



Institute of Actuaries of Australia

# Liability coverage – whither claims-made?

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## **Liability Coverage – Whither Claims-Made?**

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## **Abstract**

Claims-made insurance policies are offered in various liability classes. Most notable amongst these is medical indemnity – a class which has received heightened public awareness recently with the financial difficulties experienced by United Medical Protection (UMP). This paper examines the concepts underlying the claims-made basis for rating insurance – an area less familiar than the claims occurring basis to actuaries in this country.

We compare and contrast the claims-made and claims occurring bases of rating insurance products, focusing on the following aspects:

- pricing and reserving
- variations in the type and extent of risk
- reinsurance protection
- impact on solvency measures for the insurer
- tail coverage
- unfunded IBNR and
- switching from claims-made to claims occurring.

## 1. Introduction

For a number of reasons the insurance industry has endured a period of turmoil in the past two years.

One of the issues which has received some focus during this period has been the provision of cover on a *claims-made* basis. This is usually confined to professional indemnity (PI), director's and officer's (D&O) insurance and medical indemnity. It is in the last of these where some of the pitfalls of claims-made coverage have been recognised.

This paper discusses the reasons for the different forms of coverage (claims-made and claims occurring) and investigates their differences. It appears under the following headings:

- Background terms
- Historical context
- The insurer's perspective
- The insured's perspective
- Reinsurance issues
- The new legislation
- Conclusions

While claims-made cover has attractions for insurers, for policyholders there would appear to be clear disadvantages associated with claims-made cover.

In the new legislative environment insurers may find themselves forsaking claims-made cover for the capital-hungry claims occurring cover.

## 2. Background terms

### Claims occurring and claims-made

Most types of insurance are provided on a **claims occurring** basis. Claims occurring means that the insured is indemnified for a loss sustained, as defined by the insurance contract, if the incident giving rise to the loss *occurs* during the period of cover. The claim can be reported at any time in the future (however, subject to any specified limitations).

An alternative type of cover to claims occurring is that provided on a **claims-made** basis. Claims-made means that the insured is indemnified for a loss sustained, as defined by the insurance contract, if the incident is *reported* to the insurer during the period of cover (some further rules for eligible claims are described below). The classes on which such coverage is offered are generally liability classes (as noted earlier). In passing, it seems odd, however, that claims-made has not been generally offered in public liability, which has similar characteristics as these classes.

### Retroactive date

Claims-made policies have a range of special rules for which losses are eligible. A loss is able to be reported during the cover period if it occurs after some particular date. This date, commonly referred to as the **retroactive date**, is the earliest date on which an event giving rise to a loss under the policy can have occurred.

The retroactive date is generally the first date on which a claims-made policy is written (but there may be some provisions for losses which occurred before the time the insured's first policy is written – sometimes called prior events cover).

Alternatively, the insured may need to obtain separate prior events cover if they are switching insurers from one claims-made policy to another. Of course, if the insured's previous insurance was on a claims occurring basis, then their prior events are, by definition, covered.

### Run-off / Tail cover

When an insured retires, or switches insurers, there is the potential for claims which occurred before retirement/switch to be brought against them. Taking first the case of switching insurers (out of a claims-made policy), the insured would need to obtain 'tail' cover for incidents prior to them switching, but which are reported after the switch. This cover may be obtained from the original insurer, prior events cover from the new insurer, or some special policy from a different insurer.

Similarly on retirement, the insured would need to obtain/purchase insurance for events to be reported after their retirement (or risk the potential financial consequences of not being insured for claims reported after retirement).

### **Contractual Liability**

The insurer need only pay and reserve for claims on the basis of contractual liability. That is, for claims-made insurance it is not necessary to reserve for claims which may be reported at some future date, notwithstanding that the incident occurred in the coverage period – as there is no effective contract at the balance date which covers such claims.

This issue has come to light in the operation of Section 54 of the Insurance Contracts Act (1984), which prescribes the basis under which an insurer may not refuse to pay claims under certain circumstances.

Section 54 says in part that -

“ ... Subject to this section, where the effect of a contract of insurance would, but for this section, be that the insurer may refuse to pay a claim, either in whole or in part, by reason of some act of the insured or of some other person, being an act that occurred after the contract was entered into but not being an act in respect of which subsection (2) applies, the insurer may not refuse to pay the claim by reason only of that act but the insurer's liability in respect of the claim is reduced by the amount that fairly represents the extent to which the insurer's interests were prejudiced as a result of that act.”

The act goes on to say that omissions are sufficient (subject to some provisions) to enact Section 54. Broadly this boils down to the issue of what impact the omission to notify the insurer of the claim when the insured had been notified had on the insurer.

In the case of *FAI v Australian Health Care Pty Ltd*, in which the insured was notified of a claim, but failed to notify the insurer during the policy period, FAI was found to be fully liable for the claim given the provisions of Section 54. This has put into question the effectiveness of claims-made contracts, and has led to a Federal Government review. Insurers await the outcome of this review with more than a casual interest.

In this paper we include as claims reported only those in the pure sense of reporting of claims in the year of insurance, and do not consider any provisions for the late reporting of claims under claims-made policies.

### 3. Historical context

Marker and Mohl (1980) describe the general historical context of providing claims-made cover in medical indemnity insurance in America in the 1960's and 1970's. While claims-made had been around for many years prior to this in other liability classes, the reasons for providing such cover in this instance are similar, and as such we give a summary of the reasoning for such cover from their paper.

The basic theoretical premise for providing claims-made coverage is to be able to price insurance cover on a basis subject to less uncertainty than pricing on an occurrence basis. The assumption is that an insurer should be able to more accurately predict the premium required to be collected for incidents reported in the next year only, than for all incidents occurring in the next year (which need to be provided for over many years).

This was of particular concern in liability insurance in America during the 1960's and 1970's where claims incidence was rising (a more litigious society) and superimposed inflation levels were particularly high – partly as a result of many judgements being awarded an unexpectedly high levels. Economic conditions were also against insurers at this time, dampening profits.

The IBNR provisions held on the existing occurrence basis were generally found to be inadequate given that the initial pricing basis was far removed from the emerging experience (that is, there was a large – and unfunded – IBNR provision required). Future experience under such circumstances was subject to extreme uncertainty, and large rate increases would have been required to adequately cover the risks underwritten in the future. These rate increases were generally seen as unaffordable, and claims-made was seen as an easier solution. The true rate increases required could be curbed (in the short term at least) by providing cover which only depended on the claims reported in the next year.

In liability classes such as PI, D&O and medical indemnity, claims can emerge many years after the incident leading to the claim occurred. Furthermore, such claims can be very large.

This is doubtless why claims-made cover was seen as desirable for these classes in Australia. However, the question to be considered is whether the environment existing in 2003 has changed to such an extent that the justification for claims-made cover has diminished.

## 4. The insurer’s perspective

### 4.1. Data

To assess technical issues, in this and subsequent sections, we have used data from an aggregated set of liability portfolios, each of which have been written on a claims-made basis. These data will be used to assess the theoretical aspects of claims-made from a variety of perspectives, most particularly in the timing of claims under the two covers.

In the analyses which follow it is important to appreciate that we are always dealing with the **same** claims experience, and that what is different is what parts of the whole dataset are included in the analyses.

Because the data is the same, this means that we are not considering variations in claimant behaviour under the two systems, in particular the reporting pattern under a claims occurring versus claims-made basis.

The following sections should be considered in the context of the comparison of trends of claims occurring and claims-made covers. The absolute levels of claim numbers, claim sizes and other items measured in this section will vary between portfolios and portfolio types (PI, medical indemnity etc). Furthermore, while the portfolio is a mix of various portfolios, it should not be regarded as an “average” portfolio.

### 4.2. Claim numbers

The following table shows, for a given policy year, the claim notification pattern that is covered for liability under each of the two coverages.

Development Year	Claims Made (a)	Claims Occurring
0	100%	39%
1		25%
2		8%
3		10%
4		4%
5		3%
6		2%
7+		9%
Total	100%	100%

(a) In theory. In practice some claims from development year 1 may be accepted for liability.



As the table shows, under a claims-made policy, the insurer is only liable for the claims reported in the year for which the policy has been written. For a new claims-made book this would mean around 40% of the claims that would be required to be funded under a claims occurring policy.

Under the claims occurring basis the average duration between incident and notification is around 2 years longer than under claims-made.

With a stable exposure, claims frequency and reporting patterns, the number of claims from a new claims-made book will be around 90% of that under claims occurring after 6 years. This point is illustrated in the graph below.

### Number of Claims



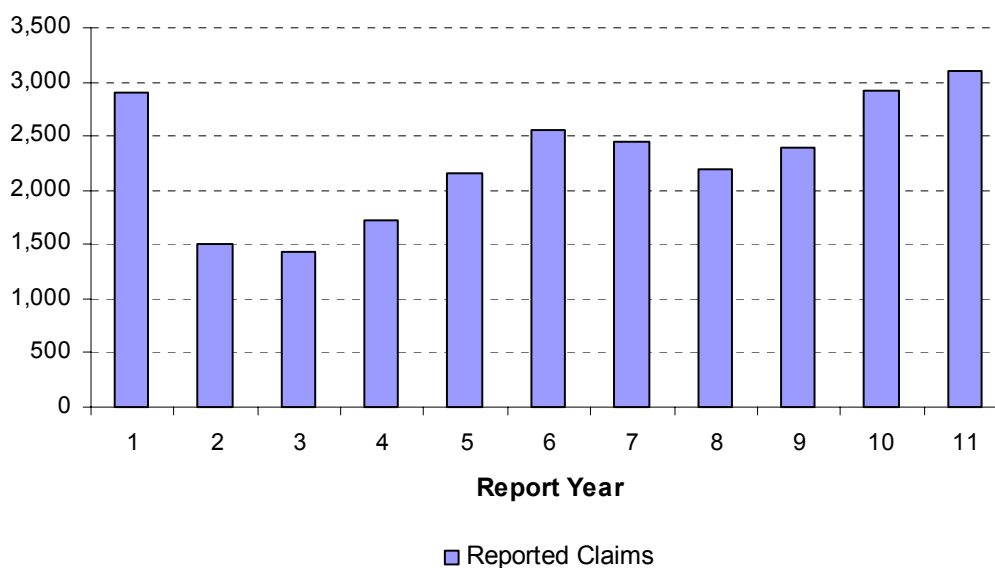
In practice the relativities of the numbers reported under the two types of cover will depend on the retroactive dates of policies in the portfolio, and the age of the portfolio. And of course the reporting patterns are unlikely to be stable.

For premium setting it is necessary to estimate the numbers of claims for the forthcoming year. Under a claims occurring basis the number of claims can generally be estimated with reasonable accuracy in a stable or known trend environment.

However, under a claims-made basis the number of claims reported in a particular year can be subject to significant variation. This can occur even in a period of a stable underlying frequency of incidents, because of changes in claimant attitude to reporting. For example, some insurers may deliberately encourage earlier reporting to take advantage of the current years' reinsurance cover. Legislative change can result in dramatic increases in the number of claims reported prior to the change (eg. medical indemnity and the NSW Health Care Liability Act 2001). Following increases in numbers there can be corresponding reductions in subsequent years.

The following chart shows the numbers of claims reported under a relatively mature claims-made book, with no major changes in exposure. As can be seen, there has been significant variation in the annual reports.

**Variation in Number of Claims Reported**



In our view the level of uncertainty in estimation of future claim numbers is likely to be **higher** under claims-made cover than under claims occurring cover.

This view is reinforced when we consider the question non-zero/zero claims. The proportion of zero claims would be expected to be significantly higher under claims-made cover, as incidents are reported which have little chance of success. We have observed levels of zero claims of 60% to 70% in some claims-made classes. This proportion can vary somewhat from year to year, more so than under claims occurring cover, where levels are much lower.

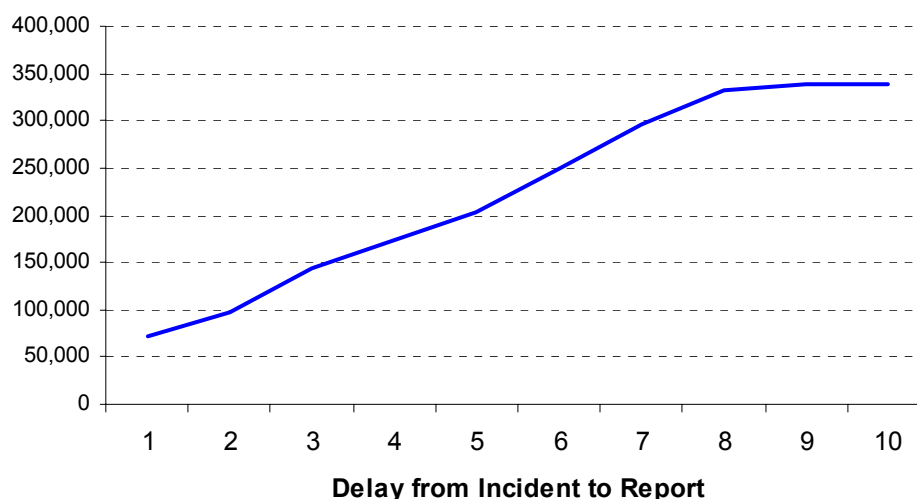
### 4.3. Average claim size

To derive an average claim size under each form of cover we have analysed payments per claim settled and formed models from the analyses.

General observations on the experience are as follows, each of which has a major influence on the subsequent comparisons:

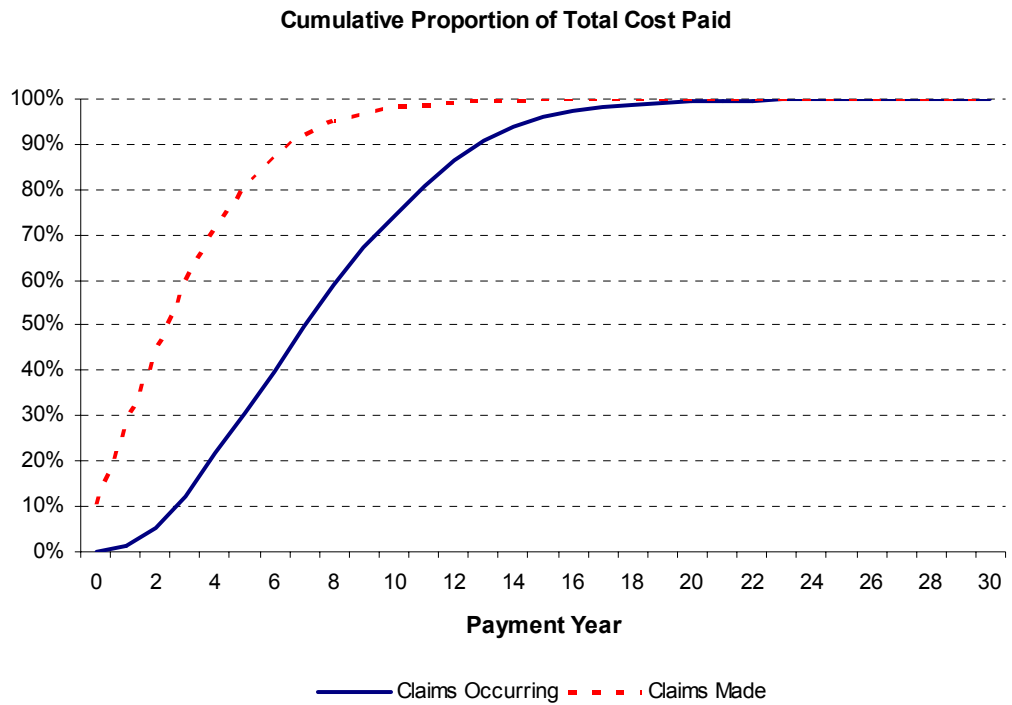
- (a) There has been a relatively high level of superimposed inflation in the experience, quantified at around 8%pa.
- (b) Average settlement size varies according to the delay in notification, as indicated in the following graph.

**Average Claim Size by Notification Delay**



The settlement size of claims reported in later development years is up to seven times that of claims reported in the first development year.

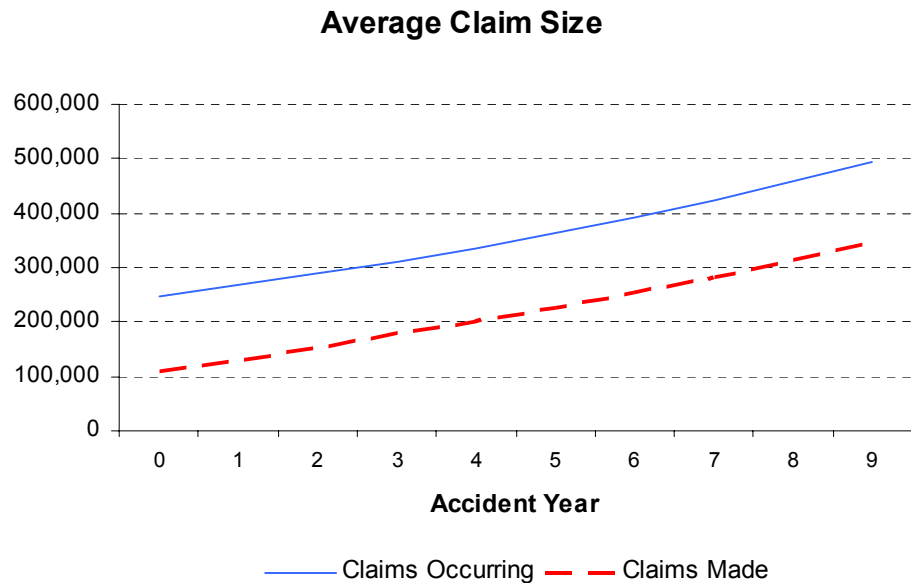
- (c) As expected, the payment pattern is faster under a claims-made policy than under claims occurring.



The mean term of a claims-made policy is around two years shorter than that of a claims occurring policy, consistent with the absence of late reported claims.

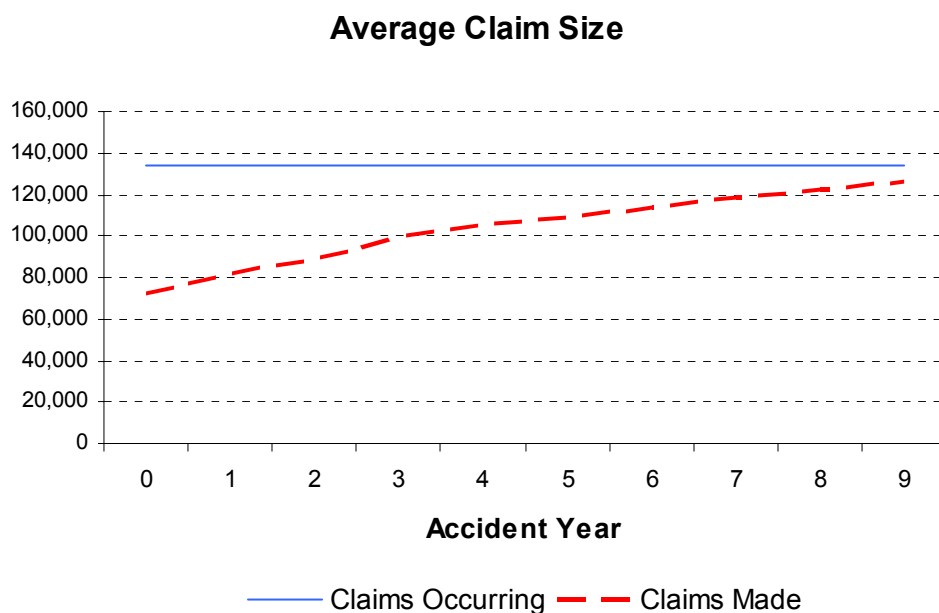
With this background we have estimated ultimate average claim sizes under the two forms of cover, recalling once again that there is **no** difference in the claims data.

The graph below shows the estimates for a new book of business, assumed to be stable in claims exposure, but subject to superimposed inflation of 8%pa.



The average under claims-made is always lower, essentially because of the effects of superimposed inflation on the longer payment pattern under claims occurring. Of course superimposed inflation rarely operates in such a predictable manner, and may be more of a payment year effect rather than accident year.

The effect of removing all future superimposed inflation is shown in the following graph.



With zero superimposed inflation, the average claim size under a claims-made policy approaches that under a claims occurring policy. It is much lower at the outset because of the size difference according to delay in notification, but this reduces as the portfolio matures.

Because of the longer term and the potential effect of superimposed inflation it would be expected that level of uncertainty in the estimation of average claim size is greater under claims occurring cover than under claims-made.

This discussion essentially relates to non-zero claims, and the uncertainty associated with this feature is attributed to claim numbers, discussed in Section 4.2.

#### 4.4. Risk premiums

To compare the risk premiums under claims-made and claims occurring bases we combine the observations made above for claim numbers and average claim sizes.

In the table below we compare the two premiums for a start-up portfolio of liability business, and in subsequent years as more business is written. The portfolio is assumed to be stable in exposure and underlying numbers of claims. Two ratios are shown, firstly assuming that superimposed inflation is at the observed levels of 8% per annum, and secondly assuming no superimposed inflation.

**Ratio of claims-made risk premium to claims occurring**

Year	C-M as % of C-O With SI	C-M as % of C-O Without SI
1	17%	21%
2	31%	39%
3	38%	47%
4	47%	60%
5	52%	67%
6	55%	72%
7	58%	77%
8	62%	82%
9	65%	86%
10	67%	90%

It can be seen that the risk premium under a new claims-made policy is only around 20% of that under a claims occurring basis. This is the combined effect of the lower claim numbers and average claim size from the early development year notifications.

In the absence of superimposed inflation the risk premiums will eventually come together in a stable portfolio. However the presence of superimposed inflation, or any form of growth, will keep risk-premiums under claims-made lower than under claims occurring.

In practice, insurers do not generally charge new claims-made policyholders lower premiums in their early years. This can be due to a number of reasons, including: insurers catching up on unfunded IBNR from previous claims occurring policies, or the insured being charged the rate of the mature claims made book rather than the true start up cost. However, it would be possible for a new insurer or entrant into the relevant market to do so and quickly attract a sizeable share of the market. Of course, the policyholders would experience significant increases in their premiums in subsequent years.

**4.5. Profit margins**

Generally speaking, a profit margin is that component of the premium which rewards the insurer for undertaking risk. In theory, a higher profit margin for a particular portfolio would be justified for a portfolio that had inherently greater risk than another.

While this may be thought of at the class level (for example, home insurance may be less risky than liability business), there can also be more risk within a particular class on the basis of the insurance offering, such as claims-made versus claims occurring.

There are many factors to be considered in any analysis of the varying levels of uncertainty between claims-made and claims occurring such as:

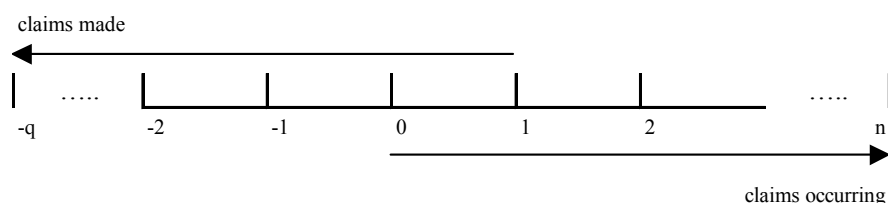
- Class of business
- Age of portfolio (and stage of maturity)
- Mix of business and changes in the insurer's operation of the portfolio
- External factors (such as the recent liability reform legislation, introducing further uncertainty, at least in the short term).

We have not attempted to formally quantify the levels of uncertainty, but can offer some general comments from the above analyses.

In our view the level of uncertainty in claim numbers for claims-made insurance is greater than the uncertainty for a claims occurring policy, as discussed in section 4.2. This is particularly so when we consider the issue of non-zero/zero claims. On its own this would imply a higher profit margin for claims-made policies.

In respect of claim size, the picture is not so straightforward. The build up phase of a claims-made book is subject to a great deal of uncertainty in respect of average settlements. However, it is only the next year's claims reports which need be considered at the time of setting premiums (from the new exposure period, plus reports from prior exposure periods). Recent changes in the environment can thus be allowed for on a reasonably frequent basis.

For claims occurring, the future cost of all claims occurring in the policy period must be estimated at the time of premium determination. The timeline below shows the relative estimation periods for the current premium (written at time 0).



Care needs to be taken with the above however, in that, for claims-made claims may have occurred any time from occurring from  $-q$  (being the first retroactive date of the portfolio) to 1, but which are reported between time 0 and 1. For claims occurring, however, the next premium is for claims occurring in time 0 to 1, but which could be reported at any time (say up to time  $n$  for simplicity).

Intuitively we would expect uncertainty to be higher under claims occurring policies, because of the longer period that estimation is required. This is exacerbated by the presence of superimposed inflation, which rarely behaves in a predictable manner.

Overall, however, it is not at all self-evident (to us at least) that the relative level of uncertainty under claims-made policies is demonstrably less than under claims occurring policies.

As such, we would not expect significantly different profit margins to be required.

#### 4.6. Reserving

The following table shows the build-up of central estimates of outstanding claims of business written under the alternatives forms of coverage, for start-up portfolios. Once again, we have assumed a stable portfolio, both with and without superimposed inflation operating at 8% per annum on the average claim sizes.

**IBNR as a proportion of risk premium**

Year	IBNR as % current years RP (Incl SI)	IBNR as % current years RP (Excl SI)
1	483%	386%
2	463%	364%
3	519%	408%
4	498%	386%
5	512%	397%
6	528%	410%
7	531%	412%
8	516%	396%
9	476%	357%
10	418%	294%

The above ratios are relative to the risk premium in the year, being the claims-made risk premium.

Considering first the situation where no superimposed inflation is present, the relative amount of IBNR in the central estimates under a claims occurring basis is initially around 4 times the claims-made risk premium. This reduces in the ultimate to less than 3 as the current year's risk premium increases (see Section 4.4).



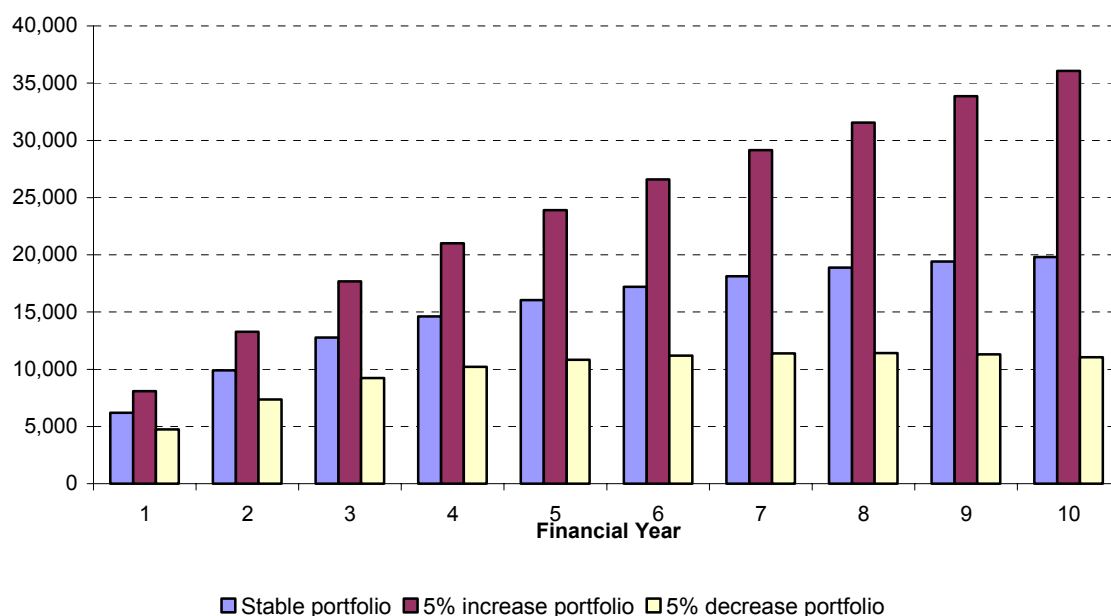
Where superimposed inflation is present the multiples are higher, and in the ultimate is closer to 4 times the risk-premium.

These multiples are consistent with the reporting pattern given in Section 4.1.

The following table shows the numbers of “unfunded” IBNR claims under a claims-made portfolio where business written each year:

- i. Is stable
- ii. Increases at 5% per annum
- iii. Decreases at 5% per annum

**Number of Cumulative IBNR claims**



For the stable portfolio, the graph essentially illustrates the same points as in the earlier table.

However, with 5% per annum growth portfolio, the number of IBNR claims at year 10 is around 80% more than in the stable portfolio.

Alternatively, where numbers are reducing at 5% per annum, the numbers of IBNR claims at year 10 is around 40% less than in the stable portfolio.

These relationships translate directly in higher/lower reserves required under a claims-occurring basis.

#### **4.7. Risk margins and capital requirements**

The preceding section deals only with central estimates of outstanding claims. The question of appropriate risk margins under the two forms of coverage must also be considered.

The issues are reasonably similar to those discussed with respect to profit margins in premiums.

For reserving, the uncertainty with respect to numbers of claims is generally lower under claims occurring policies than claims-made policies. However under claims-made it remains for around 3-4 years after the notification of the incident. This is about the time which elapses before ultimate non-zero claims are known with any degree of confidence, longer under medical indemnity.

Once again the uncertainty with respect to claims sizes is likely to be lower under claims-made policies.

While we have not carried out any formal calculations we suspect that if this were to be done, the coefficient of variation of the outstanding claims distribution under claims-made would be **higher** than under claims occurring.

In theory this would mean higher risk margins. However they would be applied to significantly lower central estimates.

With respect to premium liabilities the risk margins are not likely to be very different under the two forms of coverage. In this case the levels of premium would also be higher under claims occurring, leading to higher absolute amounts of capital required.

In summary, it is clear that the amount of capital required under claims occurring will be much greater than under claims-made. This is not because of the greater uncertainty in the specific coverage, but because of the greater exposure in amounts of outstanding claims and premiums.

Assuming the APRA risk margin of, say, 11% to 15% of central estimate, and consistent with the analyses in Section 4.6 above the amount of additional capital required under claims occurring would be around 30% to 60% of the risk premium for the most recent year.

#### **4.8. Summary**

The above discussion can be summarised quite succinctly as follows:

- (a) There is probably a higher level of uncertainty in pricing claims-made policies compared to claims occurring policies. Accordingly, and ignoring

the vagaries to the market, profits will be more variable under claims-made.

- (b) Claims-made policies will require significantly less capital, because of the lower reserves for outstanding claims.

The attraction of (b) for insurers will doubtless outweigh any disadvantages seen in (a), particularly in an environment where access to capital is limited.

## 5. The insured's perspective

In Section 4 we have considered the different forms of coverage from the insurer's point of view. In this section we consider issues that are more pertinent to the insured party in a claims-made environment. These include:

- Gaps in claims-made cover
- Problems of switching
- Premiums paid for cover provided

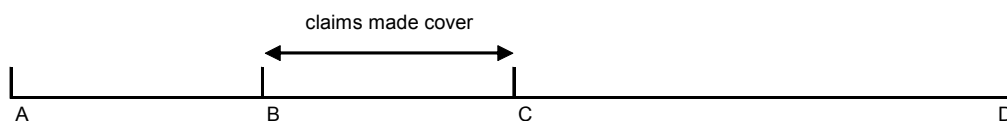
### 5.1. Gaps in claims-made cover

As discussed, claims-made policies cover eligible incidents reported during the policy period. For an insured's professional lifetime, one would want coverage for all claims occurring during that lifetime. This raises issues for the different types of coverage and switching coverage types.

This sub-section discusses the nature of coverage and gaps that can emerge at the commencement and completion of claims-made coverage. The following sub-sections go on to discuss the various issues that emerge on switching cover types.

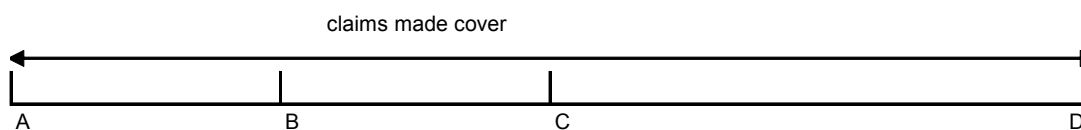
Consider the following situations. Firstly, for someone who is exposed to risk from time A to D and has claims-made coverage from time B to C. Assuming the retroactive date is at time B, then there needs to be some form of coverage for times A to B and C to D. Whether the insured had claims occurring cover, or has to purchase prior events cover or tail cover is trivial here. The key issue is that there needs to be some form of cover from times A to D (incurred).

#### Claims made cover from time B to C



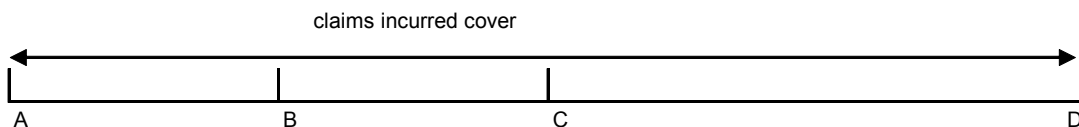
Further possible coverage scenarios are as follows:

#### Continuous claims made coverage



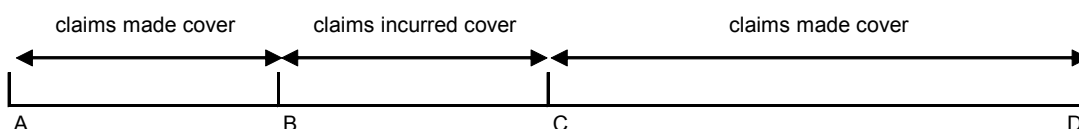
Under this scenario, coverage is provided for all incidents reported from time A to D. Tail cover needs to be sought for incidents reported after time D.

### Continuous claims incurred cover



All incidents are covered which occur from time A to D.

### A mixture of claims made and claims incurred cover



All incidents are covered during the period A to D, but some tail cover is needed for incidents reported after time D (but not for incidents occurring between B and C).

Many other combinations of cover are possible, but the principles are the same. The questions arises: what are the associated costs of each type of cover?

In theory, the costs associated with the two types of coverage should be equivalent, although the timing of the premium payments can vary significantly. In practice, the situation is not so clear.

New policy owners are not necessarily charged the true claims-made rate for their policy age, and are more-so charged a mature book rate. That is, they do not pay the lower initial premiums observed in the claims-made book start-up, and end up paying more overall for their cover. This is discussed further in Section 5.3.

## 5.2. The problems of switching

### 5.2.1 Switching claims-made insurers

The insured would need to purchase prior events cover to cover potential exposure to incidents occurring prior to the switch. This comes at a cost. The cost to the insured is higher than would be the case of continuing claims made insurance, in that they would need to purchase prior events cover, and the new premium in practice is higher than the true first year claims made premium.

This type of issue has recently been brought to light in the Australian medical indemnity industry. One of the major issues for doctors has been the Federal Government's "IBNR levy" to fund the cost of prior events following the closure of UMP to new business.

There may be market conditions, as per the example, which force such a switch upon the insured. In general the insured must weigh up the potential costs of the switch with any benefits to them before making it.

### **5.2.2 Claims occurring to claims-made**

This is a relatively simple switch. Cover is provided for all IBNR claims under the occurring policies (subject, of course, to insurer safety). The retroactive date under the claims-made cover would be the first date the claims-made policy was taken out.

### **5.2.3 Claims-made to claims occurring**

This is a slightly more complex proposition. Under the new claims occurring policy the policy owner is covered for all incidents occurring in the period of cover going forward.

However, there is an opportunity for claims to be reported which occurred during the period of claims-made coverage, and prior events cover needs to be purchased. This is similar to the situation described in Section 5.2.1, and prior event coverage would need to be sought.

### **5.2.4 Tail / IBNR cover**

When an insured retires (or similar) from their profession, and their insurance coverage was on a claims-made basis, they may be exposed to incidents reported after their retirement (which obviously occurred before their retirement). As such they will need to purchase cover for these potential claims. This is analogous to the previous section on switching from a claims-made policy – but with no replacement policy.

The following table shows, for various portfolio ages, the ratio of the cost of tail cover to the cost of the latest year's claims-made premium for our indicative portfolio. As can be seen, the costs throughout the policyholder's life may be lower than under a claims occurring basis, but the final cost of retro cover can be a significant cost burden to the insured.

**Ratio of retro-cover premium to last year's claims-made premium**

Year	Retro Prem as % Last yrs RP
1	483%
2	463%
3	519%
4	498%
5	512%
6	528%
7	531%
8	516%
9	476%
10	418%

Essentially this means that the premium for tail cover is about 5 times that of the last year claims-made premium for this portfolio. This would be a similar ratio for any of the switches out of claims-made described in this section (and in some of those sections, an additional premium for the next year's cover is required on top of this).

**5.3. Premiums paid for cover**

As mentioned in Section 5.1, the insured is rarely charged the true claims-made risk premium in the early years of their policy, and more towards a mature book rate. Using our indicative portfolio, and assuming it is mature at 10 years, this means that insureds can pay around 10%-20% more than under a claims occurring basis.

Similarly, for an insured who switches coverage type every few years, these costs can multiply.

**5.4. Summary**

From the above sections, on a pure cost basis, it is difficult to see the benefits of claims-made insurance from the insured's perspective.

It can be more expensive for an insured with continuous claims-made cover, and then even more expensive for an insured who changes insurers or coverage types with any frequency.

It should be remembered that sometimes the insured may not have the choice of whether to switch coverage or insurers.

## 6. Reinsurance issues

Reinsurance is required for any portfolio as protection from large claims and risk accumulation. One of the key aspects of a reinsurance program is that the reinsurance actually protects the underlying portfolio. Of relevance to the present situation is that there are no coverage gaps in terms of reinsuring a claims-made portfolio on the same terms as the direct risk.

Problems emerge if the direct insurance is provided on a claims-made basis, yet the reinsurance is provided on an occurring basis or vice versa. This issue has emerged recently in Australia in some liability classes where there has been an underwriting shift from claims-made to claims occurring bases. However, the reinsurance market has not completely responded to these changes and still offers coverage for these portfolios on a claims-made basis.

This scenario places the reinsurer at an advantage in that they can respond more quickly to pricing changes for the next year's premium, and indeed places the reinsurer – insurer relationship in a similar position to that of insurer – direct insured for the underlying contract.

It is self-evident that insurers of liability classes require the continuing support of reinsurers. However, the question is whether the form of the reinsurance cover should always determine the form of the direct cover. While this might be considered ideal, it need not be a necessary condition.

Any mismatch of cover will mean greater risk for the insurer, and hence the need for more capital than would otherwise be the case.

In the illustration in Section 4.6 above an insurer writing claims occurring cover, but reinsured only on a claims-made basis, would have only around 40% of its liability protected by reinsurance.

Protection of the IBNR component would depend upon the payment of future reinsurance premiums.

The availability of reinsurance on a claims-made basis is clearly a discouragement for insurers wishing to offer claims occurring cover.



## 7. The new legislation

As noted earlier claims-made cover in Australia is restricted to the PI, D&O and medical indemnity classes.

Until recently none of these classes were subject to statutory restrictions, with the eligibility for claim and subsequent quantum of claim determined entirely within the common law environment. Indeed, this would have been one of the factors which determined that claims-made cover only would be offered by insurers.

This situation is now changing.

In the case of medical indemnity insurance, which covers personal injuries resulting from negligence of medical practitioners, legislation has been enacted in all Australian jurisdictions in the past two years which is intended to significantly affect the eligibility to claim and the quantum of claim.

While the legislation varies by jurisdiction, it generally includes, inter alia:

- Changes which mean that practitioners who have behaved in a manner generally accepted by their peers cannot be said to be negligent
- Limitations on the maximum period for notification of a claim
- Caps on general damages (GD)
- Thresholds for access to GD
- Reduced GD awards at the lower levels
- Increases in discount rates for assessing future economic loss
- Restrictions on legal costs.

The intention of the changes is to reduce the numbers of successful claims, and to reduce the amounts for those claims which are successful.

While the success of the changes cannot be assured, it seems clear that medical indemnity is a much more insurable risk than previously. Certainly in the immediate future, we would expect lower levels of superimposed inflation.

Indeed, the changes go a long way to bringing medical indemnity insurance into line with workers compensation and CTP insurance, which are offered on a claims occurring basis.

In the case of PI and D&O, there is also legislation in the offering, in particular the introduction of proportionate liability replacing “joint and several”. This would be expected to reduce average claim sizes for individual insurers.

In summary, the environment for classes now offered on a claims-made basis has changed significantly, such that the risks for insurers has reduced.

## 8. Conclusions

This paper has presented a limited analysis of some of the features of claims-made policies.

One of the main reasons that claims-made cover has been offered in some liability classes is the perception that it limits the risk for insurers. However it seems to us that the uncertainty in pricing claims-made cover is likely to be higher than under the more conventional claims occurring basis. For reserving it is not clear that the uncertainty is less under claims-made cover.

These views are strengthened following the recent legislative changes which will reduce the relative risk for claims occurring cover.

However, the need for significantly higher relative reserves and hence capital under claims occurring still remains. This, together with the lack of availability of reinsurance protection under claims occurring is a strong disincentive for insurers.

Notwithstanding this, the disadvantages of claims-made cover for insureds has been brought into sharp focus with the need to fund the IBNR of UMP. Governments are applying pressure to insurers to forsake claims-made cover, and still awaits the outcome of the review of Section 54 of the Insurance Contracts Act.

In this environment, it may be that insurers will, albeit reluctantly, agree to write all liability classes on a claims occurring basis. This will result in transitional funding issues and the need for more capital, which insurers will not find attractive.

## 9. References

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