Safety initiatives can lead to financial forecasting errors

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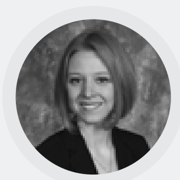

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A popular adage in the risk management world is "the best claim is no claim at all." Lockton observes our clients, as well as others in the insurance industry, working diligently to avoid workers' compensation, general liability and auto liability claims to achieve the best results. However, to achieve maximum results, you will need to do more than reduce the amount spent on claims.

When safety or claim management initiatives are implemented, it is imperative to communicate these fully to actuarial or financial partners. The financial estimates need to be adjusted appropriately for the changes.

Let's imagine three scenarios of effective safety initiatives:

1. ACROSS-THE-BOARD INITIATIVE: Avoid all types of claims equally.
2. TARGETED INITIATIVE: Avoid the most plentiful type(s) of claim.
3. TARGETED INITIATIVE: Avoid the costliest claims.

The first situation may not lead to forecasting errors, but the other two — without appropriate communication — can be detrimental to a company's forecasting abilities and lead to suboptimal decisions. Let's explore how this happens.

Scenario 1

In theory, an across-the-board safety initiative translates to an easy scale down of loss potential, allowing typical forecasting methods to be unaffected. If this is the case, extra communication may not be necessary. In practice, this blanket approach is difficult and not frequently achieved.

Improvements in technology are allowing companies to become more sophisticated in their risk management practices. The increase in available data is driving companies to use targeted initiatives to reduce claims.

Scenario 2

The most frequent claims in a workers' compensation program are small, routine losses. These losses have the potential to become large claims but don't add much cost to the company. When safety managers are given an incentive to reduce claim counts, they may be drawn to these more prevalent claims.

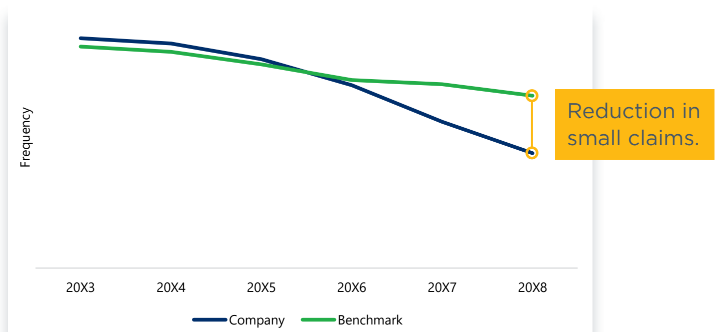
PREVALENT CAUSES THAT DRIVE DISPROPORTIONATELY LOW INCURRED LOSS

Cause description	% claims	% net incurred
Struck by	22%	16%
Miscellaneous causes	14%	9%
Cut/puncture	10%	2%

Targeting reduction of small-dollar claims can result in underestimating financial forecasts if not communicated properly.

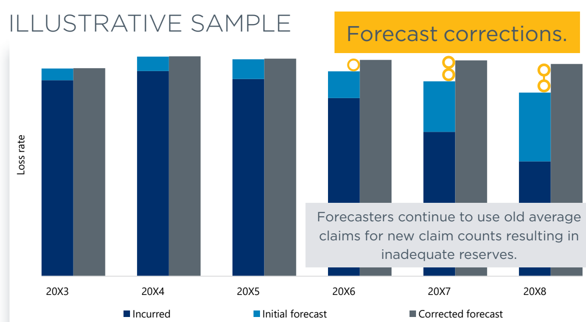
Taking care of this low-hanging fruit can provide quick improvements and appears to be a boon to the company when looking at percentage improvement in frequency. However, this type of initiative doesn't always result in a significant impact on total cost in the typical forecasting process.

ILLUSTRATIVE SAMPLE



By removing these smaller claims, the distribution of what's left leans toward costlier claims that typically have greater potential for development and escalation. Without full disclosure about the changes to forecasting partners, they may see lower counts and continue to use historical development factors or benchmark factors. These historical factors have the less adverse mix of claims represented in them, making them inappropriate for the new environment. Applying these factors will bias the forecast low.

ILLUSTRATIVE SAMPLE



This forecasting error is typically discovered as ultimate cost estimates slowly creep up over time above the initial forecast. The higher corrected forecast adjusts for the change in the mix of claim types.

Scenario 3

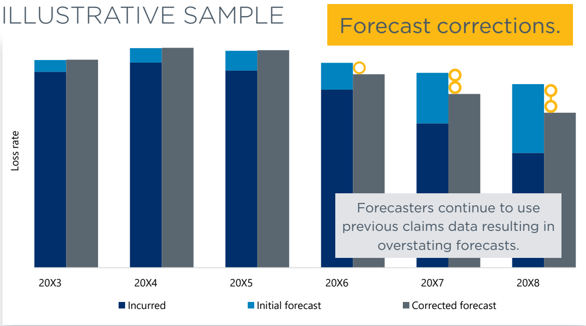
This represents an opposite situation from the previous scenario. In this instance, a company targets only the costliest claims. Impact on frequency can be minimal, and impact on severity is nearly impossible to see in the short term.

In this case, the company would see forecasts biased high. However, as policy years close out, the incurred experience is favorable to original estimates.

While coming in under budget may seem like a favorable situation, it can still cause risk management issues. Higher forecasts:

1. May cause over-investing in additional safety initiatives, understating the company's return on investment.
2. Can mean loss reserves are inflated on the balance sheet, reducing the company's net equity.
3. Lead to insurers overstating collateral needs and potentially increasing premiums that can't be recaptured.

ILLUSTRATIVE SAMPLE



Targeting reduction of most costly claims can result in overstating financial forecasts if not communicated properly.

In both targeted safety initiative scenarios, avoid forecasting errors by communicating the initiatives to the forecasters. Then they can modify their methodology to adjust for the shifting mix of risk. Safety associates, risk managers and actuaries often have different backgrounds and may need help translating.

Risk manager or safety associate may say:	Actuaries need to know the impact on projections
We're divesting a manufacturing plant that accounts for an inordinate number of claims. We think that we'll be better off purchasing those parts from a supplier.	▪ Potential to reduce both frequency and severity.
Our employees have an unusual number of cuts and punctures. While they're almost never serious, we want to keep our workers safe. We've purchased new personal protective equipment, adjusted machinery guards and trained on refreshed safety procedures.	▪ Effort is likely to reduce most frequent claims. ▪ May have a minimal impact on total cost.
We've had some expensive back and shoulder injuries recently. We've just added new equipment to aid in lifts and have also trained employees on proper techniques.	▪ This may help reduce most costly claims. ▪ May have a minimal impact on frequency, but material impact on total cost.

Lockton's Analytics team works in both worlds and can help clients by being a translator in meetings with risk control, insurers and actuaries. This ensures that the story is relayed in a way that the forecasters will adjust appropriately for the change.

Implementing safety and claims management initiatives can provide employees with a safer workplace while reducing costs. However, communicating those initiatives to your forecasters and insurance broker will help you maximize those savings by setting aside the correct amount for collateral and loss reserves. With questions on claim forecasting, contact your Lockton team.

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