Losses, Contracts and Money…Oh My!

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Demonstrate the impact of claims management, reserving, discounts and contract language have on negotiating a Commutation

- Issues will be presented from both Ceded and Assumed perspectives
- General structure of coverages will be presented
- Values will be defined for each issue
- After each issue presented there will be a brief Q&A period
- Audience will vote on the adjustment, if any, to be applied
- Discuss outcome

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The Direct Coverages

Direct Policies:

Primary WC

X/S WC: x/s $500,000 SIR

- 1/1/1996 – 12/31/2000
- Underwritten by: MGA's
- Key states: CA, NY, and MA
- Industries include:
  - Construction
  - Hospitality
  - Employee Leasing
  - Entertainment

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Key Reinsurance Contract Terms

- 1996 – 2000, Five year treaty
- 50% of $1 Mill each occurrence
- Ultimate Net Loss: Expenses are in addition
- Loss occurring on risks that attach
- Billed on a bordereaux basis
- Losses over $250K require individual reporting
- "Follow the Settlements" provision
- Reinsurer has the right to associate in the defense at their expense
- Commutation on, or shortly thereafter, 12/2010
- "Honorable Engagement" and "Errors and Omissions" clauses
- Sunset Provision Endorsement prohibits any new claims after 12/31/ 2010

Mandatory Commutation Clause

Issues: Mandatory Commutation-Language

1. It is agreed that 10 years after the expiration of the contract, the company shall advise the reinsurer of any claims during the period of this agreement which have not yet been settled which may give rise to payments under this contract.

2. The company and the reinsurer agree that at that time, the reinsurer's liability with respect to such claims shall be commuted. The company and the reinsurer shall, if required, mutually appoint an independent actuary who shall investigate and determine the value of unsettled claims and the payment of reinsurer's proportion of this sum shall constitute complete release of the reinsurer from any such claims and the liability of the reinsurer for further losses that may come due under this contract shall be terminated. The cost of any independent actuary shall be borne equally by the company and the reinsurer.

Mandatory Commutation Clause Required Commutation December, 2010

December, 2010 "As If"
Ceded Commutation Offer

Primary	Loss	Expense	Total	Ceded	Ceded Commutation Offer
Paid	$2.00	$0.40	$2.40	$1.20	$0.00
O/S	$1.36	$0.24	$1.60	$0.80	$0.80
IBNR	$2.00	$0.40	$2.40	$1.20	$1.20
X/S					
Paid	$1.36	$0.24	$1.60	$0.80	$0.00
O/S	$0.64	$0.16	$0.80	$0.40	$0.40
IBNR	$1.36	$0.24	$1.60	$0.80	$0.80
Grand Total	**$8.72**	**$1.68**	**$10.40**	**$5.20**	**$3.20**
(in millions)					

December, 2014
Ceded Commutation Offer

Primary	Loss	Expense	Total	Ceded	Ceded Commutation Offer
Paid	$2.50	$0.50	$3.00	$1.50	$0.00
O/S	$1.70	$0.30	$2.00	$1.00	$1.00
IBNR	$2.50	$0.50	$3.00	$1.50	$1.50
X/S					
Paid	$1.70	$0.30	$2.00	$1.00	$0.00
O/S	$0.80	$0.20	$1.00	$0.50	$0.50
IBNR	$1.70	$0.30	$2.00	$1.00	$1.00
Grand Total	**$10.90**	**$2.10**	**$13.00**	**$6.50**	**$4.00**
(in millions)					

Reserve values shown in ceded commutation values reflect: Application of WC reserving model incorporating an annual increase of 6.5% for medical inflation, and a Present Value Annual Discount of 2.0%

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Issue: Mandatory Commutation – Summary of points raised

Ceded: No reduction

- No specified formula to calculate IBNR or the commutation value
- No requirement to complete a commutation
- Reinsurer did not seek commutation in 2010 or reserve its rights with respect to payments issued post 2010
- 2010 IBNR value would have been increased in a 2010 offer to account for future exposures
- The reinsurer paid as billed through 2014
- The Errors and Omissions Clause excuses any failure to commute in 2010
- The reinsurer received the benefit of the funds
- IBNR includes IBNE

Assumed: $1,300,000 reduction

- No payments for the increases in o/s reserves or IBNR value, or the $500,000 paid post YE 2010
- There are standard approaches to IBNR, no need to dictate formulas in the contract
- Intent was to extinguish liabilities in 2010
- Cedent controls the data, they should initiate Commutation discussions
- Trends do not support a position that an offer in 2010 would have fully covered the exposures seen today
- The Honorable Engagement clause requires the use of 2010 data, consistent with the intent of the parties

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Vote: How much should the 2014 YE ceded commutation offer of $4.0 M be reduced by, if any?

A. $0

B. $500,000, the full value of the change in ceded IBNR between the periods, or (2014 ceded IBNR: $2.5 M, 2010 ceded IBNR: $2.0 M)

C. $250,000, split the difference between $0 and the change in ceded IBNR of $500,000

D. $1,300,000, the full value of change in the commutation offer of $800,000 (2014 offer: $4.0 M; 2010 offer: $3.2 M) plus $500,000 (amounts paid in the period between 2010 and 2014)

E. $650,000, split the difference between $0 and the change in the commutation offer value of $800,000 (2014 offer: $4.0 M; 2010 offer: $3.2 M) plus $500,000 (amounts paid in the period between 2010 and 2014)

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Reinsurance Audit Issues: Claims Management, Over and Under Reserving and Fraud Detection

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Reinsurance Audit Issues: Claims Handling and Reserving

- Claims settled in the last 12 months under $25,000 in total paid, were settled at values that were 20% less than the carried outstanding reserve
  - New TPA
  - Improved resolution of medical only claims
- Shortfalls in reserves for open severe injury PTD claims of 5%
  - Stair stepping of reserves due to Cedent failing to respond to TPA requests for authority
  - Resolution not diligently pursued
- Fraud detection program is not producing any results

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Issue: Reinsurance Audit Issues: Claims Handling and Reserving – Summary of points raised

Ceded: Reserves and IBNR should not be subject to any "issues" reduction

- TPA focus is "low hanging fruit"
- The pending consists mostly of large claims
- Large losses are developing
- The "follow the settlements" clause, renders the reinsurers opinion regarding the success of any fraud detection program irrelevant
- The assuming reinsurer never raised a concern with respect to fraud detection prior to this commutation discussion
- The reinsurer never associated in the defense of any case to conduct a fraud investigation or request the ceding company to do so

Assumed: Outstanding reserves and IBNR should be reduced 20%

- Improved claims management has resulted in reserve takedowns of 20% for closed claims
- The fraud detection program has not delivered results, implementing a robust program would likely drive down exposures
- The honorable engagement clause requires the cedent to act in good faith and this includes vigorously pursuing fraud investigations

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Vote: How much should the 2014 YE ceded value of $4.0 M be changed by, if any, for claims management issues

A. $0
B. 20% decrease, the value of the reserve reductions on closed claims at the time of settlement
C. 10% decrease, split the difference on perceived savings, between 0 and 20%.
D. 5% increase, due to reserve shortfalls in higher value claims
E. Other

Medical Inflation Factor

Issue: Medical Inflation Factor - Summary of points raised

Ceded: Apply 6.5% Medical Inflation

- 5.5% 15 year average medical inflation experienced by Cedent
- PwC HRI, projects for 2016 medical inflation in general will be 6.5%
- Claimant pool requires extensive medical care and reserves are projected for a long period
- Factors leading to the increase include expensive specialty treatment, new drugs and investments to guard personal health data
- Hospital service costs increased 82% from 2001 to 2010

Assumed: Apply 2.7% medical inflation rate

- NCCI, Moody's and the US Department of labor suggest WC medical inflation will remain below 4% at 2.7% (2015) and 3.4% (2016)
- States who implement WC reform help achieve savings
- Improved fee schedules reduces costs
- Using "Networks" helps mitigate inflation

Vote: What medical inflation factor should be used?

A. 2.7%, NCII 2015
B. 3.4%, NCII 2016
C. 5.5%, 15 year average medical inflation experienced by Cedent
D. 4.0%, split the difference between A and C
E. 6.5%, PwC HRI

Present Value Discount

Issue: Present Value Discount of Reserves (including IBNR)-Summary of points raised

Ceded: Apply 2.0% PV discount

- July 21 , 2015 Annual T Bill Rate 0.31%
- S&P 10 Year Real Interest Rate 0.51% , July, 27, 2015
- 1.97% seven year rate treasury yield curve , December 31, 2014 (range 1.97 %-2.1%)
- Deal should reflect current yield as it is being paid from current cash flow
- Loss pool is aging, and limit soon to exhaust
- Premium needed for taking back the risk

Assumed: Apply 6.03% PV discount

- Treasury Bill rate at time written, 1996, ranged from 5.03% to 6.03%
- Advances in medical care results in individuals living longer, warranting a longer payment pattern and greater PV discount
- The bulk of the claims remaining are pension type claims, the IRS requires the establishment of a "yield curve" which should be used for discounting pension claims

Vote: What Present Value Discount should be used?

A. 2.0%, the approximate mid range between seven year treasury yield curve of 1.97% and 2.1%
B. 5.03%, the 1996 (year business placed) Low T-Bill
C. 3.5%, split the difference between A and B, also the 10 year rate corporate bond yield
D. 6.03%, the 1996 (year business placed) High T-Bill
E. Other

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Sunset Provision

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Sunset Provision

Treaty Language:

"No claims reported to the reinsurer after 12/31/2010 will be accepted under this agreement".

Facts:

- Paid value $60,000, Ceded $30,000
- One claim under x/s WC cover
- Reported on bordereaux, billed and paid by the reinsurer in 2012
- File audited by the reinsurer in 2012
- File set up as a "precautionary file" in 2009 by the Cedent, and precautionary files are not reported on the bordereaux
- In the 2009 audit, reinsurers were provided with a listing of all precautionary files, this file was on the list
- Ceded IBNR in 2010: $2.0M, in 2014: $2.5M

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Issue: Sunset Provision - Summary of points raised

Ceded: No discount

- The reinsurer had notice of the loss when they received the precautionary claims listing in 2009, as such they had timely notice
- The file did not exceed the $250K individual reporting threshold
- The reinsurer did not reserve its rights when notified of the loss in the bordereaux, or when they paid or audited the file in 2012
- Reinsurers paid the claim as billed
- IBNR for this book of business was routinely communicated to reinsurers, reinsurers have been constructively put on notice
- The Errors and Omissions Clause negates any late notice argument
- IBNR includes IBNE

Assumed: $2.5 M discount

- Cedent is responsible for the front line management of the exposures, it is their burden to report the losses
- Identifying a loss on a precautionary claims run for audit selection does not constitute notice
- The Sunset provision negates any need for IBNR
- Industry trends with respect to IBNR do not fully support a position that a presented offer back in 2010 would have fully covered the exposures seen today
- The Honorable Engagement clause requires the parties to act in a fashion that is consistent with the intent of the parties, i.e. no losses will be covered if reported after YE 2010

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Vote: How much should the 2014 YE ceded value of $4.0 M be reduced by, if any, for the Sunset provision?

A. $0

B. $30,000, the ceded value of the loss paid should be credited to the reinsurer

C. $2,500,000, the 2014 value of ceded IBNR, should be eliminated

D. $500,000, the difference in the 2010 and 2014 ceded IBNR

E. B and C, or $2,530,000

F. B and D, or $530,000

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