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Claims Inflation: Lloyd's Thematic Review

Claims inflation

Lloyd's claims inflation oversight activity

- Impact of inflation on insurance claims is in focus due to trends like social inflation causing higher uncertainty around forecasting
- Price inflation indices are only one piece of the puzzle – claims inflation is also driven by other factors such as court awards and changes in technology, healthcare and the social and legal environment causing "excess" inflation
- Lloyd's Market Oversight Plan for 2021 included a thematic review of social inflation. The capital workstream has completed its work and published a report on Lloyds.com, while work underpinning the reserving and underwriting workstreams has begun and is planned to be shared with the market in 2022
- In the following slides we highlight some of our findings from the capital workstream
- We have included outputs from a survey sent to the Committee of Actuaries in the London Market group (CALM) and completed by 38 unique managing agents (which broadly represent the make-up of the Lloyd's market)

Claims inflation

Our definition

Claims inflation

Change in expected claims cost level of a like for like policy over time, where like for like means having consistent policy terms, coverage and exposure. This includes impacts from both severity and frequency effects.

Pure inflation

Change in average price of goods and services related to a basket of representative claims, due to changes in price level and / or utilisation. This includes, for example, labour, energy, construction and care costs. Pure inflation in claim costs is equivalent to general economic inflation.

Excess inflation

Ways in which claim costs rise above general economic inflation. It captures, for example, growth in costs associated with emerging risk from new materials, medicines and technologies, changes in the legal environment and social attitudes. The spread between pure inflation and the full extent of claims inflation from the additional cost drivers is excess inflation

Social inflation

Change in claim costs over and above pure inflation resulting from increasing litigation, broader definitions of liability (excluding those caused by changes in policy terms and conditions), more plaintiff-friendly legal decisions and larger compensatory jury awards

Claims inflation

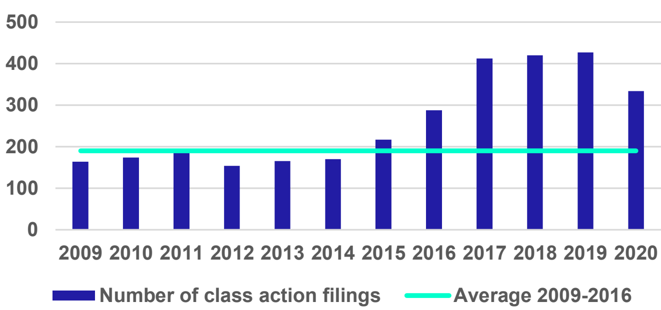
Social inflation – emerging trend or old news?

#BlackLivesMatter

Johnson & Johnson pays $230m to settle New York opioids case

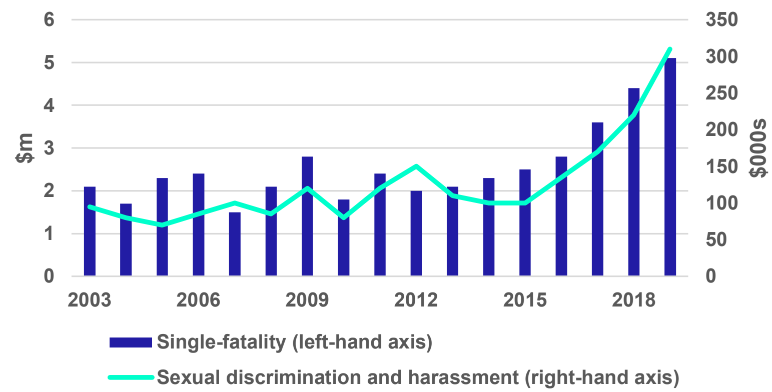
The Guardian

No. of securities class actions filed in the US (Cornerstone Research)



#MeToo

Median cost of single-fatality and discrimination cases (Advisen)



4.12.2020 EN Official Journal of the European Union L 409/1

DIRECTIVE (EU) 2020/1828 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 25 November 2020

on representative actions for the protection of the collective interests of consumers and repealing Directive 2009/22/EC

FINANCIAL TIMES

Insurers face extra $15bn asbestos bill

Claims on historic policies 'show no sign of abating', study finds

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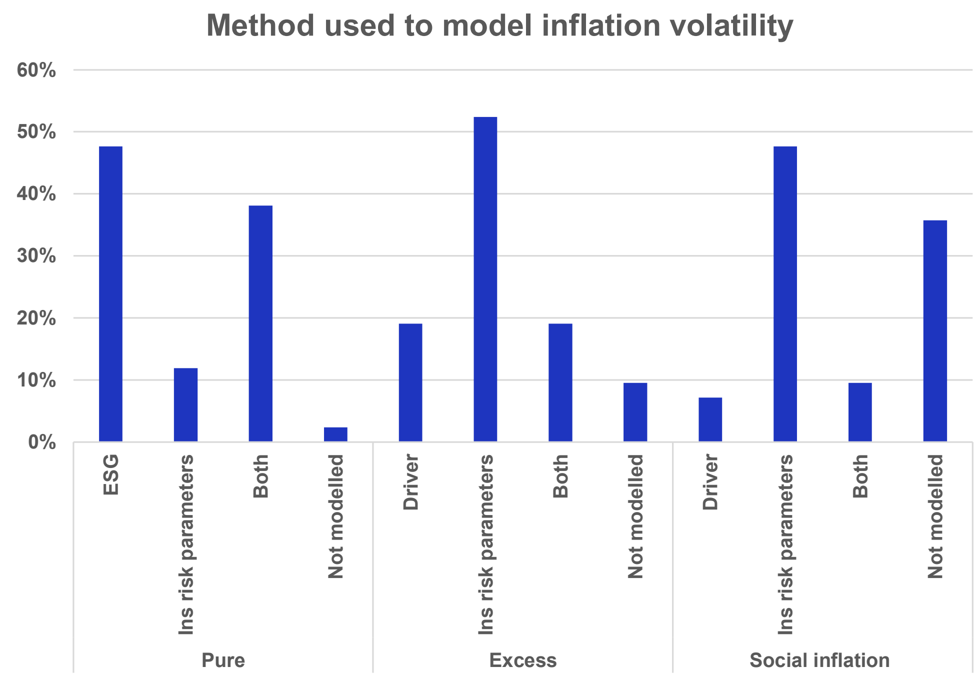
Finding: Excess inflation assumptions tend to be implicit



Key for the chart:

- ESG: Inflation volatility taken from an external vendor ESG model (typically price, wage and medical indices by currency are used)
- Ins risk parameters: Adjust insurance risk parameters (e.g. dependency and/or volatility parameters) to include an allowance for inflation - often done in a way that makes it difficult to quantify the impact to capital
- Driver: Apply explicit inflation scenarios in the model to mimic real world events – this enables quantification of inflation risk

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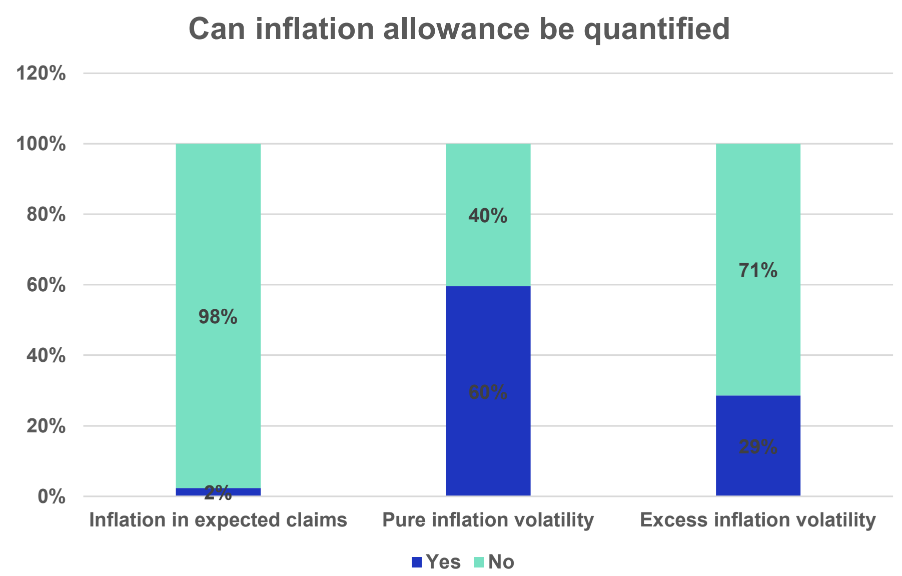
Claims inflation

Finding: Excess inflation assumptions tend to be implicit

Challenges

- Stripping inflation effects out of claims data is onerous and potentially spurious, therefore assessing what the right volatility assumptions should be is difficult
- Informing senior risk management about the potential outcomes from changes in the external environment
- More difficult for validators and external parties (e.g. regulators) to get comfortable with how much risk is being modelled
- Inflation is a driver of dependency in capital models but can't be quantified as such when it's embedded in the data and model parameters



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Finding: Excess inflation assumptions tend to be implicit

Good practice approaches

- Let scenario analysis inform the parameterisation - develop inflation specific scenarios for long-tailed classes with input from underwriters and other areas of the business. Get their input to establish potential loss outcomes and the likelihood of these outcomes
- Make more allowances in insurance risk parameters explicit - a lot of syndicates use a ‘scoring’ system to establish correlation between pairs of risk. Set this up so the impact of scores on correlation and capital can be isolated
- Adjusting ESG indices to align volatility to internal views – we’ve seen syndicates manually adjust ESG indices with the help of their investment teams, as well as parameterise their own inflation indices to overlay the ESG
- Build explicit scenarios and shocks in the model to mimic real world events like hyper-inflation or large claim settlement events which simultaneously impact multiple cohorts of business

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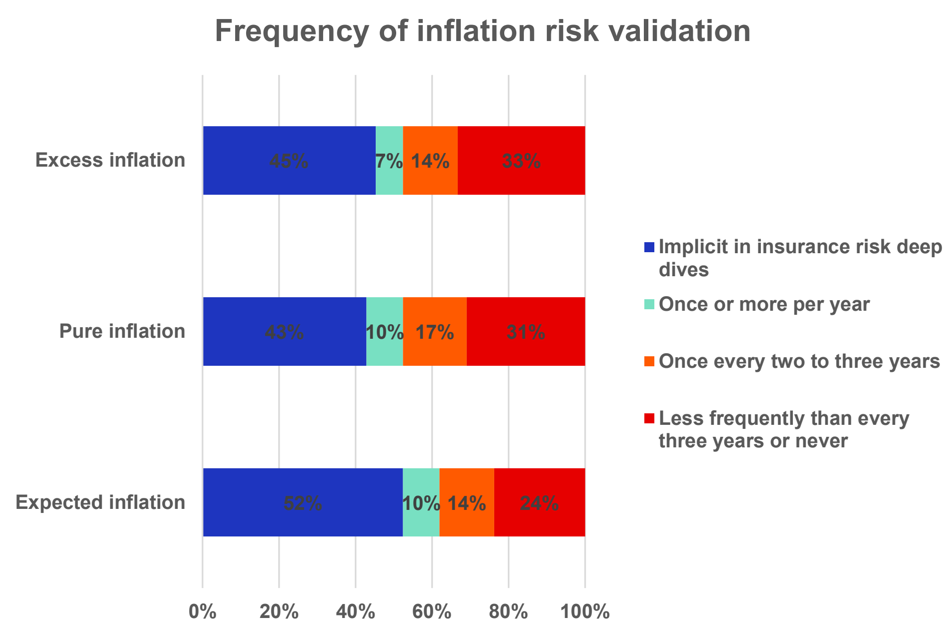
Finding: Excess inflation assumptions are not challenged enough

Challenges

- Limited explicit outputs and parameters to validate
- Detailed and specific validation of inflation risk is not common and detailed testing we have seen is focused on ESG inflation
- Testing collected by Lloyd's suggests that excess inflation volatility does not materially impact many syndicate models (although results are affected by limitations in being able to isolate the impact)

Good practice approaches

- Consider how material the risk is for the syndicate and whether the validation approach is commensurate, plan a deep dive if needed
- Challenge capital modellers more to improve availability of outputs for validation
- Make greater use of stress and scenario tests, reverse stress tests and type 2 sensitivity tests, which are inflation specific



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Other findings

Syndicates can be reactive to emerging trends

- Make use of internal working groups and knowledge from the risk management function - can be easier for larger syndicates or those linked in to big organisations that potentially have more resources, initiatives and internal experts
- Make more use of internal data such as claim watchlists and knowledge about the development of litigation outcomes
- Smaller organisations may need to rely more on external data and research, but there is a lot of information available publicly (e.g. ISO, CPI and wage data, CIAB, consultancies and brokers)
- Actuaries often rely on methodologies that project past trends into the future, these aren't always appropriate and thinking about alternative outcomes and ranges of estimates is important for risks when data is sparse

Consistency between teams could be enhanced

- Views between pricing, planning, claims, reserving and capital don't need to be the same but from our work we saw a limited number of capital teams demonstrate that they consider other internal views. Sharing of information and discussion around judgements will help to enrich the assumption setting process
- This is a theme that the PRA identified with respect to how loss ratio assumptions can be underestimated compared to the views of inflation from claims teams
- Some syndicates use inflation frameworks that collate internal views of inflation and trends for key lines of business, and these link into capital model parameterisation
- Work closely with other teams to improve quality and granularity of data (e.g. develop more granular data triangles that can help with analyses) – start small and pick material exposures

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