

Understanding Step Factors in Claims-Made Insurance Policies

For many insureds, the concept of *step factors* and how they impact premium costs can be unfamiliar or misunderstood. A clear understanding of step factors and why they are an essential part of claims-made insurance pricing can help insureds anticipate increases over time.

WHAT IS A STEP FACTOR?

A step factor is a rating mechanism used to discount a policy's premium at the beginning of a coverage period and increase the premium over time to reflect increased exposure associated with services provided by an insured. Step factors are common with long tail lines, like medical professional liability, in which claims are typically filed long after an alleged incident.

With a claims-made policy, the retro date should be considered as the date coverage starts. Nothing before that date is covered.

The following chart illustrates how a step factor progresses from year one to a fully mature \$10,000 policy.

In the example, the coverage period starts with a retroactive date that begins on the inception date, which is the first year the policy is in force (1/1/2020 - RDI). The premium is discounted the first year of the coverage period because exposures have only just begun to develop, and the likelihood of a claim being reported during the first year is expected to be lower than subsequent years.

The step factor depicts the percentage of the mature premium for each year as the coverage period extends. The approximate increase over prior year, depicts the percentage the premium increases over the prior policy period. As the policy matures, the percentage of increase year over year typically decreases.

By year 5, the policy has a coverage period of 6 years, and the mature policy premium reflects the expected, ultimate cost of claims.

In year 7, the 6th year renewal, step factor will no longer be applied to the premium.

OTHER FACTORS THAT MAY AFFECT PREMIUMS

In addition to step factors, premiums can be affected by other factors such as business growth and prior claims history. Changes to business operations, limits, deductibles, policy terms, and rate increases can impact premiums. Market conditions, such as hard or soft insurance cycles, also influence pricing. Social inflation has been another driving factor influencing rate increases. Further, insurers may apply discretionary underwriting credits or debits based on the insured's individual risk profile.

STEP FACTOR EXAMPLE (6 YEARS, MATURE PREMIUM = \$10,000)

Policy Year		Step Factor	Premium	~ % Increase Over Prior Year
Year 1	Effective 1/1/2020 Retro Date Inception (RDI) 1/1/2020	.47	\$4,700	N/A
Year 2	Effective 1/1/2021 1st year renewal 1/1/2020	.71	\$7,100	+50%
Year 3	Effective 1/1/2022 2nd year renewal 1/1/2020	.81	\$8,100	+13%
Year 4	Effective 1/1/2023 3rd year renewal 1/1/2020	.90	\$9,000	+11%
Year 5	Effective 1/1/2024 4th year renewal 1/1/2020	.95	\$9,500	+5%
Year 6 (Mature)	Effective 1/1/2025 5th year renewal 1/1/2020	1.00	\$10,000	+5%

The chart above depicts approximations.

FINAL THOUGHTS

Step factors allow insurers to adequately price risk over time and reflect the increased potential for claims as an insured continues to operate. With step factors, policyholders pay premiums commensurate to the exposures they actually have, and understanding how and why these multipliers work is key to budgeting wisely, especially in the early years of coverage.

When quoting or renewing a claims-made policy, contact your Arlington/Roe broker to discuss step factor schedules, the insured's current step level and what to expect in order to help bolster renewal retentions and win new business accounts.

Contact one of our Healthcare & Human Services brokers for more information:



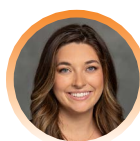
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