CLAIM ACCELERATION - IT'S BIASES AND UNINTENDED CONSEQUENCES

By Debra J. Hall[1]

Introduction

Less than a year ago, I wrote about the issue of claim estimation/acceleration and the attempt at involuntary acceleration of reinsurance recoveries being pursued by several insurance receivers. The purpose of that paper was to tell the reinsurers' side of the story on this issue of tremendous importance to the reinsurance industry -- and to suggest that there are other, more sophisticated alternatives available to meet the stated goals of receivers without resorting to this unfair, heavy-handed method. This paper is intended to update the former one.[2]

In the intervening months, much more data has been developed and reports have been issued, criticizing the process of acceleration and pointing out the inequities not only to reinsurers but to claimants.

Some receivers have begun to show an interest in these studies and the suggested alternatives, while others have continued to pursue a methodology that is unlawful in most states and unfair and inequitable to most parties concerned. Unfortunately, the only group of people profiting from these pursuits, thus far, are a handful of lawyers, actuaries and accountants.

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1 Debra J. Hall is Vice President and General Counsel of the Reinsurance Association of America (RAA) located in Washington D.C. The RAA represents reinsurers writing over 75% of the U.S. reinsurance premium assumed by U.S. reinsurers. The views expressed are those of the author and not necessarily those of an individual reinsurer or group of reinsurers.

2 Debra J. Hall, *Claim Estimation - So What's the Big Deal?,* Insolvency Workshop 1997 (January 1997)(sponsored by the National Association of Insurance Commissioners and the International Association of Insurance Receivers). A copy is attached for your reference.

The purpose of this paper is to demonstrate the ever more heightened concerns of reinsurers and the support that the industry's position has gained from a variety of experts and scholars. And once again, it is hoped that through this additional information, receivers will revisit their initial thoughts about this methodology and work with the industry to develop better, commercial approaches to a significant problem.

The Goals of Receivership

In a report issued in July 1997, former Illinois insurance director Philip R. O'Connor set forth receivers' goals in estimating claims and accelerating reinsurance recoveries.[3] These are: a reduction of time and costs associated with keeping estates open; avoiding uncollectible reinsurance through reinsurer insolvencies; and avoiding "windfalls" to reinsurers through the premature cut-off of liabilities.[4] Dr. O'Connor suggested that we view these goals in the context of the general goals of a receiver. He listed the four operating principles of receivership management:

(1) fair allocation of estate assets according to the established priorities;

(2) a vigorous marshaling of assets and a fair allocation of the burden, including that of reinsurers, to meet the estate's obligations;

(3) resolution of the estate's business as promptly as possible; and

(4) minimizing the administrative costs of the receivership in order to maximize assets available for insureds and claimants.[5]

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[3] P. R. O'Connor, The Search for Improved P&C Liquidations: The Unintended and Unwarranted Consequences of Accelerated Reinsurance Collections (July 1997) (unpublished report prepared for the RAA by Coopers & Lybrand Consulting / Palmer Bellevue, Chicago, Illinois).

[4] *Id.* at 2.

[5] *Id.* at 3-4.

Dr. O'Connor places these operating principles of a receiver within the "overarching goal" of insurance regulation -- "to provide a regulatory framework which will contribute to the maintenance of public and policyholder confidence in the protective promise of insurance." The value and success of any regulatory initiative is whether it contributes to the achievement of this overarching goal.[6]

The following is a review of the four operating principles of receivership management identified by Dr. O'Connor and a discussion of the reason why he and others have concluded that claim estimation/acceleration fails to meet these objectives.

1. Fair Allocation of Estate Assets

In his report, Dr. O'Connor concludes that claim estimation/acceleration fails to achieve this operating principal primarily because it will result in some claimants being overpaid and others being underpaid. Claim estimation/acceleration results in the fundamental error of applying estimates of incurred but not reported (IBNR) claims as if they were actual projections of ultimate loss to be sustained by claimants.[7] Dr. O'Connor notes that although IBNR estimates are a necessary component of financial statements and solvency determination, such estimates simply do not rise to the level of certainty required for establishing and fixing claims of individual claimants.[8]

Others have expanded on this notion of unfair allocation and found that estimation/acceleration contains "systematic biases" in favor of or against certain claimants,

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[6] *Id.* at 5.

[7] *Id.* at 9.

[8] *Id.*

reinsurers and guaranty associations. In an expert witness report prepared in connection with the litigation surrounding the Integrity estate's attempt to accelerate reinsurance recoveries, Dr. Neil A. Doherty, an economist and professor with The Wharton School noted that:

> [i]t is fundamentally incorrect to assume that allocation of claims on the basis of the expected net present value of loss, will result in an unbiased allocation. This is a point that should be known by an actuary of even modest technical competence. It is necessary to estimate and use the entire loss distribution. Failure to use the whole distribution will produce systematic biases between the parties.[9]

While Dr. Doherty notes that bias results with respect to a number of interested parties, he goes on to state that this bias affects certain specific classes of policyholders,

> [t]he choice available to policyholders to file proof of claim for known losses serves to reduce the overall IBNR allocated for any policy year. This creates a bias in favor of those with relatively short tailed losses from those whose losses mature more slowly.[10]

In addition to this systematic bias created by plans like that proposed by the Integrity liquidator, experts have noted the significant problems raised for claimants by the lack of data generally or the lack of data available to certain classes of claimants.

In a paper prepared by Tillinghast-Towers Perrin, it is noted that while large policyholders may have a sufficient base of historical claims information to form an estimate of unknown claims (subject to the effects of unknowable events), smaller policyholders would not necessarily have the

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[9] Neil A. Doherty, Discussion of the Final Dividend Plan for the Liquidation of Integrity Insurance Company 1 (August 20, 1997) (unpublished expert witness report) (on file with the RAA).

[10] *Id.* at 2.

volume of past claims history to make any such estimates in a useable manner.[11] According to Tillinghast, this disadvantage exists for smaller policyholders with respect to estimation of both known and unknown claims.[12]

An illustration of this point is helpful. Although a large Fortune 500 pharmaceutical company may have sufficient claim history upon which to base an estimate of future claims,[13] individual professionals, e.g., an architect, probably will not. Although that architect may indeed suffer a loss, or be sued for a later developing event -- the architect does not have a sufficiently large enough claim history to make any future claim actuarially estimable. In other words, the chance that there exists an as yet unknown event that may materialize into a claim -- is purely random or hypothetical -- but not statistically supportable. This ground-up estimation results in the cut-off of claims for policyholders that would have otherwise been compensated had the estate remained open.[14] To do otherwise would not be "actuarially reasonable."

Not only are smaller policyholders and those with longer-tailed claims disadvantaged in the manner illustrated above, but the inevitable overpayment of some claims and the underpayment of others, as a result of the estimation process, can have devastating effects on claimants regardless of their size or characteristics.

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[11] Tillinghast-Towers Perrin, The Effects of Uncertainty in Actuarial Methods Used in Property & Casualty Insurance Insolvencies 6 (April 1997) (unpublished report prepared for the RAA by Tillinghast-Towers Perrin, New York, New York).

[12] *Id.*

[13] While such an estimate might be feasible, its degree of reliability is a different matter.

[14] A ground-up estimation is based on actuarial projections that individual claimants have suffered a loss.

For example, in a top-down estimation plan,[15] every policy is determined to have a value and every policyholder some type of recognizable future loss.

But if there are 5,000 policyholders

- and 250 have claims;
- and claims are $25,000 each;
- in the aggregate there is $6,250,000 of unpaid loss.
- If each policyholder is given a share, then each receives $1,250;
- 4,750 policyholders get $1,250 too much; and
- 250 policyholders get $23,750 too little.

It is a fallacy to presume that reliance on the law of large numbers will result in an equitable allocation of estate assets. In his report, Dr. Doherty notes that:

> [a] determination of aggregate losses for a portfolio which contains significant long tailed liability business will be subject to considerable error. This is because liabilities are significantly correlated and one cannot rely on simple application of the law of large numbers to assume that risk will be removed.. . . Determinations for individual policyholders will be surrounded by even more uncertainty than the portfolio determination.[16]

In providing rationale to justify the Final Dividend Plan in Integrity, the liquidator of Integrity states that "while the estimation process will not value all claims with 100% exactitude,

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15 Top-down estimation refers to a methodology where aggregate numbers are established and then individual claimants assigned a share in the overall pool of assets, on the basis of some calculation like the percentage of premium paid for coverage.

16 Doherty, *supra* note 9, at 2.

it fairly treats all interested persons and permits them to participate in the valuation process."[17] But Dr. Doherty notes that this statement gives a totally misleading impression of accuracy because:

> '[n]ot 100% exactitude' seems to suggest that valuations can come reasonably close to the true underlying value of claims. As argued above, the degree of exactitude may be closer to 0% than 100%.[18]

While this biased and unfair result of the estimation process is not necessarily intended by those who are advocating its use, it is one of the many unintended consequences that can result in the quest to produce public policy that has not been thoroughly analyzed.[19]

2. *Marshaling of Assets and Fair Allocation of Burdens*

The problems that reinsurers perceive in the acceleration of reinsurance recoveries, include: the unfair alteration of contract terms; the inherent arbitrariness with which claims are estimated and allocated; and the erroneous assumption about the certainty of actuarial opinions. These concerns are relevant to the question of whether claim estimation/acceleration results in a fair allocation of the burden of insolvency.

Biases Among Reinsurers

Dr. O'Connor discusses the fact that estimation of inherently speculative claims disregards the timing intricacies and the layering effect of reinsurance. The inevitable result, he says, is that

> some reinsurers will bear burdens that ought to have been borne by others, some reinsurers will pay an estimated IBNR that would never

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[17] *Id.* at 15 (*citing* Certification of Richard L. White in Support of Liquidator's Application for an Order to Show Just Cause to Establish Procedures for Final Approval of the Liquidator's Final Dividend Plan, June 11, 1996).

[18] *Id.* at 16.

[19] O'Connor, *supra* note 3, at 4.

> have developed into claims at all, and some will escape the liabilities they would have otherwise incurred if the insurer had remained a going concern rather than having undergone liquidation."[20]

This point is highlighted further when Dr. Doherty sets forth three varying allocation schemes of agreed-to claims. The results demonstrate an "immense difference" in the "distributional assumptions" with respect to the allocations, despite the fact that all three distributions had the same expected loss.[21] It is not difficult to predict how actuaries representing various parties would exercise their actuarial judgments in those scenarios.

In finding that allocations can "systematically favor one reinsurer over another,"[22] Dr. Doherty states that this "enormous scope for gaming"[23] exists unless the complete distributions of individual policyholder losses are known and used (which is only possible if the receiver awaits the actual development of claims). For example, gaming can include allocation of losses (1) to years in which reinsurance limits are higher, (2) away from insolvent reinsurers, and (3) toward reinsurers from whom losses may be easier to collect for jurisdictional reasons or otherwise.

Tillinghast also supports the view that allocation at the reinsurance level is highly problematic:

> Proportional treaties would tend to have a similar level of uncertainty to the aggregate. This level of uncertainty would increase with excess of loss treaties, and tend to be greater for higher layers than for lower layers. If facultative covers were used, the uncertainty related to these covers would depend on the concentration of certificates amongst reinsurers. A small

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20 *Id.* at 14-15.

21 Doherty, *supra* note 9, at 8.

22 *Id.* at 9.

23 *Id.*

> number of reinsurers writing a large number of facultative certificates would have the same uncertainty characteristics as treaty reinsurance for a comparable layer. Reinsurers writing only a small number of certificates are in a comparable position to a single case reserve -- it would be unusual to be able to estimate the ultimate value with a high degree of certainty.[24]

Bias Against Reinsurers and Others

Aside from the systematic biases and potential for gaming *among* reinsurers, Dr. Doherty notes that estimation/acceleration results in an inflation of IBNR, a bias which works *against* reinsurers as a whole.

> The choice available to policyholders to file documentation of IBNR is the equivalent of a financial option which creates an opportunity for overpayment without a corresponding opportunity for underpayment. This will inflate the average IBNR claim above its true value.[25]

As noted by Dr. O'Connor, the second operating principle of receivership management requires that the allocation resulting from the burden of insolvency be fair. But that burden cannot be accurately anticipated to ensure fairness.

The problem -- and inherent unfairness -- with reliance on actuarial estimates to irretrievably estimate and fix liability is illustrated by two Illinois rehabilitations, Centaur and Amreco. Numbers obtained from publicly available information, demonstrates the variability of actual payouts from IBNR estimates over an eight-year period for each of these estates.[26] In both estates, the receiver has continued payments of actual developed losses during the periods reviewed.

With respect to Centaur, it was estimated in 1987 that prior losses incurred in 1984 and prior

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[24] Tillinghast-Towers Perrin, *supra* note 11, at 7.

[25] Doherty, *supra* note 9, at 2.

[26] O'Connor, *supra* note 3, at 10 (*citing* Appendix A).

years could cost approximately $151 million to resolve. However, after eight years of development, the cost was $100 million in actual paid losses plus a reduced estimate of $15 million of future developing losses.[27] In other words, the original 1987 actuarial estimate was overstated by approximately $35 million -- or 23%. If payments had been made on the basis of the 1987 actuarial estimates -- claimants would have been overpaid and (assuming full reinsurance recoveries) reinsurers would have significantly overpaid their contractual obligations to the estate.

The result in Amreco would have been similarly unfair, but to different entities. After eight years of development in that estate, the original actuarial estimates turned out to be understated by over $110 million -- or 124%. Had payments been made on the basis of the original actuarial estimates, ceding insurer claimants[28] would have been severely underpaid and reinsurers would have paid for less than they owed.

Receivers advocating the claim estimation/acceleration approach assert that as long as estimates are done by "qualified actuaries" in accordance with "sound actuarial practice" the risk of inaccuracy is justified.

But, Dr. Doherty disagrees, noting that

> [i]n addition to the considerable risk surrounding the expected policyholder loss, there is unlikely to be adequate data to provide a reliable estimate of the expected value and the other parameters of the loss distribution. Delegating estimation to "qualified actuaries" using "sound actuarial practice" conveys a false sense of accuracy. Given paucity of data and an unstable legal environment, even sophisticated actuaries are likely to produce widely

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[27] *Id.* at 11.

[28] Amreco was a reinsurer that wrote no primary insurance business.

diverging estimates of individual loss distributions.[29]

Receivers sometimes justify the use of actuarial estimates for acceleration on the industry's reliance on such projections for other purposes such as reserving, loss portfolio transfers and reinsurance commutations. But contrary to receivers' claims that these uses lend support for the involuntary acceleration of reinsurance recoveries -- these historical and well-accepted uses of actuarial projections are a world apart.

As noted by Tillinghast-Towers Perrin, actuarial projections are used by the insurance and reinsurance industries for the purpose of calculating reserves, but the reserve estimation process is "self correcting" over time.[30] Changes to reserves that were previously unrecognized or not quantifiable, are reflected in a subsequent accounting period.[31] The reserve analysis of an ongoing company reacts to these events as the situation warrants. Use of actuarial estimates for the purpose of fixing claims and assessing liability is unalterable. It cannot be corrected over time -- nor can the injustices be remedied.

As receivers point out, there are certain commercial transactions that involve loss reserve projection, including loss portfolio transfer and reinsurance commutations. But, as noted by Tillinghast-Towers Perrin, these transactions are voluntary in the sense that neither party is compelled to enter the transaction.[32] It is through the give and take of negotiation that a price is mutually agreed, presumably reflecting each parties' estimate of claim liabilities and assessment of

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29 Doherty, *supra* note 9, at 11.

30 Tillinghast-Towers Perrin, *supra* note 11, at 4.

31 *Id.* at 5.

32 *Id.*

the risk of uncertainty.[33] If agreement cannot be reached, and a mutual level of certainty or comfort achieved, the parties are free to walk away.

As noted earlier, one principal objection to the involuntary acceleration of reinsurance recoveries is the unilateral alteration of reinsurers' contractual agreements. While some seem to dismiss this concern lightly, Dr. Doherty notes the chilling effect that this lack of reliance on contracts creates in the overall economic system.

> If the liquidation process is to serve the public interest, it should treat parties fairly, relative to the contracts that each entered into, and it should facilitate future insurance commerce. The fact that the FDP abrogates specific, mutually agreed contracts in favor of an administrative process in which the liquidator has considerable discretionary powers, carries important negative implications for future commerce. Future policyholders, insurers and reinsurers will be rather less confident that the policy terms which are mutually agreed will be honored should an insurer become distressed. This has a number of disturbing effects. First, all parties will become more wary of transacting insurance. For example, reinsurers will be wary that their contracts will be overturned in favor of a consumer oriented insurance commissioner who can secure higher recoveries by crafting a settlement plan. The prospect of future settlement plans of this sort also increases uncertainty which will make investors more wary of supplying capital to reinsurers. This will adversely affect the cost of future reinsurance and more expensive capital will increase the potential for future insurance insolvencies.[34]

3. Prompt Resolution

Dr. O'Connor discusses the problems associated with keeping estates open for very long periods of time. He notes that the widespread introduction of guaranty funds 30 years ago resolved the most obvious and politically abrasive problems associated with this phenomenon.[35] But,

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33 *Id.*

34 Doherty, *supra* note 9, at 16.

35 O'Connor, *supra* note 3, at 17.

notwithstanding the fact that most policyholders and claimants are paid in a timely fashion by guaranty funds, receivers continue to view the earlier closure of estates as a desired goal. It is unlikely that the estimation/acceleration methodology proposed by receivers will meet that goal.

To the contrary, Dr. O'Connor states that additional delay is the more likely result:

> precisely because [estimation/acceleration] has the unintended consequence of creating a likelihood of mis-allocation of the burdens among reinsurers.[36]

It is the fact that involuntary acceleration of reinsurance recoveries is an alteration of parties' existing legal rights and obligations that has, and will continue to, place reinsurers in the position of vigorously contesting assignments of liability resulting from those determinations.

Dr. O'Connor correctly notes that there are at least three levels of anticipated litigation (some of which are currently being pursued). The first level involves constitutional and statutory challenges to the unilateral alteration of contractual rights. The second level goes to the question of the appropriateness and accuracy of estimates involving unknown loss. And the third, will be individual disputes regarding receivers' allocation methodologies with complex litigation, or more likely arbitration, matching estimates of unknown loss to reinsurance coverage time periods and ascending layers of liability.[37]

The significant volume of litigation and arbitration that acceleration methodologies will spawn will ensure that estates are kept open -- not closed, and that substantial amounts of estate assets will be squandered on lawyers and expert witnesses -- not claimants.

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[36] *Id.* at 18.

[37] *Id.*

The certainty of these predictions is borne out by existing litigation. For example, the Integrity liquidator proposed a final liquidation plan in mid-year 1996. Reinsurers objected on the basis of constitutional and statutory grounds during the remainder of that year. Following the liquidation court's ruling in favor of the liquidator, discovery has ensued during 1997 and will continue into 1998. A four-week trial is expected some time in 1998. After the conclusion of the trial and post-hearing briefing, the reinsurers will finally be in a position to appeal the liquidation court's 1996 ruling on constitutional and statutory authority. That appeal will certainly extend into 1999. An appeal to the New Jersey Supreme Court will bring in the new millennium. At that point, at least, four years will have passed and all that will be accomplished is the initial round of litigation.

Assuming the unlikely scenario that reinsurers will lose in the first round of litigation, the early years of the next century will be spent in litigating, and more likely arbitrating, specific allocations of estimated unknown losses to individual reinsurers and specific reinsurance treaties. This litigation or arbitration will take at least as many years, and more likely, more than the first round of litigation.

Additionally, in the event that the liquidator, like many others, insists on litigating these issues before the liquidation court, another costly and time-consuming round of litigation will likely result as reinsurers fight to preserve their jurisdictional rights to have their disputes heard in federal courts or before arbitration panels for which they contracted.

In summary, Integrity is a real-life illustration of the fact that allocation methodologies are not likely to result in early closure of insolvent estates. If Integrity pursues its current allocation methodology, even conservative estimates demonstrate that they will be litigating for at least another decade while the estate remains open not only incurring normal administrative expenses but also the

increased cost of litigation and arbitration. As one of the litigants in the Integrity matter, the RAA estimates that the parties have already expended millions of dollars in the costs of litigation -- and yet, we have now only begun a process that will likely last at least five times longer than the efforts expended thus far. And all this expenditure of time and money *assumes*, for purpose of argument, that the liquidator prevails every step of the way.

Faced with this picture of a "successful series of battles" -- it is incumbent upon a liquidator, and policy makers, to step back and ask themselves if they haven't, indeed, lost the war. Reinsurers certainly view this dismal scenario as an unfortunate and unwanted one -- but, if their contracts are to have any meaning whatsoever in the context of a liquidation, they simply have no other choice.

Perhaps, the most ironic factor in the years of litigation spawned by allocation methodologies is the fact that time will, in and of itself, prove the reinsurers' point. As Dr. O'Connor notes

> [t]o the extent that the "final" IBNR estimates prove incorrect [through experience and actual claim development during the years of litigation], which, by their nature they will be to varying degrees, the stronger will be the case for those disputing the original IBNR estimates and their effects. It should be expected that receivers will find it necessary to periodically re-estimate the "final" IBNR numbers. These estimates will be necessary in order to make the same sorts of adjustments made by going concerns. These IBNR adjustments, while warranted by events, belie the very rationale for [estimation/acceleration].[38]

4. Minimizing Administrative Costs

Probably, little more needs to be said, in light of the foregoing discussion, to illustrate the fact that allocation methodologies will not minimize administrative costs. In fact, such methodologies will significantly compound the routine overhead expense involved in running off

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38 O'Connor, *supra* note 3, at 19.

estate claims. In arguing that early closure would serve claimants' interest by reducing administrative expenses, receivers are making certain implicit assumptions: (1) administrative expenses are disproportionately high when compared to the benefits achieved by actual claim development; and (2) administrative expenses cannot be reduced in a fashion that will overcome assumption (1). Once again, however, Dr. O'Connor's report provides an additional perspective worthy of consideration. He focuses on the fact that there is a genuine lack of information about the costs of administering liquidations which bases assumptions such as these more on impression than on empirically-based knowledge.[39]

Before considering such dramatic changes to liquidation management (not to mention fundamental alterations to parties' contractual rights), further data is necessary to evaluate the efficiency and effectiveness of the current receivership system. Specifically, Dr. O'Connor recommends that a simple remedy for the current lack of information would be a continuing requirement of insolvent estates to file an annual statement[40], at least with the insolvent insurer's domiciliary state and the NAIC. Of course, the cost for such filings could and should be waived for such entities.

I have been involved and/or witnessed debates at various times over the last decade concerning the filing of financial information by receivers. Numerous arguments are often asserted why receivers can't or shouldn't follow some type of standardized reporting format, including: the poor condition of insolvent's records, the cost of doing so, the unwanted disclosure of litigation

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39 *Id.* at 20-21.

40 *Id.* at 22.

strategy or compromise of negotiating posture for commutations. However, each of these arguments fail when one refuses to accept them at simply face value.

There is no doubt that an insolvent insurer's records are often in varying degrees of poor quality upon the insurer's takeover. But, receivers proceed immediately to remedy that situation. Indeed, the liquidator must get the records in order to fulfill his or her statutory responsibilities.

The cost of filing an annual statement is not unreasonable in light of the value that it provides to potential creditors of the estate, policy makers and the public. Computer software is available which makes this task manageable from a cost and a resource perspective. Estates having only minimal assets could be exempted from the requirement.

Arguments of receivers that disclosing financial information reveals litigation strategy or compromises their commutation posture simply rings hollow. Disclosure in accordance with the annual statement is no less and no more onerous than that required for ongoing companies.

Dr. O'Connor notes that the lack of empirical data about receivership costs is relevant to the overarching goal of maintaining public confidence in the insurance system.[41] Consideration of systematic changes should not take place until such data is developed and analyzed in light of this overarching goal.[42]

Conclusion

Three times the California insurance commissioner has tried and failed to pass an estimation/acceleration statute in California. Reinsurers' attempt to amend Missouri law to prohibit

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[41] O'Connor, *supra* note 3, at 21.

[42] *Id.* at 27-28.

acceleration passed both the House and the Senate insurance committees in the 1996-97 legislative session, only to fail for procedural reasons later. Once again, reinsurers will be back at the Missouri legislature in November.

Noted experts and scholars have reviewed the issue and published reports giving support to reinsurers' positions and buttressing their claims of unfairness -- unfairness to claimants, reinsurers, and guaranty funds.

Less than a year after *Claims Estimation - So What's the Big Deal?*[43] was presented, the legal and political landscape is far different. The involuntary acceleration of reinsurance recoveries is a novel, but not a winning concept. It would be far more productive and far less costly to develop commercial alternatives that protect -- not offend the interests of affected parties.

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[43] Hall, *supra* note 2.