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FINANCIAL REPORTING ISSUES RELATED TO HEALTH INSURANCE

Moderator: PAUL R. FLEISCHACKER
Panelists: PHYLLIS A. DORAN
JOSEPH MICHALCIK
JAMES N. ROBERTS
Recorder: DARRELL D. KNAPP

1. Definition of "good and sufficient" provision for unpaid and actuarial liabilities as used in the NAIC model bill.

2. Actuary and auditor relationships in documentation, reasonableness of results, materiality, margins, and disclosure.

3. Techniques for estimating unpaid claim liabilities.

4. Reverse testing: What kind? How often? How are results communicated to senior management?

5. Considerations regarding incurred date coding in establishing claim reserves?

6. Reserving methodologies for alternative funding products.

7. Reserves for catastrophic claims.

8. Measurement, evaluation, and adjustment for claim department backlogs, changes in claim submission patterns, and environmental changes, etc.

MS. PHYLLIS A. DORAN: In October 1984, the American Academy of Actuaries adopted Recommendation 10 dealing with Statements of Actuarial Opinion for Health Service Corporation Statutory Annual Statements. This was in response to the NAIC requirement for such a statement of actuarial opinion beginning with the 1983 statement blanks for Health Service Corporations. The required opinion and also the Academy's recommendation parallel those that had already existed for the life insurance company blank and the casualty blanks. As a result, actuaries that work for HMOs, Blue Cross/Blue Shield plans, and other health service organizations are now frequently in the position of either signing a statement of actuarial opinion or preparing information for another individual who will sign them - similar to the situation of many group and other actuaries in the commercial insurance companies.

The actuary signing a statement of opinion should address the broad issue of whether all actuarial liabilities have been established. The actuary needs to consider provisions for experience rating refunds, items that relate to due and unpaid or unearned premium, and to the category of other actuarial liabilities specific to that corporation.

MR. PAUL R. FLEISCHACKER: Our first issue is the suggestion in the NAIC model bill that stated actuarial items make a good and sufficient provision for all unpaid and other actuarial liabilities of the corporation.

MR. JAMES N. ROBERTS: The actuary could take the balance sheet perspective or the earnings statement perspective. Although they are obviously related and one leads to the other, sometimes they can produce different conclusions in the same set of circumstances.

In the balance sheet perspective, the major consideration is adequacy. Provisions made for assumed obligations must be sufficient under reasonable assumptions about future events. A more conservative approach could require that adequate provisions be made under a more pessimistic set of assumptions. Under the balance sheet perspective, especially where major assumptions have been developed using historical information, a margin may very well be appropriate. The final liability then established would have a high probability of adequacy. This would be the approach primarily taken where solvency is the key issue. The balance sheet perspective leads to conflicts such as the continuing block versus the terminated block dilemma. Statutory accounting emphasizes the balance sheet perspective, since in that environment, solvency is the overriding consideration. It may also be used when the insurance company is viewed as a creditor or as a possible takeover candidate.

Under the earnings statement perspective, the same type of questions may be present, but a somewhat different yardstick may be applied. The chief objective would be the matching of income and disbursement during the accounting period. This perspective would be emphasized in many of our working relationships, since the earnings statement is often the focus for senior management. It is also the perspective taken for a lot of analysis that is related to operational issues. In measuring past and potential decisions, the major issue is usually the effect on profits. If you are looking at a particular question that's related to your operation, your first question is going to be the effect of the decision on profits. Management information reports would be designed to analyze each pricing assumption so that reported or restated profits can be tied back to all of the key areas in pricing.

The conflict between the balance sheet and earnings perspectives comes about because of the time frame in which most actuaries are required to operate. Liabilities need to be established immediately after an accounting period closes. Because of this, the balance sheet perspective is often emphasized when the key question is whether enough money has been put aside to meet all the obligations. In group medical insurance, these liabilities mature pretty quickly, and the true results become knowable with a reasonable degree of confidence. For this reason, a restatement of financial results should be a regular part

of reporting.

MS. DORAN: An important concept regarding sufficient reserves is the "best estimate liability." A best estimate of the liability is one the actuary believes has a 50 percent probability of being too high and a 50 percent probability of being too low. When we think of good and sufficient provisions, the requirement for statutory reporting, we want to have a greater than 50 percent probability that these liabilities are adequate. If, in establishing your liabilities or claim reserves initially, you feel it is the best estimate, then it is important to add some type of margin.

There are a lot of auditors concerned with what the proper margin reflected as a percentage of liabilities is. Frequently, auditors have been frustrated that actuaries can't say there is a specific percentage margin that is required by our own principles and guidelines. In setting an appropriate margin, an actuary needs to think about the block of business that is being considered - has it been historically possible to estimate the liabilities for this business with precision, or is it one with a lot of uncertainty and perhaps new developments that requires a larger margin? The question should be whether you start with a best estimate and then add a margin or whether you are conservative in developing initial estimates so that there is implicit margin in those estimates.

MR. JOSEPH MICHALCIK: An actuary of a Blue Cross corporation doesn't have any other lines of business that can offset any understatement of reserves. Good and sufficient might have a different definition in these circumstances.

MR. ANTHONY J. HOUGHTON: Traditionally we have not discounted for interest in medical. You can look at that as some type of margin that might give you a couple of points. This might change that fifty-fifty to maybe fifty-five - forty-five or sixty-forty in your favor.

MS. DORAN: If you're developing reserves for financial reporting, "best estimate" is what you want, and for statutory statements you want to add a margin. Any management reviewing these results understands those differences if they exist.

MR. FLEISCHACKER: Our next issue is the actuary and auditor relationships with documentation, reasonableness of results, materiality, margins, catastrophic reserves, and disclosure.

MR. MICHALCIK: When I first worked with auditors in reviewing reserves for a financial statement, I worked for a large mutual insurance company and health reserves were not a big part of the total business. At Blue Cross/Blue Shield of Oklahoma we do have an outside auditor, and their actuary reviews everything that I have done.

Our relationship has stayed at a very high level because we've had adequate documentation of everything that I have done; why I have done it; where the numbers come from; and why I'm doing things. We've also been open about everything that we've done - identifying

best estimate claim reserves upfront and saying that this is the desired margin and this is prior years' variation experience. You must have consistent margins or methodology in the way your reserves are established. Variations in methodology or percentage margins are a concern to auditors.

Our auditor strongly advised against having a catastrophic reserve as part of the claim reserve. A catastrophic reserve is not for a known event that has already taken place, so you can't measure it. He also introduced a concept of materiality in types of things you can and can't do. This is considered in the way you document and think through the whole process of setting claim reserves.

MS. DORAN: I've been in the situation of providing a statement of actuarial opinion as an independent consultant, and documentation and reconciliation of data are very important to us. They should also be important to any actuary within the organization whether signing an opinion or not. Frequently, the data that are available in the required degree of detail to actually estimate liabilities (the data of paid claims by incurred dates, and so forth) don't tie in with the claims data that go into the final financial statement. You must look at aggregate totals of the data that are used for those estimates; compare the data with the information that is actually in the income statement; and, if nothing better is available, make some type of reconciling adjustment to recognize that difference. You must investigate why there are differences and understand whether you are distorting things by making some type of flat percentage adjustment. Sometimes differences in the identification of what a paid date is in terms of the actual claims coding versus how it is recognized in the general ledger require an adjustment to the liability.

Materiality relates to the subjective concept of margins. The materiality and potential fluctuations of the liabilities should be accounted for in identifying an appropriate margin.

MR. ROBERTS: Dealing with the high-amount, low-frequency claims has always been a problem. Reinsurance allows you to spread the effect over a longer time period. There isn't general agreement on the right way to handle it. From the point-of-view of the earnings statement, the large claim can produce significant swings in reported earnings, especially for the smaller company. There is some parallel between this and the treatment for bad debts in general accounting, where a portion of revenue is earmarked for such bad debts, and actual bad debts are charged against this first. If there were agreement in our industry to use the same approach, it might help solve the problem.

MR. FLEISCHACKER: Our next topic is a general discussion of the techniques that are appropriate for estimating unpaid claim liabilities.

MS. DORAN: Actuaries tend to be concerned about the best or proper formula for calculating the claim reserve or the completion factors. They place too much emphasis on the formula and the statistical techniques used and not enough emphasis on understanding the formula, how it is used, and if the results are appropriate. The key

to understanding a formula is having good information. Most companies have some type of automated system where they can actually evaluate and monitor the results of whatever formula or formulas they are using. Historically the emphasis in calculating claim reserves has been perhaps 90 percent on the formula and crunching numbers and maybe 10 percent on looking at the results. It should be the opposite, and it can be with the automated systems that are now available.

No formula can always be right because all formulas assume that history repeats itself and that is not the case. The types of formulas commonly used are two categories which I'll call an average lag approach and a seasonal approach.

An average lag technique calculates a lag or completion factor to be the average of some pattern of completion factors that have been observed in the past. The average can be over three months or a year.

The seasonal approach is best described by example. We're looking at liabilities as of December 1984, and the completion pattern for January 1984 was identical to what we had observed in the payments of January 1983, as of December 1983. Instead of averaging over a recent period, we are looking at the pattern of seasonal completion from year to year.

Neither of these techniques is more appropriate in more cases but account for different considerations when being applied.

A far more important issue is how claims are coded within a calendar year. If there is some type of allocation or batching of claims by incurred date within a calendar year, it is best to start with a seasonal completion factor approach and then consider the impact of claims coding.

If a company installed a new claims system in October 1984, all sorts of claims backlog result. After the system is installed and gets going, claims are being paid more quickly than they were in the past. The actuary who is looking at completion patterns based on historical claims has got a number of problems. As of December, the completion factors might tend to understate actual incurred claims because they have slowed up as of the end of the year relative to the past. A year later, when things have sped up, the completion factors would be based on when things were slow, so the opposite occurs and claims tend to be overstated. Very frequently the test of whether a completion factor is working well is made by what happened last year - was it high or low in terms of the estimates that are produced. In fact the answer for the next year might be the opposite of that.

Looking at claim inventories helps you understand claims processing and the speed of claims payments. Claim inventories have a number of problems: How is a claim counted? When is it counted? Is it counted when it comes in the door? When does it get in the claims processing system? It is best to try to get to the bottom of the statistics and understand them, and see whether they are available as a tool to you in estimating what is happening to your claims payment pattern? Summarizing the claims that are paid, this month and for prior months,

as they are spread by incurred date is helpful. You can see patterns that will help you figure out whether the payment has increased or slowed down the speed of payment and help you apply judgment in the final results.

In estimating the claims incurred for the most recent months, completion factor techniques tend to be unreliable because the actual percentage completion is so low then. It is helpful to look at that period using both a completion technique and a projection technique. For a completion technique, you group claims into quarters of incurral and then look at the historical pattern of percentage completion or you might want to group into individual months. In a projection technique, you project average claims costs from historical data of claims related to the number of policies, or whatever measure you can get of the exposure, so you can recognize expected changes in exposure. If your results under those two approaches are consistent, you can be comfortable with the results. If you find that they are different, you can investigate the differences more easily. Either the trend hasn't been handled as expected or your completion patterns are different.

MR. ROBERTS: The key issue is not developing the technique. The actuary should have no trouble coming up with a computational device once the problem is well understood. Understanding the liabilities under the particular contracts in question; when they attach to the insurer; and the tools to measure them should be emphasized. The actuary needs to pay particular attention to the claim coding process. An actuary who has a new valuation assignment should sit down next to a claims examiner for a few days and observe how given claim circumstances result in the coding of data.

The basic technique is to observe the historical lag pattern and use that to complete a partial runout, so that we can guess at the still unknown portion. The other technique is to observe the current rate of claim incurral related to some exposure index whether it is premiums, number of lives, or some other inforce measure and guess what the most recent months incurrals are.

If both techniques are used, the completion factor approach doesn't give much information for the most recent month because typically less than 5 percent has been paid. A small variation in that can lead to large errors in the projected reserve.

I use both approaches simultaneously on a month by month basis and take a weighted average of the two. I use a heavier weight towards the rate of claim incurral and exposure method on more recent months and towards the completion factor approach on the older months. It gives reasonably good results.

It's important to segregate the business for which you're trying to set up reserves into the basic characteristics that will affect the speed of the claim payment such as benefit type (dental versus medical, high versus low deductible, or long-term versus short-term disability). You need to make sure that data used to study the historical pattern are reasonably homogeneous.

It is important to look at the claim payment method in use on the particular piece of business. Policyholders may pay their own claims, either directly in their own office or through some administrator, through a TPA, through direct submission by policyholders to your claim office, or through claims being funneled through the employer. All of these different methods of paying claims produce a different completion pattern.

If you want to try to immunize yourself from a change in the mix in your business, it is important to segregate the major characteristics in terms of analyzing the data.

MR. MICHALCIK: If you are writing a medicare supplement policy, and you're paying or processing claims on a bill or a statement from the primary carrier, you need a hint of whether the primary carrier is experiencing a slow down, speed up, or some sort of delay. You must also consider whether you're in a position where a significant portion of your business has changed benefit structure, not only between lines of business, but within a line of business. If a significant block of business was all hospital paid-in-full, and you changed to require a deductible, a different rate of claim payment can result. This change may also cause a delay in the claim department learning how to process new claims. Keeping the environment in mind can be as important as the raw numbers themselves.

MR. FLEISCHACKER: What kind of reserve tests are made, how often are they made, and how much detail is needed or given to senior management people?

MR. MICHALCIK: I maintain a chart that has about twenty-four months of reserve tests by line of business, which can be hospital, comprehensive, and major medical, and I update that chart every month for a couple of reserve dates. I maintain a grand total as well. I can tell, by line of business and by month or quarter of the year, where I am very high or low in terms of testing my actual reserves.

I also use this as a quick check on what I'm going to recommend for the current month's reserve. I'm required to calculate a reserve for a monthly financial statement, and if I find that I have a string of numbers that has been reserve tested in the forty million dollar range, and I want to move the reserve up or down forty-five million dollars, I must be able to explain to the senior management why I want to move it up or down. The reserve tests become a baseline in explaining which way reserves are going, and it is important that they be tested as frequently as possible.

MS. DORAN: It is important to perform those kinds of restatements. They can be used in restating your financial results, and in understanding how your formulas have worked. However, I think extrapolating from the relationship in the past is overemphasized. That relationship frequently reverses itself because of the way completion factors work: if it overstated it one time, it might tend to understate it in the future. An independent actuary, either as a consultant or one who didn't actually put the liabilities together, should be careful there.

If you don't understand what process and degree of judgment was used to set up those liabilities in the past, it is hard to conclude anything from that relationship. Although, it is very important to be able to look at those kinds of numbers.

MR. ROBERTS: This is a brief comment about the left-hand side of the balance sheet. The premium issue appears fairly frequently in the environment of restating financial results. Actuaries often overlook the reporting of the due and uncollected premium asset. We look at the reserve test issue because we have to do a Schedule H. The misstatement of premiums occurs because of retroactivity occurring during the current accounting period. Delayed reporting of employee activity and issued or canceled cases are at fault. No matter what system is in place, there are bound to be errors since we have to set up the asset immediately at the conclusion of the accounting period. If you don't go back and restate your premiums when you find out what the true inforce was, you are often mislead by the income and payout side. It is a related area that deserves more attention than it gets.

MR. FLEISCHACKER: What considerations regarding the incurred date coding does an actuary need to address in establishing claim reserves?

MS. DORAN: Almost without fail, every company uses some type of method of batching or combining incurred dates in its claim processing system. Someone sends in a batch of claims that they saved up during the year, and instead of using the actual date of service for the claim, the whole batch of claims is coded with the earliest date of service in that batch.

The approach that should be used when setting incurred dates used in measuring your financial results is whatever incurred date follows from your policy provisions. In most cases, that will be date of service, but there certainly are exceptions. If a claim is covered under a disability extension, then it would be appropriate to go back and use the initial date of disability.

Most actuaries think their companies use date of service in coding their claims. Frequently, that's not the case - the actuary didn't observe it. I recommend that you talk to your claims people about how much or little of this batching may occur.

A lot of what actuaries call seasonal patterns to claims incurral is occurring because claims tend to get batched to incurred dates within the calendar year. Frequently the calendar year of incurral is correct for purposes of deductibles, but within that calendar year, claims get batched to the earliest part of the year. That has all sorts of implications for measuring your financial results by quarter within the year, even though they might be right in terms of the overall year. It affects your completion factors and all of your techniques.

Companies in that situation should use what I earlier called the seasonal method for assigning completion factors. If you use an average completion factor from prior months, you're going to be averaging in months with all different patterns. You get a result, and later when

you've got more runout, you will get another result. You aren't going to be able to look back at how claims ran out compared to your initial estimates.

MR. CHRISTOPHER FITZSIMMONS IV: One problem with our claims operation is how many January 1985 claims are coded January 1984 as incurred dates. That runs into February but by March, people have realized that it is the new year. We don't have many problems with claims crossing years because, if you have a batch of claims and some of them are incurred in 1985 and some in 1984, you have to assign two different claim numbers. Within a year, we might have a shoe box of claims with a January 1984 claim combined with a three thousand dollar or four thousand dollar hospital claim incurred in December 1984. That gets assigned to the January incurred date. We haven't come up with a way to solve the problem, although we have recognized it.

MS. DORAN: I might add that that problem of using January 1984 instead of 1985 can also apply to the work papers of actuaries putting liabilities together.

MR. HOUGHTON: You see January claims being two and a half times the average of the year and December claims being maybe 60 or 70 percent, so you know there is obvious coding bias. One company, which had a computer system to batch claims, actually prorated them from the early month to the later month. They had a rule that the hospitalization date of confinement wasn't used but the date of surgery was. For all the miscellaneous claims, if the dates were January thru May, they prorated through their computer 20 percent to each month.

MS. DORAN: If you have to deal with this problem, get a sample that is large enough to be statistically valid about what date of service was coded compared to what it really is.

MR. ROBERTS: In addition to looking at the claim coding and how your claim examiners are doing it, it is important to read the contract. If a string of payments are attributed to one incurral date, it is essential that that string of payments really is a liability at that point in time. If the date of service is the date that's available most easily in your claims system, then that will probably solve a lot of your problems. The batching problem needs to be solved. If you are getting the true date of service on each separate payment, that can be used as the model for setting your lag pattern. You need to look at the provision for the extension of benefits in the contract. You may have liability attached to a string of payments if there was disablement continuing during that period. If an approach was used for coding that identifies the service date, you need to adopt a separate method to handle your extended liability. There is some difference of opinion among actuaries whether you use the so-called terminated block of business approach or the continuing block of business on your extended benefits. It is useful to look back at the income statement perspective rather than just the balance sheet perspective. If the object is to match your disbursements with your income, then you might want to ask about the time frame that piece of premium was designed to pay for that policy benefit and the extension of benefit provision. It's pretty clear that a benefit to the customer has accrued as of the

beginning of a period of disablement, whether or not the group policy continues inforce. The terminated block approach is the more conservative approach in setting reserves, but if you look at it from the income point of view, you've built a good case for doing it that way.

MR. MICHALCIK: In the last two Octobers, our medical care insurance seems to have a very high amount of incurred claims. It could be related to the three month carryover provision or batching.

MR. FLEISCHACKER: We had a client project in which we had a problem with the three-month carryover provision. The claims department had batched claims paid in the last quarter with at least one with an October service date, so they were assigned back to October. They did it strictly so that it would be easier for them to keep track of the carryover, and it dramatically affected both the completion factors and the incurred claims for that time period. As a result, we had to make some judgment adjustments to the results.

MR. ROBERT A. ALEXANDER JR.: We've noticed a very definite seasonal pattern in our medical claims and attributed it to how people postpone things during the holiday season; December tends to be a low month and January then catches up. Also, we use a batching method in assigning incurred dates where a January and May expense that came in on the same bill would be incurred all in January. Anything that falls over the calendar year is split into two separate claim drafts. The December claims that come with the January claims are coded to last year and the January piece, that normally would have been coded back to the earlier month, is coded to January. That accounts for the high part of January claims. This builds in conservatism in our claim liability. Using these claim lag factors typically produce a claim reserve that is higher than the true liability once the case cancels and claims runout. We have also noticed a seasonal bias in our disability income claims on teachers. Few claims are incurred in July and August but many in September.

MS. DORAN: You need to be careful in looking at your method that calculates your lag factors. Look at what period of time your average lag factors are based on, and how those factors compare with the period to which you are applying them. There is seasonality to claims, but we may be attributing more to this seasonality than actually occurs.

MR. ROBERTS: If you identify the seasonal pattern and how it affects your reporting, you really have an interesting dilemma with your company management. It is essential that everyone understand what basis you are using and how that pattern is reflected in your earnings reports. In many companies it's difficult to get through the first quarter of the year that is perhaps a break even or less. For restatement purposes, we must be sure that we are measuring the actual results against an expected model which reflects that seasonal pattern. Whether you use that in your formal earnings report is another issue. I am not sure whether it is appropriate to smooth those out having each month's statement reflect 1/12 of the expected annual results, or whether earnings should reflect a true seasonal pattern.

MR. JOHN WAGNER*: The accounting profession leans toward booking the expense when it occurs, and not smoothing it out, although I know corporations do it.

If you deal with twelve-month periods on a completion or projection basis, you eliminate some of your seasonality problem.

MR. ROBERTS: If you always use the December 31 runout pattern to establish a reserve, you will have pretty smooth reported earnings. In a sense, however, it smoothes out a pattern that you are able to identify.

MR. CHRIS SIPES**: If we break down the data to where you have some of the information without a lump of coding and if you do your liabilities on bases so that types of claims that are lumped together can be looked at separately, then you're not destroying your overall liability estimates as much.

When we did have a lot of lumping we did a projection based on the exposure of what claims should be over a twelve-month period. Each month we refined the projection, so we were honing in by December on what claims looked like in December.

MR. FLEISCHACKER: Our next topic deals with alternative funding products and the appropriate reserving methods for them, specifically, minimum premium and stoploss insurance products.

MR. ROBERTS: There is industry agreement on handling minimum premium plans in your books. However, a company might book the total disbursements, whether they are coming directly from policyholder funds or from company funds, as income and also as disbursements. This gives you an inflated income statement, although the bottom line is the same. It is more customary to collapse these agreements before you book them. You only book those items as income which reflect obligations directly related to the insurance company, whether that is a claim or an expense obligation. In a minimum premium plan where you charge the customer 10 percent of the normal charge on a fully insured plan, you would only book the 10 percent as premium and you wouldn't show any claims on your books except claims that went over the attachment point.

MR. MICHALCIK: I started considering the potential losses on administrative services only (ASO) stoploss insurance about two years ago. Relying on my own interpretation of materiality, I look at the emerging experience of the largest cases at December 31 to see whether any of them are already over the attachment point. The day will come when I'll be looking at a prospective loss, and I'll have to consider some sort of claim liability for emerging losses on that particular group.

* Mr. Wagner, not a member of the Society, is with Blue Cross/Blue Shield Association.

**Mr. Sipes, not a member of the Society, is with Professional Administrators.

MR. ROBERTS: One approach is to set up the total net premium as reserves until you know otherwise. It delays the release of any profit on the stoploss arrangement. It lets your valuation be consistent with your pricing assumptions until you know otherwise.

If you do collapse minimum premium arrangements before you book them, it will distort all the measures that company management likes to look at in terms of expense ratios, loss ratios, and earnings ratios, assuming that these are all ratios to premium. The concept of equivalency premium is often used to pay agents and brokers and also as a measure of sales. It is the best method of combining your fully insured and alternate funding business together to look at some of these broad measures. You may need to run two sets of books, one with an equivalent premium approach for various management measurements and one collapsed in your regular earnings statement.

MS. DORAN: Blue Cross plans frequently have so-called cost-plus business and the plan may view it as being the same whether or not they set up both the liability and an offsetting premium asset for that business. Auditors view these as two different things. They may require both the liability and the offsetting asset, and they may put a probability of receipt on that offsetting premium asset because of the uncertainty about what would happen if some company defaulted on reimbursing the claims that the plan had actually paid.

MR. PETER M. THEXTON: I am connected with a working group of the NAIC that is considering accounting for what they call the ASO/cost-plus business. Their tentative conclusion is you should collapse the in and out part for which the insurance company has no risk and not report that on the books. Further, they're going to recommend that the fee income the insurance company is collecting for its services and paying claims with should not be booked as miscellaneous income on the annual statement, but as a negative expense item in a special line on Exhibit 5.

MR. HOUGHTON: Accounting for risk charges or aggregate or specific stoploss has to be consistent with accounting for payments. Let's suppose that you had a plan on a calendar year basis where your risk charges for covering in excess of some attachment point were going to be $10,000 a month. In your pricing, 70 percent of that was for expected claims and the rest were margins. If you were to set up an unearned premium reserve at $7,000 per month, so that by the time you reach the end of the calendar year you would have $84,000, you would probably end up making a payment, in the following year once the full aggregate, which had exceeded the attachment point, became known. Since you don't have anything in claim liabilities, that aggregate payment should probably be coded as 1985 - not 1984, despite the fact it came from payments on behalf of policyholders in 1984. On the other hand, if you took that $7,000 a month and put it in as claim liability, so that you had $84,000 claim liabilities, then when you make that payment in 1985, you would charge an incurred date of 1984, so the two would match out. Either one is all right as long as you get the proper date for the payments versus handling charges as either an unearned premium or a claim liability. There have been companies that

simply take the whole thing in as profit because it hasn't been large for them. Every month the $10,000 went in as income, no unearned and no liability, so if you ever had a claim, it came as a bounce against surplus right at the time.

MR. FLEISCHACKER: Related to stoploss reserves is the concept of a reserve for catastrophic claims.

MR. MICHALCIK: The Oklahoma Blue Cross plan started to issue more policies with unlimited maximums and certainly a one million dollar maximum is commonplace on everything else. We talked about having a modest well-documented reserve for catastrophic claims. I wanted to have it as a separate line item from surplus and claim liability on the financial statements. Our accounting people didn't want it on a separate line, so we started to include it as part of a claim reserve. It was never intended to smooth fluctuations out because of changing utilization or the fact that we misrated a block of business. Our auditors raised concerns about whether that was acceptable by their standards. We eventually decided to eliminate that particular item. We couldn't measure anything to calculate the reserve on and the specific contingencies for which we wanted to hold that reserve hadn't occurred yet. The auditing firm that we work with was relatively disciplined on the whole topic and convinced us that it was not proper accounting treatment to try and set up such a reserve. It is almost certain that sooner or later you are going to have a case that is going to cost one million dollars. We are going to have to charge it to the month it occurs rather than to some specific reserve. Part of the problem this year was that the reserve had gone up relatively quickly, but that speed pointed the reserve out to the auditing people that it was not in agreement with their opinion of generally accepted accounting principles. Other companies have the problem that if the reserve has been a specifically identified item in workpapers and it is a large amount of money by whatever standards auditors want to use, they are going to ask you to take it out of your financial statements as not being appropriate.

MS. DORAN: Actuaries should consider the relationship between actuaries and auditors and what happens when there is a difference of opinion. Is it our role merely to measure the liabilities that the accounting profession agrees should be established, or should we be providing opinions on whether those liabilities themselves should be established? There are no easy answers and these kinds of problems are just going to continue in the future.

MR. FLEISCHACKER: We handle it through an implicit margin in the reserves. Last fall we were reviewing reserves for a company and the auditor did not want an explicit reserve for catastrophic claims, but they did allow us to have a little extra margin in the overall claim reserves to take into account that there are going to be those variations.

MS. DORAN: Wouldn't an alternate be to allocate a certain proportion of premium as a pool for this coverage and then use a loss ratio technique for setting up the liability? Most actuaries would agree a

loss ratio technique is appropriate on an extremely low claim frequency block of business or one where there is not much history.

MR. FLEISCHACKER: It seems that the catastrophic loss pooling is very similar to specific stoploss reserving requirements.

MR. ROBERTS: There is some precedent for this in accounting too as in the treatment of "bad debts."

MR. FLEISCHACKER: The next issue is the general knowledge that you need to know about your claim department -- particularly, how you go about measuring and evaluating claim department backlogs, changes in claims submission patterns, and environmental changes.

MR. MICHALCIK: I've been continually frustrated in using inventory counts and claims received numbers in a quantified approach for making adjustments to claim reserves calculated otherwise. I had no luck with different tricks like correlating between receipts and dollars paid out, or dollars processed on the change in inventory or taking numbers of claims processed in the last three months versus the three months before that and comparing them to seasonal trends of receipts and the number of days worked in a month. I am more or less relying on intuition. You can calculate a range of reserves around where the real number should be and rely on your figures and judgments from prior history for a recommendation to management that they use the higher or lower end of the range at certain points in time.

MS. DORAN: The problem isn't the claims that aren't yet reported, but looking at inventory statistics and educating yourself on figuring out the problems with all the information that you can possibly have when estimating liability.

MR. ROBERTS: You need to understand not only what the effect of a given level of backlog is on your current liability estimate, but how that affects the basic reserve technique that you are currently using. How does that affect the lag pattern? You also have to remember that a current inventory situation will affect your future observations of the lag pattern. You need to monitor that on a regular basis and find some way of working that into your basic technique for determining a reserve.

MR. FITZSIMMONS: We take our in-course-of-settlement figures, back them out of the "true incurred but not reported (IBNR)" and try to compare that "true IBNR" figure to the various benchmarks for that premium or paid claims. That tracks more smoothly than our total figure does. We calculate the in-course-of-settlement at the end of each quarter by taking paid claims during the first certain number of days during the month, pulling out the ones that were paid and reported in the current month, and adding that to an estimate of the pending list. Usually, by the time we make the estimate, we have very few claims that are not in a system of some nature.

MR. ALEXANDER: The American Academy of Actuaries has recently established a committee on Health Insurance Practices and Principles.

One of the jobs that we have is to put together a set of recommendations and interpretations similar to what has been published already for pension and for dividends. Our recommendations and interpretations encompass claim reserving, relationships with auditors, various factors considered in determining claim reserves, and general guidelines. It gives general indications of what should be considered by the actuaries in putting together a reliable estimate of claim reserves.

MR. LAWRENCE M. FREDRICKS: I'd like to hear someone talk about the relationship between statutory reporting and GAAP reporting in reference to deferred acquisition expense reserve and claim reserve.

MS. DORAN: There could be some argument for the position that you would want to use a best estimate claim reserve in GAAP earnings, whereas you include an explicit or implicit margin in the statutory reporting. Not too many companies are actually doing that. For most commercial companies, the difference may not be material to the bottom line.

MR. ALEXANDER: We do a couple of things for GAAP accounting for claim reserves. We use a seasonality adjustment for quarterly statements. This doesn't impact the annual statement, but it does impact GAAP reporting to our management for quarterly statements. The other area where we get into GAAP accounting is with long-term disability claims where you can reevaluate claims at a more reasonable rate of interest.

MR. FLEISCHACKER: On the deferred-acquisition cost (DAC) side, most companies are not setting up very much in the way of deferred acquisition costs. We have had a few clients if they have a high first-year commission and a low renewal commission structure, that will take that excess and set that up as a DAC, but then amortize it over a very short period of time, like three or four years.