

The Art of determining the Reserve for a Complex Loss

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Often the first question from an Insurer or an Insured when faced with a catastrophic loss is – how much? Whilst ostensibly a simple question to ask, the nature of the response very much depends on the available information and the experience of a skilled adjuster familiar with the business that has suffered the loss. There is usually no singular ‘right’ answer and often the ‘best’ answer is a hybrid approach.

Insurers are required by regulators to set aside suitable reserves to pay claims. It is therefore important that realistic estimates are placed in front of Insurers at an early time such that they can account for the potential losses, and importantly confirm that they hold suitable levels of cash such that they demonstrate solvency. Significant and unexpected changes in Reserves can cause major issues for Insurers.

At the outset of a major loss there is often very little information available as the Insured prioritises issues including making the affected site safe, personal injury to staff, mitigation of the incident, media and stock exchange releases, responding to regulators and so on. There are however certain approaches that can be taken to predict the range of a loss and this article explores what these are and the potential associated pitfalls with each.



Examples of Complex Loss

The following is focussed on individual major losses rather than how an Insurer might reserve for catastrophic and widespread events such as cyclones / hurricanes affecting a large number of risks.

Typical industrial losses where CTA is involved in determining Potential Exposures include:

- Property damage – Significant fires
- Machinery breakdown – Turbine, generator, and transformer failures
- Construction risks with or without DSU – LNG Projects
- Operating loss with BI – Open pit or underground mine sites or related processing trains
- Liability loss – third party property of every kind and description

Each of the above loss scenarios may require consideration of nuances specific to the risk. To illustrate these nuances the following examples will explore factors that might be involved when considering Reserves and how CTA Adjusters look to ensure a realistic estimate calculation.

Property damage – large fire



Where a fire completely destroys the Insured property much of the cost determination can be retrospective. Items that feed into determining the reserve could include:

- Declared values
- Recent valuations
- Original build costs (if the property is relatively new)
- Rebuild estimates
- Recent inventory data
- Experience of the adjuster (if an urgent indication is required and data is scarce)

Once an early estimate is determined then further estimation efforts through the use of quantity surveyors or builders might be considered subject to Insurer's need for accuracy. CTA Adjusters not only utilise experience to determine early projections but they are well versed in managing consultants in the estimation exercise.

LNG Construction

– CAR Policy



Losses involving complex industrial construction risks may utilise the following information when setting reserves:

- Original Purchase Orders
- Invoices for materials
- Details of contractor labour rates
- Specification of the involved equipment
- Detailed understanding of the installation procedure

Both onshore and offshore LNG construction claims tend to be technically complex. CTA Adjusters often work closely with the Insured to extract necessary cost data such that the estimates can be refined during the course of the claim. It is often not possible or practical to formulate estimates for such losses using external consultants because of the sheer size and complexity of the assets involved, and to this end it is more a matter of working closely with the Insured to determine the exposure.

Machinery breakdown

– turbine

When turbines fail the damage can be innocuous (blade chips) or catastrophic (bent shaft). In considering the reserve for the reinstatement of such machines the following may come into focus:

- Extent of Damage and reparability
The Original Equipment Manufacturer (OEM) view may differ to external third party specialist contractors.
- Supplier inspections and manufacturing availability. There is often a limited number of workshops which can actually undertake repairs and/or manufacturing.
- Will Business Interruption drive reinstatement schedule? How can the schedule be reduced cost effectively?

The estimation of turbine losses often requires detailed cost data from the manufacturer. CTA Adjusters experienced with rotating equipment and power generation can often obtain useful cost data from OEM's via our contacts in the industry.

Operating Loss – Business Interruption at a mine



Mine losses are notoriously difficult to reserve for as the operations are subject to forecast mine plans, operating variables, the Insured's expectations that are projected to shareholders, location and scale. Nonetheless Insurers wish to know how much and quickly. Typically things to consider when setting early reserves can include:

- Historical production – track record leading up to the loss
- Likely reinstatement schedule – is the scope of reinstatement understood?
- Forecast sales / mine plans – what was planned had the loss not occurred and how 'optimistic' are these forecasts?
- Alternative sources or means of production – can alternative operations increase output?
- Commodity price fluctuation
- Declared values

Mining business interruption quantification is often adversarial given the many inputs and assumptions that can be placed into loss models. The propensity for two parties (the Insured and Insurers) to determine different positions on quantum is a regular occurrence; the Insured is often keen to model what optimistically "could" have occurred rather than using the historical data showing what conservatively "would" have occurred. Thus the main effort which CTA brings to the table in such matters can be early expectation management.

Reserving approaches

These examples shed light on why reserving for claims at the onset of a complex loss is highly dependent upon the experience of the adjuster within the particular industry. Generally speaking there is no 'wrong' approach, however the key to accurate reserving such that fluctuations are minimised is always dependent on the quality of the information available, understanding how to interpret it in the context of the insurance cover available, and identifying those items which may be at risk of change during the claim lifecycle.

Once an indication of the incident value or range is established then the likely policy response can be overlaid onto it to establish the reserve.

In practice there are pitfalls and Insurer preferences when it comes to establishing reserves. One thing for sure is that if Reserves substantially increase during the course of a claim, because the adjuster 'missed something', they are likely to receive some frank feedback from Insurers!

Typical pitfalls

There are a number of factors which can lead to under or over reserving losses including:

1. The age of the data. A building valuation which is 5 years old may be too remote to the current market costs.
2. Incomplete damage assessment. If not all damage is confirmed, then it is likely that any estimate of repairs will be understated.
3. A lack of understanding of the equipment. If the machinery is bespoke or uses exotic materials that need to be sourced from overseas, then costs can easily escalate.
4. What is the real business loss every week? If a good understanding of the business interruption potential is to hand then decisions around reinstatement options can be made where savings can be achieved and claim leakage avoided. If the 'real' loss is under or overstated this can lead to incorrect policy application or guidance given to the Insured in respect of Increased Costs of Working.
5. Policy interpretation. If an exclusion is considered not relevant or a matter considered 'damage' when in fact it is a 'defect' then the loss estimate could vary wildly.

The above is not an exhaustive list but is indicative of why reserving can be difficult.

What to advise?



Often an adjuster might be confronted with a few reserving options dependent on the confidence in the information available. Insurers could be advised for example of the following options:

1. Refrain from raising a reserve until more accurate data is available.
2. A clear estimate could be provided if the assets requiring repair or replacement are well understood; or
3. If there are some aspects of cost which could fluctuate then a 'range' of estimates may be appropriate i.e. best and worst case estimates.

Important in all advices to Insurers is that a full explanation of the assumptions and data that are used in the reserve is explained. In this way the Insurers can make some judgement as to how they may reserve for the claim. Insurers, like most people, do not like surprises and to this end the more information that is provided around the reserve estimate calculation, the better.

Hiccups

Whilst adjusters try their best to establish a sound reserve estimate or range, from time to time developments in claims occur which are beyond the control of the adjuster. Typical examples of such developments include:

1. Discovery of new damage – typically costs will go up!
2. Difficulty in repairs which were not envisioned i.e. materials being obsolete
3. Suppliers not meeting their proposed schedules – this can impact business interruption claims in particular.
4. Mitigation works may be better than expected i.e. water removal was successful and mould avoided.
5. Government intervention can make for interesting challenges i.e. a site is deemed 'unsafe' and access is prevented.
6. Commodity price changes can lead to arguments regarding the value of a BI claim.

The list can go on.

Conclusion

The reserving exercise is not only an effort to assign a dollar value to an Insurance claim; it can also be a task of expectation management. It can be an art but with effort and experience it may better be described as a science.

Information quality and an understanding of what the information represents is key. An experienced adjuster who is familiar with the industrial assets and business involved can be invaluable in ascertaining a sound reserve advice.

CTA has been involved with many losses over the years involving large power generation equipment failures, mining, construction with DSU and energy property. Often the larger component of these losses can be the business interruption element. In understanding the business CTA is able to more often than not provide Insurers the early quantum insight that they crave.

About Us

CTA is one of the leading loss adjusting businesses in the market. We provide loss adjusting services across energy, marine, aviation, property, casualty and special risks along with average adjusting services for ship owners. The business primarily focuses on larger and more complex commercial losses arising from major insured incidents and claims. CTA is a business of Charles Taylor Plc (www.ctplc.com) which is quoted on the London Stock Exchange (CTR).

Charles Taylor plc is a leading provider of professional services to clients across the global insurance market. The Group has been providing services since 1884 and today employs over 2,100 staff in 107 locations spread across 29 countries in the UK, the Americas, Asia Pacific, Europe the Middle East and Africa.

The Group offers services, principally on a fee-based model and operates through three businesses – Management, Adjusting and Insurance Support Services. It also owns insurers in run-off. Charles Taylor's vision is to become the professional services provider of choice to the global insurance market.

CTA Expertise

CTA has qualified engineers on staff throughout all Australian offices with diverse backgrounds ranging from “big picture” Project Engineering / Construction right through to detailed design work. Our Engineering Adjusters hold Adjusting qualifications and are members of the Australian Institute of Chartered Loss Adjusters (AILCA), the Australian & New Zealand Institute of Insurance and Finance (ANZIIF), or other UK-based professional bodies of equivalent or higher standards.

We ensure outcomes are concisely reported to Insurers to match their requirements in documenting the circumstances of the loss in a clear and logical manner, allowing them to reach a conclusion in respect to policy response.



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