Module F UNIT 11

CLAIMS AND RESERVING

Purpose

At the end of this unit the participant should be able to demonstrate an understanding of the requirements relating to handling claims and establishing reserving.

Assumed knowledge

The difference between Short and Long Tail insurance.

Short Tail are those types of insurance where claims are known either within the policy period or a reporting period (typically twelve months) thereafter and where claims are typically settled within two or three years of the incident leading to the claim. Examples being Property Damage or Marine Cargo.

Long Tail are those types of insurance where claims may not become apparent or reported for several years after the expiry of the insurance policy period and/or where the time taken to reach the settlement of a claim may take longer (say three or more years). These are typically liability insurance covers such as Public or Employers liability, Motor Third Party liabilities or Pollution liability.

NB: Long Tail is not to be confused with Long Term. See Unit 20

Summary of learning outcomes
1. Explain the difference between the requirements for handling claims when written direct compared with on a fronted basis
2. Explain the importance of establishing Incurred But Not Reported ("IBNR") reserves and the process by which IBNR reserves may be determined
3. Explain the importance and necessity of informing and liaising with the captive's reinsurers
4. Explain the need for the captive to act independently from, and not be influenced by, the parent organisation when settling claims or establishing claims reserves

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CLAIMS AND RESERVING

11.0 CLAIMS HANDLING

11.0.1 Direct writing

The manager's role in this is exactly the same as the management of any other insurance company and it is important that it sets out and agrees the claim process, systems and the role each party will play at the onset. If the business is written directly, a global loss adjuster may need to be agreed and appointed with contact details circulated so that they can be contacted at all times in the event of notification of a loss. Some serious losses occur at the commencement of a long holiday so the loss adjuster needs to be able to respond rapidly to get things moving and ideally minimise any business interruption loss. The appointment of the loss adjuster should be a joint decision between the risk manager and the captive manager and they will need to have regard for any local procedures in the different countries. Having agreed the loss adjuster, this should be notified to all subsidiaries and the necessary personnel should be instructed as to what action they need to take in the event of a claim. Factory personnel have several responsibilities when a loss occurs, whether it is a serious accident or a fire and the early appointment of a loss adjuster and attendance, possibly, of the group risk manager can take a heavy weight off the shoulders of factory personnel. At the same time such early appointment ensures that the loss is settled in accordance with the proper insurance conditions.

This latter point is important from a reinsurance aspect. In setting the claims handling procedures, it should be agreed whether or not the reinsurers of the captive (if they are involved in this risk) will defer the loss settlement to the primary insurer, which may indeed be the captive, or whether they need to be involved so that their interests can be protected. Many reinsurers are quite happy to leave loss settlements to agreed firms of global loss adjusters which is another reason for establishing such a programme, but others may want to participate in the claim handling and possibly employ their own consultant or adjuster in agreed circumstances. What is important, when it is apparent a loss could fall into the reinsurance programme, is that the reinsurer is notified without delay whether or not detailed loss estimates have been prepared.

The above procedures need to be set up at the commencement of the programme and be part of the emergency procedures. To speed things along the loss adjusters could well be supplied with copies of the insurance policies so that they can familiarise themselves with the cover and know exactly what to do when an incident occurs. These systems are important regardless of whether the business is written direct or fronted. Where the business is fronted then, of course, the primary claims handling role in the arrangement is that of the fronting company but the system is the same and everybody has to agree that system at commencement.

Sometimes, particularly where a high volume of claims activity is anticipated on, say, motor, public liability or employers' liability insurances, best practice may be the appointment of an outside claims handling agency experienced in handling a high volume of claims as claim administrators. This should be operated within pre-agreed delegated authority guidelines and it is recommended that the captive manager should perform an audit, at least annually, of the outsourced functions (including further spot checks on individual claims) to enable the manager to satisfy the captive board that all claims are being handled within the guidelines and within the policy conditions.

Of importance is the availability of cash. With the larger claim a payment on account may be authorised at quite an early stage and the first element to be paid will often be the captive's retention. Thus, the captive has to maintain a level of liquidity sufficient to meet potential and unexpected losses whilst having processes in place to collect loss recoveries from reinsurers fairly rapidly. Ideally there should be a clause in the reinsurance contract defining speed of payment after provision of a loss adjuster's report. It is not for the captive to fund its reinsurers; indeed, for the larger loss it is unlikely that the captive would have sufficient funds immediately available. On the other hand, it does have to settle its losses on the same basis as any other insurer. Accordingly, it needs to collect from its reinsurers then add its retention and pay this within any agreed time span specified in a loss adjuster's report which is generally three to four weeks from the date of a report.

There is nothing unusual about this; it is normal practice but it does make the claims payment process smoother if reimbursement terms can be organised and agreed before the loss.

Writing on a direct basis, captives would act very much as a traditional insurer. What is important is that the captive only pays claims strictly in accordance with policy terms and conditions. If it were to do otherwise it is not acting as a bona fides insurer and not only could this undermine the tax deductibility of the initial premium but the payment from the captive back to the parent group may not be considered as an insurance receipt which could have tax ramifications there also. It could, for example, be considered a dividend or other transfer of profit from a subsidiary to the parent.

Thus, ex-gratia payments should be considered very carefully. No insurer would make an ex gratia payment without a good reason and generally the circumstances have to put the loss very close to an insured loss and possibly with some ambiguity as to whether it is or is not covered. To save argument and litigation expense, insurers may make a contribution which they may care to term ex-gratia. It is rather more difficult for a captive to do this but if the payment is recommended under, say, a loss adjusters report and if the payment is approved by the board, then it should be in order. Documenting the rational for the settlement is key in case of challenge by the tax authorities of the insured party.

11.0.2 Fronted

When the captive is fronted it is acting in the role of a reinsurer to the fronting company. As it is the fronting company that has issued the insurance policy it is they that typically will handle the claims. The captive will follow the fortunes of the fronting company and so will set case reserves at the level determined by the fronting company and will settle claims when requested to do so by the fronting company.

There are other aspects which need to be addressed to ensure the efficient operation of the captive.

11.1 CLAIMS RESERVING

It is good practice that the captive has a robust reserving policy and maintains adequate loss reserves, not only for claims that have been reported but also reserves for Incurred But Not Reported (IBNR) incidents. For this to occur a comprehensive recording and statistical system should be in place. Where the programme is fronted most of the information will be reported by the fronting insurer so it would be important for the captive to contact the fronting insurer and agree the system of claim notification, particularly when the captive might be writing a products liability or employer's liability account where there are likely to be a large number of open claims over a long period. The fronting insurer should be aware of the need for rapid notification of loss information to the captive not only for the captive's own reserving but for onward notification to the captive's reinsurers.

The whole reserving programme, particularly in relation to the calculation of IBNR provision, relies heavily on historic information. The captive ought to have access to this as it was probably part of the original feasibility study but where this may not be so, particularly in the greater detail that may now be required, it is important that a system be set up to record essential information. Paid and reserved claims should be recorded in a manner which will, with liability business, show how the claims develop over time. Liability claims tend not to be notified until a period (maybe two or three years) after inception of the year of insurance and individual case reserves may vary up and down as the claim develops. There tends, however, to be a predictable development pattern for each class of risk and it is not unusual on liability classes to see a peak of incurred claims around three or four years which then falls away to ultimate settlements at about year eight.

Looking at a schedule reflecting the writing of the same policy for eight years, year 1 would have 8 years of claims history, year 2 would have 7 years, year 3 6 years and so on. These figures then create a triangle, hence the term 'claims triangulation' when one is looking at how claims history develops and from that the expected ultimate losses to arrive at a calculation of IBNR reserves. An example claims triangulation is shown below.

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11.1.1 Claims Triangulation

INSCE			CLAIMS PAID AND REPORTED					100%
YEAR	2001	2002	2003	2004	2005	2006	2007	PROJECTED
2001	133	176	233	352	312	293	296	300
%	44	59	78	117	104	98	99	
2002		144	184	202	269	253	252	250
%		58	74	81	108	101	101	
2003			168	272	420	380	396	400
%			42	68	105	95	99	
2004				178	269	336	362	350
%				51	77	96	103	
2005					180	240	286	
%								
2006						198	264	
%								
2007							210	
%								

2001–2004 - YEAR 1 Average 49% of ultimate
YEAR 2 Average 70% of ultimate

SO Project 100% ultimate for 2005 = 370 (use highest)
and similarly ultimate for 2006 = 400

With the maintenance of these sort of statistics to produce the triangulations, the manager will be able to produce forecasts as to the ultimate cost of claims. The tail of liability claims is something not to be forgotten and adverse trends in any triangulation should be examined and reserving corrected as necessary.

From time to time an actuarial review would be of value with the actuaries producing a report to advise whether the loss reporting system is adequate, whether the past reserving is adequate and whether any adjustments may need to be made for the future. This information will then dictate whether there needs to be any adjustments to the premium pricing apart from the more important aspect of ensuring that the captive is adequately reserved and has liquid funds available to meet its obligations. Changes in the business may require variations in future projections and any apparent anomalies from past trends need to be examined.

What is important in captive reserving is that the manager and the group risk manager are not influenced to meet certain financial targets. The captive will normally produce a budget to be incorporated in the parent company's overall budget. Naturally the captive budget is going to vary depending on loss experience and there can be considerable variance to budget year on year. If this happens to coincide with adverse budget variances elsewhere in the group, there could be pressure on the manager/group risk manager to assume a more optimistic view of claims. It is most important that such pressure is resisted and it is an area where the manager and the board should maintain a robust reserving policy, calling upon actuaries if necessary, to support their case. Captives should have sufficient IBNR provisioning and they should seek to avoid having IBNERs (incurred but not enough reserved). A captive cannot rely on future premiums to funds historic losses and so should a captive cease writing the business and be put into runoff, then its reserves should be fully adequate to meet its liabilities.

Unexpired risk provisions are used to cater for the estimated value of claims and expenses attributable to unexpired policy periods which are not co-terminus with the captive's financial year end. Such a provision would be established for policies written on a claims made basis where the estimated value of claims attributable to the unexpired period in force exceeds the unearned premium reserve.

Similarly, for policies written on a claims made basis, adverse development reserves, based upon previous experience and trends, can be used in conjunction with actual claims provisions to ensure sufficient provisions are maintained to reserve for the ultimate cost of notified claims where insufficient information is available to assess liability and quantum.

Self-test questions
Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text. 1. Provide two reasons why a captive might appoint a global loss adjustor? 2. When might an outside claims administrator be appointed by a captive rather than using the Insurance Manager to handle the claims process? 3. When should reinsurers be advised of a claim? 4. What is an ex-gratia claim payment and why should captives be wary of making one? 5. What is the importance of maintaining reliable and detailed claims statistics?

Summary of learning outcomes
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