Insurance Loss Reserves and Federal Income Tax

Lawrence White, ACAS, MAAA
Internal Revenue Service

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WHY DOES THE IRS AUDIT RESERVES?

Loss reserves (or, more precisely, the <u>change</u> in loss reserves) are a major component in determining income.

Auditors cross-check payments, review receipts, and examine deductions of all sorts, **including loss reserves.**

PRINCIPLES BEHIND LOSS RESERVE STANDARD

Purpose of reserves:

1) To reflect the liabilities of the insurance company

General Ledger

ACCOUNT: ACCOUNT NO.

Date		Description	Post Ref.	Debit		Credit		Balance	

2) Reserves represent money put aside to pay claimants

PRINCIPLES BEHIND LOSS RESERVE STANDARD

Audit implies checking the <u>accounting</u>

The accounting principle that applies is the MATCHING PRINCIPLE, which states that *revenues and any related expenses be recognized together in the same period.*

When funds aren't actually paid, an *accrual* is established to match revenue and expenses.

PRINCIPLES BEHIND LOSS RESERVE STANDARD

Effects of a poor accrual

- misstatement of financial condition
- misstatement of income

Affects shareholders and policyholders who expect dividends based on the results of that year, both in the year of misstatement and the year of correction.

PRINCIPLES BEHIND LOSS RESERVE STANDARD

The ideal is to get the accrual right, recognizing that these are just estimates.

PRINCIPLES BEHIND LOSS RESERVE STANDARD

The ideal is to get the accrual right,

In computing "losses incurred," the determination of unpaid losses at the close of each year must represent actual unpaid losses...

recognizing that these are just estimates.

... as nearly as it is possible to ascertain them.

This is Treasury Regulation 1.832-4(a)(14)

PRINCIPLES BEHIND LOSS RESERVE STANDARD

The other main IRS reserve regulation:

Treasury Regulation 1.832-4(b)

Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the *deduction for* "losses incurred" which represents *unpaid losses at the close of the taxable year comprises only actual unpaid losses…*

These losses must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a *fair and reasonable estimate of the amount the company will be required to pay*. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. (*emphases added*)

OTHER LOSS RESERVE STANDARDS

STATUTORY ACCOUNTING

from SSAP 55:

"For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses."

STATEMENT OF ACTUARIAL OPINION

Actuary does pass/fail on whether reserve "makes reasonable provision"

According to American Academy of Actuaries (which issues ASOPs):

- "Solvency monitoring is **THE** purpose for writing the statement of actuarial opinion (SAO) No other purpose exists"
- "Reasonable" in SAO does NOT mean "prudent," "proper," "adequate," or other terms
- ASOP has "no definition of what is material"
  - Materiality may differ if used for purpose other than solvency, e.g., income

(source: 2/18/2013 webinar by AAA)

OTHER LOSS RESERVE STANDARDS

WHAT ABOUT RANGES?

IRS regulation: “as nearly as can be ascertained”

SSAP 55: “If, for a particular line of business, management develops its estimate considering a range of …reserve estimates bounded by a high and a low estimate, management's best estimate of the liability within that range shall be recorded”.

Actuarial Opinion: “makes reasonable provision”

Actuarial Standard of Practice 36

Statements of Actuarial Opinion regarding P/C Loss & LAE Reserves

3.7 Reserve Evaluation —The actuary should consider a reserve to be reasonable if it is

- within a range of estimates that could be produced by an unpaid claim estimate analysis that is, in the actuary's professional judgment,
  - consistent with both ASOP No. 43, *Property/ Casualty Unpaid Claim Estimates,* and
  - the identified stated basis of reserve presentation.

(original not in bullet point format)

Actuarial Standard of Practice 43

Property/Casualty Unpaid Claim Estimates

3.1 Purpose or Use of the Unpaid Claim Estimate
The actuary should identify the intended purpose or use of the unpaid claim estimate…
Where multiple purposes or uses are intended, the actuary should consider the potential conflicts arising from those multiple purposes.

3.4 Materiality
The actuary should evaluate materiality based on professional judgment, taking into account the requirements of applicable law and the intended purpose of the unpaid claim estimate.

ASOP 43

Property/Casualty Unpaid Claim Estimates (cont.)

3.6.2. Assumptions

The actuary should use assumptions that, in the actuary's professional judgment, have *no known significant bias to underestimation or overestimation of the identified intended measure* and are not internally inconsistent. Note that bias with regard to an expected value estimate would not necessarily be bias with regard to a measure intended to be higher or lower than an expected value estimate.

(emphasis added)

Actuarial Standards Regarding Reserve Estimates

ACTUARIAL STANDARDS FOR SAOs

Materiality for SAOs - most commonly used are

- either 10% (or greater) of surplus or
- 10% of carried reserves

US PC Industry Summary (in $ millions)					
	2013	2012	2011	2010	2009
Reserves	637	623	616	627	626
Surplus	703	615	575	599	556
Common Materiality Standards					
10% reserves	64	62	62	63	63
20% surplus	70	61	58	60	56
Income	85	44	23	48	42

In 4 of 5 years, income is "not material" using SAO standard

Provision for Adverse Deviation

Is the "Matching Principle" appropriate for loss reserves?

One school of thought is that reserves should be "prudently conservative."

> In some ways, the estimation of unpaid losses seems *inevitably* conservative, taking into account the many risks generated by a company's insurance business, given that companies are necessarily averse to driving themselves out of business by ignoring the array of risks they might encounter. Professional actuarial standards and NAIC accounting standards are consistent with this kind of "conservatism."

(R. Riley, http://www.foley.com/intelligence/detail.aspx?int=8097)

Provision for Adverse Deviation

Isn't it prudent – or maybe even necessary - to provide for times when losses are worse than expected?

Health Reserves Model Regulation specifically states:

The total contract reserve established shall incorporate provisions for moderately adverse conditions.

Why *not* include some provision for adverse deviation (PAD), aka "margin" or "risk load", from expected?

Effect of Provision for Adverse Deviation

Reserve for expected losses	4,000
Surplus	2,000

You have 1,000 in additional funds – what do you do?

Effect of Provision for Adverse Deviation

	START	Take as profit
Reserve for expected loss	4,000	4,000
Surplus	2,000	2,650 (after 35% tax)
Additional funds	1,000	
RESOURCES		**6,650**

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Effect of Provision for Adverse Deviation

	START	Take as profit	Have PAD
Reserves	4,000	4,000	5,000
Surplus	2,000	2,650 (after 35% tax)	2,000
Additional funds	1,000		
RESOURCES		**6,650**	**7,000**

Effect of Provision for Adverse Deviation

What happens if there is Adverse Deviation later?

	Taken as profit	Have PAD
Starting Reserves	4,000	5,000
Starting Surplus	2,650	2,000
Payout of PAD (no income tax effect)	---	-1,000
Calendar Year loss	-1,000	0
FIT (35%) deduction	+350	0
ENDING RESOURCES	**6,000**	**6,000**

So, no difference in resources (ability to pay) with or without PAD (no reason to have in reserves)

Effect of Provision for Adverse Deviation

Why then the concern about having a PAD?

1) ***Bird in the hand***
2) ***This bird lays eggs!***

Effect of Provision for Adverse Deviation

Is concern over loss reserves being adequate for adverse conditions *obsolete*?

Effect of Provision for Adverse Deviation

Is concern over loss reserves being adequate for adverse conditions *obsolete*?

- **Risk-Based Capital**
- **A.M. Best's BCAR**
- **Enterprise Risk Management**

Effect of Provision for Adverse Deviation

HYPOTHETICAL QUESTION:

Two insurers both expect to pay 75% loss ratio.

- Insurer A writes basic limits auto coverage in numerous states.

- Insurer B writes one liability line of business in one state.

A & B have different requirements for RESOURCES to pay potential adverse experience.

Should they book different RESERVES?

REAL QUESTION:

When are reserves *beyond* a "fair and reasonable estimate of the amount the company will be required to pay" "as nearly as can be ascertained"?

IRS Audit of Loss Reserves

IRS will ask for your support for the reserve #.

(In theory, will have SAP documentation showing why booked amount is "best estimate.")

Generally, this documentation will be:

- actuarial analysis
- management explanation of differences between actuarial estimate and booked amount (if any)

This information is available on the shelf.

IRS Audit of Loss Reserves

IRS will review history of loss reserve development (actuaries use past experience to predict future, why not auditors?!)

Simple reason – if reserving methodology or selection process produces reserves in excess of actual losses, it likely will show up in past experience

IRS Audit of Loss Reserves

Review Analysis for:

- LDF selections
- ELR assumptions
- Frequency/Severity Trend assumptions
- Methods used to generate indicated ults
- Selection within range of indicated ultimates

IRS will often make its own reasonable assumptions and see where carried reserves fall relative to these new indications

IRS Audit of Loss Reserves

Loss Development Factor selection review:

Year of Accident	1 - 2	2 - 3	3 - 4	4 - 5	5 - 6	after 6
2007	1.370	1.248	1.060	1.052	1.007	
2008	1.624	1.181	1.143	0.959	0.949	
2009	1.367	1.176	0.990	0.994	0.996	
2010	1.488	1.134	1.043	0.939		
2011	1.388	1.097	1.017			
2012	1.309	1.196				
2013	1.434					
Arithmetic average	1.426	1.172	1.051	0.986	0.984	
Company selected	**1.543**	**1.195**	**1.085**	**1.018**	**1.009**	**1.041**
Co.'s consultant sel.	1.397	1.160	1.064	0.994	0.994	1.034
IRS selected	1.450	1.185	1.055	0.994	0.996	1.046

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IRS Audit of Loss Reserves

Expected Loss Ratio assumption review:

Year	Earned Premium	Company Estimated Losses	Company Estimated Loss ratio	"Expected" Loss Ratio (for typical year)
2005	54,086	30,313	56.0%	
2006	58,230	20,625	35.4%	Company should expect losses & ratios in line with results of earlier years, BUT
2007	63,389	26,250	41.4%	
2008	79,329	30,625	38.6%	
2009	88,549	40,000	45.2%	
2010	90,774	38,125	42.0%	
2011	87,774			
2012	83,290	No visible basis to pick 65% given prior years' experience		65.0% ?
2013	79,724			
2014	74,155			

IRS Audit of Loss Reserves

Selection among Indicated Ultimates

		Ultimate Loss Projections						
Report Year	Rep't Loss	Reported Devel.	Paid Devel.	Berquist-Sherman	Report Yr. Method	Freq./ Severity	Born-Ferg.*	**Selected**
2006	837	926	1,075	901	920	1,131	1,121	**1,100**
2007	2,189	2,205	1,894	2,165	2,192	2,156	2,662	**2,500**
2008	4,329	4,305	4,566	4,142	4,456	4,595	7,861	**7,000**
2009	10,245	11,104	10,359	10,456	11,606	11,018	14,983	**14,000**
2010	9,905	13,160	9,323	12,610	13,391	13,136	16,822	**16,000**
2011	8,177	13,361	10,748	12,722	13,588	14,582	16,327	**16,000**
2012	5,627	10,173	10,336	9,721	10,625	14,972	15,451	**15,000**
2013	4,449	11,259	N/A	11,017	11,733	15,030	15,224	**15,225**
SUM	45,758	66,493	N/A	63,734	68,511	76,620	90,451	**86,825**
Sum X '13	41,309	55,234	48,301	52,717	56,778	61,590	75,227	**71,600**
		Selection appears to be based on outlying (B-F) estimate						

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IRS Audit of Loss Reserves

Selection among Indicated Ultimates

		Ultimate Loss Projections							
Report Year	Rep't Loss	Reported Devel.	Paid Devel.	Berquist-Sherman	Report Yr. Method	Freq./ Severity	Born-Ferg.*	*Prior Selected*	**Selected**
2006	837	926	1,075	901	920	1,131	1,121	*1,200*	**1,100**
2007	2,189	2,205	1,894	2,165	2,192	2,156	2,662	*2,250*	**2,500**
2008	4,329	4,305	4,566	4,142	4,456	4,595	7,861	*8,000*	**7,000**
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SUM	45,758	66,493	N/A	63,734	68,511	76,620	90,451	*77,302*	**86,825**
Sum X '13	41,309	55,234	48,301	52,717	56,778	61,590	75,227	*77,302*	**71,600**
		** - B - F method is outlier because it uses prior estimates as ELR*							

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IRS Audit of Loss Reserves

Review of Management Explanation

- Differences of opinion with actuary
- Factors not in data and/or actuarial analysis
  - Change in reinsurance and/or retention
  - Court case affecting current liabilities
  - Change in mix in business

  (but then, why didn't actuary consider these factors?)
- Provision for uncertainty?

Summary

IRS audit of loss reserves is a typical and necessary part of the audit of an insurance company.

Accounting principles, not just IRS ones, ask for appropriate matching of expenses with revenue.

As with any deduction, the key is documentation.