CHAPTER 16: CLAIMS-MADE RATEMAKING

During the 1960s and 1970s, loss trends for many liability lines increased dramatically due to high economic and social inflation, as well as increases in claim frequency. This was especially the case for professional liability insurance including medical malpractice. As discussed in Chapter 6, claims for long-tailed insurance products can take many years to report and settle. Because of the long-tailed nature of professional liability, it took several years before insurance carriers realized that their products were significantly underpriced. Once companies realized their rates were inadequate, they either reduced coverage or filed for large rate increases or did both to try to improve profitability. This delay in recognizing price inadequacy highlights the significant pricing risk that exists for long-tailed insurance products relative to short-tailed ones.

The long period between the occurrence of a claim and the settlement of a claim can be driven by a reporting lag (i.e., the time between the occurrence date and report date), a settlement lag (i.e., the time between the report date and settlement date), or both. From a loss development perspective, reporting lag relates to pure IBNR (claims that are incurred but not reported), and settlement lag relates to IBNER (claims that are incurred but not enough reported). For a product like medical malpractice, it may be many years before an insured becomes aware of a claim and reports it. For example, it may take several years for the physician's error to cause identifiable symptoms. Even after the claim is reported, it may take many years for the claim to be ultimately settled due to factors such as the need for ongoing treatment and lengthy court proceedings.

In an attempt to reduce the pricing risk inherent in professional liability, the industry introduced an alternative to occurrence coverage that minimizes the time between the coverage inception and claim settlement. This alternative is called claims-made coverage. The major difference between claims-made and occurrence coverage is that the coverage trigger is the date the claim is reported rather than the date the event occurs. Consequently, the difference in pricing these products is not in the coverage provided, but rather in the timing of the pricing decisions. When pricing claims-made policies, the actuary only needs to project claims reported during next year's policy period. When pricing occurrence policies for professional liability and other long tail lines, the actuary must consider claims that will be reported many years into the future.

This chapter covers:

- Aggregation of losses by report year and report year lag
- Coverage triggers for claims-made coverage
- The five principles of claims-made policies
- Issues related to coordinating coverage between claims-made and occurrence policies.