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# It's About Time: An Examination of Loss Reserve Development Time Horizons

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Pages 143-168 | Published online: 08 Feb 2019

Cite this article <https://doi.org/10.1080/10920277.2018.1538804>

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Abstract

A rich body of research in the practice of loss development horizons development error contrast practice patterns development current business horizons

management estimates. ment years of estimation compare and common ment appropriate er than the t lines of ment

horizons are necessary to establish insurers' ultimate liability, relatively short-term

development horizons may be more appropriate when attempting to identify deliberate manipulations or to assess solvency risk, where the short-term variations are the primary object of interest. Ultimately, this article investigates the degree to which methodology originally developed for estimating loss reserve errors is appropriate today, in particular, relative to current data availability.

## ACKNOWLEDGMENTS

The authors would like to thank two anonymous referees for their helpful comments that greatly improved the article.

## Notes

1 An insurer's earnings are based (at least partially) on the losses the insurer reports. Increases (decreases) in loss reserves, therefore, decrease (increase) an insurer's earnings during the reporting period. We would consider any intentional altering of reserves to affect insurer earnings to be "earnings management."

2 Andersson and Petersen (2003) discuss the development of loss reserve estimation methods and the impact of the development on the insurance industry.

3 We apply

4 A review of the literature indicates that the development of loss reserve estimation methods is a complex task.

5 For many years, the loss reserve estimation method used by the insurance industry was the "rule of thumb" method. This method is based on the assumption that the loss reserve is a constant percentage of the reported loss. However, this method is not based on any theory and is not supported by empirical evidence. The development of loss reserve estimation methods is a complex task that requires a deep understanding of the insurance industry and the underlying risks. The development of loss reserve estimation methods is a complex task that requires a deep understanding of the insurance industry and the underlying risks. The development of loss reserve estimation methods is a complex task that requires a deep understanding of the insurance industry and the underlying risks.



6 Researchers have often used different scaling variables (premiums, reserves, incurred losses) to measure the relative amount of error between insurers. In our multivariate tests, we will scale by the developed reserve for our tests on the individual lines of business and by total assets for our tests on aggregate reserves.

7 Anderson used a one-year development, though, subsequently, most research has utilized a longer development horizon.

8 Schedule P has been completely redesigned since the time that Anderson conducted his study and now includes much greater reporting detail, more lines of business, and a full 10 years of development history (originally, Schedule P included only five years of development). Even with all the reporting changes, these two basic approaches—the AYD and the CYD—continue to appear in the literature today. Moreover, the one-year and two-year CYD measures are now incorporated into Schedule P Part 2 for each of the major lines of business.

9 Subsequent researchers have often labeled development from AY to AY + 4 as “five-year development” because there is some loss development during the accident year itself. However, Forbes specifically defined loss reserve development in the statement year as “no development” and referred to development from AY to AY + 4 as four-year development (Forbes [1970](#), 531). We consistently use the terminology of Forbes and

Anderson as the development horizon. In the current literature, the development horizon is often referred to as the number of years from the accident year to the end of the development period.

10 Schedule P was redesigned in 1997 to reflect the current format. The current format of Schedule P was all that was needed to reflect the current format.

11 It is important to note that the current format of Schedule P was all that was needed to reflect the current format. Aggregate reserves are reported on Schedule P.

12 These measures are used to measure the development on either the AYD or CYD measures.

13 Petro and others (1997) found that the current format and that the current format of Schedule P may reveal the current format of this



article for parsimony, but interested readers can contact the authors for an illustrative case.

14 The hypothesis is written such that rejecting the null would be in support of the Forbes Standard.

15 For the CYD calculation, the reserves are summed for each accident year within a calendar year; that is, the  $t$  subscript represents the sum of all reserves set in year  $t$ .

16 There are data limitations to the KFS study, particularly related to the lack of consistency in defining the ultimate losses; that is, instead of using  $AYt + 9$  for ultimate losses, KFS were forced to use the latest year available. That means that for certain accident years, the “ultimate” developed reserves were established as early as  $AYt + 3$ . The KFS data set was also relatively small, with between 48 and 67 observations in each of the 10 available accident years from 1977 to 1987. Additionally, only three of those accident years (1977, 1978, and 1979) had a full 10 years of loss history, and hence we see the relaxation of the definition of “ultimate” in their research. Therefore, each of the other accident years in their study (1980–1987) had fewer than 10 years of development, and the ultimate losses were probably misstated. By contrast, we examine thousands of observations (depending on the line of business), and each of our 10 accident years is fully developed to  $AYt + 9$ .

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21 Tables 2a and 2b report the mean paid to incurred ratios (and conduct statistical test on their difference relative to 97%). The results presented here are similar when conducting similar tests on the median paid to incurred ratio in that all lines except four take more than five years to develop to 97% or greater of "ultimate." The four exceptions include three previously discussed (homeowners, private passenger automobile liability, and miscellaneous short tailed lines) as well as the combined line. In this case, the median paid to incurred ratio for the combined lines is statistically greater than 97% after five years of development. This last result will give some solace to those using a five-year reserve error period; however, we note that this relies on the median, and consistent differences still exist across lines.

22 Again, most of the extant literature examines reserve errors on an aggregated basis.

23 As an alternative measure of accuracy, we computed the proportion of insurer-year observations in each development year that reported developed accident year reserves that fell within 1% (or within 5%) of the ultimate developed reserve. In untabulated results (available from the authors), very few insurer-year observations achieve the 1% standard of accuracy for any given line of business or for their aggregate results. In fact, only 36% of insurer-year observations show a reserve within 1% of the final reported reserve by year 5. Even with the looser standard of having the estimate fall within 5% of the ultimate requires a significant development horizon, and that the accuracy

24 With some since 10 years accident years, a

25 Howe tly different from zero mean change in the h is significant reserves. Therefore ay be that three ye t the reserves purely subjectiv dditionally, if the purp , the bulk of



the errors show up relatively quickly. Arguably, a one-, two-, or three-year horizon is sufficient to detect deliberate manipulations.

26 While we do not use the reserve error metric in Grace and Leverty (2012), we use their model as an overview of commonly cited reserve error-based incentives. See Barth and Eckles (2018) for a further discussion on the reserve error used in Grace and Leverty (2012).

27 We define the following lines as long-tailed: farm multiperil, homeowners, commercial, medical malpractice, workers compensation, products liability, auto liability, and other liability. This is consistent with the definition found in Hoyt and McCullough (2010), Eckles and Halek (2010), and Carson, Eastman, and Eckles (2018).

28 The Wald test allows testing the significance of coefficients across models. See Judge et al. (1985) for further discussion.

29 We appreciate an anonymous reviewer for this observation.

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