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SEC Medical Rollforward

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Summary: Recently, Wall Street analysts and the SEC have been pressing publicly held managed care companies to disclose their reserving practices in order to gauge impact of prior period incurred development on earnings. Due to lack of clarity and lack of an industry practice standard on the subject, the reluctant SEC medical rollforward schedules that have been published have generated on-and-off confusion because of differences in rollforward reserving practices.

MR. JOHN C. LLOYD: I'm going to update you on some work that's been done by a bunch of other actuaries on the topic of SEC medical rollforwards.

I'm going to try to give you a little bit of the background and the history of what prompted a lot of this to happen and a lot of these other measures that analysts are producing. We're going to talk a little bit about the metrics and measurements some people, even non-actuaries, have developed, which we're calling the search for transparency. And then John's going to talk about the real topic, which is the rollforward schedule, or at least a limited version of the topic

So in terms of history and background, we have a fair amount of pressure from market analysts, which is what started a lot of this. To their credit, they're trying to determine what the true medical loss ratio is when they look at publicly traded companies, and trying to get a handle on earnings so they can do recommendations as to good firms and bad firms. We're talking about a group of people that, when they talk about the demographics, have some difficulty separating delivery of medical care from insuring medical care. So there is not a great deal of

sophistication, necessarily, in at least some of the analysts that are asking these questions.

We have a little trouble with incurred but not reported (IBNR). The first trouble I have is, by a necessity, it's an estimate. Secondly, it is, as valuation actuaries can tell you, not necessarily a transparent estimate. They're very comfortable with formula-driven estimates even if they're wrong, but judgmental estimates leave something to be desired. So any time judgment is involved, how do they determine whether a judgment call is a good one, a bad one or a biased one?

They have also perceived some problems in the past. There have been, much to our chagrin, errors in estimation made. We have to confess because it's usually a quarter later that it becomes obvious. But they're aware that there are missed estimates. They're also aware that there is some conservatism. There's a lot of debate about what constitutes valid conservatism versus arbitrary conservatism. Naturally, when they see changes in conservatism, they immediately leap to manipulation of earnings and, quite frankly, you don't have to be all that unsophisticated to leap to that.

Everybody thinks the actuary is doing something with the reserves, including the people in our industry. So, you can imagine what people on the outside looking in tend to think.

In the search for that they tried metrics and measurements to try to get that kind of disclosure. So when you look at it, the problem is estimates are not exact. The best estimates, even if you read the Actuarial Opinion, could be subject to other outcomes depending on circumstances. Another one of the issues that we talk about regularly, and especially in SEC calls, is the impact of prior period development. That's usually one of the things we have to explain somewhere down the road.

Now one of the problems is that restated earnings are typically an internal measurement. If you look at statutory blanks, you don't see restated earnings except in certain exhibits. It's compounded by the lack of uniformity in margin. We have a lot of different definitions of what constitutes an appropriate margin, if any, for health insurance reserves. It is driven a lot by the fact that health actuaries, by having to attest to sufficiency, have actually set up a somewhat different benchmark than some of our other practice counterparts. The one thing we would like to have and that they would like to know is that there's a consistency margin. And in a lot of the conversations and articles you read, they're not so much bothered by conservatism or margin as they are by our ability to change our mind about what kind of margin we have.

A good example of why they struggle with this might be seen if you follow somebody's earnings through an underwriting cycle, such as inChart 1. Essentially, the first two years they're making money. Now when they're making money the immediate question is how conservative the liability estimates were that were

behind that because in the second year they were making money. In this example, let's suppose the third year we report pretty good earnings again, but we have a reserve miss. So between what you reported as earnings and what you might now have restated as earnings, there's a problem. Your liability wasn't great enough, so your earnings were actually a little worse.

You get a prior period adjustment coming in the next year and that essentially catches you up with the reserves you didn't set up the previous year and actually drives your reported earnings lower than they really were. It looks like earnings really swung a lot more than they did because you're double counting the reserve change.

In the third year, if you show what might actually be worse losses, they look like they could be on a statutory basis less losses. So even though you're showing losses, you might actually be in question whether you're being aggressive on your margin at that point because you're in a down cycle. One of the problems we have is when you're an outsider and the only thing you have is a quarterly or an annual statement blank to look at, you're looking at these things thinking the reserve changes actually accentuate the problem for us.

We're also getting regulator and auditor pressures. The margin is a problem and when they couldn't deal with it a lot of the auditors decided that we would use best estimate. They were concerned about the redundancy in reserves. Auditors started looking at it year-by-year and said, "You know, every year your reserves aren't right. You always have some percentage left over, so why don't you learn to get it right?" To which the actuaries would answer, "We do get it right. It's always X percent."

The other problem was that the P&C interpretation of this is you gave a whole bunch of estimates and you somehow averaged on them. You don't need any margin. So with the P&C inconsistency, the way health actuaries set reserves created some problems there. Their reaction to it was to produce a guidance that said you must book a best estimate and then everybody freaked out because that meant we couldn't have any margin.

And so, we had the really illustrative guidance that we should have some margin, but we don't have to have some margin. That was interpretation 1-28, which is not as bad as it sounds. The problem the regulators struggle with is if they say you should have X amount of margin, it's only relative to how conservative your pick might have been for your base estimate to which you're applying it. So it could be possible that for a very conservative base pitch you need less margin. They had to skirt the issue of how much is an appropriate amount of margin by saying you should have some, whatever that means.

We also kind of fall back to the provision for adverse deviation, which is problematic for accountants because they see that as something that happens as a GAAP

concept and that only applies to long-term liabilities when you're allowed to do that. So even when you say, "I have provisions," they say, "No, you're long-term. You don't get to be risk-free." Your IBNR life insurance companies don't put any provision for adverse development on their life insurance IBNR. Then again, they just count how many people died by face analysis so it's not exactly the same problem.

The other problem, frankly, is a flat percentage. Before this became an issue most actuaries argued that if I put 5 percent on this year and then I put 5 percent on next year, I have a history of earnings and I'm consistent. Then they ask us, "Why do you need the 5 percent?" You say, "Because we have varying degrees of uncertainty in these estimates we've done." They say, "Why is that always 5 percent then?" So we've sort of caught ourselves in our own box. The percentage that's appropriate in a period of upheaval may not be the right percentage that you should have on in a period where everything is running on greased grooves. So the problem you run into is that we're not consistent in our explanations about the things that we say we're consistent in doing.

Trying to help analysts understand health carriers is one of the missions that the Financial Reporting Working Group that got started at the Society is doing. It's trying to help the outside public come up with appropriate ways to look at health insurance liabilities. One of the things we have to recognize is the IBNR and our dominant balance sheet entry, so it's going to be interesting. We also have to keep them aware of the fact that it's not like P&C companies. In this case, one of the analysts' reports I read for a schedule like you get from the P&C company shows the build out of the reserve. But what he doesn't realize is that's years and it's kind of easy to do on an annual basis. It's appropriate for what they do whereas ours don't build out that way, obviously.

Also, the other problem they have trouble with is when you make a change on P&C reserves, you're typically doing something that impacts earnings over multiple years, whereas one of our misses comes and goes in a quarter. They presume a reserve misstatement for people that are playing with P&C is going to be some massive deal that they have to watch for the next three years to see what it does to earnings. So, quite frankly, we know that doesn't happen.

We also tend to not be like life and annuity companies. They're less prone to short-term judgmental costs, statutory or GAAP reserves or factor basis. Most of them get audited, do a few schedules and rollforward to the next year-end and everybody is happy, whereas as everybody here knows that the health insurance reserves could change dramatically in one quarter. In their case, you usually have to unlock reserve changes and ask permission to change. So there's a big deal associated with reserve judgment calls for those entities that we, frankly, don't face.

Lastly, the nature of the business keeps moving under the analysts. First we shifted risk to all the providers and our liabilities went down. Now the providers decided

they didn't like it and the liabilities went back up. So you have a lot of things changing. If you're an outsider, even if you're a specialist in a health company, there's a lot of moving parts going on here in terms of product mix, electronic submission of claims and things that we know, but if you don't do every day, may appear mysterious to you.

An example for historical context is the way most of us look at IBNR. It comes from a culture of a hard copy claims examiner environment. We spend a lot of time on lag factors. You had a tail to these claims and you explained to everybody how the tail works. There's quite a bit of calculation there. It has a fairly significant impact on going from what's a paid basis to an incurred basis because there was a long tail. At the very bottom of it we said these last three months are an exception because credibility blending has to be used because that's too volatile.

We sold this story pretty well and explained it all. If you think of what it meant in terms of people looking at the results of liabilities, it was not uncommon to see somebody with three to six months of claims in IBNR. If you think about it, there was paper being mailed in from all over the country and there were big examiners here examining the claims. Then there was the video process. We'd only cut checks once a week. There were a lot of things going on here that caused a fairly long tail. It was not uncommon if it was three or four months before you were 50 percent complete in those kinds of environments, and you could get pretty substantial impact with that kind of tail on your paid incurred ratios.

If you look at the current state, which I'm not real sure we've fully caught up with yet, one of the topics tomorrow is going to be alternative ways of calculating IBNRs. One of the reasons why people are looking at that is they're now electronically submitted and adjudicated so a lot of this is untouched by human hands. We still compute lag factors on what's left that's unpaid simply because that's your base. The term I've developed for it is it's the fly rod effect. If you change the base just a little you can swing the last few months quite a bit. So having lag factors to get stuff that's 95 percent fully complete is still important.
However, the per-member-per-month (PMPM) credibility blending stuff that we used to be the flow away for the last few months of liability is now a much larger portion of liability as that tail has shrunk. So, the things that we used to do where the lag was important and developed a lot of liability has now moved down to a lot more judgmental calls about current trends, current inventories and things that are happening near term for which there are still fairly poor statistical credibility. One of the things folks have moved to is abandoning lags altogether and starting to try other stochastic models that project incurred claims.

The last month for some Blue plans can be half of their liability. It's gotten that fast. I've had a number of conversations in which it was pondered if the flu was going to cause December to be a bad month or is everybody being on vacation going to cause December to be a good month. You can get pretty diverse opinions about

what one month looks like, depending on who you ask. There's a lot of pressure on explaining that to people.

The metrics associated with that, as you could imagine, are such that you can get two months of claims or even a month and a half for some HMOs. So it's pretty complete at 12 months. You ought to get fairly good insight, although it won't be complete because of some other issues like seasonality at quarter, which certainly has less impact in absolute terms, but is still significant. So given that context, there's a lot of work, and we're going to talk about SEC rollforward schedules.

The other painful exercise has been something called "days in claims payable." This was something that the analysts developed that, frankly, started a lot of this reaction of health actuaries because we're not sure that days in claims payable means just exactly what they think it means. The analysts think this is great because, coming from other industries, they do a lot of things based on days. There are days of inventory. There are days in receivables and days in manufacturing. There are days in supply chain. So, measuring something as a relative base that is based on the number of days of something is a familiar way to look at things. It was kind of natural they might have moved to that.

They recently applied this to claims payable. The typical definition you get can be seen inChart 2: the ending days claims payable is equal to the medical claims payable over medical expenses divided by days in the period. So you take how many claims a day and divide in the liability and you have a number. Really the number that I like better is average days in claims payable, which is the average of the beginning and ending days claims payable. What you read a lot or hear a lot in some of the analysts' calls is looking at someone's days in claims payable and deciding what that's a precursor of and what they have done.

One of the problems we felt early on with days in claims payable is that nobody knows exactly how to define it. Are all claims payable defined the same? We actually did a survey as part of the Society working group to see how many people were defining it in the same way. Some people put their litigated claims up there. It's not as straightforward as it sounds. Some people actually never have aggregate reserves; they actually put everything in claims payable. So there's an issue of what's in there. There's also an issue if you move from a fee-for-service to a capitation on something that liability changes, without any real explanation anywhere in the financial statement, as to why it changed.
Something fairly simple but that still needs to be looked at is: How many days do you divide by? It says days in a quarter, so how many days is that? We found some people used 90 days because it's three months and 90 is the average. Some people use exactly how many days there are, and some people use even more complicated things. Essentially, when you're trying to look at what days in claims payable means relative to another company, you have a lot of weird things going on. Also, what do you do about margin?

The interpretations assigned to this are really a problem in that there's some feeling that a higher days in claims payable somehow means the reserve is more conservative because they haven't reduced the margin. It could also mean that those are understated because you haven't paid claims lately and you've reduced all the margin, but we're going to ignore that for right now. The interpretation applied to it is a problem.

The unexpected drops in it, or at least unexpected from their perspective, are initially taken as earnings manipulation. So what we really have a problem with is that they're looking for the magic bullet. They're looking for something that tells them what the actuary or management did to these reserves. They want a way to raise the question in their discussion with them about the days in claims, without reading the rest of the financial statements or listening to management. If you just look at days in claims payable you have a way of figuring out what's going on here.

Our problem with it is that it's one number taken out of context. Examples we've seen along the way of this are obviously claims inventories and operational changes. If you don't understand days in claims payable and your association with those changes, you have a real problem. We also have seasonality in payment cycles or seasonality in the actual incurred claims. Many of those are going to impact it. Then you have the risk mix. As we mentioned earlier, if you have provider risk contracts that are changing under you, obviously your days in claims payable are going to change. And then there are the one-time changes like reserve catch-ups and things like that.

The actuarial reaction for this has been the Financial Reporting Working Group, which probably began out of the chief actuaries meetings. There was probably a cavern-oriented gripe session that followed it. But for whatever reason, it was decided that maybe this was something health actuaries should tackle.

We also had to react to the American Academy's best estimates paper that kind of said that we were going to now use best estimates. At the time I worked for Ernst & Young. John worked for and still works for Deloitte. We immediately had to go beat on accountants from one coast to the other about the fact that we were not going to tell an actuary to put margin in reserve and that he was wrong. That was fun. And also, among the actuarial staff at the various accounting firms we had problems with this because we knew what the health actuaries were doing and we also knew that it was inconsistent with what expectations were elsewhere.

The other problem was somebody wanted a reaction to these other metrics. There was some concern that actuaries were sort of losing their control over this topic. There was concern that we were being more reactive to numbers like days in claims payable or rollforward schedules that other disciplines were developing for us because we weren't stepping up to a disclosure and transparency.

So the next step out of our group is there's a white paper that's sort of in draft form. We circulated it among folks and now the Society is trying to figure out what to do with it because there are about 15 constituencies that we don't want to offend, such as the Academy people and the P&C people. The reason why we went through this painful little exercise is to give you a context on what this working group is working on and to try to get a little more actuarial involvement to help in dealing with these issues.

MR. JOHN M. STENSON: The title of the discussion is "SEC Medical Rollforwards," but one of the things we're trying to do is talk about the issues around that. What is it that we're trying to do with the medical rollforward schedule and what are the challenges facing us? And obviously, what the SEC rollforward schedule, the days in claims payable schedule and the statutory statements do are to tell the reader or the world at large how you do historically in your reserve development. The issue, of course, is that's a bottom-line result, and all of these disclosures really deal in the bottom-line result.

There may be some more information that you can use to allocate that bottom-line result to different points in time or be able to understand from an order of magnitude perspective, but it really doesn't explain it. To be perfectly honest, one of the things that it doesn't do is help explain the differences between what could be offsets. You may have been over for one reason, but under for another. This could be a big problem with your reserve-setting process, but from a bottom-line basis you got lucky and it's not exposed in any of these rollforward schedules.

One of the things we're going to want to do, in the interest of transparency and trying to get people to understand what we do, is to be a little more transparent in all the things that we look at when calculating a reserve. I think we're going to want to be able to demonstrate that we've taken a look at the things that can cause variances in our IBNR estimates to the extent that we can. Several potential causes of variance are shown in Chart 3. There may be some that wouldn't apply in a particular situation. There may be others that could apply in our particular situation. But, we're trying to find the proper balance between the accuracy and the cost of achieving the accuracy of our reserve estimate. We are also trying to get people comfortable, especially the outsiders, with what you've done in the development of the reserve process. Have you considered all the factors and been as transparent as you possibly could be?

There are several things that we raise when we're having discussions with our clients and taking a look at their reserves. We want everyone to be comfortable that everything's been accounted for. We get to a point where other outsiders, whether they are analysts, regulators or other entities that are looking at our reserves and the results of our rollforward statements, are asking these kinds of questions as well. And some of these are fairly obvious. Some of these your companies have experienced.

Also, as shown inChart 4, there are obviously implications of doing this well and not doing it well. I think one of the most important factors, unfortunately, is that in the times we live in there are errors, mistakes and egregious actions. Unfortunately, a lot of outsiders don't look at any of those as being a whole lot different. And many mistakes, many actual judgments, are criminalized if you're wrong whether it be results in additional oversight, auditor problems or shareholder litigation for those of you who work at entities that are publicly traded. In today's day and age, unfortunately, we're not as tolerant as we used to be.

It's not a simple thing that we're involved with in calculating reserves. There are a lot of things that link together and form the basis for what we're doing. As actuaries, we can't operate in the ivory tower. We have to understand how all of the processes link together, how all the operational drivers impact the way that we develop reserves and what's happening at our companies, the interlockings with the processes and procedures and all of the financial aspects of your company whether it be cost of capital, interest, etc.

I'm going to show you a couple of examples of rollforward analysis. I've taken a fairly simple analysis in this case and created a hypothetical example for your review, but first I want to lay out a few of the benefits, as stated in Chart 5. One is that it enables a reviewer to reconcile beginning and ending claim reserve balances so you can understand from an earnings statement perspective incurred claims being paid plus changes in reserve. The benefit of a rollforward analysis is you can understand where the reserve was at both the beginning and the ending points in time. It does, perhaps, limit the need for the days in claims payable metric. Some of the analysts are actually getting fairly sophisticated in looking at this as a substitute for that, and it provides a more transparent view. It kind of varies in the level of transparency that it provides, and I'll discuss some of the differences that we're actually seeing in some of the rollforward exhibits that are being provided. Also, outside observers can more easily make adjustments based upon what they see.

There are limitations, of course, to this, as listed inChart 6. One is that the amounts are provided net and gross of reinsurance. If you don't understand the details of the company's reinsurance arrangements, you may not be able to take out the impact of that in either the beginning or the ending period. For the most part, companies that I've seen do this rollforward exhibit do it on an annual basis. So if you want to understand earnings or other performance by quarter, it could be difficult to do. You wouldn't necessarily have all the information on an annual basis, and you wouldn't be able to determine if the fourth quarter was better than the first quarter or whatever.

Results may be presented on a global basis. If you're interested in any kind of segmentation of the rollforward analysis, that's probably not going to be available. It may be separate based upon a statutory basis, but it may not be.

These are obviously mostly done by companies who file SEC statements, so it's not necessarily going to be available. It's not going to necessarily line up with the way that they file statutory statements. Some carriers that present this information provide it on a gross basis versus a net basis, and there's more information that's available if it's provided on a net basis. You'll be able to see the impacts for those companies that may be making adjustments at year X for a particular point in time. You'll be able to determine if that goes back to year X minus one, year X minus two or beyond.

Chart 7 is a managed-care industry overview sheet that I actually took from an analyst report, which is a very good report. It was done by folks at the Bank of America. Especially for those of you who work at publicly traded companies, I recommend to look at this report. I think it shows a level of sophistication that's starting to emerge, at least in the analyst field, as to how they're taking a look at what we do as actuaries and understanding the implications from an operating basis on reserving and all the other aspects of financial statements.

In summary, I think the more information you provide, the more transparent that you are. The benefit of no disclosure, obviously, is that you're able to have more control over the information and, thus, the interpretations people will make from that information. The more information you provide, the less room for interpretation because you're putting the information out there for them.

There are a couple of considerations to make as you're taking a look at the examples. You should know some of what the analysts are going to be trying to figure out as they look at this, such as how provisions for adverse deviation are being handled, and how the actuaries have made changes to those. Have they disclosed changes that they've made to those and how should I use those disclosures in terms of this interpretation? They're also going to try to start making conclusions as to what is driving these relative rates of positive or negative prior period adjustments. Is there a correlation between underlying trend and prior period adjustments? With higher trends, does that mean that there's a higher chance that there could be a prior period adjustment because it's a more difficult test to make? Or is it changing trend that's going to do that?

If we're transparent and clear in the information that we provide and how we use it, we'll help people get to the correct conclusions versus them using the information that's there and trying to come up with their own conclusions. Perhaps it's a little less concerning with that than there is if they start trying to make conclusions about how recent operational performance has impacted the level of prior period adjustments. Are we guilty of earnings manipulation or earnings management? We're trying to stow something away for a rainy day.

If the future behaves like the recent past, we may be going into something of a slightly downward underwriting cycle. The years 2002, 2003 and 2004 were good years for most carriers. So what are we going to do? What kinds of prior period

adjustments will come through if 2005, 2006 and 2007 start to deteriorate? I think people will take a look at those adjustments compared to what we reported and try to draw conclusions from those compared to what we did in the good years, so to speak, with the results. And we're just going to have to be careful about the linkages that people will make between the two.

One of the things that I've seen done when they take a look at these prior period adjustments and make accounting for them is that they really adjust the revenue growth rates. You can actually get profit growth rates and you can actually get some pretty significant adjustments based upon the changes that are made.

I've put forward a fairly simple example in Charts 8 and 9. In kind of a five-year time horizon here we say, in this example, the total incurreds are paids plus the change in reserve. But, that's from an operating statement perspective. What are we saying from a true performance perspective? So in year X, my 3,915,000,000 of incurred claims is what will be reported from an operating statement, but in reality it's a function of what I truly believe this year and adjustments that I've made to prior years estimates.

Going forward, there's a linkage and, in this example, I always have some adjustment. I've always been a little conservative in the reserves that I hold, and in this example I've actually swiftly assumed that all reserve has run out over 12 months. In most of the companies that we run, that's a simplifying assumption that's not going to be available in reality. But when I have varying adjustments in the amounts of incurreds, what happens, on an earnings basis, can be pretty significant. From an actuarial perspective, we may not view being 110 million over reserve (75 million one year, 50 million another year, 80 million another) as bad. In fact, we've had a level of conservatism in all of our reserves and that may not be viewed as bad. But when that gets translated into earnings changes, you see what can happen.

If we take a look at the earnings adjustments in the various years and compare them to the earnings adjustments from the following years, I have what can be a relatively significant amount of over- and understatements in a particular year, because in the first year I had 110 million of overstatement from the prior year. In year X plus one I have 75 million of overstatement. I've actually overstated the earnings in the one particular year to the tune of $35 million in this case. For a company that has total incurred claims in my example of over 4 billion, that may not be a significant absolute amount. However, if I had a $4 billion company and then I had $100 to $150 million of earnings, that would be a good year. So 35 million of over- or understatement in earnings can be viewed as being fairly significant.

One of the things that we pulled together is an understanding that in order to help limit the volatility in the IBNR variances and the impact that has there are usually five risk areas that we take a look at. In reality, there are five risk areas that you

take a look at in any operational process. Those five areas, as can be seen in Chart 10, are people, process, technology, data and pools. Looking at people, there could be not much sharing or communication, or companies could have regular reserve meetings that are very cross-functional. The chief actuary, the CFO, the chief operating people and the sales and marketing people are involved, and everybody understands what goes into the reserve development process and all the right information is shared and done on a regular basis.

When it comes to process, I think Sarbanes-Oxley has had an impact, especially for many not-for-profit companies and not publicly traded companies. They are adopting Sarbanes-like process overhauls and developing documentation accordingly. I think that it's been the challenge for a lot of actuaries. A lot of the actuaries at the companies that we work with have found it challenging to be very open about that process and document it in a detailed fashion. If there's not a direct reporting line at least between the CFO and the chief actuary, there could be some tension because the CFO is going to have to attest in a publicly traded environment to all the processes and procedures around significant financial items. So some of the actuarial judgment is being called into question, and we're being forced to document that process and share more and more of what we do both internally and externally.

In the processes that are much more tightly defined and involve a lot of cross functional input, we've seen them doing better in mitigating variances than others. When it comes to tools, the more automated the better, and the less manual adjustment and manipulation on the tool results the better.

Basically, reserving is one of the financial and operational processes that a company goes through. As part of all of Sarbanes, we've seen a lot of companies take a look at all of their financial processes. And when it's been an environment where it's been very silo-oriented, the people that are using a holistic approach to reassessing all of their processes are finding that if they take a look at this and it goes beyond the compliance nature, it actually helps them in the operating of their whole business. They're actually able to be much more efficient in what they do, and it has improved their bottom line. Sarbanes is some of the driver of this, as well as a lot of the other issues that we talked about early on.

MR. LLOYD: One of the things that we've done is there is a draft of a white paper that was finished a few months ago.
Our first general sense is this is not something that's going to go away. I think there are committee members that now have their analysts hosed down and compartmentalized, but our general assessment is once these guys learn a tool they just apply it to all nails even if it's not a hammer. So one of the things that will happen is that these discussions will be ongoing, and we think health actuaries will continue to be challenged as to how they do their job.

There is a fairly fundamental aspect of what a lot of actuaries do, so I'm going to talk about some general things that are going into the white paper. First of all, we think it needs to have a general discussion of the nature of the liability and the nature of actuarial practice. There is a fair degree of sophistication, but there certainly needs to be more. I think the first thing is that it should have some preamble that talks about how we do our job. I've had this discussion with the accountants on why the actuaries put margins and why health actuaries view it differently than others. We've also talked about the general nature of the guidance we have and realistically why it's not a problem as long as it's transparent.

The second thing we'd like to do is to kill some of the other metrics. Basically, we think a lot of times it is chewed up by explaining why A and B does not equal C just because it did last week. There's a lot of connecting the dots out there that we'd like to kind of, in a nice way, get off the table.

One of the issues with the group, frankly, is you think you have to give them something when you take that away, as much as we hate it. You can't just say it doesn't work and then walk away. You need something put in the right context to talk about what it is we do and how. We're thinking that the rollforward schedule probably is the most reasonable thing you can throw out there. You have to give them red meat and the rollforward schedule seems to be close enough to Schedule H. It has some aspects to it that at least make it a good starting point.

I think the other thing we want to say, though, is it's going to be relevant and it's going to be standardized. People cannot do their rollforward schedules working in different ways or they're right back to where they started from. So some path needs to be reached for how you do a rollforward schedule.

MR. STENSON: We also need to decide what additional information needs to be included with the rollforward schedule.
MR. LLOYD: The last point is that there is no magic bullet. The rollforward schedule tells you something, but you can't just lay somebody's rollforward schedule out and say, a-ha, you're not having the dialogue. So I think the other thing we're thinking needs to come out of this is actuaries need to understand that they have to be able to explain why their schedule looks the way it does. It gives you an opportunity, frankly, to discuss your business in terms that you control as opposed to somebody else's analysis of your business and the inferences they might call. So that's sort of where the group is heading.

MR. STENSON: Is it a situation where part of your reserve disclosure is part of your 404 or 404-like documentation? Is it something that you put forward with your reserve estimates and then deal as from that or explain in the rollforwards, or is it just depending upon what your rollforward would say? Would you just want to deal with explaining the results of the rollforward?

MR. LLOYD: The other thing, too, is we don't think it's going to solely be related to the SEC because with Sarbanes-Oxley and the other questions coming, people are looking for tools to understand, whether it's a publicly traded company, a Blue Cross plan, a publicly traded Blue Cross plan or whatever it is. But in general we think that auditors and other interested parties are going to want some kind of tools to work with here.

MS. KAREN BENDER: I concur with you that the payment process has been speeding up. Why not just wait a couple of months before we issue a statement? I've been in this business longer than I care to admit, and I remember four decades ago we would not even talk about experience until we had three months or more. You know, now if we waited three months to issue a statement, we wouldn't be having this discussion. That doesn't apply to some of these things that do have a longer tail, such as maybe your stop-loss in health care. So is this too logical?

MR. LLOYD: Well, there are two issues that came up in this. One is I got beat up for saying that things have shortened up a lot. We trained the analysts that there are issues of seasonality and there are some legitimate things going on there that mean that sometimes in a given quarter you don't get full perception. A month later I can tell you whether you listened or not.

MS. BENDER: At least a few months later you'd be able to tell. After three months how many had a loss ratio that changed significantly using whatever outstanding estimates? Those are very, very stable. And if they are not stable, then you have other problems going on that this isn't going to help anyway.

MR. LLOYD: We had actually talked about the rollforwards in terms of your discussion. If an actuary is shown to be consistent three months after a quarter, leave him alone. It means this is probably working well. But I think there was some pushback among the group about doing that. That may be one of the things that we talk about more. You can tell 90 days later when you do your next quarterly statement without having to wait a year.

The other problem, frankly, isn't ours to manage, which is if you're a week late the analysts are all over you for what you are hiding. Being able to push back on the analysts and say if you'll just wait 90 days when they read an inference in that you didn't work on Saturday is kind of tough.

MR. JIM GALASSO: I'm a consultant now, but a lot of my life I was in a company environment. In a company environment I tried to teach the people that were getting information that you should believe it after 90 days and don't believe the most recent quarter. That's obviously not practical in an SEC environment for companies that have to prepare financial statements to the current quarter.

I have been working with a number of analysts actually and I try to work with them to get information to where you can see all the reported results, but you'll also be

able to get recast. It would be beneficial to recast the financial statements for the rollforward issues so that we can give analysts reported results, recast results quarter by quarter. I think that would be very good. A lot of the companies might not like that, but given the push, I think that's where we're going to end up.

MR. LLOYD: You're exactly right. Part of what we as a committee wanted to do, because we're a diverse set of actuaries here, is to look at the willingness of some companies to say, "Here are my recast earnings." In some cases, companies are willing to do that. But I think until we reach some uniformity or agreement as to how far we have been pushed to the wall on this, there will be some resistance to giving up more than you have to give up. I think what started me on this is that I think it's a fairly fundamental challenge to help actuaries as a profession to be able to deal with this.

MR. STENSON: One of the things that some of the analysts are starting to realize and some of you, too, is that obviously they want to understand if this is what you say your "incurred claims" were. By definition, obviously, that's the intent of calculating reserves. So if that's the case and you miss, what's the impact of that on future pricing? Then what is the earnings outlook, for you as an entity, especially in terms of all the mergers and acquisitions activity that has taken place? They're not only trying to understand how your historic performance has actually been compared to what you stated, but what your prospects are on a going-forward basis. They have connected the dots that you are basing your pricing on your view of historic incurred claims. So what are the rollforward ramifications of that?

MR. LLOYD: I think the other thing we worry a little bit about is that at some point there will be a Financial Accounting Standards Board (FASB) pronouncement if we don't produce something that gets out ahead of that. And I think based on some of the other FASB pronouncements we've had to accommodate, that doesn't strike us as the best thing that could happen to the health actuarial profession.

MR. FRANK AMRINE: I'm part of this committee. One of the things that interests me the most is the diverse way in which we calculate the rollforwards that are being reported to the SEC or in our statements. The committee took a survey asking people what's in there and what's not in there. Is litigation in there? Is it not in there? Is this in there? Is that in there? And it seemed to me just listening to this small committee talk that it's going to be a great uphill battle to get people to get us to change the way we're doing things and to get some consistency that has been mentioned here. So I want people to comment, if they would, on the likelihood that companies would change the way they calculate things.

MR. LLOYD: I think the one thing that we are hoping is the rollforward schedule is a little less likely to be one of these tools where they lay company A beside Company B and say, "This company is better because they had more days in claims and, therefore, is more conservative."

One of the problems we really saw with the lack of uniformity is that different companies measure different things differently. In the recent rollforward schedule you're being compared against yourself, whereas in some of these other metrics they try to compare it from company to company, and to Frank's point, that's where the wheels fall off because not only is it not the same reporting, it's not even the same situation driving the reporting. It makes a huge difference.

MR. JIM GEYER: I am also a member of the committee. I'm responding to Frank's challenge. I think it's a legitimate question. I think it's unlikely that many companies will change what they do without some sort of FASB ruling ultimately. We like our disclosure. We think it's appropriate. We've gotten good feedback from analysts on it, and we don't think an actuarial pronouncement or a Standard of Practice is going to carry enough weight with the company to change what we do.

I think, as you have said quite eloquently and very well, this is a challenging area for us. There are a lot of difficulties and misleading aspects to days claims payable. It goes up at times when your reserves are weakening, and it can go down at times when your reserves are strengthening. So it can be very misleading and analysts are looking for further information. I think the rollover is the first step. I do suspect over time we'll look for enhancements and maybe we'll get some standardization, but I do think ultimately there would be some FASB involvement.

MR. STENSON: I am with Deloitte where I work with a bunch of auditors, and they get concerned when they don't understand what's being put in front of them. They like to tell you what to do not only in the preparation of it, but in the underlying aspects of it. I just get concerned that if we're not as clear with them as we could be through the form of the Public Company Accounting Oversight Board (PCAOB) or using Sarbanes as a hammer, not only are they going to tell us how to describe what we do, but they're going to start telling us what to do.

MR. LLOYD: Frankly, I just got through looking at someone's Sarbanes-Oxley 404 compliance testing, and the accounting approach is very mechanical. You do this, you do this, you do this, you do this and then you add it up. And I think one of the things that we're trying to resist a little bit is that this is a fairly judgmental process. The mechanical process of ticking off the various things you should consider is fine. But what you do with them in terms of setting a liability tends to be less arithmetic and less subject to the kind of things like FASB. We think we need to introduce that aspect to them if we're going to have this be viable-type guidance.

MR. STENSON: As an example of a situation I found, the chief actuary of this company before setting the reserve, obviously, wanted to understand from the provider contracting people, if there are significant provider contracts that are open that could involve retroactive adjustments. That makes perfect sense. So they took this report regularly from the person who was responsible for this unit. There must be good communication between the two entities as to how this information is being

used in the setting of the reserves. The understanding from the giver of that information should understand that I want to be accurate.

The giver of this information was thinking I don't want there to be surprises later on, so there was a level of conservatism. The assumption as to what could happen in these provider contracts never materialized in actuality. So that conservatism would vary and there would be some significant reserve changes as a result of that. That kind of process check and understanding of the information is to a level beyond just taking a look at provider contracts. Do you understand all the information that's being given? How transparent are we going to be forced to be around all that? I don't know what kinds of pressures you're facing at companies that you work for, but we're being asked to take a look at that in some detail.

MR. GEYER: It's interesting that we as actuaries are naturally focused on the IBNRs that we're involved with, but there are a lot of other items on the balance sheet that we see from time to time in premium receivables and other assets. I suspect every industry has its similar item. The idea of getting to full transparency, showing what the real run rate is for a quarter, is probably something that analysts would like to see in every industry. I don't think we're unique. As I said, even within the insurance entity, health IBNRs are not the only item that can have out-of-period noise to them. That is my observation.

MR. LLOYD: This committee has been fairly inclusive. To that point, we want to expose the topic a little bit today and try to get as much input as we can, because you're the one managing. When we get in a room full of publicly traded companies and chief actuaries, there's no shortage of divergent opinions. But I think we are trying to reach some kind of balance between what should be disclosed and explained in our jobs.

I think I agree with Jim that there is a certain level of detail that I'm sure they're looking at that we want to pull back at. If you want to share with us by e-mail or get on the committee, I think we are striving to get some kind of wrap-up. Some people wish it would go away, but we think it's still lurking there in the bushes for the next down cycle. So, we welcome the help.

Chart 1

Reden & Anders, Ltd.
An Ingenix Company

Underwriting Cycle and Earnings

Reported Statutory Earnings

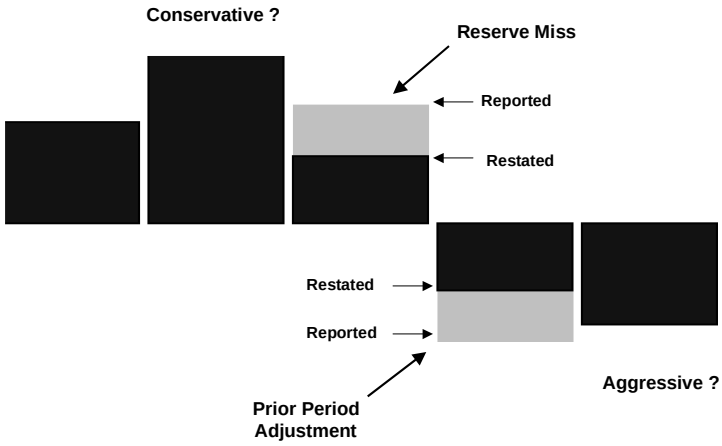

Chart 2

Reden & Anders, Ltd.
An Ingenix Company

Search for Transparency

- **"Days in Claims Payable"**
  - **Common analyst tool for other financial entries**
  - **Attempt to apply it to Claims Payable**
- **Typical Definition**

$$\text{Ending Days Claims Payable} = \frac{\text{Medical Claims Payable}}{\text{Medical Expenses / Days in Period}}$$

$$\text{Average Days Claims Payable} = \frac{\text{(Beginning Claims Payable + Ending Claims Payable) / 2}}{\text{Medical Expenses / Days in Period}}$$

Chart 3

Causes of Variance in IBNR Estimates

Actual results always vary from estimates — Variance has three major parts:

- **Internal drivers including:**
  - Systems
  - Data Integrity
  - Data Timeliness
  - Process Disconnects
  - Data Supporting Assumptions
  - Introduction Of New Products
  - Changes In Plan Designs, Underlying Population Morbidity, Marketing, Strategy
  - Changes In Medical Management Programs
  - Changes In Provider Contracting
  - Changes In Reserving Philosophy or Models
  - Management Judgment
- **Industry trends including**:
  - Impact of Medicare and Medicaid Cost Shifting
  - Competitor Actions
  - Investment Returns
  - Regulation
- **Random Variables**

Goal is to Find a Proper Balance Between Accuracy — and the Cost of Achieving the Accuracy — While Not Understating or Overstating by too Great a Margin

Chart 4

Projecting Medical Cost Trend and Setting Reserves

- Implications of Doing Well:
  - Quick Response to Market Trends for Improved Margins
  - Less possibility of Surprises
  - Premium Price to Earnings Ratio (PE) Compared to Competitors
  - Better Access to Capital
  - Credit Rating Agency Implications
  - Higher Returns on Equity
  - Pricing Advantages
- Implications of Not Doing Well:
  - Criminalization of Errors
  - Lower Market Cap Due to Earnings Surprises
  - Poor P/E Compared to Industry
  - Increased Legislative & Regulatory Oversight
  - Over-capitalization and Free Cash Tied up in Risk Based Capital
  - Inaccurate Pricing – Future Financial Statement Implications
  - Shareholder Litigation

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Chart 5

Roll-Forward Analysis - Benefits

- Reconciles Beginning and Ending Period Claim Reserve Balances
- Limits the need for days in claims payable metric
- Provides a more transparent view of an insurer's reserving practices
- Outside observers can more easily make earnings adjustments for variations in reserve margins

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Chart 6

Roll-Forward Analysis - Limitations

- Analyses are presented net and gross of reinsurance recoveries
- Data on an annual basis makes quarterly re-allocation of earnings difficult
- Results are presented on a "global" basis so earnings re-allocation to proper periods is difficult
- Some carriers use gross reserve adjustments and others use net.

Chart 7

Roll-Forward Analysis – Gross vs. Net Basis

	Gross Reserve Disclosure	**Net Reserve Disclosure**	**No disclosure**
Pros	Allows rough estimation of earnings, excluding any subsequent reserve accruals	Can determine actual run-rate earnings in a given period.	For a short time, there will be less investor scrutiny on the reserves of these insurers.
Cons	Can not accurately estimate the impact of reserve adjustments on earnings in any period. Can not track level of conservatism from one period to period.	Can not track level of conservatism from one period to period.	Investors will discount companies with less transparent results. Pressure will grow on the industry to improve disclosure
Calculation	Total amount of favorable or unfavorable development.	Total amount of favorable or unfavorable development, offset by reserve accruals for future development	N/A

From "Managed Care Industry Overview", March 2004, Bank Of America, Joseph D. France, et al

Chart 8

Roll Forward Analysis – Hypothetical Example

Amounts in Millions

	year x	year x+1	year x+2	year x+3	year x+4	year x+5
Reserve at 12/31 prior year	910.0	975.0	1,100.0	1,300.0	1,500.0	1,700.0
Incurred claim expenses during the year						
Incurred from this year	4,025.0	5,100.0	5,700.0	7,000.0	8,000.0	9,400.0
Incurred from prior years	(110.0)	(75.0)	(50.0)	(80.0)	(130.0)	(100.0)
Total Incurreds	3,915.0	5,025.0	5,650.0	6,920.0	7,870.0	9,300.0
Claim Payments						
Current year claims	3,050.0	4,000.0	4,400.0	5,500.0	6,300.0	7,500.0
Prior year	800.0	900.0	1,050.0	1,220.0	1,370.0	1,600.0
Total Payments	3,850.0	4,900.0	5,450.0	6,720.0	7,670.0	9,100.0
Reserve at 12/31 current year	975.0	1,100.0	1,300.0	1,500.0	1,700.0	1,900.0

Chart 9

Roll Forward Analysis – Hypothetical Example

Impact on Earnings

	year x	year x+1	year x+2	year x+3	year x+4
Earnings Adjustments					
Related to Prior Year	(110.0)	(75.0)	(50.0)	(80.0)	(130.0)
Related to Current Year	(75.0)	(50.0)	(80.0)	(130.0)	(100.0)
Amount of Over (Under) Statement	35.0	25.0	(30.0)	(50.0)	30.0
Average Common Shares (millions)	110	110	110	110	110
Earnings per Share Impact	$0.32	$0.23	($0.27)	($0.45)	$0.27

Chart 10

Leading Practices in Mitigating Volatility in IBNR Estimates

Risk Areas	High Risk Practices	Moderate Risk Practices	Sound Practices	Leading Practices
People	Major changes in processes not shared between disciplines	Routine monthly reporting shared between all disciplines	Major operational changes are routinely discussed with interdisciplinary team	Major operational changes are discussed & decided by interdisciplinary team
Process	Policies inconsitient and/or undocumented & process inconsistent and/or not well controlled	Policies are documented but deviations are common	Policies are documented & deviations from policy are infrequent	Consitient policies are fully documented & followed across entire organization
Technology	Multiple input systems require manual feeding of data	Multiple input systems require minimal manual feeding of data	Input systems provide the critical data needed	Input systems provide all data needed in a reliable & timely manner
Data	Critical data is unavailable or lacks consisitency & integrity	Data quality questions exist due to multiple reporting systems that do not reconcile	Only minor reconciliation issues between multiple reporting systems	All data reconciles with other reporting systems
Tools	Multiple tools are required & interpretation of results is difficult. Manual intervention required	A single tool is required but manual adjustments are frequent and interpretation of the results is complex	A single tool is employed with clear results and minimal manual adjustments	A single tool produces clear and accurate results

Variance Reduction →