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Résumé de l'article

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The Advantage of Claims-Made Forms For Insurance Buyers*

by

Thomas A. Konopka

L'auteur décrit les avantages à utiliser des formulaires d'assurance basés sur la datation des réclamations, où l'élément déclencheur de l'application des garanties de la police n'est pas la survenance d'un événement proprement dit, mais plutôt la date à laquelle la réclamation est présentée.

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The Cyclical Roller Coaster

Hard and soft liability insurance market cycles are often likened to a ride on a perilous roller coaster. At times, coverage is restricted and prices rise rapidly, followed by an era of plentiful capacity when insurers, in their quest for new clients, offer liberal coverage terms, eut prices and accept unfamiliar risk - leaving buyers wondering what lies ahead.

During the restricted market of the mid-1980s this country experienced the most severe liability insurance crisis of the century. Insurance buyers and underwriters learned an important lesson from this crisis: Liability insurance, especially long-tail lines such as professional and product liability (which may take many years to discover and settle), is difficult to price adequately and requires considerable underwriting expertise. It also is hard to evaluate Joss reserves. As claims for long-tail liability are discovered and settled,

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many insurance companies find that the premiums charged in prior years were too low to pay for future losses. The companies may then eut future losses by withdrawing from the market place. Here is what happens:

- lnsurers' loss reserve fonds are "strengthened" (increased).
- This increases underwriting losses, sometimes causing operating losses.
- This, in turn, may cause a reduction in insurers' working capital.

- lnsurance premiums rise.
- Coverage restrictions are mandated.
- Non-renewal notices are sent to policyholders.

A liability insurance crisis results.

Eventually, loss reserves become adequate, profits return to underwriting, acceptable surplus levels are restored, and insurer balance sheets are strengthened. The liability crisis ends, only to reappear later on. *Figure 1* shows one aspect of the cycle - the loss ratios of general liability insurers (including medical malpractice) from 1969-1989.

Occurrence coverage looks at when a loss happened and "assigns" that event or occurrence (or manifestation, or onset, or cause) to a policy that was in effect at the date of loss. With this approach, when an insurer offers professional, product or other long-taï! liability insurance, the underwriter must set a price today that will be adequate not only to cover losses discovered in five, ten or fifteen years, but also anticipate societal, legal, inflationary, and other changes that impact the dollar value of losses. Perilous roller coaster cycles result from these pricing problems.

The main reason claims-made coverage was introduced was to reduce the large degree of uncertainty involved in making projections of ultimate losses. Under occurrence coverage, a long time would typically elapse between the time when premiums were set and the time when daims were eventually paid, often many years later. This time lag makes it difficult to project ail elements affecting the cost of long-tail daims. These elements may be broadly grouped

under the categories of social, legal and economic inflation. All of these have generally proven to increase claim costs over time. Examples include changing judicial attitudes and decisions and the rising cost of medical services.

Figure 1

General Liability (Including Medical Malpractice)

Loss Ratios 1969-1989

Claims-made insurance focuses on the date a loss is discovered and assigns the claim to the current policy in force. Long-tail liability insurance written on a claims-made basis requires the insurer to set a price today that is adequate to fund losses reported today. While this approach will not eliminate all the possible ups and downs, it results in less uncertainty, as well as adequate protection for today's claim. Thus, it offers a better chance of price stability and a stronger

assurance of continued coverage and hope for ending the recurring market cycle. Following are the reasons why long-tail liability nsurance buyers should expect better results from daims-made msurance.

1. Today's Claim 1s Covered by Today's Limit

A fact of life is that over time most buyers require higher liability limits. With daims-made insurance the policy can be constructed to have the current policy limit apply to a daim made today, even if the date of loss, or "occurrence," happened many years before.

Limits purchased many years ago under an occurrence policy may prove insufficient today. On the other hand, purchasing a higher limit under an occurrence policy in order to provide for the potentially higher cost of daims many years in the future, is costly, and may not even be necessary to provide for daims that are reported nearer to the incident date. Since the reporting of claims under an occurrence policy happens over an indefinite rime span, it is almost impossible to provide for adequate limits for every claim while still maintaining cost efficiency. *See Figure 2,* for a schematic of this comparison.

For example, assume that two insureds have been purchasing product liability insurance since 1987. Buyer A has occurrence coverage and buyer B has daims-made coverage. During policy years 1987-1990, each buyer purchased a $1 million policy. In 1991, both insureds increase their limits to $5 million.

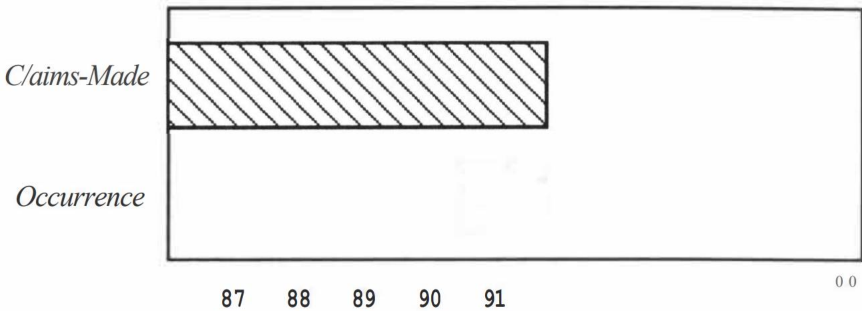
If a claim brought in 1991 for an incident that occurred in 1987 is ultimately settled for $1.75 million, the occurrence carrier would be responsible for $1 million (the 1987 policy limit) and buyer A would be self-insured for the remaining $750,000. The daims-made insured, having a $5 million policy in effect when the claim was made, would have sufficient protection. By having today's limit apply to a claim made today, insureds buying higher limits over rime get built-in "inflation protection." With occurrence coverage, the limit in effect at the date of loss (not the date the claim is made) would apply.

Figure 2

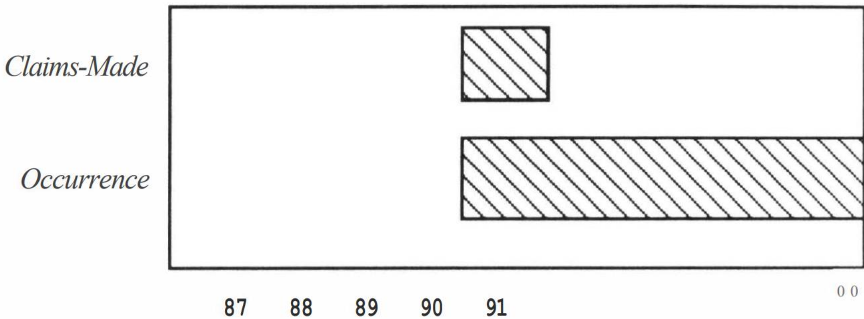
Claims-Made vs. Occurrence Forms

Coverage Year - 1991

Year of Occurrence



Year of Report



2. Lower Initial Cost

If claims-made coverage offers built-in inflation protection, why does claims-made coverage cost less? The answer is due to the nature of long-tail loss development patterns. Development refers to the time lag between the date of incidents and claims and their final evaluation. The evaluations always get bigger.

Since these development patterns require less prernium to cover losses in the early years, claims-made insurance rates can be Jower in the early years. As losses develop, rate increases will mirror loss cost increases anticipated over the next 12 months, Jeading to moderate incremental premium adjustments and stabiJity over the long run.

Looked at another way, in the first year of the claims-made program, claims must both occur and be reported in that year for claims-made coverage to apply. In the second year, the incident must occur in either the first or second year and be reported in the second year. This contrasts with an occurrence policy, where there is no lirnit on when a claim can be reported.

Occurrence coverage requires a "front-end" premium Joading to cover losses that will take years to discover. In the highJy uncertain Jong-tail liability insurance environment, this substantiaJ front-end loading will be reflected in higher insurance costs.

More importantly, even a mature claims-made policy should generally cost less than an occurrence poJicy covering the same period. There are two reasons for the lower cost. First, claims covered under the claims-made policy cover losses that occurred in the past but are reported today, but the occurrence policy covers claims that occur today and are reported in the future, which are then settJed even further in the future. Due to various types of inflation cited above, the cost of the claims covered under the occurrence poJicy will be higher on average than the cost of the claims-made poJicy claims.

Second, claims-made poJicies reduced the uncertainties associated with projecting the ultimate value of long-tail daims. The only rime lag on claims-made policies is between the date a claim is reported and the date when it is settled. Occurrence poJicies have an additional time lag between the date of incident and the date of report, as well as the lag until seulement. This is a much longer time over which to project the future cost of claims, resuJting in more uncertainty. Insurers typically charge for that uncertainty by building in a risk Joad into the premium. Since claims-made poJicies contain Jess uncertainty, the risk Joad is generally smaller. Thus, premiums for a claims-made policy shouJd always cost Jess than those for an

occurrence policy, or should prove to cost less over the coverage term.

3. Long-Term Price Stability

Because of the shorter time period between the coverage "trigger" and the claim settlement, as described in the previous section, claims-made underwriters can offer better price stability. Since the time lag is shorter under claims-made coverage, premiums will be more responsive to unexpected, sudden changes in trend rates or in reserving practices, to cite two examples. Under occurrence coverage, it takes a longer time for these changes to become apparent, and the inevitable rate increases are larger when they do.

The pricing of occurrence coverage is therefore more susceptible to insurance market cycles. The long-tail nature of claim settlements makes occurrence policies appealing during periods of high interest rates (when underwriters are generally willing to write occurrence policies for less premium) than when interest rates are low and underwriters are earning less investment income. Underwriters often underestimate the ultimate loss costs, and the investrnent incorne earned on premium and loss reserves may be inadequate to make up for the premium shortfall. Insurers' losses, when they become evident, may be more severe than anticipated. Then the cycle turns, leading to sharply increased prices and decreased capacity and availability.

Claims-made policies are less attractive in terms of "cash-flow underwriting," since the tirne lag between coverage and claim settlement is shorter. Also, as pointed out above, claims-made pricing is more responsive to ernerging changes, such as declines in underwriting profitability. Claims-made policies do not require the sarne level of incurred but not reported (IBNR) reserves; mainly case reserves are booked. Therefore, the overall level of reserves is lower than that for occurrence coverage. Not only does this reduce the inherent variability in setting loss reserves, but it also makes financial staternents less susceptible to large-scale reserve deficiencies and external swings in asset values (such as stock market reverses). All of this tends to produce greater premium stability over the long term for clairns-rnade coverage.

4. Greater Assurance of Coverage and Limits Availability During Hard Market Cycles

Hard market cycles brought about by insufficient loss reserves adversely affect both primary and reinsurance carriers. In hard markets, reinsurance availability is significantly dirninished. During these periods, the reinsurance market is far more willing to write reinsurance for claims-made than for occurrence-form primary insurance.

When reinsurance for occurrence coverage becomes unavailable, primary insurers providing occurrence coverage are forced to withdraw their occurrence insurance from the market, leaving many insureds with no liability protection. This is what happened in the rnid-1980s.

Why Are Occurrence Forms Coming Back?

If claims-made insurance is a sound solution to destructive market cycles, why is occurrence coverage for long-tail liability insurance being promoted and offered by insurance brokers and underwriters? Reasons for favoring occurrence over claims-made coverage fall into three categories: regulation and tradition, coverage perpetuation, and insured/insurer comrnitments.

1. Regulation and Tradition

In heavily regulated industries such as insurance, change is the exception to the rule. Attempts to introduce alternative coverage approaches are subject to extensive scrutiny and deliberation by state insurance regulators, underwriters, and brokers. This built-in process creates roadblocks, is expensive, discourages innovation, and creates a strong bias for the status quo. Occurrence forms have been around for a long time; claims-made forms are newer.

2. Coverage Perpetuation

An often voiced concern about claims-made insurance is: What happens if the policy is not renewed? Claims-made critics usually argue there is no coverage if there is no policy in effect. This is the most frequently cited criticism of claims-made coverage.

Critics go on to point out that an occurrence policy will always offer protection if coverage was in effect at the date of loss (although occurrence underwriters, once they are "off' the risk, have been known to require legal action to be reminded of their obligation under the old, expired policy).

Claims-made coverage that is not renewed offers protection for insureds and injured parties if an insured elects to purchase extended reporting period ("tail") coverage. Typically, claims-made insuring agreements offer a five-year extended reporting period for defined additional costs.

In a situation where there is no more claims-made coverage, there are additional options. Insureds can evaluate these to determine which best meets their goals: cost efficiency and reduction of uncertainty. These are the options:

- ***"Tai/" Coverage***

The first option is to purchase the extended reporting period (or "tail") for an additional cost. The additional cost is roughly equivalent to paying the additional premium that would have been paid for occurrence coverage. (It is important to note that the buyer of occurrence coverage has been paying more premium each year, for the reasons stated earlier.) The claims-made policyholder benefitted from lower premiums. On non-renewal, he generally has the option to convert to occurrence coverage. Purchasing an extended reporting endorsement is not always equivalent to converting to occurrence coverage; under the former, there may be a time limitation during which claims can be reported. However, the time limitation is generally sufficient to cover the vast majority of expected claims. Unlimited reporting endorsements are sometimes available.

- ***Retroactive Dates***

The second option is to purchase another claims-made policy from a different insurer with the same retroactive date as the non-renewed policy. A variation of this option is purchasing a policy with a retroactive date at least several years earlier than the new policy's effective date, although not necessarily the same as the non-renewed retroactive date. This would provide for extended

reporting of rnost clairns not covered under the non-renewed policy. The availability of this option varies greatly arnong insurers, and the exact terms are subject to negotiation.

- ***Self-Insurance***

The last option is self-insurance of the extended reporting period clairns. This option rnay be viable for insureds with sufficient financial capacity to absorb these losses. Insureds with relatively favorable clairns experience rnay elect this option. The decision to self-insure rnay be made in this case by weighing the cost and benefits of self-insurance versus purchasing extended reporting coverage.

3. The Additional Cost

The cost of these three options is in addition to the prerniurns already paid for clairns-rnade policies. This cost would be unnecessary if occurrence coverage had been purchased. But it is important to remember that the higher cost of occurrence coverage over many years implicitly includes the cost of these kinds of options (except for self-insurance, obviously). The difference is that clairns-rnade coverage gives the insured the option of what type of coverage should be purchased (or not purchased), and the chance to minirnize the cost of the elected coverage.

4. Insured and Insurer Commitments

Another popular criticisrn of clairns-rnade coverage is that the retroactive date allows insurers to hold insureds hostage and disrupts coverage continuity if the insured switches carriers. Claims-made detractors emphasize that if an original retroactive date is changed (moved forward), any clairn made during a policy period based on an incident that occurred before the in force policy's retroactive date is not covered. Therefore, if a carrier change is desired or required, a coverage gap will be created if the new carrier will not agree to use the original retroactive date.

Although the extended reporting period feature significantly mitigates this problem, this criticism highlights the imponance of selecting a carrier with a demonstrable commitment to meeting the insured's long-term liability protection needs.

Long-tail liability insurance is often described by brokers and underwriters as "difficult to place." It requires an underwriter to be exceptionally well-versed in the nature of the exposure and highly skilled in loss prevention and claims management. A buyer of long-tail liability insurance needs to look beyond the policy form (claims-made or occurrence) and evaluate the underwriter's expertise, selection standards and behavior during soft and hard cycles. An insurer writing long-tail liability claims-made or occurrence coverage primarily for "market share" or "cash flow" potential is likely to be a short-term player.

5. Moving the Retro Date Forward

There could actually be an advantage to moving a retroactive date forward. It could reduce cost of the replacement coverage significantly by eliminating coverage for very early years, in which there is a very small likelihood of claim. The insured must be willing to accept this risk in exchange for the cost savings. Accepting some risk is the basis for "insured commitment." Many insureds should be able to accept this residual risk, but are afraid of the unknown.

Insurers writing occurrence policies on long-tail lines are subject to a large degree of this uncertainty and thus are more susceptible to underwriting cycle. It is entirely possible that the occurrence insurer may not be able to honor the commitment which has already been paid. Insurers writing claims-made coverage can also become insolvent, but since their uncertainty in pricing and reserving for long-tail lines is significantly reduced, one would expect that these companies will be less prone to insolvency. It is easier for regulators to monitor and detect their financial deficiencies. The risk of insolvency to the insured is less, since there is a shorter time period over which the insured expects the insurer to honor its obligation. The insurer/insured commitment is more easily achieved under a claims-made program because of increased stability for both.

In summary, the characteristics of certain liability insurance (such as professional and product liability) when written on occurrence forms inherently cause roller coaster market cycles, and perpetuate the likelihood of future liability crises. Claims-made coverage is a rational solution for long-tail liability problems. It

offers stable pricing, coverage availability, and better promise of solvency over the long run.

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