Risk Managers Should Get Onboard with Independent Auditing of Claims
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Much has changed in the world of claims administration over the past twenty years. Consider that twenty years ago there were almost twice as many commercial insurance companies operating across the U.S. as there are today. Some of those former insurance operations closed their doors due to poor management and others were absorbed in the frenzy of merger and acquisition activity. Clearly there are fewer commercial insurance carriers handling more business with less claims staff than was the case two decades ago. Twenty years ago, we only had "independent adjusters;" now we have third party administrators (better known by the acronym "TPAs")." Twenty years ago, unbundled claims services were a rarity and unique to only a select few national or international accounts. Today, the use of TPAs for claims administration is common among even small to middle market commercial accounts.

The decline in the number of functional claims departments within the commercial insurance industry and the increase of outsourced or unbundled claims services has given rise to an ever increasing need for reliable, independent auditing of the claims process by risk managers and the agents and brokers working as risk consultants. These types of claims audits are frequently either conducted or reviewed as part of the responsibility of the risk manager or practicing risk consultant. Regardless of the method, foregoing outside auditing is no longer an option for the risk manger and should be consider an integral part of managing the risk of his or her client company.

It has always been true that commercial insurance companies conduct audits of their internal claims operations and, generally, that has not changed over the last twenty years. The problem, from the perspective of the risk manager or consulting risk manager, is that the scope of the audits conducted by the insurance companies of their own internal claims departments are broad and do nothing to address how the insurer is administering the claims of any one account. Internal audits at most insurance companies typically place a very low importance on functions such as correct location coding, accurate loss coding/descriptions, and other key tracking measures valued by risk managers. More importantly, the results of these internal audits are never made public and would never be shared with anyone outside the corporate structure of the particular insurance company or group. The net result for the risk consultant of any company utilizing traditional carrier based claims handling is that there is virtually no access to the internal audit results or ability to influence the quality control process used by his/her client's insurer(s).

The auditing process at most TPAs is an even more troublesome prospect. The same auditing obstacles found in carrier based claims administration, i.e., overly broad scope and lack of outside scrutiny are present in TPA claims administration, however, it has been this writer's observation that internal auditing by many and perhaps most TPAs is nonexistent. Given the significant rise in the number of commercial insureds utilizing TPA claims handling for one or more of their lines of insurance, the widespread lack of any type of internal auditing by TPAs should give any risk manager cause for serious concern.

There are some in the risk management community that believe despite the pitfalls and lack of access to internal auditing at both the carrier and TPA levels, regulatory auditing by state departments of insurance provides a safety net and an additional layer of quality assurance in the claim process. This is largely a myth as state departments of insurance do not have the manpower or the capability to conduct audits of anything other than the most poorly performing claims operations. In many states, there is virtually no auditing oversight of TPA claims administration in the property and casualty lines of business. The need, therefore, for the risk consultant to conduct regularly scheduled independent auditing of both carrier based and TPA based claims handling has never been greater.

Auditing Carrier Based Claims

How can a risk manager audit his or her carrier based claims? At first glance, this might seem a daunting prospect, however, in practice it is generally a fairly straightforward process. I suggest to all of my clients that they negotiate the outside auditing process at the time they are negotiating their coverage placement. During this "honeymoon" phase, most commercial carriers are willing to a negotiate an audit schedule thus eliminating the potentially uncomfortable situation of arranging the process post policy inception. Additionally, local or regional claims managers at the carrier level conduct claims committee or suit committee reviews of potentially serious claims. Most claims managers, if approached properly, have no objection to a risk manager sitting in on these meetings when his or her claims are being reviewed by the committee.

Even if there was no pre-policy inception negotiation or discussion of an outside audit, a commercial insurance carrier is really not in a position to refuse a request from a policyholder to audit any or all of a particular policyholder's open and/or closed claim files. The insurance company is acting as an agent of its policyholder in the act of settling both first and third party claims. As such, the carrier cannot avoid outside auditing by hiding behind claims of privilege or confidentiality, as it is the policyholders' privilege and confidentiality that the carrier, acting as the policyholder's agent, is acting to protect. While this approach may be more confrontational, it is certainly better than the alternative of allowing an insurance company to continue to potentially mishandle claims on behalf of its policyholder without discovery.

Auditing TPA Based Claims

Auditing of TPAs is a much more straightforward proposition for the risk manager or consultant. The auditing process should be made part of the contractual agreement between the policyholder/insured and the TPA. In this way, the TPA has accepted outside audits as part of its contractual obligation in the performance of its claims administration duties. Not only is the TPA contracted to work for and at the direction of the policyholder, TPAs are much more acclimated and accustomed to the presence of outside auditors than carrier based claims operations. TPAs typically expect to be audited by the first layer insurers and/or program reinsurers on at least an annual basis, however, this type of auditing should not be deemed to be a suitable substitute for independent auditing by the risk manager. TPA claims administration, especially in the workers’ compensation and casualty lines of business, generates specific risks to a policyholder. Reserving deficiencies by TPAs, sometimes catastrophic in scale, are unfortunately a common occurrence. Reserving deficiencies can and will have a direct impact on a company’s financial statements if allowed to reach sufficient levels. Outside auditing is the only reliable method for the risk manager to ensure that his company’s claims are being properly administered and properly reserved.

Frequently, the expertise necessary to conduct claims audits will exist within the risk management department of the insured or within the risk consultant’s operation. Most large agents and virtually all regional brokers have internal claims staff that can and should be made part of any audit team. If the requisite auditing expertise does not exist internally or within the agent’s or broker’s operation, there are many external resources available that can provide a wide variety of assistance from individual manpower to augment an audit team all the way through providing a complete audit team.

In conclusion, the need for outside audits has increased over the past twenty years due to the shrinkage of functional commercial claims departments and rise of TPA claims administration. Auditing of both carrier and TPA based claims provides the risk manager or risk consultant a critical verification tool. Regardless of the method, it is clearly part of the risk management function to review all outside claims administration. Given the potentially significant financial consequences to a company of poorly administered claims, the costs associated with regular outside auditing of all carrier and/or TPA based claims should be considered part of the cost of risk by the wise risk manager.