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Commitment Beyond Numbers

Monograph

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DD&R Reserves for Claims-Made Professional Liability Coverage

Robert J. Walling III, FCAS, MAAA, CERA and Jessica Lasher, CPA

The following article provides a general background of the accounting and actuarial considerations when evaluating a Company's recognition of death, disability and retirement (DD&R) reserves for claims-made professional liability coverage.

Many insurance companies providing claims-made professional liability policies include unlimited extended reporting endorsement coverage in the event of an insured's death, disability or retirement at no additional cost to the insured. This benefit is often referred to as "free tail" coverage and is provided to professionals for claims that occurred prior and are reported after they have ceased practicing for one of these three reasons. Frequently, free tail coverage has eligibility criteria, such as a minimum insured age or number of years the insured must have continuous coverage with the insurer.

The need for free tail coverage is borne out of the fundamental difference between occurrence and claims-made coverage, particularly at the expiration of an insured's last policy. While claims-made coverage offers insureds lower premium costs than occurrence base coverage, especially in the early years of coverage, it also creates a potential need for extended reporting coverage (tail coverage) for claims reported after the last claims-made policy expires. While many insurers sell policies and endorsements providing tail coverage, these coverages can be quite expensive, sometimes as much as twice that of mature claims-made coverage premiums.

This can appear particularly punitive in situations where a healthcare provider, lawyer or other professional has recently died, become disabled or retired. Free tail coverage is an attempt to address these circumstances.

KEY POINT

DD&R coverage is an attempt to cost effectively address the need for extended reporting coverage after an insureds death, disability or retirement.

Identifying policies containing free tail and extended reporting endorsement coverage is important because of the specific financial reporting requirements required for this type of coverage.

For example, effective December 31, 1993, the National Association of Insurance Commissioners (NAIC) began requiring Companies providing claims-made coverage with free or discounted tail coverage to record a liability to assure that amounts collected by insurers to pay for these benefits are not earned prematurely or alternatively that an insurer with an aging book of business will not show adverse operating results simply because an increasing portion of the Company's insureds are receiving benefits for which they have previously paid. This liability is referred to as "DD&R reserves". Currently, DD&R reserves are disclosed in the Schedule P Interrogatories of the Annual Statement and are separately identified and included within the scope of the Statement of Actuarial Opinion (SAO) that accompanies the Annual Statement.

Statement of statutory accounting practice (SSAP) No.65, paragraph 8 stipulates, "The amount of the DD&R reserve should be adequate to pay all future claims arising from these coverage features, after recognition of future premiums to be paid by current insureds for these benefits." The NAIC further indicates that the establishment of a DD&R reserve is based on the concept of level funding stating that the amount of incremental premium should be the same proportion of total policy premium regardless of whether an insurer is just starting to write business and does not expect any claims to be reported under the DDR extended reporting provision in the near future or has provided this type of coverage for several years. This concept is intended to encourage insurers to fund the future tail liability currently by charging an adequate premium, rather than relying on financing from future revenues.

A review of the Schedule P Interrogatories accompanying the 2010 annual statements of leading medical professional liability (MPL) insurers shows that 24 of the 25 largest MPL insurers in the U.S., by direct written premium, stated that their company issued Medical Professional Claims-Made policies that provide tail benefits in the event of DD&R. Detailed information for the ten largest insurers is summarized in the following table. A more extensive review of leading MPL insurers shows that insurance companies responsible for over 80% of the U.S. MPL insurance market provide some form of free tail coverage. Total DD&R unearned premium reserves (UEPR) for the MPL insurance industry total more than $932 million as of December 31, 2010. This does not include non-medical professional insurance, most notably lawyers professional insurers, offering DD&R coverage or DD&R reserves carried as loss and loss adjustment expense reserves (see chart below).

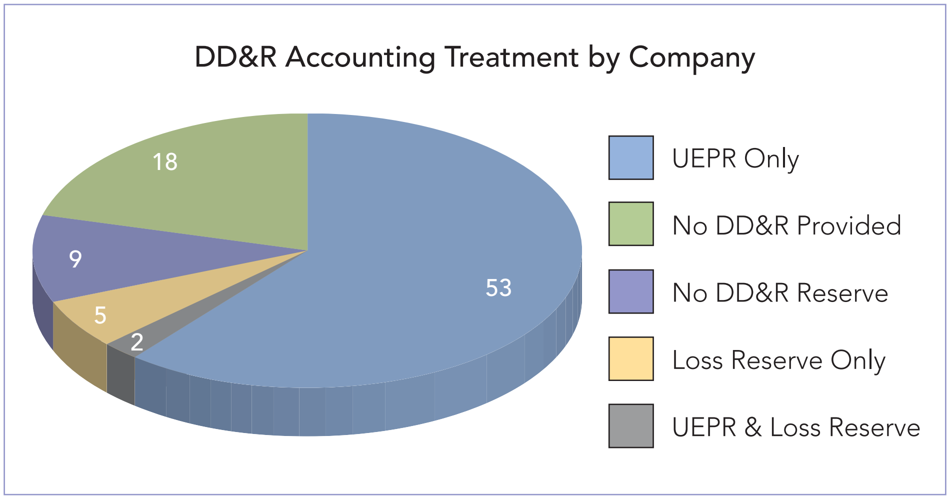
The NAIC's requirements for DD&R reserves are not explicitly mirrored within accounting principles generally accepted in the United States (GAAP), however the essence of the DD&R recognition principle is addressed within the revenue recognition guidance pertaining to Short Duration Contracts (FASB ASC 944-605-25-1), which states, "Premiums from short duration contracts shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided."

GAAP does not specifically indicate the way in which DD&R reserves should be recorded by insurance companies. Statutory accounting practices (SAP) indicate that it is most appropriate to recognize DD&R reserves as part of unearned premium; however, an insurer may consider DD&R reserves to be a claim reserve and include the reserves with the liability for unpaid losses and loss adjustment expenses if authorized by the commissioner of the state of domicile. The predominant practice is booking the reserves as part of the Company's overall unearned premium reserve. A review of the Schedule P Interrogatories accompanying the 2010 annual statements for the 87 leading MPL insurers that comprise over 90% of the total industry direct written premium provides several noteworthy facts (see pie chart on page 3):

- 69 of the 87 insurers (79.3%) provide DD&R coverage.
- 55 of these 69 insurers providing DD&R coverage (79.7%) book an unearned premium reserve for DD&R.
- Only 7 of the 69 insurers providing DD&R coverage (10.1%) book a loss reserve for DD&R.

There is also significant variability in DD&R reserves as a percentage of total unearned premium reserves. In the most extreme cases, some companies book no additional DD&R reserve, suggesting that the component of their current rates associated with DD&R is sufficient to meet all future DD&R claims obligations. Other companies have DD&R reserves that are 100% of unearned premium

Premium Rank	Company	Offer DD&R?	2010 DD&R Reserve $(000)	Unearned Premium or Loss Reserve?
1	Medical Protective Company	Yes	69,032	UEP
2	Medical Liability Mutual Insurance Company	Yes	32,408	UEP
3	Doctors Company An Interinsurance Exchange	Yes	131,779	UEP
4	Physicians Reciprocal Insurers	Yes	28,074	UEP
5	Lexington Insurance Company	Yes	1,795	UEP
6	ISMIE Mutual Insurance Company	Yes	53,491	UEP
7	MAG Mutual Insurance Company	Yes	29,345	UEP
8	ProAssurance Indemnity Company, Inc.	Yes	18,800	UEP
9	MCIC Vermont Inc.	No	0	
10	State Volunteer Mutual Insurance Company	Yes	11,500	UEP



reserves. These companies have common January 1 effective dates which results in all written premium being earned as of December 31st of each year. The graph below shows the distribution of DD&R reserves as a percentage of total claims-made MPL unearned premium reserves for the 55 leading companies that book a DD&R unearned premium reserve (see bar graph on page 4).

The practice of recording DD&R reserves as a component of unearned premium reserves is supported by the insurer's collection of premium over time to fund a benefit that will be provided in the future; however, this classification presents challenges in the event of cancellation or non-renewal as these events could require refunding premium or non-renewal to insureds which is not required under DD&R provisions. Conversely, when DD&R reserves are recorded as part of the liability for losses and loss adjustment expense reserves it presents potential classification issues as DD&R reserves represent the cost to issue tail coverage in the future at a reduced price or no additional charge rather than a current contractual liability.

Recognition of DD&R reserves as a component of losses can also skew loss development each year as the projected DD&R reserves are shifted to the most current year within each reporting cycle, resulting in skewed favorable development. Some have argued in favor of recognizing DD&R as an "other liability" or a "write-in" item within the NAIC Annual Statement due to the belief that recognition of DD&R reserves within unearned premium and losses and loss adjustment expense reserves distort exposure and loss ratios.

Companies that carry DD&R reserves are required to include the reserve within unearned premium reserves for federal income tax purposes. Including DD&R reserves in unearned premium reserves, as required by the Internal Revenue Code theoretically results in a higher taxable income than the recognition as a component of loss and loss adjustment expense reserves. This is because the 20% add back of unearned premiums to taxable income exceeds the average add back of losses and loss adjustment expense reserve discounting to taxable income ranging from 3-10%[1]. From an actuarial perspective, the calculation of DD&R reserves is primarily guided by the concept of level funding and the SSAP 65 paragraph 8 guidance regarding the comparison of expected future claims payments and expected future premium associated with DD&R benefits. This makes a cash flow model representing these future premiums and losses the ideal approach to modeling DD&R reserves[2].

The DD&R reserve computation typically involves the following steps:

1. Organize the company's current insured population into cohorts based on criteria such as age, sex, number of years insured, limit of insurance purchased and specialty. These criteria may result in different eligibility rules, have different mortality rates and/or different expected claims costs.

2. Determine the expected future premiums by cohort by year. The percentage of current rates associated with DD&R coverage costs is typically included in rate filings and is often developed based on the DD&R reserve analysis. Many companies assume 2% to 5% of rates are intended to cover DD&R claims. Based on the concept of level funding, this percentage cannot vary by cohort.

3. Determine the likelihood of an insured leaving the company due to death, disability, retirement or another reason not covered by DD&R (e.g. changing insurers). Insured lapse (non-renewal), mortality, retirement and disability rates all vary by age.

1. Range is based on the Internal Revenue Service 2010 loss and loss adjustment discount factors for medical malpractice claims made coverage over a twelve year period, utilizing an interest rate of 3.81%.

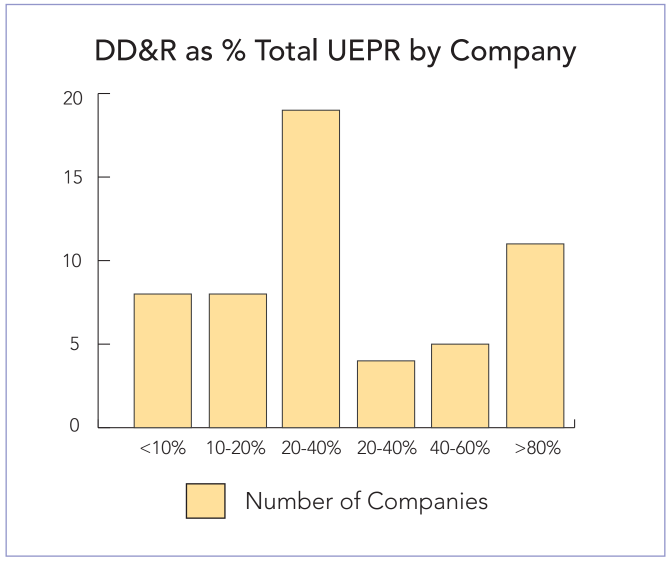
2. For a more detailed discussion of DD&R modeling, Mr. Walling's article "A Dynamic Approach to Free Tail Modeling" from the 1999 Casualty Actuarial Society Fall Forum can be found at www.casact.org/pubs/forum/99fforum/99ff401.pdf

4. Determine expected future DD&R claims costs based on the assumptions above as well as average claim frequencies and severities.
5. Adjust future premiums and losses for inflation. These assumptions are typically in line with inflation assumptions in Company loss reserve analyses and rate level indications.
6. Discount all future premiums and losses to a current cost level to reflect the time value of money. The overall difference in these present values (PV of future losses less PV of future premiums) is the Company's indicated DD&R reserve, with a minimum reserve of zero.

The concept of accruing for future DD&R benefits obligations has not been without controversy. In 2002, the future contractual obligation principle underlying the establishment of DD&R reserve was challenged by the withdrawal of one of the industry's largest medical professional liability carriers, St. Paul Guardian Insurance Company (St. Paul). St. Paul, one of the developers of the DD&R benefit and one of its leading proponents, informed its policyholders that they would no longer renew medical professional liability policies.

Further, St. Paul stated they would provide coverage for policyholders who had previously or before their policy expired retired, been disabled or deceased; however, doctors were not eligible for free tail coverage if they did not retire, become disable or died prior to the expiration of the policy. The termination of coverage resulted in the reduction of approximately $100 million in DD&R reserves, representing approximately 95% of the DD&R reserves carried by the Company prior to their termination of future coverage and withdrawal from the market.

These unearned premium reserves were fully earned and immediately impacted St. Paul's income statement. Physicians filed several suits against St. Paul's denial of tail coverage alleging that the Company had not fulfilled its obligation by leaving the medical malpractice market before doctors could benefit from the tail coverage that policyholders had funded through incremental charges included as part of their premiums. The Courts ruled in favor of St. Paul stating that the policies were subject to cancellation or non-renewal for any reason by either the insurer or insured and that in the event of cancellation the insured is not entitled to DD&R compensation other than specific qualifying benefits of death, disability and retirement that occur within the contract period. This event raised questions about the contractual nature of DD&R.



Conclusion

DD&R reserves are a material element of most professional liability insurance companies' balance sheet liabilities. The establishment of a DD&R reserve is generally accepted practice that is not only prudent, but consistent with going concern principles required by GAAP and the conservative framework and liquidity based methodology required by statutory accounting principles. Sophisticated actuarial models exist to help ensure that Company's post actuarially sound estimates of DD&R reserves that are also consistent with level funding requirements and SSAP guidance. Insurance companies providing DD&R benefits to their insureds need to actively monitor the coverage provided, eligibility requirements, how DD&R reserves are reflected in current rate filings and the level of DD&R reserves carried in their financial statements.

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ABOUT PINNACLE

Pinnacle Actuarial Resources, Inc. is an independent, full-service actuarial firm that focuses on the property/casualty insurance industry. Our home office is located in Bloomington, Ill., with additional offices in Atlanta, Chicago, Des Moines, Indianapolis and San Francisco.

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Contact us or visit pinnacleactuaries.com to discover more about how we can demonstrate our commitment to meeting your business needs.