The real bottom line

Britt Newhouse looks at the real costs involved for (re)insurers when it comes to paying claims.

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In 2004, managers of ceding companies around the globe are expected to cede approximately $140bn of premiums to their reinsurers. For this rather large sum, they expect access to capacity, increased stability in their results, and an improvement in their financial strength, all of which will translate into support for their profitability and current financial ratings. Assuming a loss ratio of 80%, cedants will recover about $112bn for claims submitted to their reinsurers. Given these benefits, they should expect greater peace of mind and the ability to sleep more soundly at night.

In recent years, chief executives have had a few restless nights due to concerns about trends in reinsurance recoverables that have drawn increasing attention to reinsurance security and the prompt payment of claims.

The stream of calamities suffered by reinsurers in recent years, from unprecedented adverse development on prior year loss reserves for long-tail lines, to the terrorist attack of 11 September 2001, to the global stock market meltdown, has weakened the finances of practically all reinsurers and driven several to the sidelines.

The financial difficulties experienced by reinsurers have given rise to two major concerns for cedents. First, will reinsurers survive to pay the claim bill presented to them by cedants? This is usually referred to as the 'ability-to-pay' issue. Second, will reinsurers be prompt or tardy in their payment of claims? This is usually described as the 'willingness-to-pay' issue.

Willingness-to-pay

In terms of willingness-to-pay, the internal review of claims-paying patterns at Guy Carpenter reveals three distinct patterns. First, standard claims show no major change in payment patterns. In fact, there is evidence of a speed-up in the payment process in recent years, in part because of efficiencies in the claims payment practices achieved through improved technology and better business practices. We can also thank improved contract language, which is far more detailed and specific than it has ever been. The industry has been forced by poor results to rely less on good faith and more on sound, analytically-based placements, which are documented quickly and accurately.

Another pattern is that complex claims are taking longer to resolve. In the past, reinsurance contracts were often viewed as 'friendly' agreements, and rarely resulted in public disputes. More recently, primarily because of the large amounts that are at stake, more disputes, whether in arbitration forums or in courtrooms, involve the trappings of not-so-friendly legal proceedings, involving depositions, evidence collection and expert testimony. The inevitable result: protracted claims resolutions. Additionally, reinsurers want to ensure that their claims payments will be honoured by their retrocessional partners, who are also giving more scrutiny to loss submissions.

And then there is the payment of claims by run-off reinsurers. The proportion of total reinsurance recoverables from this sector has increased dramatically over the last decade. Claim payments from reinsurers in run-off tend to show a longer pattern of payout for a number of reasons.

First, reinsurers in run-off were often involved in long-tail business, where claims development is slow and claims come due further from the time when the reinsurer was active. Complex claims are also more likely to be subject to the most aggressive legal interpretations by plaintiffs' attorneys.

Second, regulators in many jurisdictions generally show more patience with regard to protracted negotiations, preferring to see more people paid a higher percentage later than support a more immediate settlement discounted at present value.

And, finally, an active reinsurer wants to retain and expand its customer base and, therefore, has a strong incentive to provide a satisfactory claims service to its clients. This incentive rarely exists for managers of run-off companies, unless they have other active (re)insurance businesses.

Settlement trends

A viable approach to combat the run-off reinsurer syndrome is commutation. We have noted a trend towards final settlement of claims, notably with Equitas, the Lloyd's run-off vehicle. This year, Equitas has announced settlements with three major entities totalling $1.3bn. This has led to increased interest among cedants in negotiating such settlements, particularly when they can demonstrate to rating agencies and analysts that they are aggressively managing this area of the balance sheet. Ceding companies must weigh the value of settling for a negotiated amount against the possibility of waiting too long to get into the game.

We view the role of the broker as important in helping clients better manage their reinsurance claims issues. As intermediaries, we have a unique vantage point in the industry, with broad, global relationships and access to unique data that may be used as performance measures.

There are clearly many problems to be resolved in the reinsurance claims arena. We believe, however, with the improved finances of the reinsurance industry and the use of newly developed benchmarking tools on claims payment performance, we can look to a future of reduced concern and fewer sleepless nights for the managers of primary insurers.

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