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Developments and Findings in Exposure Rating of ECO/XPL in Clash Treaties

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Agenda

- Quick Review
- Jurisdictional Developments
- Line of Business and Policy Limit Relationships
- Insurer Size and Claims Practices
- Conclusion

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Quick Review

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Quick Review: Basic Information

- ECO/XPL losses occur in addition to or outside of policy limits, and are caused by allegations of faulty claim handling by the insurer.
- ECO/XPL losses are a significant component of the expected loss for clash treaties, but the proportion depends on the lines of business and the ratio of treaty retention to maximum policy limit.
  - Low ratio, Work Comp included → small proportion
  - High ratio, Work Comp not included → high proportion
- Traditionally a judgmental rate-on-line approach has been used to price ECO/XPL.
- A model-based approach provides consistency, ties rates more closely to available data.

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Quick Review: Braithwaite and Ware Paper

- A good basic resource:

"Pricing Extra-Contractual Obligations and Excess of Policy Limits Exposures in Clash Reinsurance Treaties"

Braithwaite and Ware, Journal of Reinsurance, Spring 1995

- Gives basic form of an exposure rating model for ECO/XPL.
- Identifies underwriting considerations when pricing ECO/XPL, including:
  - States
  - Lines of Business / Policy Limits
  - Size
  - Claims Management Quality

Quick Review: Braithwaite and Ware Model

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- Basic formula for exposure rating model for ECO/XPL expected loss:

$$E[L] = \text{Premium} * \text{Constant} * \int_{\text{Attachment}}^{\text{Limit}} f(x)dx$$

Premium = subject premium

Constant – set so as to achieve desired overall frequency, then modified by underwriting characteristics

$\int_{\text{Attachment}}^{\text{Limit}} f(x)dx$ – reflects expected average severity on the layer being priced

- Severity distribution – two-parameter Pareto

Jurisdictional Developments

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Jurisdictional Developments: Overview

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- Good sources of information: PCI, IRC, large reinsurers, brokers
- The past few years have seen numerous attempts to pass bad faith bills harmful to the insurance industry.
- 26 negative bills introduced in several states in 2011, but nothing was enacted.

  CA, CO, DC, FL, GA, IL, IA, MD, MI, MS, NE, NH, NJ, NY, OR, PA, UT

- Most efforts at bad faith reform also failed.
- Expect return of negative legislation in several states.

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Jurisdictional Developments: Florida

- Florida is by far the worst bad faith environment – mainly but not limited to personal auto
- Characteristics:
  - o Extremely short time periods in which to offer limits
  - o Written settlement demand not required
  - o Burden placed on insurer to tender policy limits without any demand
  - o No rules on how cases are to be settled
  - o No right to cure in third party cases
  - o No mandatory policy limits
  - o Presence of lawyers who take advantage of the situation
- An effort to implement bad faith reform failed earlier this year.
- 2003 Med Mal tort reform – safe harbor provision, caps on pain and suffering. However, FL Supreme Court is reviewing.

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Jurisdictional Developments: Other States

- Next tier of states with worst bad faith environments:

  WA, CA, IL (Cook County), MO (Madison County)
- Washington: 2007 law eased restrictions on filing bad faith lawsuits, significantly eased restrictions on punitive damages.
- California: denial of coverage on GL/CMP
- There have been some successes at implementing reform.
- West Virginia: 2005 reform law replaces courts with an administrative procedure for handling bad faith cases, has reduced auto liability costs.
- Tennessee: 2011 reform law limits ability to sue and punitive damages.
- Reform bills currently under discussion in GA, LA, WV.

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Line of Business and Policy Limit Relationships

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Line of Business/Policy Limit Relationships: Overview

- Frequency hierarchy by line of business:
  1) Personal Auto (low limits, strict timelines)
  2) GL / CMP (denial of coverage, complex language)
  3) Commercial Auto
  4) Other – Personal Liability, Professional Liability, Work Comp
- Severity by line of business harder to delineate, but have experienced a number of very large losses recently involving personal auto bad faith.
- Frequency by policy limit: in general, there is higher potential for ECO/XPL at low policy limits.
- Severity by policy limit: assumption that expected average severity increases as policy limit increases has been challenged by recent personal auto experience.

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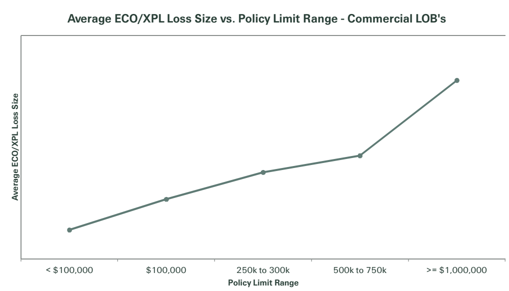
Line of Business/Policy Limit Relationships: Average Severity by Limit for Commercial Lines



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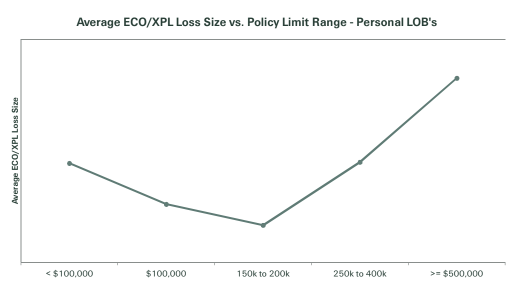
Line of Business/Policy Limit Relationships: Average Severity by Limit for Personal Lines



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Insurer Size and Claims Practices

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Insurer Size and Claims Practices: Overview

- Braithwaite and Ware: larger insurers more susceptible to lawsuits due to the deep-pocket effect
- However, we have been noticing a trend in the opposite direction.
  - involves plaintiff lawyers in states with poor bad faith environments
  - targets are smaller insurers who don't do much business in the state
  - such insurers aren't aware of / don't know how to handle the issues
  - example: personal auto in Florida
- An insurer's quality of claim management may be a far better indicator of vulnerability to ECO/XPL claims than size.

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Insurer Size and Claims Practices: Insurer Characteristics

- Braithwaite and Ware on claims practices:
  - Average workload and experience level of the staff
  - Insurer's approach to settling claims
  - Stability of claims staff
- Other claims department characteristics:
  - Level of centralization of the claims department
  - Level of authority per office
  - Level of oversight of claims handlers
  - Level of reliance on independent adjusters and TPA's
  - Level of authority and supervision given to TPA's
  - Frequency of claims audits
- Other insurer characteristics:
  - Complexity of exposures
  - Writers of niche business
  - Use of manuscript policies

Insurer Size and Claims Practices: Quantitative Measurements

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- A number of these characteristics can be measured quantitatively:
  - o Average claims staff years of experience
  - o Total number of pending files
  - o Number of pending per claim handler
  - o Number of claim handlers per supervisor (evaluation also depends on whether supervisors handle claims)
  - o For small companies: number of states written
- For renewals, all of this information can be obtained from claims audit reports
- For new business, information might be obtainable from the client or the broker

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Conclusion

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- An exposure rate for an expected ECO/XPL loss can be constructed using a model which
  - o is multiplicative,
  - o can be divided into frequency and severity components,
  - o and allows for the presence of interactions
- Potentially a good candidate for predictive modeling?
- Problems:
  - o lack of data / coding of data
  - o extreme values
  - o Pareto distribution
- Will have to rely on less rigorous approaches to estimate parameters.

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