



ACTUARIAL STANDARDS BOARD

**Actuarial Standard
of Practice
No. 29**

Expense Provisions in Property/Casualty Insurance Ratemaking

**Developed by the
Subcommittee on Ratemaking of the
Casualty Committee of the
Actuarial Standards Board**

**Adopted by the
Actuarial Standards Board
July 1997**

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August 1997

TO: Members of Actuarial Organizations Governed by the Standards of Practice of the Actuarial Standards Board and Other Persons Interested in Expense Provisions in Property/Casualty Insurance Ratemaking

FROM: Actuarial Standards Board (ASB)

SUBJ: Actuarial Standard of Practice No. 29

This booklet contains the final version of actuarial standard of practice (ASOP) No. 29, *Expense Provisions in Property/Casualty Insurance Ratemaking*.

Background

This standard was developed by the Subcommittee on Ratemaking of the ASB's Casualty Committee. The Casualty Actuarial Society's *Statement of Principles Regarding Property and Casualty Insurance Ratemaking* identifies and describes principles applicable to the determination and review of property/casualty insurance rates. These principles are limited to that portion of the ratemaking process involving the estimation of costs associated with the transfer of risk. For most lines of business, the expense component is a significant portion of the rate. For some lines of business, the expense component can actually exceed the loss component. For this reason, it is necessary to have a standard of practice to provide guidance to actuaries in the determination of a proper expense component.

Exposure Draft

This standard was exposed for review in October 1994, with a comment deadline of March 15, 1995. Thirty-one comment letters were received. The Subcommittee on Ratemaking reviewed all the comments carefully, and many of the suggestions were incorporated into the final standard. In particular, the subcommittee expanded the discussions concerning (1) residual market and statutory assessment provisions, (2) the provision for reinsurance, and (3) policyholder dividends. (For a detailed discussion of the issues raised in the comment letters, and the subcommittee's responses to such, please see appendix 2.)

Format Changes

A number of format changes have also been made since publication of the exposure draft. The ASB voted in May 1996 to change the format of all future actuarial standards of practice. Thus, sections 3 and 4 now form an appendix titled, Background and Current Practices. (Appendix 1 of this standard contains sections 3 and 4 of the exposure draft.) Further, sections 5 and 6 of the exposure draft have now been renumbered as sections 3 and 4. The "new" sections 3 and 4,

along with sections 1 and 2, now form the actual standard of practice. The heading *Preamble*, which used to apply to the first four sections of the standard, has been deleted. The board made these format changes to help the reader distinguish between a standard's substantive requirements and language intended for general information.

The Subcommittee on Ratemaking and the Casualty Committee thank everyone who provided input during the exposure process. The comments were helpful in making revisions. The Casualty Committee also thanks the following former subcommittee members, who made significant contributions to this work: Daniel J. Flaherty, Gary Grant, and Robert Lindquist. The ASB voted in July 1997 to adopt the final standard.

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ACTUARIAL STANDARD OF PRACTICE NO. 29

EXPENSE PROVISIONS IN PROPERTY/CASUALTY INSURANCE RATEMAKING

STANDARD OF PRACTICE

Section 1. Purpose, Scope, Cross References, and Effective Date

- 1.1 Purpose—The purpose of this standard of practice is to provide guidance to actuaries in estimating costs for property/casualty insurance ratemaking other than (1) incurred losses, (2) the provision for profit and contingencies, (3) investment expenses, and (4) federal and foreign income taxes.
- 1.2 Scope—This standard of practice applies to all property/casualty insurance coverages. This standard also applies to property/casualty risk financing systems, such as self-insurance, that provide similar coverages. References in the standard to *risk transfer* should be interpreted to include risk financing systems that provide for risk retention in lieu of risk transfer.
- If the actuary departs from the guidance set forth in this standard in order to comply with applicable law (statutes, regulations, and other legally binding authority), or for any other reason the actuary deems appropriate, the actuary should refer to section 4.
- 1.3 Cross References—When this standard refers to the provisions of other documents, the reference includes the referenced documents as they may be amended or restated in the future, and any successor to them, by whatever name called. If any amended or restated document differs materially from the originally referenced document, the actuary should consider the guidance in this standard to the extent it is applicable and appropriate.
- 1.4 Effective Date—This standard will be effective with respect to work performed after December 1, 1997.

Section 2. Definitions

The definitions below are defined for use in this actuarial standard of practice.

- 2.1 Commission and Brokerage Fees—Compensation to agents and brokers.
- 2.2 Expense Limitations—Legislative or regulatory rules that disallow or limit certain categories of expenses in determining rates.

- 2.3 General Administrative Expenses—All operational and administrative expenses (other than investment expenses) not specifically defined elsewhere in this section.
- 2.4 Loss Adjustment Expenses (LAE)—All expenses incurred in investigating and settling claims.
- 2.5 Other Acquisition Expenses—All costs, other than commission and brokerage fees, associated with the acquisition of business.
- 2.6 Policyholder Dividends—Nonguaranteed returns of premium or distributions of surplus.
- 2.7 Premium-Related Expenses—Those expenses that vary in direct proportion to premium, e.g., premium taxes. These expenses are sometimes referred to as *variable expenses*.
- 2.8 Rate—An estimate of the expected value of future costs.
- 2.9 Residual Market Provision—A provision for the entity's costs that represents its share of residual market profits or losses.
- 2.10 Statutory Assessment Provision—A provision for the entity's costs stemming from any mandated assessment.
- 2.11 Taxes, Licenses, and Fees—All taxes and miscellaneous fees except federal and foreign income taxes.

Section 3. Analysis of Issues and Recommended Practices

- 3.1 Categorizing Expenses—The actuary should be familiar with the pertinent requirements for defining expenses, such as those prescribed in the *Instructions for Uniform Classification of Expenses*, published by the National Association of Insurance Commissioners (NAIC), or Regulation 30 of the New York State Insurance Department. The actuary should also be familiar with the entity's own methods of classifying and assigning expenses.
- 3.2 Determining Expense Provisions—The actuary should determine the provisions for loss adjustment expenses; commission and brokerage fees; other acquisition expenses; general administrative expenses; and taxes, licenses, and fees that are appropriate for the policies to be written or coverages provided during the time the rates are expected to be in effect. In addition, where appropriate, the actuary should consider subdividing the expense categories. Expense provisions should reflect the conditions expected during the time these policies or coverages are expected to be in effect and should include all expenses expected to be incurred in connection with the transfer of risk.

For expenses other than premium-related expenses, the actuary should consider estimating these expenses on a basis that is not directly proportional to premium, such as

per policy, per coverage, a percentage of claim losses, or per unit of exposure. Studies or actuarial judgment may support such estimates.

- 3.3 Start-Up Costs—The actuary may amortize start-up or development costs using an appropriate amortization period.
- 3.4 Expense Trending—In determining the future expense components of the rate, the actuary should be guided by Actuarial Standard of Practice (ASOP) No. 13, *Trending Procedures in Property/Casualty Insurance Ratemaking*.
- 3.5 Policyholder Dividends—The *Statement of Principles Regarding Property and Casualty Insurance Ratemaking* of the Casualty Actuarial Society (CAS) classifies policyholder dividends as an expense to operations. When the actuary determines that policyholder dividends are a reasonably expected expense and are associated with the risk transfer, the actuary may include a provision in the rate for the expected amount of policyholder dividends. In making this determination, the actuary should consider the following: the company's dividend payment history, its current dividend policy or practice, whether dividends are related to loss experience, the capitalization of the company, and other considerations affecting the payment of dividends.
- 3.6 Residual Market and Statutory Assessment Provisions—The actuary should include a provision in the rate for any residual market costs or statutory assessments expected to occur during the period of time the rates are expected to be in effect. If these costs are assessed retrospectively, it may be appropriate to include a provision to recover these costs to the extent they were not included in previous rates.
- 3.7 Provision for Reinsurance—The actuary may elect whether to include the cost of reinsurance as an expense provision. If a provision for reinsurance is included, the actuary should consider the amount to be paid to the reinsurer; ceding commissions or allowances; expected reinsurance recoveries; and other relevant information specifically relating to cost, such as a retrospective profit-sharing agreement and reinstatement premiums between the reinsured and the reinsurer.

Section 4. Communications and Disclosures

- 4.1 Conflict with Law or Regulation—The rate filed with a regulator may differ from an actuarially determined rate because of expense limitations. If a law or regulation conflicts with the provisions of this standard, the actuary should develop a rate in accordance with the law or regulation, and disclose any material difference between the rate so developed and the actuarially determined rate to the client or employer.
- 4.2 Documentation—The actuary should be guided by the provisions of ASOP No. 9, *Documentation and Disclosure in Property and Casualty Insurance Ratemaking, Loss Reserving, and Valuations*.

4.3 Disclosures—The actuary should include the following, as applicable, in an actuarial communication:

- a. in addition to the disclosure covered in section 4.1, the disclosure in ASOP No. 41, *Actuarial Communications*, section 4.2, if any material assumption or method was prescribed by applicable law (statutes, regulations, and other legally binding authority);
- b. the disclosure in ASOP No. 41, section 4.3, if the actuary states reliance on other sources and thereby disclaims responsibility for any material assumption or method selected by a party other than the actuary; and
- c. the disclosure in ASOP No. 41, section 4.4, if, in the actuary's professional judgment, the actuary has otherwise deviated materially from the guidance of this ASOP.

Appendix 1

Background and Current Practices

Note: This appendix is provided for informational purposes, but is not part of the standard of practice.

Background

Inflation—Prior to the relatively high inflation of the 1970s, a predominant ratemaking technique involved including expenses, other than loss adjustment expenses, as a percentage of premium. In doing so, it was assumed that the expense portion of the rate was subject to the same trend (usually very low) to which the loss and loss adjustment expense portions were subjected. However, higher levels of inflation had a rather significant impact on the expected change in the various components of the rate. By the 1970s, the assumption that the trend in expenses would approximate the trend in losses was being questioned. Although the actuarially determined loss trend may have been applied to the loss and loss adjustment expenses as usual, a separate analysis and trend may have been necessary to properly reflect the anticipated change in certain other expenses.

Expense Flattening—Expense flattening techniques assign expenses to policies or other units of exposure rather than in proportion to premium or losses. Thus, expense flattening is a procedure sometimes used to determine that portion of the rate that does not vary in direct proportion to premium or losses.

Expense Trending—Expense trending reflects how changes over time affect expenses. Over the years, separate trending of expenses has become a more common ratemaking technique. However, including expenses as a proportion of premium is still used.

Actuarial Literature—Although the property/casualty actuarial literature is relatively sparse on the topic of expense provisions in ratemaking, techniques for separately trending losses and expenses and alternatives to premium-related expense provisions have been included in such literature. Also included are discussions about the inappropriateness, in some cases, of assuming proportional expenses for administrative ease when, in fact, some expense categories do not vary in direct proportion to premium.

Regulation—Beginning in the late 1970s, some regulators have applied expense limitations in either limiting or disallowing certain expenses and in requiring expense flattening.

Current Practices

Categories—Expenses other than investment expenses are generally divided into five broad categories to determine the expense component of the rate. These expenses are (1) loss adjustment expenses, (2) commission and brokerage fees, (3) other acquisition expenses, (4) general administrative expenses, and (5) taxes, licenses, and fees. Studies may be conducted to determine which expenses vary in direct proportion to premium, losses, number of policies, or other units of exposure, and which expenses may be independent.

Loss Adjustment Expenses—Loss adjustment expenses are generally of two types: allocated and unallocated. Allocated loss adjustment expenses (ALAE) are sometimes combined with and, thus, treated the same as, incurred losses (IL). ALAE are combined with unallocated loss adjustment expenses (ULAE) for some lines of business. ULAE may be expressed as a function of IL plus ALAE, but may also be expressed as a function of premium. For lines of business in which all loss adjustment expenses are combined, the loss adjustment expenses are generally expressed as a function of either IL or premium.

Commissions and Premium Taxes—Commissions and premium taxes are typically paid as a percentage of direct written premium. Such expenses are generally treated as premium-related expenses.

General Administrative Expenses and Other Acquisition Expenses—General administrative expenses and other acquisition expenses may be expressed as a function of premium; or may be partially related to premium, partially related to the number of policies, and partially related to the number of exposures.

Current Information—Historical expenses are generally analyzed in light of current relevant information to determine whether they will be representative of future costs.

Budgeted versus Historical Expenses—Because of the prospective nature of ratemaking, certain expenses, such as commissions, are generally based on budgets rather than determined from historical data.

Expense Trending—Historical expenses may be adjusted to reflect changes over time.

Residual Market and Statutory Assessment Provisions—Residual market costs and statutory assessments are often included as expenses. For those classes of business written in the voluntary market that caused the insurer to receive a share of the residual market, the residual market provision may be separately identified or embedded in the rate.

Appendix 2

Comments on the Exposure Draft and Subcommittee Responses

The proposed standard of practice was approved for release as an exposure draft in October 1994, with a comment deadline of March 15, 1995. Thirty-one comment letters were received and reviewed by the Subcommittee on Ratemaking of the ASB's Casualty Committee. Summarized below are the substantive issues raised and questions contained in the comment letters, printed in lightface. The subcommittee's responses to those issues appear in **boldface**.

Note also that, as mentioned in the transmittal memorandum to this standard of practice (see page vi), the ASB adopted on May 1, 1996, a new format for all actuarial standards of practice. Thus, the section numbers below refer to section numbers in the exposure draft, unless otherwise noted (some section numbers have remained the same).

Section 1. Purpose, Scope, and Effective Date

Section 1.1, Purpose—Several comments were received asking for clarification of the issues covered by the standard. **The subcommittee added the phrase *for property/casualty insurance ratemaking* to clarify that the standard is limited to ratemaking. Further, the section was revised to note that the subject of federal and foreign income taxes is clearly *excluded* by the standard. The subject of investment expenses was also specifically excluded since the subcommittee agreed that the subject should not be considered in this standard.** One commentator questioned whether allocated loss adjustment expenses were included in the standard. **The subcommittee revised the section to make it clear that all loss adjustment expenses are included in this standard.**

Section 1.2, Scope—A few commentators noted that this section is ambiguous in its use of examples. **The subcommittee modified the text to clearly note that the standard applies to all property/casualty coverages.**

Section 2. Definitions

Section 2.1, Allocated Loss Adjustment Expenses—**This definition was deleted since it is not used in the standard.**

Section 2.4, General Administrative Expenses (now section 2.3)—Several comments were received regarding reinsurance expenses. **The subcommittee added a new section, Provision for Reinsurance (see section 3.7), to discuss the treatment of reinsurance expenses. No changes were made to the definition of *general administrative expenses*.**

Section 2.5, Guaranty Fund Assessments (now section 2.10 and titled, Statutory Assessment Provision)—**The subcommittee developed a broader definition that refers to all statutory assessments in order to reflect guaranty fund assessments, and emerging statutory insurance and reinsurance mechanisms, such as the Florida Hurricane Catastrophe Fund, the Florida Windstorm Underwriting Association, and the California Earthquake**

Authority, as well as various administrative and special fund expenses for which entities are assessed. The subcommittee also replaced the word *insurer* with *entity* to further broaden the application.

Section 2.8, Policyholder Dividends (now section 2.6)—One comment letter noted that this was a weak definition. **Although the definition was slightly modified, the subcommittee believes that the revised definition is the most descriptive and definitive one available. The subcommittee deleted the phrase *charged to operations* at the end of the definition and added the phrase *or distributions of surplus*.**

Section 2.9, Rate (now section 2.8)—**No change was made. This definition is the same as the one found in the CAS *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*.**

Section 2.10, Residual Market Provision (now section 2.9)—**Per comments received, the entire second sentence of the section was moved to section 4.9 of the exposure draft, which can now be found in appendix 1 under the title, Residual Market and Statutory Assessment Provisions.**

Section 2.11, Taxes, Licenses, and Fees—**Based on comments received and on an analysis of the insurance expense exhibit breakout, the subcommittee inserted the words *federal and foreign* before *income taxes* to make clear that state income, municipal, police department, fire department, etc., premium taxes should be considered.**

Section 2.12, Unallocated Loss Adjustment Expenses—Some commentators noted that since some companies contract claim handling as a percentage of each claim cost, some types of claim costs could be classified as “allocated” for one company and “unallocated” for another. **This definition was deleted since it is not used in the standard.**

Section 2.13, Variable Expenses (now section 2.7 and titled Premium-Related Expenses)—One commentator suggested that this section be titled, Premium Variable Expenses. **The subcommittee agreed in concept and changed the title to, Premium-Related Expenses.**

Other commentators suggested that the standard define *nonvariable expenses*, since the term is used in section 4.8 (this section can now be found in appendix 1, Current Practices, with the title, Expense Trending) and section 5.4, Measurement Base. **The subcommittee deleted use of this term. Thus, no definition is necessary. Expenses that are not related to premiums are treated in the second paragraph of section 3.2, Determining Expense Provisions, in this standard.**

Section 3. Background and Historical Issues (Now in Appendix 1 under Background)

Section 3.1, Inflation and Price Controls (this section can now be found in appendix 1 under the title, Inflation)—It was noted that *price controls* are not mentioned elsewhere in the section. **This phrase was deleted. The subcommittee also modified the wording in the last sentence of the paragraph to make the application of the loss trend less restrictive.**

Section 3.2, Expense Flattening (this section can now be found in appendix 1)—It was suggested that the word *policies* be expanded to *policies or other units of exposure*. **The subcommittee agreed and made the modification. In addition, the wording in the last sentence was changed to make the definition of *expense flattening* more explicit.**

Section 3.3, Expense Trending (this section can now be found in appendix 1 under Background)—It was noted that the phrase *expense trending* does not need to be italicized. **The subcommittee deleted the italics and replaced *measures* with *reflects*, since expense trending is not a true measure of changes.**

Section 3.4, Actuarial Literature (this section can now be found in appendix 1)— **In the first sentence, the subcommittee replaced the word *expenses* with the phrase *expense provisions in ratemaking* to make it consistent with the subject of the standard of practice. In the last sentence, the wording was modified to be consistent with the section, Expense Flattening.**

Section 3.5, Regulation (this section can now be found in appendix 1)—It was suggested that the second sentence (*These expense limitations should be taken into account when establishing the premium rate filed with the regulator.*) reflects procedure rather than background. **The subcommittee deleted this sentence from the section, and modified the wording in section 4.1 of the standard to reflect this change.**

Section 4. Current Practices and Alternatives (Now in Appendix 1 under Current Practices)

Section 4.1, Categories (this section can now be found in appendix 1)—Suggestions included rearranging this section to remove the reference to specific loss adjustment expenses and inserting this reference into section 4.2. It was also suggested that the draft may be too limiting regarding current practice. **The subcommittee moved a portion of this section to the section directly below it (i.e., the old section 4.2, Loss Adjustment Expenses), and rewrote the remaining text to broaden the scope of current practice. Also, the word *special*, describing the studies that could be conducted, was deleted.**

Section 4.2, Loss Adjustment Expenses (this section can now be found in appendix 1)—It was suggested that the third and fourth sentences were inconsistent. **The subcommittee revised the third and fourth sentences of this section to clarify that unallocated expenses may be expressed as a function of premium.**

Section 4.3, Commissions and Premium Taxes (this section can now be found in appendix 1)—A concern was expressed that this section did not mention “truly variable commissions, e.g., ones that include profit-sharing based on loss ratios.” In addition, minor editorial changes were recommended. **The subcommittee is satisfied that this section is broad enough to allow the actuary to work with variable commissions. The editorial suggestions were adopted.**

Section 4.4, General Administrative Expenses and Other Acquisition Expenses (this section can now be found in appendix 1)—One commentator suggested that this section is inconsistent with sections 4.1 and 5.1 of the exposure draft. In addition, minor editorial suggestions were offered.

The subcommittee does not agree that an inconsistency exists among the sections, but it did incorporate the suggested editorial changes.

Section 4.5, Specific Jurisdiction versus Nationwide—Minor editorial changes were suggested. **After further consideration, the subcommittee concluded that this section was not necessary and deleted it.**

Section 4.8, Nonvariable Expenses (this section can now be found in appendix 1, Current Practices, with the title, Expense Trending)—Concern was expressed that this section restricts expense trending to only nonvariable expenses. It was also suggested that this section be broadened to include a discussion of the prospective treatment of expenses. **The subcommittee renamed this section Expense Trending, modifying the text to acknowledge that expenses may need to be adjusted to reflect changes over time.**

Section 4.9, Residual Market Provisions and Guaranty Fund Assessments (this section can now be found in appendix 1 with the title, Residual Market and Statutory Assessment Provisions)—A few comment letters requested making this section more general by removing references to *guaranty funds* and removing the reference to *state-specific residual market costs*. **The phrase *guaranty fund* was replaced with the term *statutory* in the title, and the phrase *state-specific* was eliminated from the section. The subcommittee also added language to identify an appropriate treatment of a residual market provision.**

Section 5. Analysis of Issues and Recommended Practices (Now Section 3)

Section 5.1, Categorizing Expenses (now section 3.1)—Concerns were expressed that requiring the actuary to be familiar with the *Instructions for Uniform Classification of Expenses* and with the entity's own methods of classifying expenses is too onerous. **This information (i.e., that contained in the NAIC publication and the entity's own methods) is important to the selection of an appropriate expense methodology. The section was left unchanged.** It was also suggested that the National Council on Compensation Insurance statistical plan be added to the list of expense definitions. **The subcommittee believes that the requirement to be “familiar with the entity's own methods” covers this issue.**

Section 5.2, Determining Expense Components (now section 3.2 and titled Determining Expense Provisions)—Several concerns were expressed about the discussion of ULAE and ALAE. Also, several comments requested that residual market costs be discussed in a separate section. **The discussion of ULAE and ALAE was deleted. Also, the subcommittee added a new section, Residual Market and Statutory Assessment Provisions (see section 3.6), and a new paragraph providing direction for handling expenses that do not vary directly with premium. This new paragraph replaces section 5.4 of the exposure draft.**

Section 5.3, Start-Up Costs (now section 3.3)—Comments were received that start-up costs should be more precisely defined. **The subcommittee believes that the determination of which costs are start-up costs and which are not should be made by the actuary in each unique situation. The subcommittee changed the language to include development costs, and made**

other editorial changes, but did not think it appropriate to more explicitly define these costs.

Section 5.4, Measurement Base—Several comment letters stated that the term *nonvariable expenses* needs to be defined. It was also suggested that the reference to *premium discounts or expense constants* be deleted. **As noted earlier regarding comments on section 5.2, the subcommittee deleted this section and moved the discussion of expenses that do not vary directly with premium to the second paragraph of section 3.2 of this standard.**

Section 5.5, Expense Trending (now section 3.4)—It was suggested that this section specifically identify the pertinent sections of ASOP No. 13, so that actuaries would not need to review the other standard of practice. **ASOP No. 13, *Trending Procedures in Property/Casualty Insurance Ratemaking*, should be reviewed whenever an actuary is engaged in ratemaking. No changes were made to this section.**

Section 5.6, Policyholder Dividends (now section 3.5)—Concerns were expressed that this section is unclear as to when policyholder dividends are (or are not) associated with the transfer of risk. **The subcommittee rewrote this section for clarification and to provide additional guidance.**

Note, as well, that two new sections have been added: section 3.6, Residual Market and Statutory Assessment Provisions (see the comments above regarding section 5.2 of the exposure draft), and section 3.7, Provision for Reinsurance (see the comments above regarding section 2.4 of the exposure draft).

Section 6. Communications and Disclosure (Now Section 4)

Section 6.1, Conflict with Law or Regulation (now section 4.1)—It was suggested that the actuary should quantify the economic impact of any limitations or exclusions. It was also suggested that conflicts should be disclosed to the regulator, in addition to the client or employer. **The subcommittee revised this section to note that, if a law or regulation conflicts with the provisions of this standard, the actuary should develop a rate in accordance with the law or regulation, and disclose any material difference between the rate so developed and the actuarially determined rate to the client or employer. In those situations where the regulator is neither a client nor an employer, it could be inappropriate for an actuary to disclose information directly to the regulator. Thus, the section was modified accordingly.**

Section 6.2, Documentation—One comment letter suggested that this section should simply reference ASOP No. 9, *Documentation and Disclosure in Property and Casualty Insurance Ratemaking, Loss Reserving, and Valuations*. **The subcommittee made the suggested change.** The Subcommittee on Ratemaking of the Casualty Committee thanks everyone who took the time and made the effort to write comment letters. The input was helpful in developing the final standard.