' comp, D&O separately from Other Liability Claims Made)
- Impact of changes in reserving methodologies
- Data on non-US operations – global Schedule P
- Changes in claim settlement practices (claim department)
- GAAP vs. Stat. reconciliation

An analyst's perspective

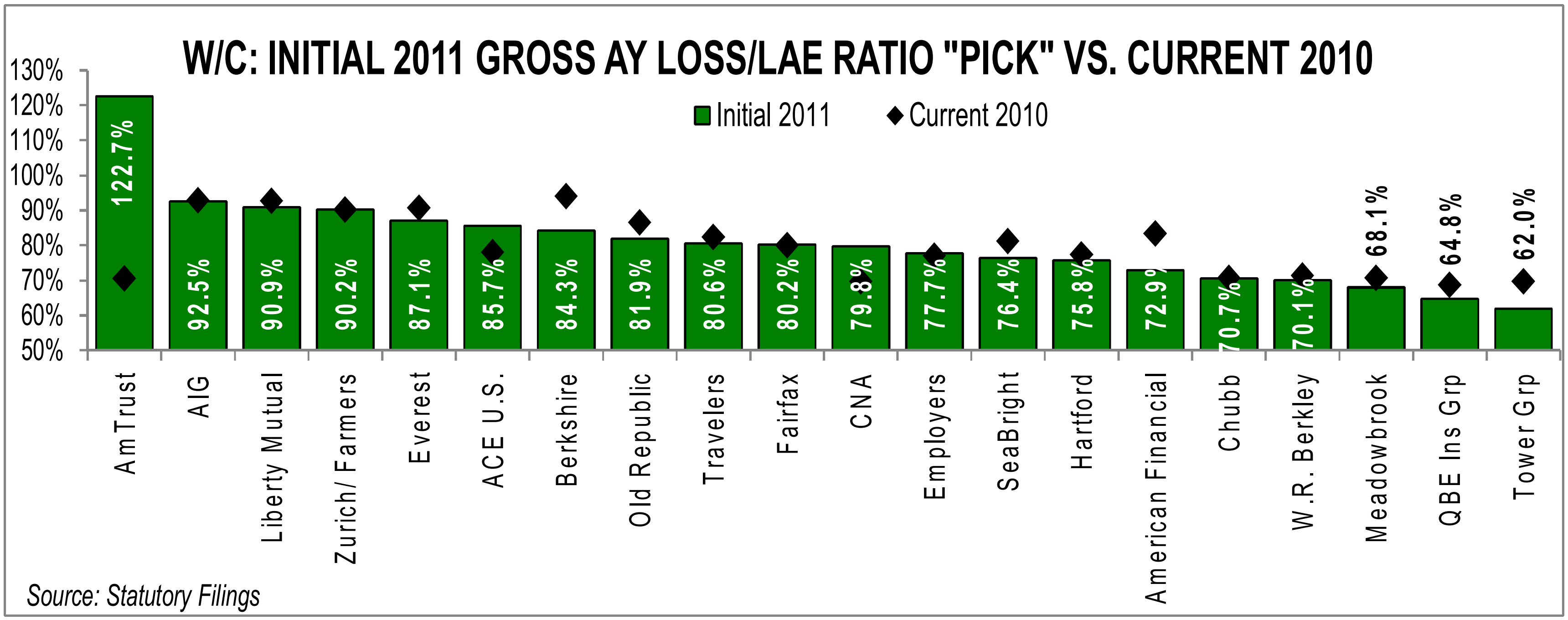
Increasing number of offshore companies disclose global loss triangles



Source: D&P Analysis

An analyst's perspective
What analysts do with data & information from disclosures

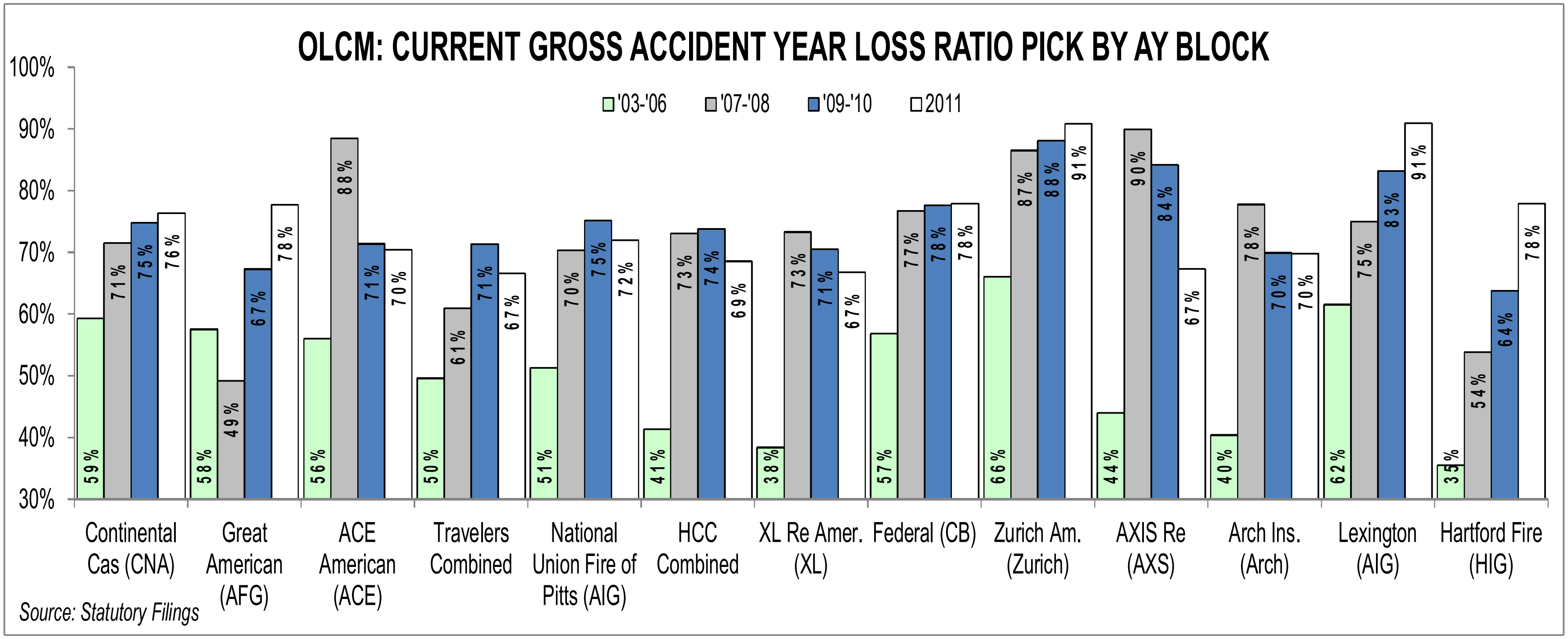
- Opinion about reserve adequacy – investors want to know
- Comparison between companies – starting point to ask questions
- Comparison example #1:



An analyst's perspective

What analysts do with data & information from disclosures

- Comparison example #2:



SEC hot topics

Andrea Selvaraja
PwC

SEC Hot Topics
Comment Letters

- What are they?
- Comment letter process
- What do or can they lead to?
- Common comments:
  - Methods and assumptions
  - Change in estimates (prior period development) – why did amounts change, and why in the current period and not in a prior period
  - Variability – more insight on how sensitive the reserve amounts are to changes in key assumptions
  - Timing

SEC Hot Topics

Illustrative Comment #1 – Methods & Assumptions

"Expand your disclosure describing methods used to determine your reserve for unpaid losses and loss adjustment expense as follows.

i. Explain the strengths and weaknesses of each method.

ii. Explain the factors that you consider in selecting one method over another method.

iii. Discuss and quantify the impact of changes in method for each period presented."

- Companies have expanded disclosures to provide much more information on the basics of actuarial reserving

SEC Hot Topics

Illustrative Comment #2 – Changes in Estimates

"Please provide a detailed discussion addressing the specific reasons for the change in estimate of claims occurring in prior years, as the current explanation of such changes solely attributes them to lines of business, and does not provide insight into the underlying causes for the changes. Further, explaining developments as due to "lower than expected reported loss activity or favorable claim development" does not appear to be sufficiently informative."

- Company reactions have included:

  More description – accident years, identification of specific claims or adverse/favorable rulings

SEC Hot Topics
Illustrative Comment #3 – Assumptions

Please identify and describe those key assumptions such as frequency and severity that materially affect the estimate of the reserve for loss and loss adjustment expenses. In addition,

- Explicitly identify and discuss key assumptions as of latest balance sheet date that are premised on future emergence that are inconsistent with historical loss reserve development patterns and explain why these assumptions are now appropriate given the inconsistency identified.

SEC Hot Topics

Illustrative Comment #4 – Management Adjustments

"Describe management's policy, if any, for adjusting the liability for unpaid losses and LAE to an amount that is different than the amount determined by its actuaries.

- If such a policy exists, describe the method used by management to determine the adjustment and the extent to which it relies on objective versus subjective determinations. Such adjustments may include, but not be limited to, an incremental provision, a reduction in the liability, or a reversal of a previously recorded adjustment.
- When such adjustments or reversals are made, include MD&A disclosure that identifies the amount of the adjustment or reversal, the method used by management to determine it, and the specific underlying reasons that explain why management believes the adjustment or reversal is necessary."

SEC Hot Topics

Illustrative Comment #5 – Reserve Variability

"In order to show investors the potential variability in the most recent estimate of your loss reserve, quantify and present preferably in a tabular format the impact that reasonably likely changes in the key assumptions identified may have on reported results, financial position and liquidity. Explain why management believes that scenarios quantified as reasonably likely."

- Company reactions have included:
  - Providing ranges, or
  - Identifying several assumptions and showing the amount of change to reserves from changes in the assumption, with an added explanation as to why the different scenarios are reasonably likely

SEC Hot Topics
Illustrative Comment #6 – Timing of Adjustments

You disclose that "Given the high degree of statistical uncertainty, and potential volatility, it would be unusual to adjust reserves on the basis of one, or even several, quarters of loss development activity. As a result, unless the incurred loss activity in any one quarter is of such significance that management is able to quantify the impact on the ultimate liability for loss and LAE, reductions or increases in loss and LAE liabilities are carried out in the fourth quarter based on the annual reserve review described above."

Your financial data shows that the majority of your total net reductions in ultimate loss and LAE liabilities for the year were recorded in the fourth quarter in each of the past three years and that the amount of these reductions has been significant. Please identify for us the nature and extent of a) new events that occurred or b) additional experience/information obtained since the previous quarterly reviews that led to these changes in estimate in the fourth quarter. Explain why recognition in earlier quarters was not required and how recording adjustments only in the fourth quarter complies with GAAP for interim financial reporting.

Dialogue

Closing Remarks

- Thanks to Smitesh, Julia, and Andrea for their time and willingness to share their perspectives.
- Thank you for your participation.
- Please complete an evaluation for the session.
- Enjoy the rest of the seminar.