Claims-Made vs. Occurrence CGL Policies

Recognizing the Potential Hidden Costs When Making a Purchasing Decision

Abstract: In a VU "Ask an Expert" question, an agent advised that his state had enacted legislation requiring licensed contractors to carry liability insurance. CGL premiums for small contractors from his markets range from about $4,000 to $6,000. However, some agents are aggressively marketing claims-made CGL policies for only $1,500. The question is, "Which policy — occurrence or claims-made — is the better value?"

Occasionally an insured is faced with the decision of whether to purchase a claims-made policy or the more traditional occurrence form. There ARE legitimate reasons why an insured might prefer a claims-made vs. occurrence policy. For example, with "long tail" exposures where there might be a lengthy period of time between occurrence and claim such as in medical malpractice insurance, the claims-made policy might be the superior approach.

The reason for this is that, if an occurrence policy was in force, the insured must go back possibly decades to the time of the occurrence in order to file a claim. The insured may not have a copy of the policy or even remember who his agent or company was years ago. It's also possible that, even if the carrier is identified, it might be out of business. If not, how likely are the limits on a decades-old policy to be close to the limits the insured probably carries today?

However, for most insureds under most claims scenarios, there is not much of a lag in time between an occurrence that causes BI or PD and the claim or suit that arises from the person harmed by the occurrence. For that reason, most insureds are better off with an occurrence form even though the claims-made form may be significantly less expensive when both are presented as part of one or more insurance proposals.

The reason for this is that an occurrence policy covers only occurrences that take place between the inception and expiration dates of the policy, though claims are covered forever into the future. In contrast, the claims-made policy covers occurrences that take place between the retroactive date and expiration date of the policy, but only for claims made prior to the expiration date of the policy or shortly thereafter.

When the claims-made policy becomes effective, the retroactive date is typically the same date as the effective date. However, with each policy renewal, the retroactive date remains the same. That means that the current claims-made policy is now picking up occurrences going back several years. This increases the insurer's potential liability and, thus, the cost.

Below is a chart, for example purposes only, that shows how an occurrence premium can remain relatively stable while the claim-made premium increases significantly until, typically within 3-5 years, it is about the same as the occurrence policy premium. At that point, the insured may be ready to go back to an occurrence form, but he discovers the need to purchase something called an Extended Reporting Period endorsement.
Note that, within about five years, the claims-made premium is about the same as the occurrence premium. In some cases this can happen even quicker. Keep in mind, too, that if the insurer nonrenews, the insured retires or dissolves the business, or decides to switch back to an occurrence policy or a claims-made policy from another insurer, he will need to purchase an Extended Reporting Period (ERP) endorsement. Otherwise, he will not be covered for any claims made beyond the policy expiration date for occurrences that take place prior to that date.

Typically, the insurer can (and often will) charge up to 200% of the premium of the expiring policy. If that happens, in the example above, you can see that the effective premium for the fifth year is not $9,500, but rather $28,500 ($9,500 + $19,000). That cost is about double his entire savings for the prior four years. That claims-made policy looked awful good when it was offered at a 70% discount over the occurrence form, but would the insured have made that decision if he knew his $3,000 premium would balloon to $28,500 in five years or less?

However, there is one more step to the process and that’s determining the net present value of the future premium payments, including the balloon payment. The following calculation was performed by Jerry Trupin to demonstrate that, in the unique example above, the claims-made policy, from a premium standpoint, is still a slightly superior value:

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Tail End Yr 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claims Made Premium</td>
<td>$3,000</td>
<td>$5,500</td>
<td>$8,000</td>
<td>$9,000</td>
<td>$9,500</td>
</tr>
<tr>
<td>Occurrence Premium</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$19,000</td>
</tr>
<tr>
<td>NPV 2 thru 5</td>
<td>$36,660</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Add Yr 1</td>
<td>$39,658</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ERP Cost</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Chart: The Illusionary and Transitory Savings of a Claims-Made Policy Over an Occurrence Policy
Source: Vic McCarley, CIC, Alabama Independent Agents Association
Needless to say, the numbers above can change depending on the length of time it takes for the claims-made premium to catch up with the occurrence premium, the actual premiums charged, price increases, etc. Given different numbers and projections, the occurrence form could be the better financial value. At best, the analysis is a potentially complicated guessing game.

Copyright 2006 by the Independent Insurance Agents & Brokers of America, Inc. All rights reserved.

For guidelines on reprinting this article, go to http://www.iiaba.net/VU/Lib/ArticleReprints.htm.

NOTE: Policy coverages and circumstances can change at any time, so the information above may not be accurate at the time of reprinting or subsequently to that time. IIABA does not assume and has no responsibility for liability or damage which may result from the use of any of this information. The most current, up to date version of this article can be found at IIABA’s Virtual University at http://www.iiaba.net/VU.