 RISK MANAGERS' FORUM

| By Sarah Warhaftig, J.D. |

CLAIM AUDITS—
A VALUE ADDED SERVICE

No matter how much of the risk the client is sharing, the claims audit is a critical function

Each year as commercial policy renewals are issued, many of our clients undergo premium/payroll audits. They assemble their payroll and tax information, and we often assist in making the audit as stress-free as possible. These audits have become fairly routine for commercial policyholders and their agents and brokers.

As the insured's representative, we should also be thinking about another type of audit—a claims audit. These audits are an often missed area of opportunity. While we spend the majority of our time taking programs to market and advising our clients on their best choices for policies and financial risk retention, it behooves us to examine if they are receiving prompt and effective claims management services in sustaining those financial goals. Whether a fully insured, deductible, or unbundled program, the quality of claims services provided and the cost effectiveness of second- and third-party settlements directly impact the insured's bottom line.

...The quality of claims services provided and the cost effectiveness of second- and third-party settlements directly impact the insured's bottom line.

Does the type of program make a difference? Let's take a look at the three types of programs and the claims settlement challenges of the adjuster.

In a **fully insured program,** the carrier has an incentive to settle claims effectively and in a timely manner. It is the carrier's money that is at risk, and we all know that claims, unlike fine wine, do not improve with time. Even so, the carrier's claims staff may not be capable of achieving those goals. Caseloads may be high, and skill levels uneven. Successful claims management depends on continuity of the handling claims representative, realistic reserving practices, effective investigation into liability, proper application of the statute and interpretation of contracts and indemnification agreements. It is important to know that your client's claims are receiving proper attention and management. Take the time to determine if this is being done. Claims payments affect loss costs and development factors, workers compensation experience modifiers, and IBNR (Insured But Not Reported) reserves. Overpaying claims eventually drives up premiums levels.

With a **deductible program** you are still dependent on the carrier's claims staff to ensure prompt and cost effective claims resolution. How much time and effort is the claims staff devoting to handling claims under the deductible if the insured is responsible to pay that portion of the claim? One of the reasons for a claims audit is to

 © Rough Notes Co., 2005

make sure that the adjuster is paying attention to costs under the deductible.

Even with a small deductible, frequency and "slippage" of just a few dollars can have a negative impact on the organization's balance sheet. Take, for example, a large auto fleet with 100 third-party claims per year. The client has elected a $5,000 per-occurrence third-party deductible. This is a modest amount, yet one sufficient to make a premium difference. If the average auto claim in the jurisdiction is $3,500, and the carrier's claim staff is consistently overpaying by $100 a claim, the insured will suffer an additional $10,000 in deductible payments by year-end. How do we catch that $100? In and of itself, it is not a lot of money. Can we catch it every time? Probably not. But by paying particular attention to loss runs, and by auditing the claim handler's performance, we can identify trends and establish the expectation of cost-effective claims resolution. The time to audit is long before policy expiration and presentation of the deductible billing.

In an **unbundled program,** the insured and agent have the greatest opportunity to audit claims. After all, it is the client's money that will be used to pay claims. Typically, the insured is also paying the third-party administrator's fees. Depending upon the fee arrangement, the incentive to close claims and work effectively may vary. If fees are based on a set fee per claim, or a guaranteed annual flat fee, the third-party administrator has every incentive to handle claims promptly and efficiently, thereby freeing employees for other work. In the unbundled program the third-party administrator's performance is a matter of fiduciary obligation to both the insured and any excess carrier. The claims dollars spent have a direct effect on the insured's bottom line.

Even if settlement authority is closely held and sparingly granted, reserving practices can affect perceived financial stability. Setting reserves too low can result in overstating a company's assets, which eventually results in unanticipated shortfalls. Setting reserves too high limits a company's ability to undertake new ventures and may affect its ability to obtain financing or, for a municipality, its bonding capacity.

Setting the stage

How does the prudent agent or broker set the stage for claims audits and, once established, how should they be conducted?

The time to establish expectations that audits will be done is during the quotation process or, at the very latest, at the time of sale. Granted, this is easier to do with high premium or large deductible and unbundled programs. However the question of claims audits should be raised. And phrasing is everything. I recommend the fact-finding approach, "How often may we schedule claims audits?" I present the issue as a given and not really subject to discussion.

Similarly, expressing the expectation of viewing claims data online and receiving monthly loss runs is not unreasonable. The idea is to be able to sit down with the claim handler, review the files, and come away with a shared goal and objective for the management of the client's losses. Be assertive and lobby for your client; you are now a broker acting as risk manager.

If your client's program involves a third-party administrator, request copies of their best practices or service standards before entering into the claims service agreement. Obtain any measurable performance data they use to determine employee competency. During the third-party administrator's presentation or interview process, confirm that you and your client will have access to online claims data including adjuster notes and reserve and payment information. Most third-party administrators or large independent adjusting firms can offer claims file access via the Internet. If you are working with a carrier or service provider where your firm has a significant book of business, leverage your position to obtain agreement.

Getting ready to audit

Make an appointment to conduct the audit on site at the claims service provider's location. This creates less interruption of operations and also

© Rough Notes Co., 2005

allows specific questions to be asked of the individual file handler or supervisor. To the extent possible, identify in advance the files for review. A review of all open files can be time consuming, and may not provide you with a comprehensive review. The goal is to select closed as well as open claims, and new claims as well as older developed claims. This will provide insight into the skill levels, abilities and work habits of the individual claims representatives, as well as the claims management philosophy of the claims service provider. Try to view a fair or representative sampling of each. Eight percent to 10% of annual claims is a good rule of thumb for accounts with high claims volume. If your client has 500 claims annually, an audit of 45 to 50 claims should be sufficient. If your client has 30 claims annually, and you have the time, audit them all.

Criteria: Which files should be audited?

Depending on the account, the service provider and your access to information, you can develop several criteria for selecting individual files for review. Some examples are:

- Claims in litigation
- Claims involving extraordinary injuries or damages
- Minor property damage claims open longer than 120 days
- Claims with high reserves or high reserve changes
- Claims that should be reported to the excess carrier
- Claims associated with a particular product or job site
- Claims that have had numerous claims representatives assigned to them

Standards of performance: What are we looking for?

Now that the claims that will be audited have been selected, what are we looking for?

If the third-party administrator or carrier has provided their claims handling guidelines or best practices, use these to develop your audit worksheet. If you are lucky enough to have negotiated client-specific handling instructions, use these. In the absence of either of these, industry standards and best practices are the rule. Most auditors are looking for the following competencies:

- Employee compliance with internal processes and service standards
- Quality of the claims technical work product
- Reserving practices
- Employee compliance with client specific service standards
- Employee statutory compliance
- Financial integrity
- Vendor management/cost control
- Carrier reporting requirements

Who should audit?

An audit is a formal process requiring specific claims, technical, and statutory knowledge. Carriers will often audit their own claims departments. Excess carriers will audit third-party administrators. Who should audit on behalf of your client? Most often it is an independent expert who provides these services. Depending on the extent of the audit and the number of files reviewed, prices can range from a few thousand dollars to tens of thousands of dollars. If your client is unable to hire an independent auditor and this is not a service offered by your firm, consider conducting a file review. This is a verbal process where first the physical file is reviewed, and then the adjuster explains the file activity and current status to you. Phrase your questions to the adjuster to elicit information on standards of performance and best practices areas. Ask to review the claim with the supervisor if you are uncertain about, or uncomfortable with, the responses.

Concluding and summarizing the process

Once the audit is completed, whether it be a formal or an informal process, it may take some time to analyze and synthesize the information obtained. If you conducted a file review, you don't need to be a statistician or to assign point values to each competency. Remember our goal: to identify trends and to ensure that the client is

© Rough Notes Co., 2005

receiving cost-effective claims management services. You and your client want to feel comfortable with your claims service provider and confident that claims are resolved appropriately. Your service provider will know that they are being evaluated and measured. It's a healthy relationship.

If your audit has revealed that all (or almost all) is as it should be, then have your client write a letter to that effect, thanking the claims service provider and complimenting the technical staff. If your audit has identified areas of opportunity for improvement, schedule a meeting with the service provider to review them. Sometimes this can be done at the conclusion of the audit visit; most often it is a follow-up meeting. At that meeting have ready a written summary of these areas and desired improvement.

If a formal audit was conducted, there will be a report to share. Refer to specific claims and allow the supervisor or claim representative to respond. This should be a positive meeting focused on improvement goals. The final step in either situation is to establish a target time frame for subsequent audit or review.

Whether you conduct a file review or an audit, you and your client will have established the expectation levels for future claims management, thus protecting assets. And you will have provided your client with another value-added service. ■

The author

Sarah Warhaftig is vice president of Cannon Cochran Management Service, Inc., a third-party administrator licensed in 38 states. She also serves as account manager for several municipal accounts. Sarah has over 25 years of experience in claims management, litigation management, and operations management. She is a national faculty member for the Certified Risk Managers (CRM) program. For more information on CRM, call 800-633-2165 or go to www.TheNationalAlliance.com.

© Rough Notes Co., 2005